

26 October 2016

Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission
44 the Terrace, Wellington 6140

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

Dear Keston,

Vector submission on Frontier Economics memo on trailing average for the cost of debt

1. The Commerce Commission (Commission) has asked for stakeholder views on a memo by Frontier Economics submitted by Transpower to the Commission following the Commission's stakeholder workshop on the weighted average cost of capital.
2. Vector's contact person for this submission is:

Richard Sharp
Head of Regulatory and Pricing
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3. No part of this submission is confidential.

Stakeholder Workshop

4. The Frontier Economics memo addresses concerns raised at the stakeholder workshop about violations of net present value neutral discussion ($NPV = 0$) between a trailing average cost of debt and the rate on-the-day approach. At the stakeholder workshop the Commission noted stakeholders had failed to comment on Dr Martin Lally's expert report for the Commission which addressed the issue of $NPV=0$ violations for new investment.

The Frontier Economics memo

5. The Frontier Economics memo highlights a shortcoming in Dr Martin Lally's analysis, namely it does not consider the impact on investments already made i.e. the impact on the regulated asset base. The Frontier Economics memo demonstrates $NPV=0$ violations for sunk investment and new investment (all investment) are much larger under an "on-the-day" approach for estimating cost of debt than a strategy replicating an efficient debt profile of the firm using a trailing average for the cost of debt.

Addressing the problem raised by Frontier Economics

6. To minimise NPV=0 violations for all investment Frontier Economics recommends an approach for the cost of debt that closely aligns with the efficient lending practices of debt issuing firms. The Commission's information request from electricity distribution businesses showed the average tenor of debt issuing firms was close to 10 years. Accordingly, to reduce the likelihood of NPV=0 violations for all investment (especially for large debt issuing businesses like Vector) the Commission should consider the merits of a 10 year trailing average for the cost of debt.

Conclusion

7. The Commission should be concerned with minimising the impact of NPV=0 violations for all investment (especially for larger debt issuing suppliers). Accordingly, we support the analysis in the Frontier Economics memo on the incentives for investment for regulated suppliers. We believe the Frontier Economics memo provides strong evidence for the Commission to adopt a 10 year trailing average for the cost of debt given the evidence of debt financing practices of regulated suppliers.

Yours sincerely
For and on behalf of Vector Ltd

A handwritten signature in blue ink, appearing to read "Richard Sharp".

Richard Sharp
Head of Regulatory and Pricing