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Commerce Commission

By email: im.review@comcom.govt.nz

POWERCO

Dear Keston

RE: Cross-submission on the Commerce Commission's topic paper 4 – cost of capital issues

Introduction

1. This is Powerco's cross-submission on the Commerce Commission's Topic Paper 4 – cost of capital issues. In this cross-submission we address:

   1.1. debt issuance costs; and

   1.2. asset beta.

2. Enclosed with this cross-submission is a report from HoustonKemp, which contains further detail on the points, discussed in this cross-submission.

3. Also enclosed with this cross-submission is a letter provided to Powerco from a major New Zealand bank, which Powerco has provided on the basis that it will be held confidentially by the Commission.

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Initial observations

4. Before giving our detailed comments, we offer some initial observations on the manner in which the discussion around cost of capital has developed over the course of the review.

5. At the outset of this process, the Commission indicated a clear intention to avoid unnecessarily relitigating the issues of the past. In its 16 June 2015 Problem Definition Paper, the Commission indicated that, while it would review all of the IMs as per the legislative direction, it would endeavour – with the input of interested parties – to identify those key issues that warrant attention. The Commission also signalled that it would develop a decision-making framework, that would include *"a focus on only changing those aspects of the current IMs that would: promote the s 52A purpose more effectively; promote the purpose of IMs in s 52R more*

effectively… and significantly reduce compliance costs, other regulatory costs or complexity…".[1]

6. Powerco was, and remains, supportive of that approach. We do not think there is value in re-opening, just for the sake of the argument, issues that have already been extensively debated, and indeed litigated. Conversely, there is significant value in promoting regulatory certainty by refraining from 'tinkering' with the IMs. The importance of achieving regulatory certainty through the IMs is expressly stated in s 52R of the Act. As we said in our submission on the Problem Definition paper:[2]

   > *Section 52R expressly directs the Commission to have regard to the need to promote certainty for suppliers and consumers. Certainty, in the context of the IMs, is intended to provide conditions that incentivise investment by suppliers, in the long term interests of consumers. Powerco therefore endorses a principle of incremental rather than wholesale change. The Commission is well aware of the disruptive effects of regulatory change, and conversely the benefits to both consumers and suppliers of predictability and certainty. Predictability and certainty in regulatory arrangements incentivise investment and reward long-term planning, both of which are of critical importance to consumers.*

7. We said that the Commission should be wary of re-opening some of the more contested elements of the IMs:[3]

   > *While stakeholders would almost certainly take the opportunity to express their positions, if invited to do so, it is likely that all the Commission would achieve is a re-litigation of the same issues. Accordingly, when deciding whether to change an IM in response to a concern that has been the subject of previous discussion, the Commission should consider whether or not circumstances have changed, or new information or reasons are advanced, that would warrant looking at the issue afresh (as opposed to simply a re-litigation of views that have already been aired).*

8. In its 30 November 2015 update paper, the Commission noted that *"significantly changing the cost of capital IMs would not be in the interests of consumers and would not help to promote certainty under the Part 4 regime"*. The Commission expressed its agreement with Powerco's submission that, *"the basic model has been the subject of extensive argument between stakeholders and experts, and there is little to be gained by re-opening consideration of these fundamental regulatory choices"*.[4]

9. The development of the cost of capital topic up to this point created a legitimate expectation on the part of suppliers that the Commission, having canvassed the issues, had identified a limited scope to take forward in the review. It also created a legitimate expectation that the Commission would have regard to its decision-making framework, and its stated intention to preserve regulatory certainty, in deciding what aspects of the cost of capital estimate required amendment.

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[1] Commerce Commission, *Input Methodologies Review: Invitation to contribute to Problem Definition* (16 June 2015), paragraph 41.
[2] Powerco, *Submission on Input Methodologies Review: Invitation to contribute to Problem Definition* (21 August 2015), paragraph 14.
[3] Ibid at paragraph 19.
[4] Commerce Commission, *Input Methodologies Review: Update paper on the cost of capital topic* (30 November 2015), paragraphs 3.3 to 3.6.

10. The development of the cost of capital issue in this review bears out, we think, the concerns we expressed in our submission on problem definition. The Commission initially envisioned this topic as addressing issues that had been raised by the High Court, as well as two other specific concerns: (i) whether the form of control impacts beta, and (ii) the benefits of indexing the cost of debt.[5] Over time, the scope of the topic has expanded. The two issues that are the focus of this cross-submission – debt issuance costs and asset beta – were not within the initial scope of the Commission's inquiry.

11. The Commission explained its intention to re-estimate debt issuance costs and beta in its 30 November 2015 update paper. But we understood that the Commission's proposal did not signal an intent to revisit the methodology, but rather to simply update externally observed parameter values using the existing methodology. That was a sensible approach. There is no compelling reason to revisit the underlying methodology given the extensive debate over this issue in the past, and conversely there is value in demonstrating the Commission's commitment to regulatory certainty. The Commission's exercise of restraint in relation to cost of capital is particularly important given the general acknowledgement that any methodology for estimating WACC is subject to significant uncertainty. Accordingly, while tinkering with the methodology will certainly affect regulatory certainty, it is not apparent that it results in a measure of WACC that is materially more accurate.

12. Since the November 2015 update paper, the Commission has been invited to revisit the methodology in ways that we think are inconsistent with:

    12.1. the scope of the review that the Commission outlined at the outset of the process; and

    12.2. the Commission's stated intention to preserve regulatory certainty and avoid relitigating methodological choices in the absence of significant new information.

13. In our view, the revisiting of the uplift for gas beta by Dr Lally is an example of the type of tinkering, in the absence of compelling new information, that detracts from regulatory certainty. More concerning are the proposals from TDB (on behalf of Contact) and Oxera (on behalf of First Gas) to fundamentally revisit the methodology that the Commission uses to estimate beta. These are criticisms that could equally have been raised when the IMs were first promulgated, which suggests they should not constitute a basis for revisiting the methodology now. Certainly, they do not constitute the type of new information or analysis that would warrant re-opening the methodology.

14. Powerco submits that, if the Commission properly applies the decision-making framework it has established for this review, it will conclude that revisiting these issues will not better serve the Part 4 purpose in s 52A, or the IMs purpose in s 52R. We therefore invite the Commission to stand back from the detailed methodological debate that Dr Lally, Contact and First Gas are trying to initiate, and instead consider whether their comments provide a sufficient basis to displace regulatory certainty.

Debt Issuance Costs

15. Powerco's detailed submissions on debt issuance costs are set out in the enclosed report prepared by HoustonKemp. We summarise our submissions below.

[5] Commerce Commission, *Input Methodologies Review: Invitation to contribute to Problem Definition* (16 June 2015), paragraphs 255 to 261.

Direct Debt Establishment costs

16. The Commission's approach has been to identify and rely on empirical evidence of debt issuance costs, principally the survey that the Commission carried out. Powerco agrees that reliance on empirical evidence of debt issuance costs is appropriate. However, Powerco submits that an analysis of the available evidence indicates that the Commission should allow direct debt establishment costs of 33 to 37 bppa.

17. The evidence available to the Commission includes:

    17.1. the Commission's analysis of its confidential debt survey, indicating debt establishment costs of 7 to 8 bppa;

    17.2. Contact's experience, which it uses to support an estimate of 6 to 7 bppa;

    17.3. CEG's analysis of its survey of ENA members, indicating debt establishment costs of 25 to 27 bppa; and

    17.4. information from Powerco enclosed with this cross-submission, indicating debt establishment costs of 33 to 37 bppa.

18. In summary, we consider that the information made available by Powerco provides strong evidence regarding debt establishment costs. It sets out detailed information about the structure and the level of these costs and is supported by a letter from an arranger and distributor of corporate retail bond issuances in New Zealand.

19. In contrast, the value of the survey evidence is diminished because the Commission and CEG draw very different conclusions from the same information and the lack of transparency makes it impossible to reconcile their respective results. The evidentiary value of Contact's submission is also compromised, because it ignores significant cost elements and consists of unsupported claims that are specific to Contact's experience.

Indirect debt establishment costs

20. In addition to direct debt issuance costs, set out above, suppliers also incur indirect costs including:

    20.1. costs associated with meeting the requirements set out by credit rating agencies, including:

        a) maintaining liquidity (or 'headroom') so that Standard & Poor's is satisfied that a company is able to withstand adverse market circumstances, estimated at 6 to 9 bppa; and

        b) early debt refinancing (or the 'cost of carry') as part of a strategy that provides assurance to a credit ratings agency of the credibility of a supplier's approach to refinancing debt, estimated at 11 to 12 bppa; and

    20.2. costs associated with a new issue premium, estimated at 10 to 12 bppa.

21. These are all costs that a supplier would prudently incur if it raised debt in accordance with the Commission's financing assumptions. They are costs associated with efficiently raising debt, and therefore should be allowed.

Swap Transaction Costs

22. As regards swap transaction costs, the evidence provided by the Commission's survey differs from CEG's. The Commission's estimate of 2 bppa per swap translates into 4 bppa per annum in total, compared to CEG's estimate of 7 bppa. As with debt establishment costs, we consider that it is important that these results be reconciled because, as we have previously stated, survey evidence is likely to be the best information available on swap transactions costs.

23. The Commission also proposed to rely on bid-ask spreads to estimate the transactions costs of swaps. In HoustonKemp's previous report to the Commission, they stated that bid-ask spreads will underestimate the transactions costs of swaps because they do not include:

    23.1. execution spreads payable to a broker (usually a bank) for its costs in completing the transaction; and

    23.2. credit spreads payable, reflecting the risk of transacting with the supplier.

24. The Commission has not responded to this submission.

Evidence on asset beta differential

25. In its 2010 final reasons paper, for the purpose of estimating beta, the Commission adopted a process that:

    25.1. included in its sample firms that were identified by Bloomberg as either an electric utility or a gas utility; and

    25.2. estimated five yearly asset betas using weekly and monthly returns, over 20 years of data.

26. The Commission's draft decision is based on a methodology that is consistent with this. It is a process informed by new information – it refreshes its sample of firms and estimates asset betas for the most recent five year periods – but it is not affected by changes in the process.

27. In response to this draft decision, TDB (on behalf of Contact) and Oxera (on behalf of First Gas) have made submissions on the approach to estimating beta that seek to analyse the Commission's sample of asset betas by reference to the characteristics of firms in that dataset.

28. TDB provides evidence that the Commission's sample may contain many firms which conduct activities that do not closely match those of a regulated energy network in New Zealand. TDB suggests that the Commission should consider reducing its sample to improve the accuracy of the asset beta, and that the average asset beta of the sample reduces as it does so.

29. Oxera provides qualitative evidence that the systematic risks associated with New Zealand gas network businesses are higher than from New Zealand electricity network businesses. It provides evidence that gas businesses from the

Commission’s sample have had higher asset betas than electricity businesses since the global financial crisis.

30. HoustonKemp has provided detailed submissions on this point in its enclosed report. In summary:

    30.1. rather than being stable parameters, betas typically vary over time, and so the focus of these studies on information from the most recent five year period of available data weakens their applicability;

    30.2. the available empirical information offers only a weak comparison to the question before the Commission, being the appropriate beta for New Zealand gas and electricity network businesses, and so the merits of attempting to finesse the comparator set further is highly questionable; and

    30.3. there is both qualitative and indirect empirical evidence from New Zealand to support the existing uplift in the beta for GDBs, even though the available, direct empirical analysis on this question from the predominantly United States sample of comparators is insufficient for decision-making purposes.

31. Finally, Contact’s and First Gas’ submissions represent exactly the kind of re-litigating of WACC that the Commission hoped to avoid in this process. There is nothing fundamentally new about their analysis that suggests the Commission should revisit this methodological choice. Moreover, it is inappropriate for suppliers to attempt to pick and choose the elements of the WACC methodology that they don’t like. If WACC is, in a sense, on the table, then the appropriate approach would be to take a holistic approach to assessing the methodology, rather than to encourage tinkering in relation to specific parameter values.

Yours sincerely

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