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Keston Ruxton
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By email to Keston.Ruxton@comcom.govt.nz

Dear Keston

RE: Follow-up comments to the WACC Workshop

First, I'd like to share members' appreciation for the Commission choosing to run a workshop with experts to discuss specific issues on the WACC.

Hopefully the Commission found the explanations put forward by experts useful to its decision-making process.

In this letter, I'd like to address two very important issues:

- *The approach to establishing asset beta, from a process perspective; and*
- *In response to a Commission question put to the ENA, the merits of moving to a trailing average approach.*

Establishing asset beta

At the workshop, there was extensive discussion about changing the Commission's approach to measuring asset beta.

The approach in the original IMs was to simply use an independently defined sample of energy businesses operating within an economic constraint (analogous to Part 4 regulation) and then calculate the sample asset beta.

But in response to submissions on the draft decision, the Commission - having updated its sample data as part of the WACC IM draft decision - is considering departing from its previous approach.

The Commission is instead considering whether to disaggregate and filter the data to establish 'better' estimates of asset beta for New Zealand electricity and gas pipeline distribution and transmission businesses.

While we appreciate that the Commission must consider evidence placed before it, the ENA rightly expected that the process for reviewing asset beta would be based on updating the asset beta estimate, based on new data, and would most certainly not hinge on a review of the methodology.

Our reasonable expectation stemmed from the Commission's guidance that:

> 66. At this stage, we expect the key areas of focus described in the paper to include:
> 66.1 Issues raised in submissions to the problem definition paper relating to the calculation of the cost of debt (eg, the use of prevailing or long-term average rates, the use of annual indexation);
> 66.2 The use of Black's simple discount rule; and
> 66.3 The practical calculation of various parameters needed to determine the WACC (eg, asset beta, debt risk premium).[1]

At this late stage, ENA is concerned that the Commission is considering fundamental changes to asset beta calculation methodologies.

Your eleventh-hour reconsideration is particularly concerning because sample selection criteria will not be developed *ex ante,* but would instead be developed in light of quantitative results.

The potential for disaggregation could have been contemplated and consulted upon in the initial setting of the IMs. Accordingly, in this context where IMs are intended to provide a degree of certainty and predictability for regulated businesses, a departure from the settled approach needs to deliver objectively more accurate results than the status quo. In the ENA's view, any changes which are 'materially better' than the status quo must comply with criteria specified by Russell McVeagh[2], and achieve the following:

1. Meet an objective test resulting in more accurate estimates of the variable in question (e.g., the asset beta for a New Zealand electricity lines business); and

2. The chosen methodology would likely to be stable at each IM review.

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[1] Commerce Commission (2015) *Input methodologies review. Process update paper* 30 October 2015

[2] Russell McVeagh (2015) *Input methodology review: Advice on legal questions and decision-making framework*

We think that all experts attending the workshop agreed that there is not a clear sample of businesses representative of the New Zealand regulated gas and electricity businesses that the Commerce Commission is charged with regulating.

This is evident by Vector, the only available New Zealand listed electricity network business, falling outside of a narrowly-defined sample submitted by some parties. This exclusion was on the basis of its relatively high contribution of unregulated revenues.

We also note that the experts at the workshop cautioned against the practice of overly refining the sample of comparator firms, given the experience of other regulators with narrowly defined comparators, such as the Australian Energy Regulator (AER).

Ultimately the results produced by a narrow set of comparator firms have been set aside by regulators such as the AER, as the unreasonably low asset beta estimates were not reliable for re-levering the equity beta.

Further, a narrowly-defined sample will also be more subject to volatility over time, as merger and acquisition activity may further erode the availability of firms meeting bespoke comparison criteria identified by the Commission.

Overall, the ENA requests that if the Commission does decide to change the estimation methodology for asset beta, that there is reasonable opportunity for consultation and submissions on the appropriate methodology.

We think this would be a significant undertaking, with many complicated issues to address.

We also think that it would require the Commission to examine other issues, such as concerns over stocks with low beta estimates having higher observed returns than predicted by the capital asset pricing model (CAPM).

Trailing average approach to calculating the cost of debt

Commissioner Sue Begg raised the question of why the ENA and its members had not more actively pursued the trailing-average approach in the 2010 setting of the IMs?

We have subsequently reviewed the record and identified a number of matters relevant to ENA and its members' submissions at that time:

1. It is evident that there were a large number of matters "in play" when the IMs were first determined, including other matters not just relating to cost of capital. It would appear that the measurement period for the cost of debt did not receive as much attention as other matters;

2. Businesses had not been subject to price or revenue cap regulation at that time, the building blocks approach had not been developed or implemented for EDBs when the IMs were determined, and therefore EDBs had little experience with managing the risks of 5 yearly resets, including from a treasury perspective; and

3. In spite of the lower attention when the IM's were first set, it is not correct to say that ENA members were not concerned with the approach to calculating the cost of debt. A number of submissions expressed concerns that the prevailing cost of debt approach was inconsistent with efficient, prudent treasury management approaches, and especially that the short window for calculating the cost of debt was not reasonable or appropriate.[3]

As stated at the workshop, there has also been specific experience under the WACC IM and the actual performance of the approach to cost of debt compared to prudent treasury management.

There have also been advances elsewhere in regulatory practices that have demonstrated the value and practical implementation of trailing average approaches.

The value for customers would be less volatility resulting from WACC estimates from period to period that are a product of the rate on the day approach.

In Summary

In setting out an approach to the review, the Commission put forward criteria that would apply in deciding whether to make changes to IMs.

The ENA submits that, in the case of asset beta, those criteria have not been met, whereas with the approach to measuring the cost of debt, there has clearly been an advance in theory and practice in adopting trailing averages.

This makes it appropriate for the Commission to consider whether aligning the approach to treasury management practices used in workably competitive markets would be more consistent with the requirements of the Act.

We also see advantages to consumers in prices being more stable between resets. Large step-changes may be seen in prices at resets, especially when the current low-interest rate environment comes to an end or the next financial crisis occurs.

ENA also recommends that, when making its decisions, the Commission gives strong consideration to the impact on investor perceptions of any changes. EDBs and their investors remain wary of WACC changes following the out-of-cycle WACC percentile review.

Further reductions in WACC based on methodological changes which cannot objectively be shown to be "more accurate" as opposed to just "different" will cause further harm to investor and rating agency perceptions of regulatory risks.

At the start of the review, the Commission indicated that the process would be focussed on addressing the outstanding issues raised for consideration by the High Court and updating parameter estimates for new data.

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[3] See for example the submission by Asia Pacific Risk Management http://www.comcom.govt.nz/dmsdocument/6339

At this very late hour, if there are to be substantial methodological changes to asset beta, an area of inherent challenges with both theory and practice, this will bring into question the stability of the Part 4 regulatory regime.

While we accept that the Commission must assess and test the evidence before it, the Commission must also give great weight to the decisions and judgements that it has formed previously.

Kind regards,

Graeme Peters
Chief Executive
Electricity Networks Association