17 October 2023
Commerce Commission
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Wellington 6011
By email to im.review@comcom.govt.nz

To whom it may concern,

Alpine Energy Limited's submission on the Commerce Commission's further consultation on its draft decision on the cost of debt wash-up

Introduction

1. Alpine Energy Limited (**Alpine Energy** or **we**) thank the Commerce Commission (**the Commission**) for the opportunity to submit on further consultation on the Input Methodologies (**IMs**) review draft decision, and in particular, on the cost of debt wash-up of electricity distribution businesses (**EDBs**) and gas transmission business (**GTB**), dated 29 September 2023.
2. We are pleased to see further consultation on the cost of debt wash-up mechanism. We agree that there is an inconsistency between the assumption in the revenue wash-up mechanism currently, which is that nominal debt costs are variable, and the assumption in the weighted average cost of capital (**WACC**), which assumes nominal debt costs are fixed at a reset.
3. As a member of Electricity Networks Aotearoa (**ENA**), we also largely support the submission prepared on behalf of the members.

The Commission's proposal

4. In its draft decision, the Commission noted that the unexpected increase in inflation since the last IM review had highlighted issues with the way the regulatory regime assigns inflation risks between suppliers and consumers. The Commission noted that the current assignment of inflation risk benefits neither suppliers nor consumers as it makes revenue unnecessarily uncertain, can result in windfall gains and losses, and may affect incentives to invest.
5. The Commission draft decision (14 June 2023) was to amend the IMs to introduce a cost of debt wash-up. Under the proposed amendment, when inflation is higher than expected, the annual revenue wash-up would not increase revenue for the effect of forecast error on inflation on all revenue, but rather, a lesser amount that excludes the effect of forecast error on

inflation on debt. Conversely, when inflation is lower than expected, the annual revenue wash-up would not decrease for the effect of forecast error on inflation on the cost of debt (**draft amendment**).

6. In response to concerns that the draft amendment could create significant volatility in annual revenue and add to cashflow sufficiency concerns, the Commission has proposed a further change (29 September 2023). The change is to ensure all of the most up-to-date CPI information (actual and forecast) is used when determining forecast net allowable revenue at the start of each disclosure year and to smooth the accumulation of the cost of debt wash-up (**updated amendment**).

A simpler approach should be explored

7. We are pleased to see the Commission constructively responding to the concerns on its draft amendment and its acknowledgement that inflation forecast errors can have material cash flow impacts over a regulatory period.
8. We encourage the Commission to consider how historical forecasting errors over previous three regulatory periods, especially where forecasted inflation was above actual inflation, has resulted in under recovery of revenues for EDBs and how this can be retrospectively corrected.
9. We believe that the updated amendment suggested by the Commission would add further complexity to revenue adjustments, and to the regulatory regime more generally. A simpler approach that avoids the need to correct for forecast errors would reduce complexity and compliance costs in adapting their operating and compliance systems and models.
10. The Commissions updated amendment is, fundamentally, aimed at reducing the delay in addressing inflation forecasting error. We consider a better approach would be to do away with the need to correct for such errors in the first place, especially given the uncertain inflationary environment that is likely to exist during DPP4.
11. Should the Commission continue to consider implementing the updated amendment, we encourage the Commission to carefully consider the impacts of it on other aspects of the regulatory regime, to guard against the risk of unintended consequences.
12. In addition, we encourage the Commission to explore the impacts of its updated amendment under differing economic scenarios, such as where inflation is substantially and / or persistently below forecast.

13. As we have also noted in our previous submission, since 2021, inflation has been well above the Reserve Bank of New Zealand's (**RBNZ)** mid-point target of 2%. There is a significant risk that the annual change in the consumer price index (**CPI**) sits above 2% over the next default-price quality path (**DPP4**). Since the pandemic, New Zealand has also observed high variability in inflation.[1]

The updated amendment is linked to the cost of debt

14. Under the current approach on WACC, nominal debt cost is assumed to be fixed over the regulatory period.
15. In effect, it is assumed that EDBs issue inflation indexed debt or that EDBs are able to enter into interest rate swaps to lock-in the spot risk-free rate at the time of the DPP4 determination and / or to re-align interest rate repricing periods with regulatory periods.
16. We would note that issuing debt locked in to mimic the regulatory period and / or entering into interest rate swaps is not always practical. In addition, even EDBs who procure debt on efficient and competitive terms at the time of issuance may still be exposed to higher debt costs if the EDBs profile of embedded debt does not match the benchmark cost of debt.
17. We would encourage the Commission to continue to consider submissions on the benchmark cost of debt, such the ENA's submissions on the term of debt, the use of a trailing average to calculate the cost of debt and the term credit spread differential (**TCSD**) allowance.[2]

Other observations

18. In addition to the above points, we note the following on the Commission's further consultation on the cost of debt wash-up for EDB and GTBs:
    a. We commend the Commission for publishing an accompanying demonstration model which presents the implications of different cost of debt wash-up mechanisms. However, the updated amendment is not included in the accompanying demonstration model. As noted above, the updated amendment is novel. We would encourage the Commission to further update the demonstration model to present the implications of the updated amendment.

[1] https://comcom.govt.nz/regulated-industries/input-methodologies/input-methodologies-for-electricity-gas-and-airports/input-methodologies-projects/2023-input-methodologies-review?target=documents

[2] Electricity-Networks-Aotearoa-ENA-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf (comcom.govt.nz)

b. We do not necessarily agree with the Commission's characterisation of CEG's first proposed alternative, which, as noted above, we consider is preferable. CEG's proposal addresses the inconsistency between the annual revenue wash-up mechanism, which assumes debt costs vary with inflation, and the assumption in the WACC, which assumes that debt costs are fixed. In addition, we note that CEG's approach also allows suppliers the opportunity for achieving ex-ante real financial capital maintenance and net present value equal to zero, albeit that it brings forward the real return of capital relative to the current IMs.

Conclusion

16. If the Commission has any questions or requires clarification on any information provided in our submission, please do not hesitate to contact us.

Yours sincerely,

[redacted]

Marisca MacKenzie
Chief Regulatory Officer
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