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Infrastructure Branch
Commerce Commission
By email: infrastructure.regulation@comcom.govt.nz

Tēnā koe,

## Improvement in customer outcomes by reducing WACC volatility should outweigh the administrative burden of changing approaches

Powerco welcomes the opportunity to respond to the Commerce Commission's (**Commission's**) draft decision on the Common Cost of Capital Input Methodologies (**IM**) Review. As one of Aotearoa's largest gas and electricity distributors, we believe an appropriate cost of capital methodology is fundamental to enabling and incentivising the investment required for customer reliability and industry decarbonisation.

Our submission focuses on ensuring that the final IM settings deliver better outcomes for consumers by reducing volatility and providing sufficient incentives for infrastructure investment. While we acknowledge the Commission's draft view that the current IM is largely fit for purpose, we believe there are critical areas where the methodology must evolve to meet the challenges of electricity supply and the energy transition.

Our views are set out in the attached comments, and our response is also informed by Electricity Networks Aotearoa (**ENA**) and external advice from NERA for the ENA, and Competition Economist Group (**CEG**) commissioned by the Big 6 electricity distributors. Our summary views are:

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| **Smoothing supports investment incentives and consumer outcomes** | • Stable regulatory settings support the Commission's purpose under section 52 of the Commerce Act<br>• Trailing average weighted average cost of capital delivers a more stable, less volatile outcome for both investors and consumers, giving regulated firms greater confidence in their forecasts<br>• Both NERA and CEG's analysis demonstrate that a trailing average cost of debt (**TACD**) is better for investment efficiency than the status quo. |
| **Commission's analysis on revenue smoothing needs revision** | • We question the Commission's conclusion that existing smoothing mechanisms are adequate because it ignores the post-smoothing effects of trailing average approaches, under which significantly less revenue would need to be smoothed<br>• With a 10 year or 5 year TACD approach, customers would have paid a 27% or 36% increase over DPP4 whereas under the prevailing approach customers bear the full 45% increase, merely deferred over time and increased by the time value of money<br>• TACD in conjunction with alternative smoothing tools would have limited the costs and uncertainty of revenue volatility. |

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| **Administrative burden can be overcome** | • While there is some administrative burden to setting this up and designing the transition approach, there is enough precedence to draw on to ensure the complexity and administrative burden is low<br>• Annual updates of revenue would just become part of the existing annual processes we perform, with minimal administrative burden and keeps it live as opposed to a once-every-5-year exercise. |

This submission does not contain any confidential information and may be published in full. If you would like to discuss any aspects of this submission, please contact Emma Wilson (Emma.Wilson@powerco.co.nz).

Nāku noa, nā,

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# Powerco comments - Common Cost of Capital Input Methodologies

## Cost of debt methodology

A major point of feedback across the sector has been the need to smooth price changes by adopting a 'trailing average' approach to the risk-free rate component of the cost of debt. Powerco endorses updating the methodology to a trailing average approach and the reasons we consider this approach will deliver the best outcomes for both investment and customers is set out below.

We understand the role of the Weighted Average Cost of Capital (**WACC**) is not to smooth revenues, but rather to promote the appropriate incentives to invest in the network while limiting the ability of the regulated suppliers to extract excessive profits, the smoothing of revenues is an additional benefit that it delivers on top of its core purpose. However, what matters for incentives to invest is stable regulatory settings, with the trailing average approach delivering a more stable, less volatile outcomes for both investors and customers giving regulated firms greater confidence in their forecasts.

The Commission's methodology for estimating the cost of capital is well established and suppliers regulated under Part 4 and Part 6 of the Commerce Act have raised significant capital and invested in the supply of regulated services. Given this, we support the cautious approach to regulatory change, in particular around such a critical piece of the regulatory framework and commend the Commission for its careful consideration of the cost and complexity associated with this regulatory change. We have been advocating for this same level of caution in other regulatory contexts. However, we still believe there are clear benefits to customers to justify this change and that the implementation complexities are manageable.

### Trailing average cost of debt (**TACD**) benefits customers

Historically, the economic components used to set the WACC have been relatively stable. However, in recent years we have observed large swings in both DPP3 and DPP4 resets, with the DPP4 reset resulting in substantial increase to prices for customers.

The Commission uses Vector to demonstrate the effect on revenues from the different options,[1] with the conclusion that they were able to achieve a lower price change of 25% through alternative smoothing tools.

We question this conclusion, because it ignores the post-smoothing effects of the TACD approach in which the Commission could have achieved the 25% lower price change with the combination of TACD and alternative smoothing tools as well.

As Electricity Networks Aotearoa (**ENA**) and NERA point out, existing in-period smoothing tools merely reprofile revenue; they do not smooth the underlying cost input. Under the current approach, customers still pay the full 45% underlying increase; it is simply shifted from the first year and smoothed across the 5-year period, meaning customers are also paying for the time value of money adjustment.

[1] Commerce Commission, *Common cost of capital input methodologies review (fibre and regulated suppliers under Part 4) Draft decision, 10 March 2026*, table X1.

NERA's analysis quantifies this: to achieve a similar initial price shock (37%) at the start of DPP4 using an 8% alternative X-factor, the current approach requires allowable revenue to rise by 101% by the end of DPP4. In contrast, under a 10-year TACD, revenue rises by only 53% by the end of the period. This demonstrates that during periods of rising interest rates, the Commission's smoothing mechanisms simply delay price increases causing much higher price increases later in the regulatory period.

The TACD approach (either 5 or 10 year) in conjunction with alternative smoothing tools could have delivered significantly better outcomes for customers, as they wouldn't have faced such big revenue increases, and as a result are less likely to change consumption patterns which would create unnecessary uncertainty in demand forecasts for investment.

### Consumer price volatility is inefficient and unnecessary

Relying on a spot risk-free rate produces volatile outcomes that expose consumers to unnecessary risk. NERA highlights that under the current approach, the cost of debt allowance and the resulting price shock are highly sensitive to the exact start date of the regulatory period.

Fundamentally, the choice between the current approach and a trailing average is a question of appropriate risk allocation. The Commission's own risk allocation principle states that risks should be allocated to those best placed to manage them. Currently, consumers ultimately bear the interest rate pricing risk, yet they have no means to mitigate the interest rate component of their electricity bills. A trailing average approach shifts this re-pricing risk to regulated suppliers, who are better placed to manage it through staggered debt issuance.

### Investment efficiency and accuracy of the cost of debt

The Commission's draft decision expresses concern that a TACD could result in poor investment incentives if interest rates rise concurrently with a material uplift in capex. NERA notes that these concerns can be effectively addressed by implementing a weighted trailing average (**WTA**) or by using a transition mechanism (like the one adopted by the Australian Energy Regulator) that places a high weight on prevailing rates during the initial years of the transition.

Furthermore, the Commission suggests that a 10-year TACD might lead to excess profits because 10-year rates are generally higher than 5-year rates. NERA points out that this gap is not a "rent" that suppliers can obtain without cost or risk; rather, the term premium represents efficient compensation for transferring re-pricing risk to the purchasers of the debt.

## Administrative burden is minimal

The Commission notes there is an administration burden to changing the approach.[2] While we agree, we don't consider this to be material. For example, updating revenues within period and annual updates for the cost of debt, would mean regulated business are doing these processes / running these models more frequently, compared to once every 5 years, so it becomes baked into business processes, and knowledge is maintained.

We also agree with the Commission that an appropriate transitional arrangement will be required to limit the potential for any windfall gains or losses arising from the change. We are of the view that ensuring any transitional arrangement has a long enough lead-in period and allows regulated suppliers flexibility to manage the risk appropriately to suit individual circumstances should avoid any unintended consequences. A workshop could effectively work through this in more detail, given the approach to any transitional arrangements depends on the design of the trailing average and regulated suppliers existing debt arrangements.

NERA note that many other regulators with similar regimes apply trailing averages, meaning the Commission is not solving a novel problem and can draw on established regulatory precedents. Once the design decisions are made, the ongoing application of a trailing average is relatively mechanical.

There is also potential to reduce debt administration with TACD which we outline in the following section.

## Treasury implications – Powerco's existing debt arrangements

The Commission's concern that a 5-year TACD cannot be effectively hedged relies on an assumption about how interest rate swaps are used in practice. As CEG outlines, an EDB does not need a single financial instrument that perfectly hedges to an average of previous rates. Hedging a 5-year TACD is practically identical to hedging the status quo: an EDB issues debt, converts it to a floating rate portfolio using swaps, and then fixes 20% of that underlying portfolio for 5 years every year. Issuing 10-year debt and hedging a 5-year TACD is mechanically the same as issuing 10-year debt and hedging the status quo hybrid approach.

Under the current approach, Powerco currently hedges up to 100% of our core debt during the 3-month observation window, along with a forecast growth in debt over that time – that's hedging almost 6 years out. This means there is a lot of reliance on our forecast and a lot of volume in the market, as all other EDBs (who hedge) will be trying to hedge all their debt at the same time. In 2024 Powerco hedged around $2 billion, which needed to be absorbed over 63 days. However, under the trailing average approach the amount to be hedged each year could be reduced, significantly reducing the administrative burden. Additionally, this would give EDBs/GPBs more regular opportunities to review hedging levels and align these to actual debt levels, rather than relying on debt forecasts for five years.

We believe the trailing average approach would more closely mirror the efficient debt management practices of firms in a workably competitive market, by more closely aligning regulatory allowances and actual debt costs, ultimately benefiting customers through more stable pricing. This is because the trailing average approach allows

[2] Commerce Commission, *Common cost of capital input methodologies review (fibre and regulated suppliers under Part 4) Draft decision, 10 March 2026*, pg 55-56.

for more flexibility to better manage interest rate risks, by for example hedging smaller amounts such as 20% of our debt each year, is more efficient that hedging 100% of debt every 5 years.

## Tax Adjusted Market Risk Premium (TAMRP) and the cost of equity

We welcome the Commission's draft decision to amend the cost of capital IM relating to the TAMRP by removing weight from the Survey method and Dividend Growth Model and relying instead on ex-post averaging estimates.

However, we note that the Commission's draft approach proposes giving equal weighting to the Ibbotson, Siegel 1, and Siegel 2 methods. Because the Ibbotson and Siegel 1 methods assume a relatively fixed market risk premium (MRP), they pass through 100% of the volatility of the spot risk-free rate into the allowed cost of equity. As a result, the cost of equity remains highly volatile under the Commission's proposed hybrid calculation.

CEG highlight that the Siegel 2/Total Market Return (**TMR**) approach assumes the overall market return is stable, meaning the allowed MRP naturally moves inversely to the risk-free rate. With an equity beta of 0.61, the Siegel 2 approach passes through only 39% of the volatility in risk-free rates. They argue that following standard UK regulatory practice by placing primary reliance on the TMR/Siegel 2 methodology would address the between-period WACC volatility that exposes consumers to price shocks and may deter investment.

A large part of the volatility between DPP3 and DPP4 revenues was driven by the Commission's return on equity methodology. CEG's modelling shows that adopting a 10-year TACD alongside placing 100% weight on the Siegel 2 method would have more than halved the DPP4 revenue increase, dropping it from 44.9% to just 19.2%.

## Summary

Improving customer outcomes by reducing WACC volatility outweighs the administrative burden of changing approaches. By adopting a TACD and placing greater weight on the TMR approach for equity, the Commission would deliver a more accurate, stable regulatory framework that properly allocates risk, incentivises investment, and protects consumers from inter-period step-changes in revenue.