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Tēnā koutou

IM REVIEW COST OF CAPITAL IM DRAFT DECISION PAPER SUBMISSION

Unison Networks Limited (Unison) and Centralines Limited (Centralines) are consumer-owned electricity distribution businesses serving communities in Hawke's Bay, Taupō, Rotorua, and Central Hawke's Bay. We appreciate the Commission's robust framework for cost-of-capital input methodologies and support its objectives of efficient investment, appropriate risk allocation and regulatory certainty. While we support these aims, our submission focuses on ensuring that the mechanisms used to implement them in the cost-of-debt setting fully give effect to the underlying principles in practice.

As consumer-owned entities, we operate in the best interests of the communities we serve. Guided by our vision, and values, we strive to deliver economic benefits to both our customers and community shareholders, while championing a sustainable energy future. We are committed to maintaining the right balance between keeping electricity affordable and making strategic investments that secure the long-term reliability and resilience of our network. In all aspects of our operations, we place strong emphasis on meeting industry compliance requirements, ensuring we uphold all relevant standards. This approach not only supports New Zealand's transition to new energy solutions but also enables our communities to access cleaner, smarter, and more flexible energy options, now and for generations to come.

We support the conceptual soundness of the Commission's forward-looking cost-of-capital framework and its focus on NPV neutrality. Our submission is provided with the aim of ensuring these principles are fully realised in practice: that the cost of capital reflects the opportunity cost of debt and that regulated entities earn normal returns over time.

A trailing average cost of debt (TACD) is more than a smoothing device: it reallocates interest-rate repricing risk to the party best placed to manage it, consistent with Part 4 principles. However, while we support these principles, the way the TACD mechanism has been engineered means they are not fully delivered in practice.

A well-designed TACD better realises these principles by aligning allowances with how regulated entities finance their operations.

However, the current implementation does not fully reflect real-world financing behaviour. Some aspects of the cost-of-debt modelling diverge from market practice. While we support the overall direction of the draft decision, targeted refinements would better align the methodology with how debt is raised and managed, improving stability for consumers and regulated entities without undermining the core principles

EXECUTIVE SUMMARY

Unison and Centralines support the Commission's cost-of-capital framework and its objectives of efficient investment, appropriate risk allocation and long-term consumer benefit. We agree the cost of debt should reflect its opportunity cost and that regulated entities should earn normal returns. Our comments are directed at how these methodologies are delivered in practice through the specification of the cost of debt Input Methodologies (IM)

Our concern is whether the current "hybrid" cost of debt methodology fully gives effect to those principles. Although conceptually sound, blending a point-in-time risk-free rate with a trailing average debt risk premium produces sharp step changes at regulatory resets. These outcomes stem from the design of the mechanism rather than from how regulated entities incur debt costs. The issue is one of implementation, not principle.

We identify two distinct benefits from adopting a trailing average cost of debt. First, as recognised in the draft decision, a TACD offers materially superior revenue smoothing properties compared with the status quo across a plausible range of interest rate environments. Second, contrary to the draft decision's conclusions, the status quo hybrid approach is a less accurate proxy for the prevailing cost of debt than either a 5-year or 10-year TACD and therefore has weaker investment efficiency properties.

Independent analysis commissioned by the Big 6 reinforces this, concluding that the hybrid approach understates between-period volatility and performs less well as a proxy for prevailing financing costs and that reliance on within-period smoothing mechanisms does not address the underlying source of reset-driven volatility.

The draft decision places significant weight on discretionary within-DPP smoothing tools to manage volatility under the status quo. However, as these tools can be applied under either methodology, comparisons between a smoothed status quo and an unsmoothed TACD do not inform which underlying cost of debt methodology better supports efficient financing and investment incentives. Reliance on ex post smoothing also introduces uncertainty over future revenue paths, which can distort financing and investment decisions.

For these reasons, we encourage the Commission to revisit its assessment of TACD methodologies before finalising its position, including through further analysis or trialling under more realistic assumptions, and consideration of approaches that embed greater stability and certainty within the IMs themselves.

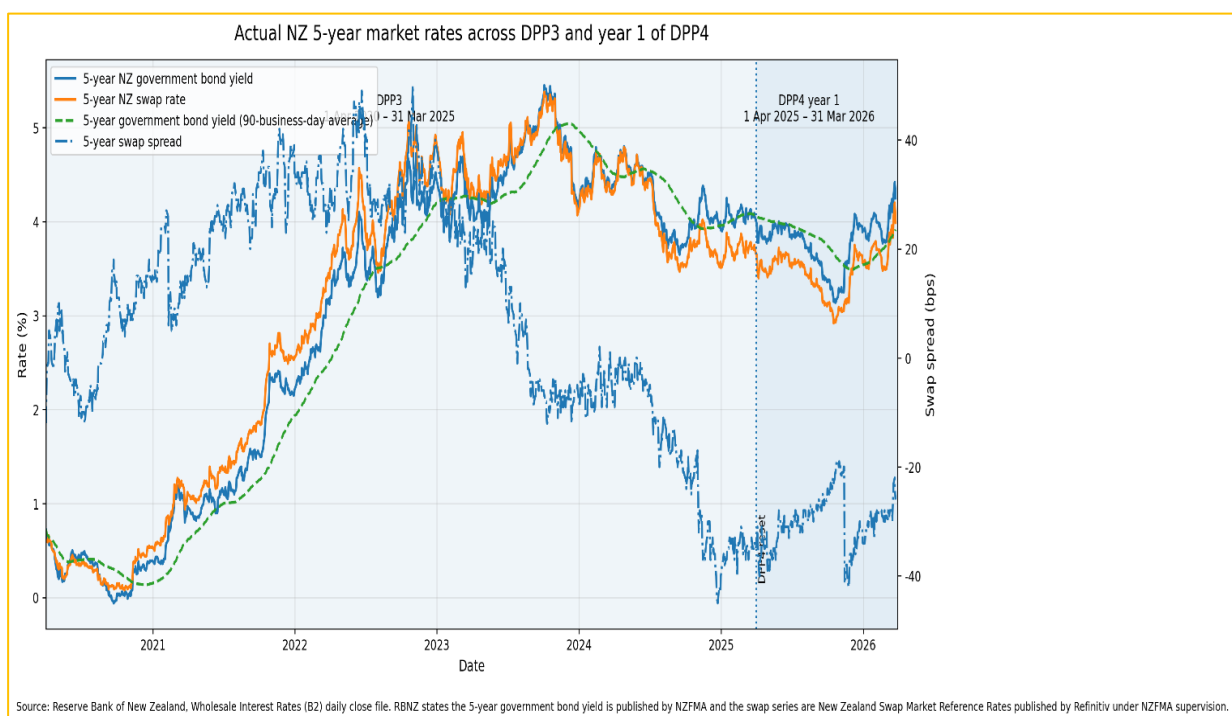
This submission should be read in alongside:

- the expert report on Economic Assessment of TACD a report for the Big 6 EDB's from CEG

REAL-WORLD FINANCING VS. THE CURRENT HYBRID APPROACH

To set up the practical discussion that follows, it is useful to consider how regulated entities finance their activities in practice. Regulated entities typically use portfolio debt structures, issuing and refinancing incrementally over time and managing credit spread risk and base interest rate risk separately. As a result, financing costs generally evolve gradually rather than changing abruptly.

Figure 1: Actual NZ 5-year market rates across DPP3 and year 1 of DPP4¹



The current hybrid approach does not reflect this reality. Anchoring the risk-free rate to a point-in-time observation at regulatory resets concentrates base interest rate exposure into a narrow and predictable window. The design therefore creates incentives for “hedge-to-the-reset” strategies, a rational response to the regulatory settings but a departure from normal treasury practice and can amplify volatility in New Zealand’s relatively small interest-rate hedging market when large issuers act simultaneously.

A trailing average cost of debt operates differently. By smoothing interest rates over a multi-year period, it mirrors how portfolio debt costs adjust as existing debt matures and new debt is issued. Financing costs therefore flow through progressively, avoiding cliff-edge movements in allowed revenues at regulatory resets.

¹ Source: Reserve Bank of New Zealand Wholesale Interest Rates (B2) daily close file.

These differences have clear implications. For consumers, sharp step changes in allowed revenues can translate into sudden and unpredictable bill impacts; a trailing average spreads these effects over time and supports smoother price paths. For regulated entities, the hybrid approach can result in a persistent mismatch between allowed revenues and actual financing costs. Addressing that mismatch may require additional hedging activity around resets or acceptance of under- or over-recovery, which can undermine investment confidence.

More broadly, uncertainty over how debt costs will be recovered across periods affects not only financing behaviour but also investment decision-making. Where future revenue paths depend on discretionary smoothing outcomes rather than being inherent in the methodology, regulated entities may defer, stage, or reprioritise investments in ways that are less efficient over the long term. These effects are relevant to assessing whether the cost of debt IMs deliver appropriate investment incentives consistent with Part 4 objectives.

Analysis supports these conclusions, showing that the hybrid approach overstates between-period volatility and is less effective at tracking actual borrowing costs, particularly during periods of rapid interest rate change. By contrast, trailing average approaches better reflect real-world financing behaviour and deliver smoother revenue and price outcomes without affecting long-term revenue recovery.

SUMMARY OF KEY MODELLING ASSUMPTIONS AND IMPLICATIONS FOR TACD

Modelling assumption	Effect in the Commission's model	Implication for assessing TACD
Perfect alignment between allowed WACC and actual financing costs	Assumes regulated entities can instantaneously align their debt portfolios with the allowed cost of debt, eliminating any timing or mismatch risk. Actual financing volatility is therefore not observed in the model.	Removes the primary real-world problem TACD is designed to address. By assuming away allowance–actual mismatches, the model understates both volatility under the hybrid approach and the stabilising benefit of a trailing average.
Focus on total revenue (NPV) rather than year-by-year price paths	Shows broadly identical long-run revenue outcomes across methods, diluting visibility of reset-year price jumps and inter-period volatility.	Conflates “same NPV” with “same consumer outcome”. TACD’s value lies in smoothing the timing of revenue recovery and prices, which is not captured by period-aggregate revenue metrics.
Effectiveness of external smoothing tools is assumed	Once wash-ups and explicit price smoothing are layered on, differences between TACD and status quo are reduced in the model.	Treats discretionary, ex post interventions as a substitute for a stable cost-of-debt methodology. Where the use and extent of smoothing is uncertain until reset, this introduces uncertainty over forward revenue paths, which can distort financing and investment decisions and reduce efficiency relative to embedding stability directly within the IMs.
Static risk-free rate (RFR) during the prior period	Fixes the RFR at a constant level, flattening the modelled TACD path and deferring most movement to the reset year.	Misrepresents how a true trailing average would operate. A correctly specified TACD would reflect rising rates earlier, increasing allowances gradually and materially reducing the reset-year shock.
Fixed historical debt risk premium (DRP)	Removes cyclical interaction between RFR and DRP, producing an artificially smooth prior-period allowance and a steeper reset step change.	Further distorts the TACD profile, making it appear more volatile than it would be with dynamic inputs. This bias results against TACD relative to the hybrid approach.
Representative EDB abstraction (single-firm model)	Masks heterogeneity in debt maturity profiles, refinancing timing, and exposure to interest rate cycles across EDBs.	Understates portfolio and timing risks faced by actual firms, again downplaying the benefits of a trailing average that aligns allowances with multi-year debt portfolios.

BENEFITS OF A 5-YEAR TRAILING AVERAGE COST OF DEBT

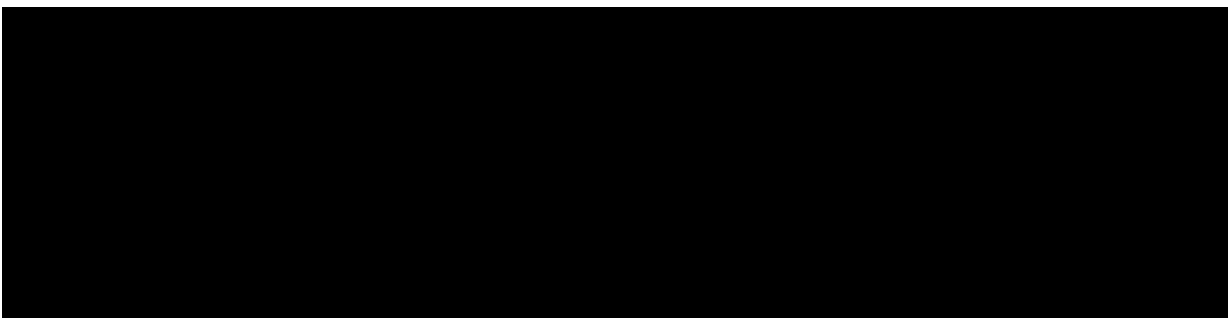
Since publication of the draft decision, independent industry experts have examined the modelling underpinning the Commission's revenue-smoothing assessment in greater detail. The analysis found the modelling understates the volatility inherent in the current hybrid approach and overstates the extent to which within-period smoothing mitigates between-period price shocks. It concludes that trailing average cost of debt approaches consistently deliver materially smoother revenue outcomes and closer alignment with prevailing financing costs across a wide range of interest rate scenarios.

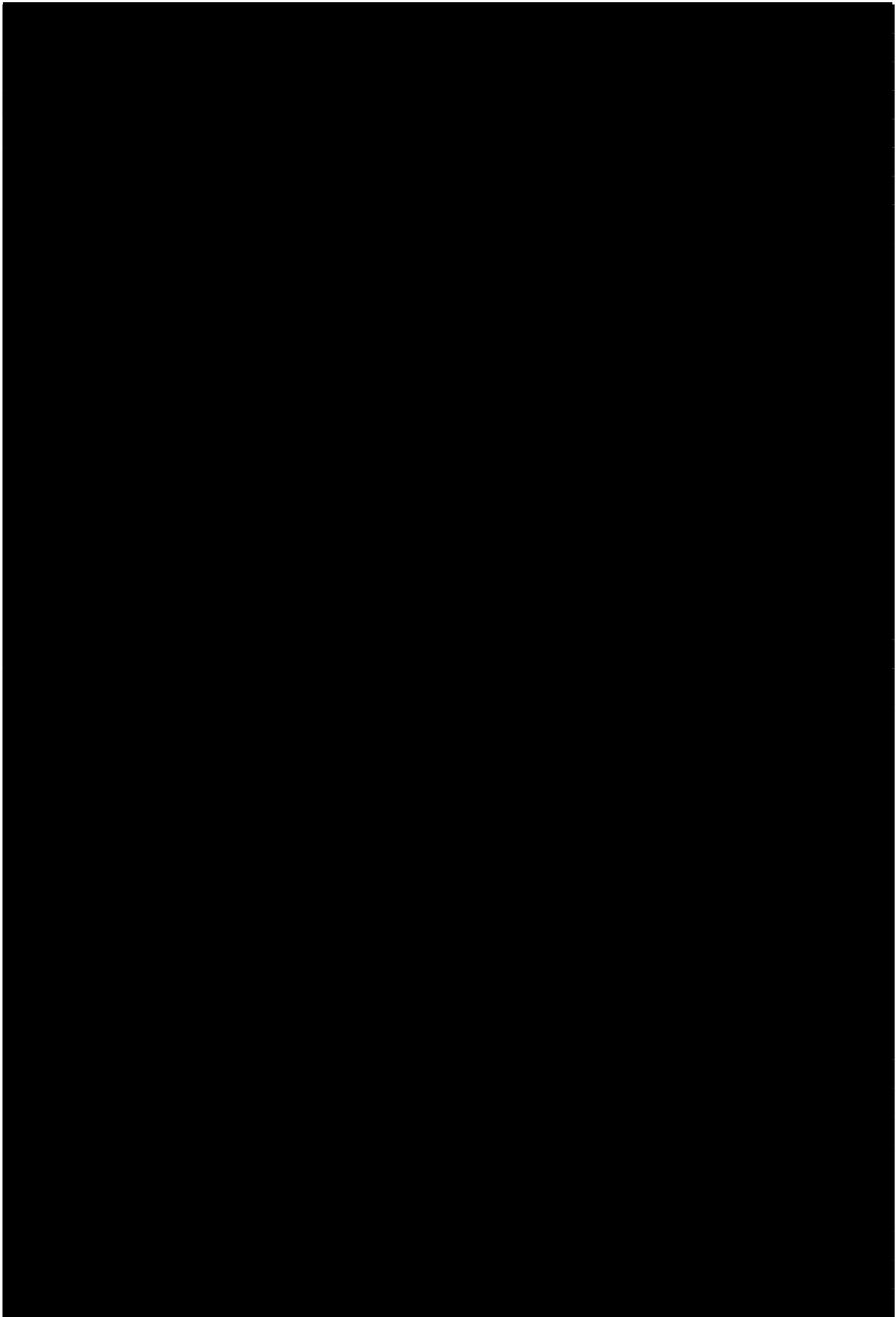
These findings reinforce the practical merits of adopting, or at a minimum enabling, a 5-year TACD within the IMs. A 5-year TACD smooths interest rate movements over time, materially reducing price volatility at regulatory resets. Under current arrangements, consumers are exposed to sharp price increases when interest rates rise between periods, as occurred ahead of the 2025 reset. A TACD would phase these impacts in gradually, supporting more predictable and stable price paths and reducing bill shock for consumers, while improving revenue certainty for regulated suppliers.

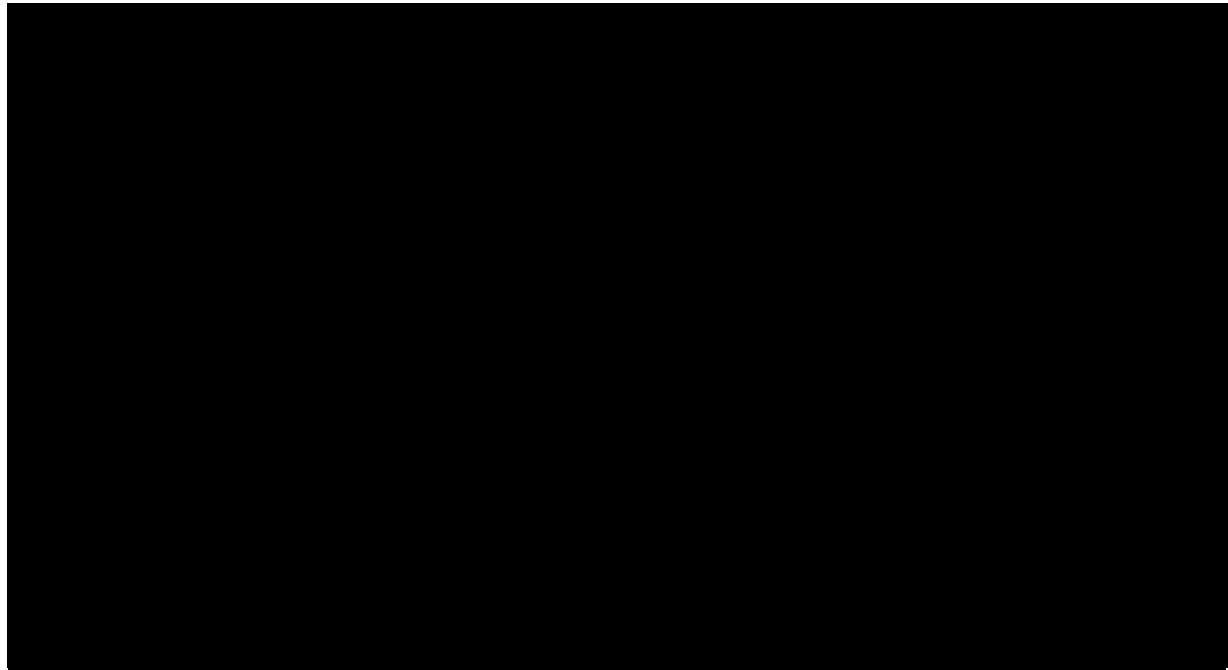
A trailing average also better reflects how regulated entities raise debt, through a portfolio issued over multiple years rather than at a single point in time. This allows allowed revenue to track actual financing costs more closely, reducing the risk of systematic under- or over-recovery when interest rates move sharply. In practice, this improves adherence to the NPV = 0 principle and reduces incentives for inefficient financing or hedging strategies driven by regulatory timing risk.

While this consultation does not extend to the cost of equity, sharp and unpredictable movements in prices driven by uncertainty over debt cost recovery can increase perceived regulatory risk more generally. Over time, this risk may be reflected in both financing behaviour and required returns. More predictable debt cost recovery through a trailing average approach would therefore support a more stable overall risk profile, without altering the Commission's treatment of equity directly.

Analysis indicates that a well-designed 5-year TACD would have delivered substantially lower volatility over the recent interest rate cycle. At the 2025–26 reset, the allowed cost of debt would have increased by around 13% under a 5-year TACD, compared with 93% under the status quo and around 64% under the Commission's TACD modelling, representing an approximate 80% reduction in volatility relative to current arrangements. Lower volatility supports more stable prices and revenue allowances, reduces investor risk, and over time can lower required returns, consistent with the Part 4 purpose.







ILLUSTRATIVE COMPARISON – ALLOWED COST OF DEBT AT THE DPP3 – DPP4 TRANSITION ²

The below summarises the relative accuracy of alternative cost-of-debt methodologies over DPP3, measured by the root-mean-square error (RMSE). Lower RMSE values indicate closer alignment with the prevailing cost of debt. The results show that the 10-year TACD is the most accurate, the status quo is the least accurate, and the 5-year TACD sits between them.

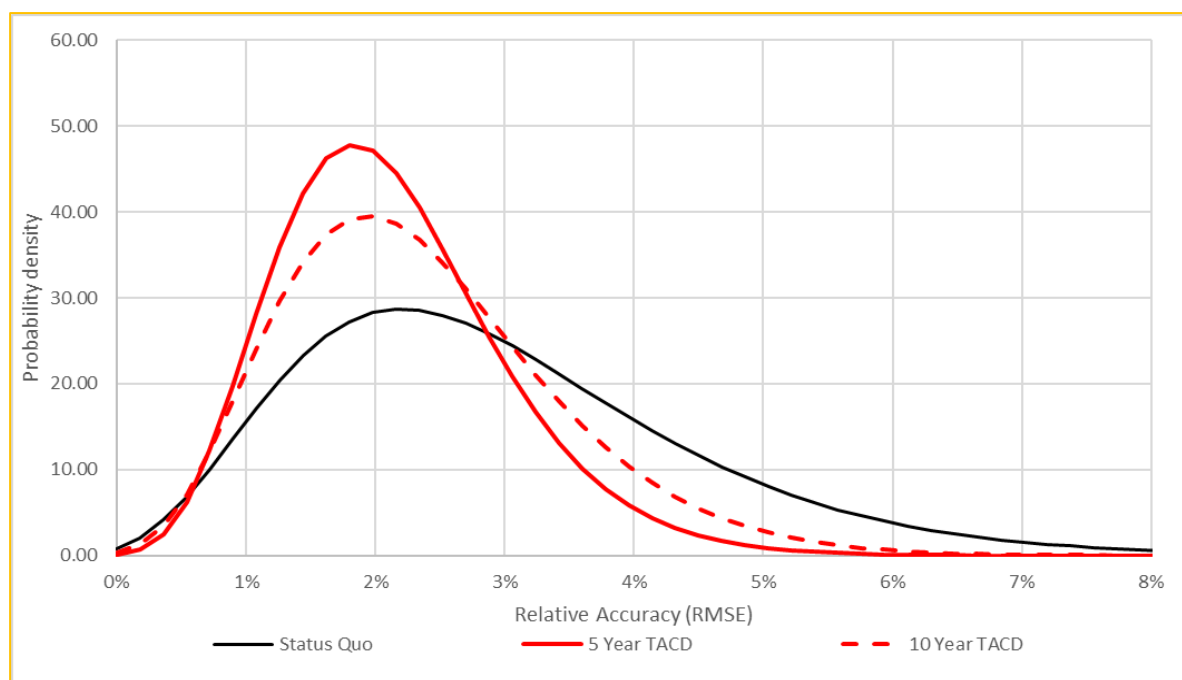
Table 1: Relative accuracy (RMSE) in compensating for the prevailing cost of debt over DPP3 (lower is more accurate)

Status Quo	5-year TACD	10-year TACD

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- ² the expert report on Economic Assessment of TACD a report for the Big 6 EDB's from CEG

Figure 4: Distribution of scenario RMSE

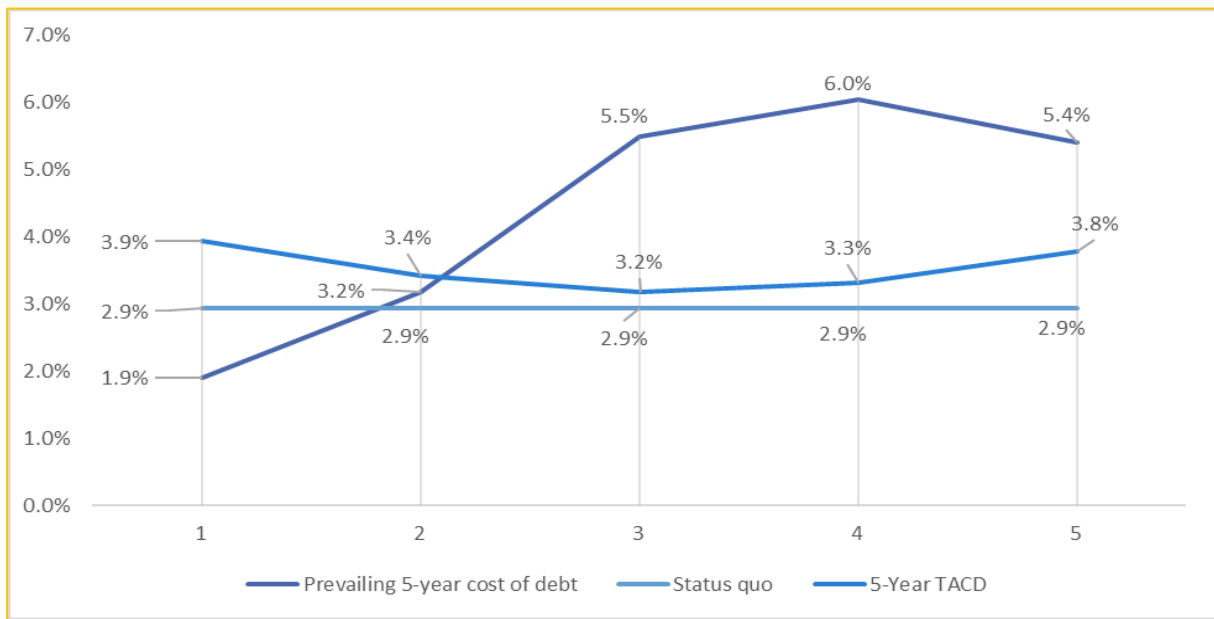
A curve that is tall, narrow, and concentrated toward the left (lower RMSE values) indicates a consistently accurate approach. A curve that is wide and extends further to the right indicates an approach that, in a meaningful number of scenarios, produces large compensation errors. As the figure 4 illustrates, the status quo approach displays a noticeably wider and more right-skewed distribution compared to the alternatives. This means that under the status quo, there is a greater proportion of scenarios in which the compensation provided departs significantly from the actual cost of debt — an outcome that exposes regulated businesses to material funding risk



The prevailing 5-year cost of debt at the start of DPP3 is estimated as the 5-year New Zealand Government Bond rate averaged over the 12 months to March 2021 (0.39%), plus the prevailing 5-year debt risk premium over the same period (1.32%), and the Commission’s allowance for debt-raising costs (0.20%).

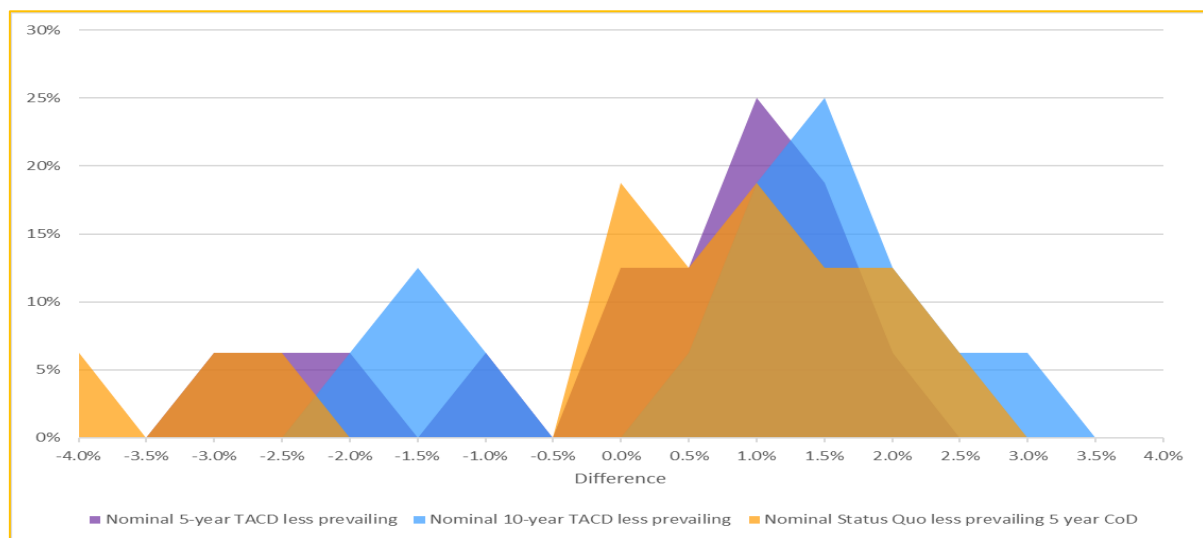
This is illustrated by charting the prevailing 5-year cost of debt against outcomes under the status quo and the 5-year TACD over DPP3. The 10-year TACD is not shown, as its accuracy is assessed relative to a 10-year prevailing cost of debt rather than a 5-year benchmark.

Figure 5: Prevailing 5-year cost of debt versus status quo and 5-year TACD over DPP3



The status quo has the largest outliers with 5% of years with an observation where the status quo cost of debt was 3.9% (most extreme left-hand side of the figure). The most extreme difference for the 10-year TACD was when the TACD was 3.0% more than the prevailing cost of debt (most extreme right-hand side of the figure). The most extreme difference for the 5-year TACD was when the TACD was 2.7% less than the prevailing cost of debt.

Figure 6: Distribution of differences between nominal estimated costs of debt and prevailing costs of debt



COMPLEXITY AND TRANSITION

We acknowledge that transitioning to a trailing average cost of debt would involve some complexity. However, we consider that the Commission's assessment places disproportionate weight on the administrative implications relative to the benefits generated by a trailing average approach.

While we acknowledge the Commission’s concern that a trailing average cost of debt would require some form of annual updating to revenue allowances, we consider the associated administrative effort to be outweighed by the benefits of improved alignment with actual financing practices and smoother price outcomes for consumers. A rolling cost-of-debt allowance would better reflect how debt is raised and managed in practice, improve hedge-ability to market conditions over time, and reduce the magnitude of step-changes at price path resets. In our view, these benefits, particularly greater predictability and affordability for consumers, justify the additional within-period adjustment, especially when compared to the scale of price shocks that can arise under a five-year static allowance.

SUGGESTED AREAS FOR FURTHER CONSIDERATION

Further Refinement of Modelling Assumptions

The Commission may wish to revisit aspects of its cost of debt smoothing analysis using assumptions that better reflect observed financing conditions. This could include allowing the risk-free rate and debt risk premium to vary over time, rather than holding these inputs constant, and testing sensitivity to imperfect alignment between allowed rates and actual portfolio debt costs. These refinements would help assess how effectively a trailing average embeds smoothing at source and the extent of volatility it mitigates in practice. Subject to resourcing, extending the analysis to multiple representative businesses or sector-wide data could further strengthen the assessment.

Exploration Of A 5-Year TACD Option or Pilot

The Commission could also consider enabling a 5-year TACD on an optional or exploratory basis in a future regulatory period. An optional or phased approach would allow implementation insights to be developed without requiring sector-wide adoption. Alternatively, a controlled pilot, such as shadow-running TACD outcomes alongside current settings, could provide practical evidence of impacts and build confidence over time, while preserving regulatory certainty.

CONCLUSION

In conclusion, we reaffirm our support for the Commission’s cost of capital framework and its focus on long-term consumer outcomes. While the methodologies are grounded in sound economic principles, the way the hybrid cost of debt approach has been designed and modelled leaves material practical benefits unrealised. Misalignment with real-world financing practices, the concentration of base interest rate risk at regulatory resets, and the body of evidence supporting trailing average approaches indicate that there is scope for refinement.

Our submission demonstrates that a well-designed 5-year trailing average cost of debt (TACD) would deliver four material benefits aligned with the Part 4 purpose. By embedding smoothing directly within the cost of debt methodology, a TACD would reduce reset-driven price shocks and support more predictable and affordable outcomes for consumers. It would also better align allowed revenues with real-world financing and

hedging practices, reducing incentives for reset-driven treasury behaviour and supporting more efficient risk management. Further, by allowing debt costs to mark progressively to market, a TACD would reduce the risk that volatility in allowed revenues is misinterpreted as equity risk, helping preserve appropriate return signals. Finally, increased certainty over revenue recovery would support more efficient investment decisions and strengthen confidence in the regulatory framework over time.

This is particularly relevant given the long financing horizons associated with regulated investments and the widespread use of portfolio-based, long-dated funding structures. Trailing average approaches are better suited to these conditions, as they smooth interest-rate impacts over time and reduce sensitivity to the timing of market conditions at regulatory resets. There is broad industry support for this view, with expert reports commissioned by Transpower, ENA, Chorus, and Vector, and supported by the Big 6, highlighting the advantages of a more origin-agnostic averaging approach.

Taken together, these benefits suggest that a 5-year TACD would strengthen the practical delivery of the Commission's cost of capital objectives by reducing unnecessary volatility, improving alignment with real-world financing behaviour, and supporting long-term consumer outcomes. We therefore encourage the Commission to revisit its assessment of trailing average cost of debt approaches before finalising its position. We also emphasise that a trailing average cost of debt is not intended to replace other existing smoothing mechanisms. This is not an "either/or" proposition. A TACD can operate alongside those mechanisms, reducing the extent to which they are required to manage volatility and improving the transparency and predictability of revenue paths and the prices ultimately faced by customers.

Unison and Centralines appreciate the opportunity to comment on the draft decision and remain committed to constructive engagement on regulatory settings that promote efficient investment, maintain service quality, and deliver long-term benefits to the communities we serve.

Parts of this published submission contains confidential information which has been redacted. We welcome engagement with the Commission and are happy to provide any additional information required, including further detail on operational considerations.

Nā māua noa, nā

Jason Larkin / Tarryn Butcher
GM Commercial and Regulatory / Regulatory Manager

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