Orion

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Dear Keston

Submission – Fibre IM Review Issues Paper – Cost of Capital Issues (Tranche 1)

1. Introduction

1.1. Orion welcomes this opportunity to provide feedback on the Commerce Commission's (Commission) consultation paper, '*Fibre input methodologies review 2027– Issues paper (Tranche 1)*'.

1.2. No part of this submission is confidential.

1.3. Orion owns and operates the electricity distribution infrastructure in Central Canterbury, including Ōtautahi Christchurch city and Selwyn district. Our network is both rural and urban and extends over 8,000 square kilometres from the Waimakariri River in the north, to the Rakaia River in the south; from the Canterbury coast to Arthur's Pass. We deliver electricity to more than 228,000 homes and businesses and are New Zealand's third largest Electricity Distribution Business (EDB).

2. General Comments

2.1. Orion supports the general principle of aligning input methodologies (IM) that are not sector specific. To this end, it does make some sense to conduct this alignment as part of the 2027 Fibre IM review. However, this raises a broader question relating to the frequency of IM reviews.

2.2. It is little more than a year-and-a-half since the final decision on the substantive review of the Electricity, Gas, Airports and Transpower IMs was published, which was then followed by an out-of-cycle review relating to reopeners and other matters to give effect to the Commission's policy decisions, largely relating to the DPP4 reset.

2.3. Section 52Y(1) of the Commerce Act 1986 requires that IMs are reviewed at intervals not exceeding 7 years, and the Fibre IMs are on a different cycle to the Electricity, Gas, Airports and Transpower IMs. The broader question that arises from alignment of sector-common IMs is how frequently they will be reviewed? Could we reasonably expect to be revisiting cost of capital issues every 2 to 4 years as each sectors' substantive IM review occurs? This may not be a particularly efficient outcome, given the time required to respond, and the cost of expert reports that are generally required to meaningfully respond to such a complex topic.

2.4. If alignment of sector-common IMs remains an important consideration for the Commission, Orion recommends that the next review of the Fibre IMs (i.e., post the 2027 review) is accelerated so that it becomes aligned with the Electricity, Gas, Airports and Transpower IMs (which must be completed by December 2030). This will allow cross-sector elements to be reviewed at more reasonable intervals.

3. Trailing Average Cost of Debt

3.1. Given the relatively short period since the substantive review of the Electricity, Gas, Airports and Transpower IMs was completed, we need to ask what has changed? Why not just propose that the relevant cost of capital settings from the Electricity, Gas, Airports and Transpower IMs be adopted into the Fibre IMs, as part of the draft decision, and move forward from there?

3.2. The 2025 reset of the default price-quality path (DPP) saw a significant uplift in EDBs' allowable revenues, with the recalculated weighted average cost of capital (WACC) being a significant driver of the uplift[1]. One aspect of the cost of capital IMs that regulated suppliers have long advocated for is adoption of a trailing average cost of debt (TACD), as a means of managing consumer price volatility. For example, in the 2016 IM review:

– Powerco recommended a 10-year debt tenor and adoption of TACD[2];

– Frontier Economics, on behalf of Transpower, highlighted the "*significant benefits*" that could accrue from adopting TACD[3]; and

– Orion noted the volatility created by the prevailing 'on the day' approach[4].

3.3. We think it is appropriate to revisit TACD considering the outcome of the DPP4 reset.

3.4. The Australian Energy Regulator (AER) has implemented a simple TACD approach (i.e., unweighted) and has used a revenue neutral transitional from the former 'on-the-day' approach to ensure that the 'NPV=0' principle is achieved. The feasibility of adopting a TACD approach was described in its explanatory notes to its 2018 rate-of-return instrument:

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[1] While the WACC was the largest contributor to the uplift in EDB revenues in DPP4, increases in the expenditures necessary for electrification also made a material contribution.

[2] Powerco. (2015). *Submission on Input methodologies review: Invitation to contribute to problem definition.* 21 August 2015, p4.

[3] Frontier Economics. (2015). Recommendations on priorities for review of cost of capital input methodology: A report prepared for Transpower New Zealand. August 2025, p8-11.

[4] Orion. (2015). *Submission on the IM review.* 21 August 2015, paragraph 54, p11.

> *"We consider ex-ante efficient compensation (that is, the NPV=0 principle) can hold under either the on-the-day approach or the trailing average approach (if a transition is applied). As such, both approaches are capable of being approximately equivalent over the life of the assets (which will be multiple regulatory periods). As either the on- the-day or trailing average approach would contribute to the achievement of the legislative objectives, a switch between regimes that is accompanied by a revenue neutral transition will also contribute to the achievement of the objectives."*.[5]

3.5. In its 2023 review, the AER decided to "*continue a consistent transition approach*" across its regulated networks, and outlined the key features of the approach:

> *"This (simple) trailing average approach:*
>
> - *applies equal weights to each annual return on debt estimate feeding into the trailing average other than the first year that the transition to the trailing average commenced*
> - *updates the return on debt estimate annually*
> - *uses a benchmark term of debt of 10 years*
> - *implements a 10-year transition into the adoption of the 10-year trailing average approach."*.[6]

3.6. The Australian experience has demonstrated that it is feasible to adopt a TACD approach. However, in addition to answering the question 'can we?', we need to answer the more important question – 'should we?'.

3.7. In New Zealand (as elsewhere), the Commerce Commission has sought the expert advice of Dr Martin Lally on matters relating to the cost of capital. Dr Lally had provided expert advice to the Commission for the 2016 and 2023 IM reviews, as well as during the IM development period.[7]

3.8. In critiquing expert advice provided on behalf of submitters to the cost of capital topic in the 2023 IM review, Dr Lally provided qualified agreement with aspects of CEG's report (provided on behalf of Electricity Networks Aotearoa (ENA)) that described superior outcomes from a TACD approach:

> *"The second exception is CEG's claim that use of a trailing average cost of debt is preferable to the hybrid method used by the Commerce Commission (involving a trailing average DRP coupled with an on-the-day risk-free rate) because it is simpler to hedge to (which benefits businesses) and is more stable (which benefits customers). I agree with both claims, but CEG neglects to mention two additional points, which favours the Commerce Commission's hybrid approach over a TA cost of debt."*[8]

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[5] Australian Energy Regulator. (2018). *Rate of Return Instrument: Explanatory Statement*. December 2018, section 10.1.4, p282

[6] Australian Energy Regulator. (2023). *Rate of Return Instrument: Explanatory Statement.* February 2023, section 9.3.7, p233.

[7] Commerce Commission IMs website. Passim.

[8] Lally, M. (2023). *Review of submissions on the risk-free rate and the cost of debt.* 17 March 2023, section 4, p23.

3.9. Dr Lally's first concern with CEG's analysis was that the current hybrid approach favoured by the Commission could be expected to yield lower consumer prices when the Commission recognised a debt tenor greater than 5 years:

> "*… whenever the Commission recognizes that a regulated firm's debt tenor is greater than five years, the hybrid approach will be expected to generate a lower average allowed cost of debt and therefore lower average output prices for consumers, but with no disadvantage to these regulated businesses because the risk-free rate component of its allowed cost of debt matches its debt costs in both cases (a TA rate in excess of five years when the regulator uses a TA approach, and an on-the-day five-year rate when the regulator uses the hybrid approach coupled with the firm's use of interest rate swap contracts).*"

3.10. Dr Lally's second concern related to the difficulty in selecting an appropriate benchmark debt tenor and its corresponding effect on the resulting cost of capital:

> "*… the appropriate debt tenor for a firm or group of firms is not obvious and any estimate of it is likely to be too high or too low, leading to an allowed cost of capital that is too high or low, with adverse implications for consumers and firms respectively.*"

3.11. In summary, from Dr Lally's review, we can conclude that a TACD approach, relative to the Commission's prevailing hybrid approach, can:

- be more straightforward to hedge, to the benefit of suppliers;
- be more stable, to the benefit of consumers;
- result in a higher cost of capital, to the detriment of consumers, when a debt tenor greater than 5 years is recognised; and
- result in a higher or lower cost of capital depending on whether the benchmark debt tenor selected is too high or too low (unknown benefit/detriment to suppliers and consumers).

3.12. We note from past reviews of the cost of capital, that debate on the topic rapidly evolves to a deeply academic discussion and one which regulated suppliers generally cannot take part in without the assistance of experts. One aspect that we find difficult to assess in such academic discourse is the materiality of both the pros and cons when weighing one option against another.

3.13. We recommend that the Commission takes a pragmatic stance in this current review and, to the extent that it is able, consider the preferences of consumers and what they value. This will involve trying to determine the extent to which consumers value stability of output prices over the risk of supplier over-compensations (noting the difficulty in assessing the materiality of any over-compensation that we referred to in the previous paragraph).

3.14. We find the AER’s comment that both the on-the-day and trailing average approaches can be approximately equal over the life of the assets (refer paragraph 3.3, above) to be compelling, and reinforces that the approach to determining the methodology for calculating the cost of debt involves decisions for the long term, and not just a single regulatory cycle or single IM review cycle.

4. Other WACC Parameters

4.1. Orion’s view is that the other WACC parameters that the Commission has selected for the tranche 1 review are appropriate.

4.2. At this time, we do not offer any specific view on those parameters but, given that the review of the Electricity, Gas, Airports and Transpower IMs was concluded a short time ago, we suggest that the Commission review the expert advice submitted in that review:

- Oxera’s (on behalf of the ‘Big 6’ distributors) review of the Commission’s WACC setting methodology[9];
- Oxera’s (on behalf of the ‘Big 6’ distributors) response to the 2013 draft cost of capital decision[10];
- CEG’s (on behalf of ENA) review of the estimation of the regulated WACC[11]; and
- CEG’s (on behalf of ENA) response to the 2013 draft cost of capital decision[12].

5. Concluding Remarks

5.1. If you have any questions about this submission, please contact the undersigned.

Yours sincerely

Alec Findlater
Regulatory Lead – Commerce Commission

[9] Oxera. (2022). *Review of the NZCC’s WACC-setting methodology*. 10 November 2022 (reviewed on 31 January 2023)
[10] Oxera. (2023). *Response to the New Zealand Commerce Commission's draft decision for Part 4 Input Methodologies Review 2023 on the cost of capital*. 19 July 2023.
[11] Competition Economists Group. (2023). *Estimating the WACC under the IMs*. February 2023.
[12] Competition Economists Group. (2023). *Response to 2023 IM draft decision on cost of capital*. July 2023.