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**Further consultation on the cost of debt wash-up of EDBs and GTBs**

1. This is Vector's ('our,' 'we,' 'us') submission on the Commerce Commission's (Commission) further consultation on the cost of debt wash-up of EDBs and GTBs. No parts of this submission are confidential, and it can be published on the Commission's website.

2. The Commission is acting in clear error by introducing the cost of debt wash-up mechanism. Even with the suggested amendments to the proposal introduced at draft decision, the Commission has misrepresented EDBs' debt compensation issue and the proposed solutions put forward by Competition Economists Group (CEG).

3. Vector has collaborated with Aurora, Orion, PowerCo, Unison and Wellington Electricity on this matter and together we commissioned CEG to review the latest consultation paper and models issued by the Commission. We refer to their report '*NZCC further consultation on using cost of debt revenue wash ups to target a nominal return on debt'* throughout our submission.

4. Vector is extremely concerned that the proposed debt wash-up mechanism is materially worse than the status quo and we urge the Commission to implement the materially better alternative proposed by CEG's report, the amended Blended CPI model.

***A flawed process for such a risk prone amendment***

5. The Commission is proposing two further amendments to the debt wash-up mechanism to deal with the debt compensation issue. Many submitters, including Vector, had already expressed their concern that this had not been forewarned previously in the Commission's IM review

process and many suppliers were concerned they had not been given adequate time to consider its implications.

6. Although the further consultation is welcomed, the issues with the proposals could have been teased out ahead of the draft decision. We note that:

   a. The Commission did not obtain input from experts in coming up with the proposed mechanism;

   b. This is a perfect example of a topic that could have benefitted from a workshop of stakeholders, experts and the Commission; and

   c. It could have at least warranted its own issues paper.

7. These concerns would appear warranted as what the Commission is proposing will lead to revenue volatility for suppliers which subsequently will lead to price volatility for consumers / retailers.

***The proposed changes do not mitigate suppliers' financeability concerns***

8. The proposed changes to the mechanism do not alleviate the financeability issues raised in our response to the draft decision. Dr Tom Hird points out the following:

   *"The Commission's preferred approach to targeting a nominal cost of debt by making revenue adjustments both:*

   - *Puts at risk the actual financeability of EDBs; and*
   - *Makes any external assessment of the financeability of a DPP decision highly problematic."*[1]

***Complexity should not be a barrier to achieving the right outcomes***

9. In the further consultation paper, the Commission states that:

   *"[…] the complexity and challenge of tracking and applying a blended index of the forecast inflation rate and actual inflation rate is less likely to promote certainty for suppliers and consumers in relation to the rule requirements and processes applying to Part 4 regulation under the s 52R IM purpose."*[2]

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[1] CEG, *Targeting a nominal cost of debt*, October 2023, p.31

[2] Commerce Commission, *Further consultation on the cost of debt wash-up of EDBs and GTBs*, IM Review October 2023, p.16

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10. We would argue that achieving the framework's following overarching objectives must take precedence over the complexity excuse of not adopting the blended CPI approach:

    a. achieving NPV=0, in line with promoting s 52A(1)(a) and (d); and

    b. in choosing between options that would achieve NPV=0, the next criteria are reducing volatility and avoiding unnecessary delays in cashflow via accruals in the wash-up, consistent with maintaining incentives to invest under s 52A(1)(a).

11. Complexity cannot be a barrier to the implementation of a solution that could seriously impact cash flows at a time when financeability is critical to the investments required to achieve net zero 2050. As CEG points out:

    *"[…] the additional complexity of spreadsheet models is trivial when compared to the cost of additional complexity in EDBs capital management if a revenue wash-up is implemented."*[3]

12. If complexity was a hurdle for implementing regulatory mechanisms that achieve the right outcomes, EDBs would not have the Incremental Rolling Incentive Scheme (IRIS), a tool that the Commission has consistently promoted throughout the IM review despite its complicated nature.

***Critique of the Commission's proposed reform***

13. CEG has pointed out a number of issues with the Commission's proposed reform:

    a. The Commission is making false assumptions on how EDBs fix their debt:

    *"In summary:*

    - *The rationale for assuming EDBs debt costs are fixed in nominal terms is that they can accurately forecast their likely debt raising requirements and lock-in interest rates prevailing immediately prior to the DPP;*

    - *Seeking to target a fixed nominal compensation for debt prevailing at the beginning of the DPP by adjusting DPP revenues in the face of unexpected inflation is internally inconsistent with the rationale for doing so.*

    *If the regulatory debt compensation is to target fixed nominal debt costs then, in my view, it behoves the Commerce Commission to design the regime in which the quantum of*

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[3] CEG, *Targeting a nominal cost of debt*, October 2023, p.6

*borrowing is predictable at the beginning of the DPP. That is, the Commission should eschew revenue adjustments in favour of revaluation adjustments."*[4]

b. Applying a cost of debt revenue wash-up could lead EDBs to adopting the Commission's debt management policy. This is not good treasury management and could lead to inefficient outcomes. CEG confirms that:

*"[…] it is reasonable to believe that EDBs are expert in their efficient capital management strategies."*[5]

c. The Commission's demonstration model is not NPV = 0. CEG explains that:

*"It is likely possible to fix these problem – but doing so requires making explicit assumptions about the carry-forward and how EDBs will efficiently fund this across two DPPs. These are assumptions that the demonstration model does not grapple with."*[6]

d. There is a compounding impact where EDBs do not hedge 100% of expected RAB growth. CEG notes that:

*"Applying a wash-up "as if" they hedged 100% of their expected portfolio could easily lead to those firms materially under-recovering their actual cost of debt and would have the potential to place them in financial distress. That is, the cost of debt revenue wash-up would tend to have a compounding effect. An EDB who was already paying interest rates above the DPP forecast level on some or all of its debt would still face a cost of debt wash-up impact on revenue based the assumption that it fixed its debt costs (which it had not done)."*[7]

e. There is no regulatory precedent for the Commission's proposed approach. Dr Hird points out that:

*"To the best of my knowledge there is no international regulatory precedent for the NZCC's proposed approach to targeting a nominal cost of debt. Regimes that do target a nominal cost of debt are commonplace (for example this is standard practice in the United States). However, to the best of my knowledge this is always achieved by not indexing the debt funded portion of the asset base by inflation."*[8]

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[4] Op cit., p.27

[5] Op cit., p.31

[6] Op cit., p.30

[7] Op cit., p.30-31

[8] Op cit., p.32

f. The Commission has not considered the interaction of the wash-up with the 10% limit on annual price increases (or revenue cap/ smoothing). Consequently, the CEG report highlights that:

> *"[…] it may be that the IM's do not allow revenues to automatically return to cost recovery levels following a significant reduction in revenues due to a cost of debt wash-up because returning to full cost recovery may require a more than 10% revenue increase (especially if underlying inflation is high)."*[9]

***There is a materially better alternative available***

14. CEG has outlined in section 6 of their report that the Blended CPI model is a significant improvement on the Commission's preferred revenue adjustment model:

> *"This is because the Blended CPI model limits the unexpected variations in the RAB that must be funded at prevailing cost of debt rates."*[10]

15. However, CEG warns the Commission that:

> *"[…] the Blended CPI model only limits these variations – it does not eliminate them. This is because the Blended CPI still increases relative to forecast CPI when inflation increases above forecast (and vice versa)."*[11]

16. Fortunately, CEG has provided an amended version of the CPI model (see Table 6.3 of the report) where RAB indexation targets the residual return on capital not provided in revenues but only the expected RAB is funded with fixed nominal debt.

17. Dr Hird notes that:

> *"[…] this model can also accommodate other more realistic assumptions about how EDBs use interest rate swaps to fix the nominal cost of debt. […] it is costly to use forward starting swaps and it is not obvious that the current regime compensates for this cost. Therefore, a more reasonable assumption might be that the nominal cost of debt is only fixed for the opening debt RAB at the beginning of the DPP and that all RAB growth is funded at prevailing rates."*[12]

18. Vector supports the implementation of CEG's amended blended CPI model, an approach that is arguably simpler, which will to continue to index all revenues (including the cost of debt

[9] Op cit., p.32

[10] Op cit., p.36

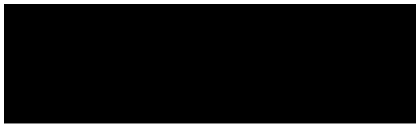
[11] Op cit., p.36

[12] Op cit., p.39

component) by actual CPI but to amend the RAB indexation formula to account for the impact of doing so, whilst remaining NPV = 0.

19. Vector has repeatedly expressed in our submissions to the IMs consultation that the best way to remove the inflation forecast risk is to remove the requirement to forecast inflation (the ability to forecast inflation accurately is just not possible). Therefore, rather than burden consumers and suppliers with this forecast risk or try and incorporate mechanisms to correct the forecasting error, a simple solution is to no longer require inflation to be forecasted, by moving to an unindexed RAB approach.

Kind regards



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