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Proposed amendments to cost of capital input methodologies for gas pipeline businesses related to the 2022 default price-quality paths

1. This is Vector's submission to the Commerce Commission's (Commission) proposed amendments to the cost of capital (WACC) input methodologies (IMs) related to the 2022 default price-quality paths (DPP3) for gas pipeline businesses (GPB).

2. We look forward to continued engagement with the Commission on the GPB reset and the upcoming IM review.

Tax adjusted market risk premium (TAMRP)

3. We support the Commission's decision to update the TAMRP to 7.5% in line with the most recent estimated determined under the Fibre IMs. As a market wide measure, it is appropriate the TAMRP is aligned with the Fibre IMs.

4. Accordingly, we agree with the Commission's reasoning that updating the TAMRP would better support the provision of ex-ante FCM and therefore better promote the Part 4 purpose than current settings.

Proposed amendments to align with four-year regulatory period

5. The Commission's draft decision states, "*The term of the risk-free rate is tied to the period of time that the supplier is exposed to interest rate risk. The supplier will be exposed to this for the length of the period. Suppliers can hedge this risk so we set the risk-free rate term equal to the length of the period…*

   We propose amending the Gas IMs to enable us to calculate an estimate of the risk-free rate that aligns with a four and five-year regulatory period. With prior knowledge of the term of the regulatory period suppliers can hedge their interest rate risk for the length of the period."

6. We have reservations with the current IM approach tying the term of the risk-free rate to the regulatory period.

7. We note the Commission's reasoning that aligning the risk-free rate to regulatory period allows suppliers to hedge interest rate risk for the length of the period. However, this is linked to a specific debt hedging strategy and is out of step with international regulators which recognise efficient debt management strategies will involve debt being raised using different products and maturity periods.

8. While we recognise this may require a more substantive IM change beyond the scope of this consultation, the Commission should give serious consideration at the upcoming IM review to adopting approaches to estimating the risk-free rate and the cost of debt more in line with international regulators.

9. We consider the estimate of the risk-free rate should use a bond with a longer term to maturity than the regulatory period to better align with the investment period of the asset. A ten-year government bond is most commonly used by overseas regulators.[1]

10. The Commission should also update its approach to estimating the cost of debt to a trailing average approach. This would mitigate price volatility between regulatory periods to better promote price stability for regulated businesses and consumers. This is the approach taken by Ofgem, the Australian Energy Regulator and almost all US public utilities.

Upcoming IM review

Net zero

11. The upcoming IM review in 2023 will set the rules and processes for regulated businesses at a critical juncture for achieving New Zealand's legislative commitment to net carbon zero. It is essential the right settings are put in place to support efficient investment to enable this transition.

12. We consider the crucial first step is for the Commission to establish what can and can't be achieved under the Part 4 of the Commerce Act (Part 4) to support the most efficient transition to a zero-carbon economy. As a backwards looking regime designed with the

[1] Brattle Group, *Report to the AER - a Review of International Approaches to Regulated Rates of Return* (June 2020) at 155

expectation of a steady state of growth, it may be current Part 4 settings cannot effectively deliver decarbonisation at lowest cost to consumers. If this is the case, then regulatory and business stakeholders should work together to ensure appropriate Part 4 settings are in place ahead of the IM review.

Appropriate settings to support investment

13. Appropriate WACC settings are a key component in the regulatory framework to support efficient investment by regulated business. We are not confident the current WACC settings achieve this, as evidenced by significant WACC reductions driven by historically low interest rates coming at a time Electricity Distribution Businesses (EDBs) need to step up investment to support electrification and GPBs face significant increased uncertainty.

14. Accordingly, we recommend the Commission consider updating the following parameters to ensure regulatory settings support efficient investment:
    - The approach to estimating the risk-free rate should be reformed in line with overseas regulators who use longer-term government bonds (most commonly 10 years) as a proxy. A longer risk-free rate is appropriate to better align with the investment period of the asset.
    - The cost of debt should move to a trailing average approach.
    - The approach to inflation should be updated to mitigate the impact of inflation forecast error.

15. We note the Commission's draft DPP decision is to maintain RAB indexation but states the Commission can consider inflation risk allocation in the next IM review. We will provide more substantive comments on the potential impact of this decision on GPB asset recovery in our response to the draft decision.

16. However, if the Commission progresses its draft decision to maintain RAB indexation, we urge the Commission to revisit this decision at the IM review for both EDBs and GPBs. The tilting of the cash-flow profile could have a material impact on the ability of regulated businesses to make investments at the appropriate times.

Yours sincerely

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