

25 August 2016



Keston Ruxton  
Manager, Input Methodologies Review  
Regulation Branch  
Commerce Commission  
44 the Terrace  
Wellington 6140

VECTOR LIMITED  
101 CARLTON GORE ROAD  
PO BOX 99882  
AUCKLAND 1149  
NEW ZEALAND  
+64 9 978 7788 / VECTOR.CO.NZ

By email: [im.review@comcom.govt.nz](mailto:im.review@comcom.govt.nz)

Dear Keston,

### **Vector cross-submission on the weighted average cost of capital IM**

1. This is Vector's cross-submission on the Commerce Commission's (Commission) Input Methodology (IM) review draft decision and report on matters relating to the weighted average cost of capital (WACC) IM, dated 16 June and 22 June respectively.
2. Vector's contact person for this submission is:  
Richard Sharp  
Head of Regulatory and Pricing  
09 978 7547  
[Richard.Sharp@vector.co.nz](mailto:Richard.Sharp@vector.co.nz)
3. No part of this submission is confidential and we are happy for it to be publicly released.

### **Cost of debt**

4. The Commission estimates the cost of debt from an estimate of the risk-free-rate (the yield on a government bond), debt issuance costs and debt risk premium (DRP).

### **Debt risk premium**

5. The DRP measures the premium for issuing private corporate debt, in the form of an investment grade bond above the risk-free-rate. The DRP is derived from the average premium from qualifying bonds from a qualifying issuer.
6. Wellington Electricity submitted bonds backed by governments are lower risk assets for investors and are likely to understate the DRP faced by a private operator.<sup>1</sup> Vector agrees with Wellington Electricity. The Commission should consider other options for expanding

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<sup>1</sup> Wellington Electricity, *Input Methodologies Review: Response to Draft Decisions*, p. 6

the DRP sample. This may include expanding the DRP sample to include foreign currency denominated debt issued by New Zealand suppliers, as suggested by Wellington Electricity.<sup>2</sup>

#### Trailing average cost of debt / term credit spread differential

7. Vector does not support the Contact Energy proposal to remove the term credit spread differential (TCSD).<sup>3</sup> The available evidence shows regulated suppliers do not finance their businesses coincident to the regulatory period. Corporate debt information requested by the Commission from electricity distribution businesses (EDBs) showed the average tenor for bond issuing entities is 9.3 years while the average tenor for bonds is 10.4 years. Firms issuing longer term debt must receive compensation either in the form of the TCSD or accounted for in a trailing average for the cost of debt.

#### Cost of equity

8. Given the cost of equity cannot be directly observed, the Commission relies on analytical modelling.<sup>4</sup> The Commission estimates the cost of equity using a variation of the capital asset pricing model (CAPM), the Simplified Brennan-Lally (SBL) CAPM. The SBL-CAPM recognises the specific circumstances of the New Zealand taxation system but retains all the other characteristics of the standard CAPM.<sup>5</sup>

#### CAPM equity beta

9. An input into the CAPM is the equity beta which measures systematic risk. Systematic risk indicates the fluctuation of the firm's returns relative to the market. The Commission derives its equity beta by comparing a sample of unlevered betas of comparable firms. The unlevered beta (known as the asset beta) removes the impact of financing on the firm's risk.

#### Asset beta sampling

10. Some submissions<sup>6</sup> have advocated for reducing the Commission's sample of comparator energy firms into sub-sectors for gas pipelines and electricity businesses. Vector supports the continued use of the sample of 74 energy companies for estimating the asset beta. The large sample will provide a robust estimate of systematic risk. Eroding the sample into smaller groups will increase the risk of sampling error where the population becomes too limited. Competition Economics Group on behalf of the Electricity Networks Association

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<sup>2</sup> *Ibid* n1

<sup>3</sup> Contact Energy, *Input Methodology Review*, p. 33

<sup>4</sup> Commerce Commission, *Input Methodologies Review Draft Decisions – Topic Paper 4: Cost of Capital Issues*, 16 June 2016, p. 15

<sup>5</sup> *Ibid* n4 p. 16

<sup>6</sup> Oxera, *Asset beta for gas pipelines in New Zealand report for First Gas Ltd*, 3 August 2016 and TDB Advisory, *Submission to the Commerce Commission on the Input Methodologies Review Draft Decisions: Comparative Company Analysis – made on behalf of Contact Energy*, 4 August 2016

tested the different sub-groups and could not find any meaningful reason for differences in asset betas between the sub-groups to warrant reducing the sample.

11. We encourage the Commission to continue to use a reasonable sampling time period. There is no reason to limit the time period to the last five years only when the Commission has available observations for 10 year time period which will improve the statistical robustness of its estimate. Vector recommends the Commission continue to use a minimum 10 year time period for its asset beta observations.

#### *Deriving the equity beta*

12. The AER uses a point estimate of 0.7 for its equity beta derived from a range of 0.4 to 0.7.<sup>7</sup> This is higher than the current equity beta of 0.61 for EDBs in New Zealand.<sup>8</sup>
13. By exercising regulatory judgement and choosing the highest estimate of the equity beta, the AER recognised the standard CAPM is likely to underestimate the return on equity for firms with equity betas below 1.0.<sup>9</sup> The AER also noted international evidence supported a point estimate at the higher end of its range. We expect the Commission to have regard to similar considerations when deriving its equity beta estimate.

#### Equity issuance costs

14. Vector supports the Wellington Electricity proposal for the inclusion of equity issuance costs as a relevant item for estimating the cost of equity.<sup>10</sup> The Commission's WACC IM anticipates suppliers will finance their regulated business by raising equity. Therefore, equity issuance costs are expected to be incurred by regulated suppliers. Given such costs have been recognised by other regulators, we encourage the Commission to provide a reasonable allowance for efficiently incurred equity issuance costs.

Yours sincerely



**Richard Sharp**  
Head of Regulatory and Pricing

<sup>7</sup> AER, *Better Regulation Rate of Return Guideline*, December 2013, p.13

<sup>8</sup> Commerce Commission, *EDB Input Methodologies Determination 2012*, published 3 February 2016, Clauses 2.4.2 (5), 4.4.2(4), 5.3.23(4)

<sup>9</sup> AER, *Better Regulation Explanatory Statement Rate of Return Guideline*, December 2013, p. 86

<sup>10</sup> *Ibid* n1, p.7