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Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch

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

Dear Keston

Input Methodology Review: Cost of capital – response to further information provided post workshop

We have reviewed the information provided by Powerco, and Oxera, to the Commerce Commission (Commission), published on 29 September 2016.

Comments on Oxera's debt beta note

With regard to Oxera's comments on the debt beta analysis, we agree with their introductory comments and conclusion below:

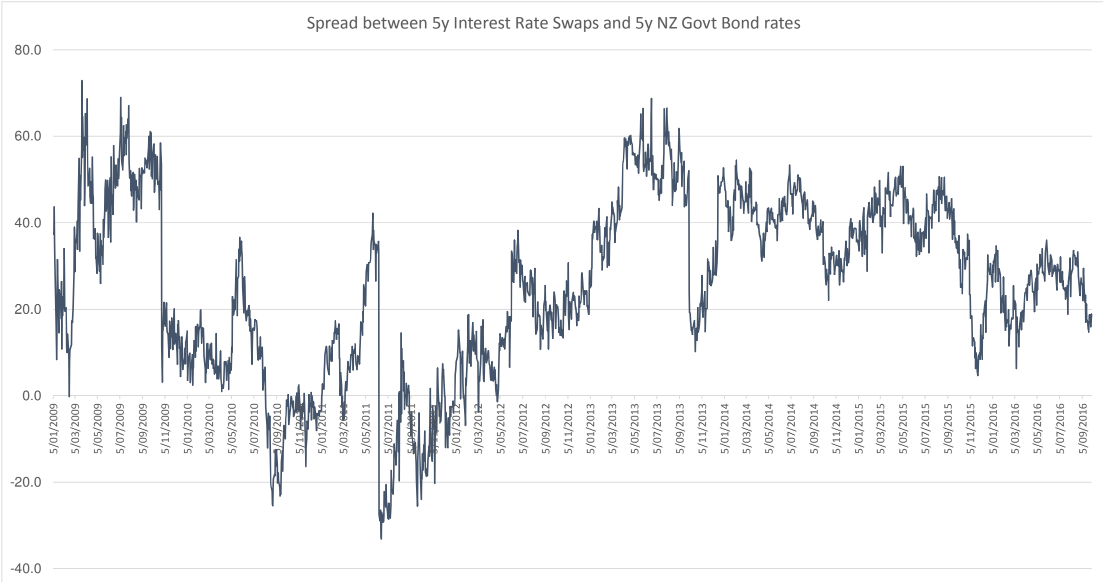
"In principle, we agree that asset betas should be adjusted for debt betas in order to ensure comparability among firms with differing levels of gearing. However CEG's analysis has a number of drawbacks that materially undermine its conclusions."[1]
And
"…the assumptions in relation to debt betas adopted by CEG are implausible."[2]

With regard to commentary on comparable company sets (page 6), we have commented in earlier submissions[3] on fit for purpose screening of comparable companies and concerns with Oxera's selection of gearing and liquidity filters, and as such have not sort to repeat in this letter.

Comments on Powerco's data analysis

We **attach** to this letter a file of the output from Bloomberg of the 5y interest rate and 5y interpolated NZ Government Bond rate since January 2009. A graph of this data is shown below:

[1] http://www.comcom.govt.nz/dmsdocument/14783 pg 1.
[2] Ibid, pg 7.
[3] http://www.comcom.govt.nz/dmsdocument/14524; http://www.comcom.govt.nz/dmsdocument/14679.



As can be seen from the graph, there is reasonable variability, with many factors contributing to the increase or decrease in the swap spread over time including, but not limited to, changes in:

- Market assessment of relative credit risk represented by the two underlying instruments (e.g. regulatory changes in the U.S., introduced to reduce systemic risk, have pushed much of the interbank US$ swap business to be cleared via central clearinghouses. This has effectively de-risked the swap market and has been a contributor to longer-dated US swap spreads trading negative (i.e. US$ interest rate swaps trading below US Treasuries) over the last 15 months);
- NZ Government bond volumes (Supply/Liquidity);
- Investor appetite for NZ Government bonds (which may wax and wane for reasons other than variability in volume); and
- Paying and receiving interest in interest rate swaps, which might come from issuers of bonds, investors in bonds, banks hedging fixed rate exposures from their mortgage books, general corporate hedging.

Over the timeframe of the last determination period (August 2014), our data shows the average spread to have been 43.0bp. This was, as pointed out by Powerco, lower than the average in July (although our calculations show a lower differential). However, as shown above, the movement is not out of line with historic market movements.

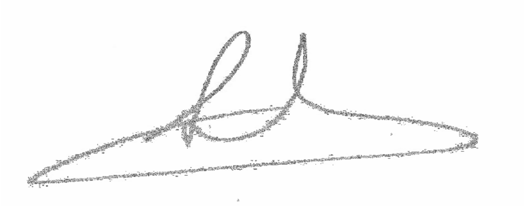
The conclusion we draw from analysing the data is that:

- There is inconclusive evidence that the spreads widened specifically just due to hedging activity from regulated entities.
- We know there are a large number of factors at play in the setting of swap spread levels and swap spread volatility during the determination period was not out of character with movements (or levels) seen many months before or afterwards.

If the “rate on the day approach” is maintained, we do not believe the swap spread variability is a factor that would require any allowance or provision in the cost of debt calculations. The Commission’s proposed move to a three month window should eliminate any concerns regarding swap spread risk.

As always, we are happy to discuss any of the above.

Yours sincerely



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