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Vector cross-submission on further consultation on the cost of debt wash-up of EDBs and GTBs

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

2. Although the cross-submission process is welcomed, the issues with the cost of debt wash up proposal could have been addressed by now if a more robust process was followed by the Commission when introducing such a significant change to the compensation of debt costs. The issues around the Commission's forecasting of inflation and its consequential impacts on the compensation of debt costs have been highlighted in other consultation processes well before the current input methodologies (IM) review. It is therefore disappointing that this topic was not raised earlier in the IM review process such as in the emerging issues phase of the process.

3. Also disappointing is that such a fundamental change to the IMs is not supported by any expert analysis. Especially since we are not aware of a cost of debt wash up mechanism, such as the Commission is proposing, being in place in any other jurisdiction.

4. From the submissions on the topic, it is clear that *only* the Commission supports the introduction of this new cost of debt wash-up mechanism. All submitters have found issues with aspects of the wash-up that is being proposed. We consider this is not surprising given it has been "rushed" in by the Commission. This is further supported by the fact that the Commission has already had to make changes to what it proposed in the draft decision.

5. Given the significant impacts on revenue volatility, which could lead to financeability issues for suppliers, we urge the Commission to adopt more well-established ways of addressing inflation forecasting errors such as the one the Commission has already implemented for Transpower i.e. un-indexing the regulatory asset base (RAB). Transpower's un-indexing approach has been

in place for over ten years, therefore any technical and implementation issues will have been well "ironed" out. The same cannot be said for the proposed cost of debt wash up. We also question why the Commission has not, in proposing the cost of debt wash-up mechanism, explained how it is materially better than what it has previously implemented for Transpower in dealing with the issue of inflation forecasting errors and the debt compensation issue.

6. We support the remarks of Electricity Networks Aotearoa (ENA):

   "As noted by ENA in past submissions there are alternative means of addressing the inflation forecast risks tied to the cost of debt. These mechanisms tackle the root cause of the volatility rather than simply masking its impact via the proposed smoothing mechanism."

7. Vector insists that the best way to remove the inflation forecast risk is to remove the requirement to forecast inflation. 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.

8. John McDermott, previous Assistant Governor at the Reserve Bank of New Zealand: Te Pūtea Matua, now executive director at Motu, laid this out in a memo[1] in July 2023 in response to the Commission's IM Review draft decisions:

   "Forecasting inflation, even a few months ahead, is challenging. Knowing where inflation will be over the next five years is immense. The problem is particularly acute now. The existing long-term inflation risks are influenced by some large and persistent secular forces whose impact on inflation is very uncertain, if not unknowable."

9. He recommended that:

   "Rather than use the Reserve Bank forecasts, a more valid regulatory approach would be to remove the inflation uncertainty altogether. The first best option is to stop indexing of RAB to forecast inflation and leave the RAB not linked to any inflation forecast. Such a change would remove a great deal of unnecessary uncertainty from the process, improving future incentives for investment."

10. We agree with Alpine:

    "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."

[1] Vector commissioned report by Motu, *July 2023 Memorandum on inflation forecasting*, submission on IM Review draft decisions, 19th July 2023

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11. Supplier financeability could be one unintended consequence of the proposed wash-up as it puts an adjustment to a non-cash item through cash. The wash-up in simple terms takes the difference between the Commission's forecast revaluation of the debt funded portion of the RAB and the same revaluation using the outturn inflation, through revenue[2]. The revaluations are non-cash however the Commission is putting the adjustment through revenue, that is cash. Therefore, if outturn inflation is significantly higher than what the Commission forecast suppliers will see a significant downward adjustment to future revenues. This could lead to a supplier facing financeability challenges, as that revenue shortfall will require additional borrowings. Depending on how a supplier is tracking against its financing metrics these unexpected borrowings may not be able to be made. The Commission has forewarned it will issue a paper on financeability as part of its electricity default price-quality path (DPP4) reset process. If the Commission proceeds with its proposed cost of debt wash-up, we will be interested to see how the Commission intends to assess financeability where a supplier could experience significant revenue volatility due the cost of debt wash-up over all periods of the next DPP period.

12. One aspect of the regime we do not believe the Commission has considered is how the wash-up will work with re-openers. We question how the Commission sees this mechanism working if an EDB applies for an unforeseen major project midway through the regulatory period. That EDB would not have hedged their debt for that unforeseen expenditure at the beginning of the regulatory period which is a fundamental assumption underpinning the cost of debt wash-up proposal. As we have previously highlighted even if a supplier could hedge its entire forecasted capital expenditure programme at the beginning of the regulatory period (and that is a big if), any increases in the capital expenditure programme would need to be funded at prevailing rates.

13. Chorus raises a similar point to Vector on the Commission's assumptions around suppliers fixing their debt costs for regulatory periods. They outline the following:

    "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."

14. Vector agrees with Chorus on the above and the characteristics described in paragraph 7 of their submission illustrating the realities of the Commission's hedging assumptions.

[2] In the further consultation paper, the Commission indicates that the cost of debt wash-up mechanism adjusts for revenue windfalls received by EDBs. The report, submitted by CEG in response, explains why this is an invalid assumption.

15. We also question if, in effect, the Commission is mandating how an EDB manages its debt portfolio as the debt wash-up mechanism could effectively punish an EDB that chose a different hedging strategy to that assumed by the Commission. It goes against prudent treasury management practice to force firms into fixing 100% of their total debt for the five-year regulatory period.

16. Chorus has a solution for bypassing this issue though:

    "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."

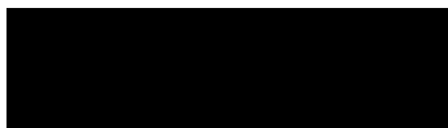
17. We see this could be a way forward *if* the Commission's proposed wash-up mechanism is introduced unchanged. However, as we have set out in this and previous submissions, and is also set out in CEG's report, there are materially better approaches than that being proposed by the Commission.

18. Finally, we note that this wash-up mechanism does not apply to Transpower or GDBs. Transpower points out that:

    "[…] the Commission does not specifically consider this an IM issue for Transpower because it could instead be provided for in Transpower's IPP determination. However, its final decision is likely to set a precedent."

19. We do not consider that the Commission has shown how the existing regimes for GDBs and Transpower have an equivalence to what is being proposed by the debt cost wash-up mechanism for EDBs and GTBs.

Yours Sincerely
For and On Behalf of Vector Limited



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