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SUBMISSION ON THE COST OF CAPITAL AND THE IM REVIEW

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the Commerce Commission's (the **Commission**) consultation paper "Input methodologies review, Update paper on the cost of capital topic" (the **Paper**).
- 2 We have also reviewed the draft submission by the Electricity Networks Association (the **ENA**) on the Paper.

Main Points

- 3 We agree with the Commission that caution should be taken when making changes to the current methods for estimating the regulatory cost of capital (WACC). In the absence of any significant evidence-based reasons for change, the Commission's current method to estimate WACC should be retained.
- 4 We are concerned that the existing approach to estimating WACC has resulted in substantial volatility in WACC values over time, because it is unreasonably dependent on the market conditions in a single month.
- 5 We support using trailing averages, in order to reduce volatility and increase certainty. This would also better reflect efficient financing approaches.

- 6 We support using ten-year bonds to estimate the risk-free rate and debt premium, in order to reduce volatility and increase certainty. This would better reflect and compensate suppliers for efficiently issued longer-term debt, and it might avoid the need for the term credit spread differential allowance (TCSDA).
- 7 We support the view that CPP WACC should be fully-aligned with DPP WACCs. This would eliminate perverse incentives and disincentives for CPPs. It would also reduce uncertainty. Full alignment is the only method to fully eliminate these effects. This could require (depending on the regulatory period of the CPP) a technical price reset part way through a CPP regulatory period to account for any change to the prevailing DPP WACC, by way of a recoverable cost.
- 8 We recommend that vanilla WACC and vanilla ROI be dropped, in order to reduce duplication, cost and complexity. The Commission should only use industry-standard post-tax WACC and post-tax ROI measures.
- 9 We recommend that suppliers be compensated for the efficient and prudent costs of stand-by bank facilities. Having these facilities is standard practice for firms. Contrary to statements in the Commission's 2010 IM Reasons Paper, suppliers are not currently compensated for these normal and prudent business costs.
- 10 We oppose any proposal to link a possible change to the form of regulatory control to a change in WACC, and in particular to a change in the asset beta. There is no consistent evidence that different forms of control have material impacts on asset betas. The Paper does not demonstrate why a different form of control would warrant an adjustment, especially when no other regulatory differences do.
- 11 We oppose a split cost of capital. This would undermine certainty signalling to investors that investments they make today are at risk of future arbitrary WACC reductions and be contrary to the long term interests of consumers. The Commission should not undertake further work on this topic.

General comments

Starting point for the review

- 12 We agree with the Paper that the current approach to estimating WACC should be used as the starting point for this review.¹ To promote regulatory certainty, any changes to the current methods should be well

¹ The Paper, paragraph 2.3.

targeted and evidence-based. Any changes should remedy a specific and significant problem with the current methods. Wholesale changes to a large number of methods, or to the high-level approach, should be resisted.

- 13 A number of alternative methods for estimating the WACC and its parameters have been proposed to date. Some of these were considered, and not adopted, when the Commission initially determined the IMs in 2010. Unless there is new and significant evidence, the Commission should not reconsider the relative merits of these methods from scratch.

Issues raised by the High Court

- 14 We agree that the Commission should review the issues raised by the High Court. We stated in our submission on the Problem Definition Paper that the High Court's issues do not require significant attention, and we are pleased that the Paper does not consider them key areas of focus. In particular:

- 14.1 The Commission, in response to the High Court, decided to reduce the percentile used for price setting from the 75th to the 67th. This change was made by the Commission following a significant amount of evidence and debate. We do not support any further reconsideration of the WACC percentile.
- 14.2 We support the continued use of the Brennan-Lally CAPM, and the Paper's proposal to not further investigate alternatives.
- 14.3 We oppose a split cost of capital. This would undermine certainty signalling to investors that investments they make today are at risk of future arbitrary WACC reductions and be contrary to the long term interests of consumers. The Commission should not undertake further work on this topic.
- 14.4 The TCSDA has some theoretical merit, but its financial impact has been minimal.

The high-level approach to estimating the WACC

- 15 We support the Commission's high-level approach to determining WACC, including:
- 15.1 the use of the Brennan-Lally CAPM
- 15.2 estimating individual cost of capital parameters.
- 16 Other alternative approaches to determining WACC which have been proposed have little or no regulatory precedent for their use.

- 17 We oppose the use of Black's '*simple discount rule*' as a cross-check on WACC, as proposed by the Major Electricity Users Group (MEUG), and we are concerned that it has not yet been ruled out. This approach has never been used in a regulatory setting, and it is difficult to see how it could be robust.
- 18 We believe that it is time for the Commission to adopt single industry-standard post-tax ROI and post-tax WACC for all determinations. Vanilla ROI and vanilla WACC are not standard industry measures and they are not well understood by industry participants or interested persons. Indeed, it is sometimes not always clear which measure is being applied or discussed by the Commission (for example, the Commission's analyst briefing slides often don't define whether the Commission means a vanilla or post-tax WACC).

Methods for estimating parameters

- 19 We have focussed on those areas of major concern. The Paper also includes a number of more detailed issues and potential changes which we have not responded to.

Reducing volatility in WACC estimates

- 20 We have concerns with the current method for estimating the WACC. The methods for estimating the risk-free rate and debt premium have led to a large degree of volatility in the regulatory WACC values used for price setting and information disclosure.

The current problem

- 21 Regulatory WACC will always change, because the risk-free rate and debt premiums change.
- 22 When the Commission initially determined the IMs in 2010, the Commission considered that a one-month period was sufficient to 'average-out' short-term volatility and that this length of period provided an appropriate balance between ensuring the estimates are current and avoiding the effects of short-term volatility.
- 23 In practice, the risk free rate and debt premiums have been more volatile than expected. There has been considerable monthly and daily volatility since 2010.
- 24 This volatility introduces significant uncertainty, and it undermines robust revenue forecasts for investment decisions.
- 25 It also increases differences between DPP and CPP WACCs, which exacerbates perverse incentives and disincentives for regulated suppliers

subject to price-quality regulation, and this is therefore contrary to the long-term interests of consumers. For example:

- 25.1 our CPP WACC for FY15 to FY19 is 6.92% (75th percentile)
 - 25.2 EDBs' DPP WACC for FY11 to FY15 was 8.77% (75th percentile)
 - 25.3 EDBs' DPP WACC for FY16 to FY20 is 7.44% (75th percentile²).
- 26 Price resets currently heavily depend on the market conditions in one specific month every five years (or when a supplier's CPP is determined). We consider that this is unreasonable, and it not reflective of normal business financing arrangements.
- 27 Businesses don't arrange all their funding (or refinance it) in one month every five years. They arrange their funding on a rolling basis over time – as their funding needs change and as they apply appropriate liquidity risk and price risk management.
- 28 We believe that more stable WACC estimates would:
- 28.1 enhance regulatory certainty
 - 28.2 improve suppliers' ability to forecast revenues, especially for when they consider investment decisions
 - 28.3 better reflect suppliers' efficient and prudent methods of financing
 - 28.4 therefore be in the long term interests of consumers.

Longer trailing average period

- 29 We support the Paper's proposal to use bond yields that are averaged over much longer period than one month. A 10-year averaging period is used by several Australian and UK regulators – including the Australian Energy Regulator (AER), NSW's Independent Pricing and Regulatory Tribunal (IPART), the Essential Services Commission of South Australia (ESCOSA), Ofgem and Ofwat.
- 30 A longer averaging period would lead to more stable estimates of the risk-free rates and debt premiums, and it would better reflect suppliers' actual financing arrangements. As we note above, debt is continually financed throughout regulatory periods. The use of prevailing rates ensures that

² Although the 67th percentile estimate has been applied in the 2015-2020 DPP price path.

changes in market conditions are quickly reflected in WACC estimates, but that does not reflect realistic prudent financing practices.

31 Since the IMs were determined in 2010, the AER has changed to using a 10-year average. Its rationale was to reflect the financing strategy of an efficient business.

32 We recommend that trailing averages be adopted, to estimate both the risk-free rate and debt premium. This will make WACC estimates more stable over time, better reflect the time period over which businesses arrange financing and hence better reflect the efficient cost of debt, and retain consistency with the predominant regulatory approach used overseas.

33 We do not support annual updating of the risk-free rate or debt premium estimates. We believe that it remains appropriate for the estimates to simply be made for each DPP reset.

Longer-term bond tenors

34 We support the Paper's proposal to use bonds with longer terms than five years, for the estimation of the risk-free rate and debt premium.

35 The Commission's recent UCLL/UBA Final Pricing Principle decision used bonds of longer terms than the regulatory period for the cost of debt.³

36 Yields on longer-term bonds are not as volatile as shorter-term bonds. Combined with the use of a trailing average, this would significantly reduce volatility.

37 Longer-term bonds also better reflect financing arrangements of larger efficient suppliers. Suppliers should be compensated for efficient debt tenors of longer than five years. The length of the regulatory price period is not the significant factor. The significant factor is an efficient and prudent financing strategy by an efficient and prudent supplier.

38 We believe that a ten year tenor is appropriate.

39 We do not consider that the term of the bonds used must match the length of the regulatory period.

³ Commerce Commission, Cost of capital for the UCLL and UBA pricing review, 15 December 2015.

Stand-by bank facilities

- 40 Larger efficient suppliers typically use a combination of bonds and bank facilities (and various hedging arrangements). A supplier would typically only actually draw down part of their bank facilities. The remainder is effectively a prudent standby, which may be used from time to time.
- 41 Standby bank facilities are prudent common liquidity risk management. No prudent treasury operation has the exact amount of bonds to meet its debt requirements on a day-to-day basis – a prudent float is required above this.
- 42 These bank facilities have significant one-off establishment fees and ongoing commitment fees. Suppliers should be compensated for the costs of these standby facilities, as they are normal, efficient and prudent business practice.
- 43 The 2010 IM Reasons Paper suggested that these costs are included in the debt premium, we strongly disagree. The IM cost of debt reflects the costs of **drawn-down** debt, but this excludes any costs associated with standby facilities.
- 44 We recommend that these costs be included with the ‘debt issuance costs’ parameter.

The CPP WACC should be fully aligned with the DPP WACC

- 45 Variances between DPP and CPP WACCs can inappropriately incentivise or dis-incentivise suppliers from applying for CPPs.
- 46 WACC uncertainty and divergence are major (potentially dominant) concerns for suppliers who consider a CPP application. They were key concerns for the Orion board for our post-quake CPP application – we weren’t able to identify a substantial component of the counterfactual to our CPP option.
- 47 Dr Lally’s proposals to simply reduce the size of the divergence is insufficient.
- 48 CPP WACCs should be **fully-aligned** with prevailing DPP WACCs, in order to eliminate perverse incentives and dis-incentives of applying for CPPs.
- 49 To facilitate this, we recommend that the Commission simply sets the CPP WACC equal to the prevailing DPP WACC. If the DPP is reset during the CPP period, then an adjustment should be made for the difference with the next DPP WACC by way of a recoverable cost.

- 50 This approach:
- 50.1 is easy to understand
 - 50.2 is simple and quick to implement
 - 50.3 would eliminate the divergence and uncertainty problems
 - 50.4 would remove all suggestion that the CPP WACC process violates the NPV=0 principle, as discussed by Dr Lally.
- 51 Price paths already include a number of similar adjustments and wash-ups.

Split WACC for CPP: Dr Lally's preferred approach

- 52 Dr Lally's preferred approach is for a split WACC – applying the prevailing DPP WACC for existing assets and capex previously approved under a DPP, and the CPP WACC to all additional capex approved under a CPP.⁴
- 53 A split WACC is inappropriate. We oppose any method where one WACC is applied to one set of Orion's assets and another WACC applied to another set, within the same year.
- 54 We oppose the additional complexity – for example, determining the supplier's actual capex approved under a DPP will be wholly impractical in practice.
- 55 The Commission's DPP price reset capex allowances are not tied to suppliers' specific projects. Rather, they're *ex-ante* high level forecasts of suppliers' future capex.
- 56 After price resets, suppliers determine the actual capex projects to be done over the next five years – in many cases, capex project will differ from those assumed on DPP expenditure forecasts – particularly in light of changing consumer requirements, different growth and emerging technologies.
- 57 Determining *ex-post* whether a capex element was included in the DPP will therefore be wholly impractical.
- 58 Furthermore, there are a number of areas where it would be impractical to incorporate the use of two different WACCs each year. For example, the IRIS mechanism uses single WACC values; the notional deductible interest formula uses a single cost of debt value; the maximum financing cost rate in commissioned assets specifies a single WACC value; the calculation of a number of recoverable costs use a single cost of debt value as the time

⁴ Lally, M., Complications arising from the options to seek a CPP, 18 September 2015, page 5.

value of money; and the capex wash-up calculation requires the application of WACC values to different capex amounts. In addition, it is unclear what an appropriate WACC benchmark would be for information disclosure purposes.

- 59 We are also concerned that a split WACC could dis-incentivise investment in ways that are contrary to the long term interests of consumers. Different returns on different assets could reduce suppliers' willingness to invest, or result in expenditure being inefficiently moved between DPP and CPP periods. The additional complexity involved may also limit understanding of the CPP process, and that could have unintended effects on the incentives that would apply in practice.

Asset beta

- 60 We are concerned that the Paper proposes to link a possible change to the form of regulatory control to changes in WACC, in particular to asset beta.
- 61 The asset beta relevant for NZ EDBs is estimated as the average observed asset beta for a large sample of regulated firms. The sample includes firms from a number of different countries, firms subject to price caps and revenue caps, as well as non-incentive regulation, and a vast range of different detailed regulatory contexts and methods. When the IMs were initially determined, the Commission considered that its sample was broadly reflective of firms with similar risk to NZ EDBs.⁵
- 62 We consider that it has not been demonstrated that an adjustment should be made to the average beta of the sample. As discussed above, the sample includes firms subject to a wide range of regulatory forms of control and detailed methods. In addition, NZ EDBs are subject to a number of specific regulatory risks that many of the other firms in the sample are not (such as the Commission's specific expenditure forecasting method). No adjustments are currently made for any of the regulatory differences within the sample, or between the sample and NZ EDBs.
- 63 Lastly, we note that the Commission is separately considering the merits of a revenue cap as the form of control. We consider that the potential for a change in the beta is problematic in this regard. In our view, the uncertainty over whether an adjustment to the beta would be made is compromising a principled debate on the appropriate form of control.

⁵ IM Reasons Paper, paragraphs H8.42, H8.159-H8.162.

Concluding remarks

- 64 Thank you for the opportunity to make this submission. Orion does not consider that any part of this submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Rob Jamieson', written in a cursive style.

Rob Jamieson
Chief Executive