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Dear Kirsty and Ben

IM review: cost of capital draft decision (fibre and regulated suppliers under Part 4)

1. This is Vector's cross-submission on the Commerce Commission's draft decision on the IM review: cost of capital draft decision (fibre and regulated suppliers under Part 4).
2. No part of this submission is confidential, and we are happy for it to be published on the Commission's website.
3. We have limited our cross-submission to the draft decision on the trailing average cost of debt (TACD).
4. We consider the evidence provided by submissions to the consultation should provide the Commission confidence that implementing a TACD will best support the long-term benefit of consumers over the retaining the status quo.

Widespread support for a TACD

5. There remains widespread support from submitters for the Commission to implement a TACD.
6. For example, Meridian submitted:

"Meridian's view is that, even if the potential impact is moderate, current pressures on consumers mean that the Commission should do all that it can to pursue measures that would help alleviate future price volatility, such as that which occurred at the start of DPP4 and in each subsequent year of DPP4. We therefore encourage the Commission to reconsider this change in making its final decision on the cost of capital IM.

While we acknowledge such a change may result in additional complexity, this is already a highly complex regulatory regime and both the Commission and regulated businesses are sophisticated enough to manage this complexity. The fact that

Electricity Networks Aotearoa (ENA) is one of the parties that has advocated for such a change provides a strong indication that regulated businesses are willing to trade off any additional complexity for the resulting consumer benefits. We also understand such an approach has been adopted in other jurisdictions including Australia and the United Kingdom, suggesting it is workable.

With regard to the Commission's point that other tools are available to smooth revenues, Meridian's view is that all available means should be utilised to manage the price volatility that consumers are experiencing. That is, adoption of a trailing average approach to the cost of debt calculation should be an 'and' and not an 'or'. Further, existing price smoothing tools appear to be more useful in smoothing price changes within DPP periods, while adopting a trailing average approach could also be useful in smoothing price changes between DPP periods. We would therefore view these mechanisms as being complementary rather than substitutes."

7. The breadth of support for a TACD reflects a shared concern from stakeholders that the current approaches can create unnecessary volatility. We consider the modelling by CEG (for the Big Six) and NERA (for the ENA, Transpower and Chorus) demonstrates a TACD has significant smoothing benefits.

The use of smoothing and a TACD could deliver greater consumer benefits

8. An important distinction is that a TACD would smooth the underlying cost rather than merely smoothing revenue to later in the period. This is explained in NERA's report and was raised by a number of submitters.
9. For example, the ENA submitted that:

"The Commission places reliance on its ability to smooth revenues using other tools. ENA considers that these tools do not address the core issue.

As demonstrated in the NERA report:

- *These mechanisms reprofile revenue, rather than smoothing the underlying cost input; and*
- *They can require higher prices later in the regulatory period, due to the time value of money applied to deferred revenues."*

10. In addition, submitters such as Powerco highlighted a TACD and revenue smoothing can work together to deliver greater customer benefits:

"The Commission uses Vector to demonstrate the effect on revenues from the different options, 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.

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."

Allocation of risk

11. Submitters also raised that the approach to the risk-free rate is also a question of risk allocation.
12. For example, Transpower submitted:

"However, independent analysis in NERA's assessment of the trailing average vs prevailing approach to the cost of debt confirms that the choice is fundamentally one of risk allocation, rather than simply a matter of revenue smoothing. While the Commission has concluded that the revenue impacts may be limited on average, stylised modelling indicates that, where interest rates move sharply, the prevailing approach can produce material between-period revenue step-changes and outcomes that are highly sensitive to reset timing. The analysis also highlights that existing smoothing tools reprofile revenue rather than moderating the underlying cost allowance, which can result in higher prices later within a regulatory period.

These findings reinforce our view that suppliers are better placed than consumers to manage debt pricing risk over time through established financing practices, such as through staggered issuance, portfolio management, and hedging strategies."

13. As NERA's report explains, appropriate risk allocation is a key economic principle for the Commission. Consumers, unlike suppliers, have no means to manage interest rate pricing risk.
14. We consider consumers will benefit from being less exposed to interest rate pricing risk under a TACD.

Investment incentives

15. As discussed in our submission and CEG's report, the investment incentive problem described by the Commission in its draft decision (i.e. that a simple TACD can lag current borrowing costs, blunting investment signals when interest rates move) applies to all methods, including the status quo. This can be addressed by a weighted trailing average. CEG's empirical analysis found the status quo had the status quo has had the greatest deviation between the prevailing cost of debt and regulatory allowance.
16. Chorus made a similar point, noting that:

"the Commission's argument about investment incentives cuts both ways. The prevailing approach exposes Chorus to large step-changes in the WACC at resets, which introduces revenue uncertainty that can itself deter investment. The TACD reduces this uncertainty by providing a more predictable path of allowed debt costs over time, which is likely to enhance – not undermine – investment incentives."

17. Submitters also highlighted that a TACD better mirrors how suppliers finance their investment in practice. This would also better support investment incentives and confidence. For example, Unison submitted:

"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..."

"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.

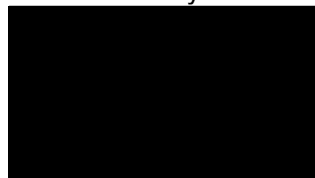
These differences have clear implications. For consumers, sharp step changes in allowed revenues can translate into sudden and unpredictable bill impacts; a trailing average spreads these effects over time and supports smoother price paths. For regulated entities, the hybrid approach can result in a 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.”

A 10-year TACD best supports the long term benefit of consumers

18. In our view, the evidence provided to this consultation makes it clear a TACD will best support the long-term benefit of consumers over the status quo.
19. Accordingly, the remaining question is whether a 5-year or 10-year TACD should be adopted.
20. Submitters appeared to have mixed views on the length of the TACD and many didn't specify a preference. However, we remain of the view that a 10-year TACD will best support the long-term benefit of consumers since it will provide the best protection against volatility between resets.

Yours sincerely



Richard Sharp
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