Part 4 input methodologies review – draft decision on cost of debt wash-up

17 October 2023

CHORUS

Submission on cost of debt wash-up

1. Chorus welcomes the opportunity to submit on the Commerce Commission's (**Commission's**) draft decision for the cost of debt wash-up for the 7-yearly review of input methodologies (**IMs**) for Part 4 of the Commerce Act 1986 (**Part 4**).[1]

2. Overall, we support the Commission's effort to address the potential cash flow volatility caused by a cost of debt wash-up. However, we disagree that a cost of debt wash-up will necessarily be required for all firms. In our view, a materially better specification of price IM would require a cost of debt wash-up to be applied to only those firms which have debt costs fixed in nominal terms for the upcoming regulatory period.

3. We **recommend** the Commission changes its draft decision from a mandatory cost of debt wash-up to one allowing firms, or the Commission, to select whether to apply the debt cost wash-up for the upcoming regulatory period, based on the circumstances of the firms. Whatever form the mechanism ultimately takes it will be important for there to be certainty as to *whether* a cost of debt wash-up applies for each firm and *how* it applies.

4. We confirm that this submission can be published on the Commission's website, and that no part of this submission contains confidential information.

A mandatory cost of debt wash-up should not apply

5. The Commission has sought feedback on additional changes to the proposed cost of debt wash-up, which are intended to reduce potential volatility in cash flows, by:

    a. Requiring the most up-to-date CPI information to be used when determining forecast allowable revenues for pricing compliance purposes each year; and

    b. Spreading the draw-down of any annual cost of debt wash-up amount over the forthcoming 5-year period.[2]

6. In our view, a cost of debt wash-up applying only to firms with debt costs fixed in nominal terms for the regulatory period would result in a materially better specification of price IM. This is because the Commission's assumption that *all* firms can, or should, hedge their entire debt portfolio to fixed rate nominal terms for the duration of a regulatory period is not plausible. That is to say, in some cases there is already an inconsistency between the cost of debt assumption in the cost of capital and how regulated firms actually finance their businesses.

7. Introducing a mandatory cost of debt wash-up can cause gains/losses relative to efficient real world financing costs. More specifically:

    a. Not all regulated firms have the ability to hedge their debt portfolios fully due to the nature of their borrowings, the limitations of debt and swap markets, financing policies, or investor preferences;

    b. The Commission has acknowledged previously that staggering debt maturity dates is an efficient financing practice, resulting in the observed cost of debt for firms varying across each year;[3]

[1] Commerce Commission, Further consultation on IM Review draft decision on the cost of debt wash-up of EDBs and GTBs, 29 September 2023.

[2] Commerce Commission, Further consultation on IM Review draft decision on the cost of debt wash-up of EDBs and GTBs, 29 September 2023 [at paragraph 11].

[3] Commerce Commission, Cost of Capital Topic Paper Part 4 IM Review 2023 - Draft Decision, 14 June 2023 [at paragraph 3.26].

c. It ignores the fact that the debt financing is required for new investments made in-period (i.e. capex) and the revaluation element of the RAB which cannot realistically be expected to be obtained at rates fixed at the beginning of the period;

d. For firms that *are* able to hedge to fixed rates, but are currently exposed to floating rate debt, or to fixed term debt with staggered maturities, there could be significant costs incurred in altering the characteristics of their debt portfolio to match that assumed by the Commission at the commencement of next regulatory period; and

e. A characterisation of windfall gains or losses arising where a debt portfolio is not hedged is misleading – as noted in our previous submission inflation forecasting errors may create transfers between different providers of finance, but that should not be the Commission's concern as it does not affect consumers.[4]

8. Moreover, applying the cost of debt wash-up as proposed by the Commission could potentially cause the growth in customer prices to diverge materially from the growth in CPI (and, over the medium-term, the incomes of consumers) which we do not think is in the long-term interest of consumers. For Chorus, creating a wedge between growth in customer prices and CPI would potentially expose it to additional stranded asset risk, given our competitors will not factor an equivalent wash-up into their prices.

9. For the reasons above, we **recommend** allowing firms, or the Commission, to select whether to apply the debt cost wash-up for the upcoming regulatory period, based on the circumstances of the firms. Such a change would better promote the purpose of Part 4, including incentives to invest.

IM determination drafting should be clarified

10. There is a potential inconsistency between the Commission's draft reasons paper which suggests that the overall inflation wash-up will operate at the allowable revenue level, and the proposed IMs which require a re-running of the MAR model and updating the values of building blocks that include inflation assumptions.[5]

11. The issue is outlined in our submission on the draft IM review decision,[6] however the draft IMs most recently proposed by the Commission do not appear to have resolved this inconsistency. Whatever form the mechanism ultimately takes for Part 4 default/customised price-quality paths it will be important for firms to have certainty as to *whether* a cost of debt wash-up applies for each firm and *how* it applies.

[4] Chorus, Submission on Part 4 input methodologies review – draft decisions, 19 July 2023. The Commission has previously noted that in any event the residual bankruptcy risk to regulated providers was small: Commerce Commission, Form of Control and RAB indexation for EDBs, GPBs and Transpower, 20 December 2016 [at paragraphs 267-268].

[5] Commerce Commission, Draft decision Financing and incentivising efficient expenditure during the energy transition topic paper, 14 June 2023 [at para.5.100]; [Draft] Electricity Distribution Services Input Methodologies (IM Review 2023) Amendment Determination 2023, 14 June 2023 [at clause 3.1.4(4)]; [Draft] Gas Transmission Services Input Methodologies (IM Review 2023) Amendment Determination 2023, 14 June 2023 [at clause 3.1.4(4)].

[6] Chorus, Submission on Part 4 input methodologies review – draft decisions, 19 July 2023 [at paragraph 14].