



**Cross Submission on Revised Draft  
Guidelines for Estimating the Cost of  
Capital**

**PUBLIC VERSION**

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## INTRODUCTION AND EXECUTIVE SUMMARY

- 1 Having reviewed the submissions lodged by other stakeholders, Telecom notes that it is the only telecommunications company to submit on cost of capital issues. Other stakeholders come primarily from the electricity industry and have submitted in detail on specific aspects of the Revised Draft Guidelines for Estimating the Cost of Capital (**Guidelines**). Their submissions on the Guidelines often link directly to submissions made on the Input Methodologies Discussion Paper.
- 2 The submissions made by other stakeholders on the Guidelines are largely consistent with the main thrust of Telecom's submission. Telecom proposed to the Commission in its submission<sup>1</sup>, that in order best to equip the Commission properly to estimate the market return for making an investment the Guidelines need to be flexible and relevant. Other stakeholders note specific issues which affect the estimation of the cost of capital in relation to their specific industries, and in doing so, emphasise the importance for the Commission of putting into place Guidelines which are able to provide the most accurate estimate of the cost of capital for those industries consisting of New Zealand's core infrastructure and strategic assets.
- 3 Given the strongly unified theme of the submissions, Telecom urges the Commission to consider the proposals set out in paragraphs 10, and 44 to 48 of its submission. The Commission should develop the Guidelines in a manner which sets out detailed formulations of the key methods of estimating cost of capital, describes how these might be assessed for suitability to a particular regulated firm or industry, clarify the evidence required to satisfy the Commission in relation to each methodology and set out clear universal points on process, but not narrow down to a single methodology.
- 4 Telecom's concerns in relation to the cross-over with the Input Methodologies process have been made more serious by the scope of submissions made by other stakeholders.

## FURTHER CONCERNS WITH THE OVERLAP WITH THE INPUT METHODOLOGIES PROCESS

- 5 The nature of the submissions made by other stakeholders also reinforces the concern expressed in Telecom's submission<sup>2</sup> that the decision to merge the Guidelines and Input Methodologies consultation processes has potential to limit the scope of the Guidelines in a way which makes them less appropriate to all future situations. The risk here, as most submitters suggest, is that the

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<sup>1</sup> Ibid at paragraphs 10 and 39-58

<sup>2</sup> *Submission on Commerce Commission Revised Draft Guidelines for Estimating the Cost of Capital*, Telecom 18 August 2009, at paragraphs 8 and 49-56

Commission's past approach to the estimation of cost of capital may not best estimate the market return for making an investment in the regulated industries.

- 6 It is clear that there is a significant overlap between the development of the Guidelines and the project to develop input methodologies for businesses regulated under Part 4 of the Commerce Act 1986.
- 7 As noted above, Telecom has previously raised concerns that the interrelationship of the two projects will give the Guidelines a particular slant. Since the Commission will be focusing on the businesses subject to the Input Methodologies process and for which it is developing specific methodologies, it would be surprising if the cost of capital issues relevant to those industries are not front of mind in the Commission's decision making process. Telecom's second concern is that the development of the Guidelines will become subject to the timelines of the process to develop input methodologies. As a result of both these issues, the Commission may not be able to develop an approach which is sufficiently flexible to be relevant and appropriate to a range of industries.
- 8 In addition, it is not clear whether the Guidelines themselves have (or will have) legal status as input methodologies for businesses that are regulated under Part 4. If this is the case, then this has significant implications for Telecom.
- 9 Telecom does not expect that the Commission intends the Guidelines to be input methodologies per se. However, as the Guidelines appear to be captured by the wording of section 52T of the Commerce Act 1986 we are uncertain as to whether they are (or will be) or not. Section 52T defines the input methodologies for businesses regulated under Part 4 as follows:  
  
*The input methodologies relating to particular goods or services must include ... methodologies for evaluating or determining the following matters in respect of the supply of the goods or services ...cost of capital.*
- 10 If the Guidelines are "input methodologies" (or become "input methodologies" as they are actually applied to a regulated business under Part 4) then there is potential for the Guidelines to be fully captured under the Part 4 regime, rather than being applicable across all sectors. All the provisions and statutory processes applicable to "input methodologies" would then apply to the Guidelines.
- 11 If the Guidelines are not input methodologies, but something more general to overlay the methodologies, then the decision to narrow down, for example, to the use of the simplified Brennan-Lally CAPM model in the Guidelines would appear to predetermine the outcome of any input methodologies determination that is subsequently made.
- 12 Whether or not the Guidelines are to become input methodologies, it is clear that submissions express serious concern with the Commission's approach to the

estimation of cost of capital. One way to resolve this issue, in Telecom's view is that this overall situation creates strong practical reasons for the Commission to remove the development of the Guidelines from the project to develop input methodologies while ensuring that the Guidelines include consistent, flexible and transparent processes and methodologies for estimating cost of capital taking account of the specific issues affecting both Part 4 and non-Part 4 regulated businesses.

- 13 Telecom has suggested that concerns with the current process would be addressed by reshaping the Guidelines in a manner which sets out detailed formulations of the key methods of estimating cost of capital, describes how these might be assessed for suitability to a particular regulated firm or industry, clarify the evidence required to satisfy the Commission in relation to each methodology, and set out a transparent process for estimating WACC across all regulated firms. In doing this the Commission will be more able to fulfil its function better in relation to both Part 4 and non-Part 4 processes.

#### **STAKEHOLDER VIEWS ON THE USE OF THE BRENNAN-LALLY CAPM APPROACH**

- 14 When considering the submissions made by other stakeholders, Telecom considers that there is a clear unifying theme - the Commission's approach to narrow application of the Brennan-Lally CAPM approach is problematic. The Commission's use of the model without detailed consideration of industry-specific issues to industries with significantly different risk profiles, demand characteristics, rates of innovation and technological change, and structures of sunk costs is likely to lead to a systematic underestimation of the required market return with resultant negative impacts on investment.

##### *Market Risk Premium*

- 15 Submissions on the cost of capital have been received from a large number of parties representing 'suppliers' potentially regulated by the Commission and from two 'user' groups whose members purchase services from these 'suppliers', being the Major Electricity Users' Group (**MEUG**) and the Board of Airline Representatives New Zealand Inc (**BARNZ**) (with a submission also made by BARNZ member Air New Zealand). It is interesting to note that MEUG and its advisor Ireland Wallace & Associates (**IWA**) are silent on the Commission's proposed MRP estimate of 7.0 percent, while BARNZ and Air New Zealand both submit that the Commission's estimate of 7.0 percent "...is appropriate to apply to regulated suppliers".
- 16 This compares to the position of 'suppliers' who have virtually all submitted that the Commission's MRP estimate is too low, particularly in light of the global financial crisis. The detailed analysis of the MRP estimate provided by submitters such as Synergies Economic Consulting on behalf of Vector for instance strongly

suggest that the Commission's MRP estimate is too low, especially when the short and long term impact of the global financial crisis is considered. Similarly, the submission by Castalia on behalf of Unison Networks examines the Commission's approach to the MRP, and contrasts it with the Australian Energy Regulator's approach. Castalia's analysis further supports the view that the Commission's estimate of MRP is too low, again, particularly in the context of the global financial crisis. The asymmetrical nature of the submissions on the MRP from opposing interest groups further suggests that indeed the Commission's MRP estimate is too low, particularly in current circumstances.

#### *Term and Cost of Debt*

- 17 Telecom notes that three of the larger firms that are active and experienced in the New Zealand debt markets and which have made submissions on the cost of capital, being Powerco, Transpower and Vector, have all raised similar concerns to those expressed by Telecom on how the Commission will treat the assumed term and cost of debt. These concerns include:
- (a) That the assumed term of debt should recognise refinancing risk, which means longer term debt should be assumed (i.e. based on observed market practice);
  - (b) That the costs of hedging the underlying risk free rate, back to the term of the risk free rate being assumed for the regulatory period, should be allowed for;
  - (c) That it is neither practicable nor cost effective to hedge the long term debt margin to a term matching that of the regulatory period; and
  - (d) That New Zealand debt markets have limited capacity and therefore some allowance should be made for the additional cost of raising debt offshore.

#### *The Effect of Leverage on the WACC*

- 18 IWA submits, on behalf of MEUG, that the WACC formula proposed (and currently used) by the Commission results in the WACC being minimized when leverage (total debt/total capital) is assumed to be nil. IWA go on to submit that the Commission should therefore use a default leverage assumption of nil.
- 19 Firstly, Telecom notes that there are a number of reasons or theories, beyond the narrow formulation of the WACC, that support the use of leverage in firms' capital structures, even under the New Zealand taxation system. This is obvious from observing the widespread use of debt in the capital structure of New Zealand companies.

- 20 Secondly, on a more technical level, if debt betas are allowed for in de-levering and re-levering equity betas and the residual component of the promised debt margin not explained by the debt beta is trivial<sup>3</sup>, then the Commission's formulation of the WACC will result in the WACC being invariant to the leverage assumption. Alternatively, if debt betas are ignored, but providing the leverage assumption used by the Commission is similar to that of the comparator firms from which betas were obtained, then the Commission's resulting WACC estimate should still be reasonable. Under this later scenario it would then be inappropriate to assume nil leverage without having first allowed for the debt betas of the comparator firms.

#### *Form of the CAPM*

- 21 Synergies Economic Consulting in its submission on behalf of Vector Ltd echo Telecom's concerns with the assumption of a closed economy inherent in the Brennan-Lally CAPM. It notes that the Australian Energy Regulator's practice is to recognise the presence of foreign investors in the domestic capital market. The Officer model commonly used in Australia implicitly assumes, as does the Brennan-Lally model that the local jurisdiction is fully segmented from the global economy. Telecom concurs that the Commission should carefully consider the influence and involvement of offshore investors in the New Zealand market.

#### *The Global Financial Crisis*

- 22 Telecom also notes that a number of submitters reinforced the importance for the Commission of considering the effects of the global financial crisis. As Castalia notes, for instance in its submission on behalf of Vector, the likelihood is that global financial markets are likely to continue to be volatile for the short to mid-term and that it is likely that there will be long term outcomes which will differ from the past. PricewaterhouseCoopers, Synergies Economic Consulting and LECG respectively note the relevance of the global financial crisis for the MRP in their various submissions. Telecom strongly urges the Commission to ensure that the final form of the Guidelines ensure that market conditions are properly taken into account in developing cost of capital estimations alongside the use of appropriate models.

### **CONCLUSION**

- 23 Given the strongly unified theme of the cross-submissions, Telecom urges the Commission to consider the proposals set out in paragraphs 10, and 44 to 48 of its submission. The Commission should develop the Guidelines in a manner which sets out detailed formulations of the key methods of estimating cost of capital,

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<sup>3</sup> If the debt beta accounts for the difference between the expected yield on the debt and the risk free rate, then the difference remaining between the promised and expected yield is the expected loss arising from default. Under the Commission's assumption of investment grade debt this residual difference should be minor.

describes how these might be assessed for suitability to a particular regulated firm or industry, clarify the evidence required to satisfy the Commission in relation to each methodology and set out clear universal points on process.

24 The process should be as follows:

- (a) A statement of the principles driving the selection process for a given methodology and regulated industry, and the proposed methodology which would be consulted on; followed by
- (b) A calculation paper for consultation, (which applies the methodology in a manner consistent with the Guidelines).