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Keston Ruxton,
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Commerce Commission,
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By email to keston.ruxton@comcom.govt.nz

Re: ENA comments on Frontier memo re Dr Lally Appendix

Dear Keston,

Thank you for the opportunity to comment on the memo that Frontier Economics provided to the Commission on the analysis Dr Lally conducted on the benefits of the trailing average debt cost approach versus the rate on the day approach.

As you are aware this is an area that ENA members feel very strongly about and it is something that the ENA has submitted on in the past. Members consider that the trailing average approach provides consumers with the best outcomes because of the strong incentives on regulated EDB's to be efficient with their investments. As the Frontier memo demonstrated, the trailing average approach also provides members with fair and efficient compensation for the debt costs on past investments that are in their regulatory asset base.

We have reviewed the Frontier report and make the following points:

- Analysis in the Lally Appendix contains erroneous assumptions that result in material under-compensation for EDB's under rate of the day approach.
- The Appendix ignores sunk assets - only focussing on new investment. Sunk investment is more important to the NPV = 0 assessment than are new investments.
- It ignores the risk-free rate component, only focussing on debt risk premium when the risk-free rate component is more important to the NPV = 0 assessment than is the debt risk premium.
- Correction for these points reverses the results of the Lally analysis and the Frontier memo illustrates that trailing average is superior in terms of providing efficient incentives to invest.

As a general point, while close alignment between the regulatory allowance and efficient firm practice will most predictably and consistently produce efficient incentives to invest, efficient practice [for large utility firms] is consistent with a 10-year trailing average debt tenor.

The importance of the third dash point above should not be underestimated. Frontier rightly explain why it is appropriate to focus on both the DRF and the RFR, in their paragraphs 28 and 29:

28. This an unrealistic assumption because, in practice, the new investment may occur some years into the regulatory period. At that point, the investment would be financed not at the base rate that may have been locked in at the start of the period using swaps, but at the base rate prevailing when the investment is made at some point into the period.

29. The only way the supplier would be able to match the base rate of future borrowing costs to the risk-free rate allowance is through the use of a forward starting swap. However forward starting swaps:

a. are typically expensive hedging instruments; and

b. may only be used in this way if the precise timing of the investment is known, which is unlikely to be the case in all instances.

ENA members are entirely supportive of the Frontier analysis and conclusions in this regard.

For the ENA, Frontier also make the very important point about hedging debt risk in the swaps market. Their section 3.1 correctly highlights the real concern that under the rate of the day approach consumers are exposed to the volatility in the *total* required return on debt for the regulatory period. To the extent that the trailing average approach provides a match between debt compensation and efficient debt costs, consumers are then not exposed to this volatility.

Again, thank you for the opportunity to comment on the Frontier memo which illustrates well why we have argued in favour of the Commission changing the approach to debt compensation under the cost of capital IM. A trailing average methodology that is designed to reflect an efficient debt portfolio is beneficial over the long term for both consumers and network businesses.

Yours faithfully

Graeme Peters

CEO