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Commerce Commission New Zealand
Te Komihana Tehokohoko
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Tēnā koutou

DRAFT INPUT METHODOLOGIES DECISIONS 2023: COST OF DEBT WASH-UP CONSULTATION

1. Unison Networks Ltd (Unison), submitted on the Draft Input Methodologies (IM) Decisions.[1] On 29 September 2023, the Commission invited submissions on the proposed amendments to the cost of debt wash-up mechanism (COD wash-up) to:
   a) use the most up-to-date CPI information (actual and forecast) when determining forecast net allowable revenue at the start of each disclosure year; and
   b) smooth the accumulation of the cost of debt wash-up.

2. This cross submission refers to Unison's 19 July 2023 submission as relevant, and Competition Economists Group's, Dr Tom Hird's conclusions.[2] **Appendix One** details support for key points in the targeted submissions provided. There is no confidential information and Unison acknowledges it will be published on the website.

3. Unison's key feedback is that CEG's report demonstrates that:
   a) the amendments **do not resolve the fundamental issues** associated with the COD wash-up in the Draft IM Decision;
   b) if it is retained, there is a **materially better mechanism to achieving the Part 4 outcomes** of the Commerce Act 1986 (Act) – CEG's amended blended CPI model; and
   c) in contrast to their policy intent, the **Commission is increasing their tolerance of the risk of underinvestment**.

4. The materially worse Part 4 outcomes (compared to the status quo) include:
   a) price volatility for consumers and retailers - reduced by the proposed amendments but not resolved; and
   b) subsequent adverse impacts on distributors of:
      i) significantly uncertain revenue (contrary to s 52R of the Act);

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[1] Unison's submission on the Draft IM Decisions, 17 July 2023: https://comcom.govt.nz/__data/assets/pdf_file/0018/323811/Unison-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf.
[2] Commissioned by the six largest electricity distributors: Vector, PowerCo, Orion, Wellington Electricity, Unison and Aurora, and submitted to the Commission on 17 October 2023.

ii) an unjustified need to retain sufficient headroom to finance large debt requirements for lengthy periods where the COD wash-up significantly reduces revenue (and cashflows) – maintaining this degree of headroom conflicts with optimal debt gearing; and

iii) increased financeability constraints restricting investment, including in supporting consumers to electrify their energy use and improve resilience.

Compounding effect

5. CEG explains distributors are unable to hedge 100% of expected RAB growth and the COD wash-up compounds the material under-recovery of the actual cost of debt (highlighted by Vector in their submission). CEG concludes:[3]

"…there would also be significant economic costs and dislocation to EDB's capital management activities, cash-flows, and "financeability" if a revenue wash-up were pursued. ***These costs would not exist if the adjustment was solely to RAB indexation****."*

"…the Commission's preferred approach of solely adjusting revenues to offset unexpected RAB revaluation:

- *would* ***dramatically increase the complexity and cost of capital management at EDBs*** *(causing wild swings in debt raising requirements); and*
- *would be internally consistent with the IM's assumed debt management policy and, ultimately, with the assumption that EDBs have a fixed nominal cost of debt. That is,* ***the revenue adjustment mechanism*** *proposed to target a fixed nominal cost of debt* ***would itself cause EDBs to be unable to achieve a fixed nominal cost****."*

"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)."*
[Emphasis added]

6. CEG's conclusions demonstrate the Commission's further 'shifting of the dial' toward the risk of underinvestment.

[3] NZCC further consultation on using cost of debt revenue wash-ups to target a nominal return on debt, Dr Tom Hird, Competition Economists Group, October 2023, paras [3(d)], [58], and [82]: https://comcom.govt.nz/__data/assets/pdf_file/0019/331840/27Big-627-EDBs-CEG_-Targetting-a-nominal-cost-of-debt-Submission-on-specific-matters-for-the-IM-Review-2023-Cost-of-debt-17-October-2023.pdf

Why does the Commission have greater tolerance for the risk of underinvestment now?

7. It appears inconsistent with the Commission's policy intent to adopt greater tolerance for a risk of underinvestment in electricity lines services. The Commission in its Draft IM Decision topic paper *Financing and Investment* acknowledged:[4]

   "In an environment where suppliers of electricity lines services are expected to deliver large volumes of investments in this decade to meet New Zealand's emissions targets and transition our economy, it is important that the pace of network growth broadly matches consumers' demand for electricity lines services."

8. More recently, Commissioner Vhari McWha released a statement:[5]

   "Resilience has never been more important, given that New Zealand is becoming more and more reliant on our renewable energy to power our lives and livelihoods,…"

9. To promote the Part 4 outcomes, it is unconstructive to compartmentalise each input methodology without considering the overall impact of the suite of decisions.[6] The Commission must put the COD wash-up with the proposed amendments in their full context and against the upcoming decade of critical investment in decarbonisation and resilience.

10. The Commission's greater tolerance for the risk of underinvestment is demonstrated in the Draft IM Decisions by the:
    a) continued indexation of Regulatory Asset Bases (RABs);
    b) lowered Weighted Average Cost of Capital (WACC) percentile from the 67th to the 65th and the approach to several components of the WACC;
    c) 'price limit' approach impacting the ability of large electricity businesses to *"earn sufficient revenue to cover their prudent and efficient costs"*;[7]
    d) exclusion of financeability and equity issuance tests (or methodologies otherwise providing certainty about how the Commission may resolve those legitimate constraints to investment);
    e) COD wash-up with proposed amendments that will undermine prudent and efficient capital management; and
    f) the continuation of financial penalties for exceeding allowances despite work relating to decarbonisation[8] or resilience.

[4] Pg 8, X8.
[5] https://comcom.govt.nz/news-and-media/media-releases/2023/cyclone-impacts-on-grid-highlights-importance-of-resilience-planning.
[6] Consistent with Alpine Energy's submission (see Appendix One).
[7] Frontier Economics, *A review of the limit on EDB price increases, prepare for the six largest electricity businesses*, 13 July 2023: https://comcom.govt.nz/__data/assets/pdf_file/0015/323106/27Big-627-EDBs-Frontier-Economics_-A-review-of-the-limit-on-EDB-price-increases-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf. CEG's report says at para [92]:
"I further note that the current IM's do not allow for a more than 10% increase in revenues from one year to the next. As a consequence, 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)."
[8] In respect of s 54Q, see below.

11. At a minimum, the Commission must clarify why it is willing to adopt greater tolerance for the risk of underinvestment in electricity lines services in this IM Review. This is despite its apparent policy intent to maintain a fair balance informed by the critical decarbonisation and resilience context facing distributors and their consumers.

The Act requires that distributors can invest in energy efficiency

12. As submitted on 19 July 2023, Unison considers that the Commission must provide incentives to invest, and avoid disincentives to invest, in energy efficiency, demand-side management and reducing energy losses. Section 54Q of the Act requires that the Part 4 outcomes are met within that statutory constraint.[9] As Unison has put to the Commission, energy efficiency in the Act must be interpreted in accordance with the definition in the Energy Efficiency and Conservation Act 2000:[10]

> *Energy efficiency means a change to energy use that results in an increase in net benefits per unit of energy.*

13. **It remains unclear to Unison how the Commission is providing a regulatory environment that will enable distributors to invest in energy efficiency** (viewed appropriately as electrification of Aotearoa for the accepted net benefits of emissions reduction to society), **demand-side management**,[11] **and**, as recently emphasised by the Commission, **resilience, at the pace and scale that "broadly matches"[12] consumer demand**. The COD wash-up and full suite of Draft IM Decisions must be re-considered with that in mind.

Nāku noa, nā

Rachael Balasingam

REGULATORY MANAGER

[redacted]

[9] Commerce Act 1987, s 54Q: *The Commission must promote incentives, and must avoid imposing disincentives, for suppliers of electricity lines services to invest in energy efficiency and demand side management, and to reduce energy losses, when applying this Part in relation to electricity lines services.*

[10] Unison's submission on the Draft IM Decisions, 19 July 2023, paras [31] to [36]: https://comcom.govt.nz/__data/assets/pdf_file/0018/323811/Unison-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf.

[11] And to reduce energy losses (s 54Q).

[12] *Financing and Investment Topic Paper, X8.*

Appendix One: Key points agreed with in submissions on the COD wash-up consultation paper released on 29 September 2023

Submitter	Key point
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.
Vector	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. 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.
	The Commission is making false assumptions on how EDBs fix their debt.
	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.
	There is a compounding impact where EDBs do not hedge 100% of expected RAB growth
	The Commission has not considered the interaction of the wash-up with the 10% limit on annual price increases (or revenue cap / smoothing)
	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.
	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.
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.
	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.
Chorus	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. 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.
	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;
Transpower	The Commission has, in all scenarios, applied a method of indexation that is not consistent with its Input Methodologies, rather is has applied a methodology consistent with the approach used by the AER (where depreciation of the RAB has been calculated on the opening RAB after adding the revaluation amount). We consider the methodology the Commission has applied is more intuitive than the approach from complying with the IMs.
	Should the Commission introduce an adjustment for the cost of debt, we support its decision to smooth this adjustment over five years, noting the significant volatility and financeability concerns that might exist in periods of high inflation.