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To: Signatories to the joint submission (Fibre IM issues paper):
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Response to joint letter: Price volatility and step changes at regulatory reset periods

Thank you for your joint letter submitted as part of the common cost of capital Input Methodologies Review. We appreciate the collective effort from industry organisations and consumer representatives in raising these matters. The Commission can assure you the issues you raised were carefully considered in reaching our draft decision on the common elements of the cost of capital.

In determining a draft decision for the common cost of capital input methodologies we focused on the goals set out in both the Commerce Act and the Telecommunications Act. Avoiding sudden price increases can help meet those goals, therefore this was a key part of our considerations.

What we examined in this review

To reach a draft decision we carried out additional empirical analysis, including:

- modelling price-path resets to better understand the sources of revenue volatility.
- assessing the impact of alternative approaches for estimating the WACC.
- evaluating a shift to a trailing average cost of debt.

What our analysis shows

The empirical analysis undertaken considered how alternative methods for setting the real risk-free rate could affect revenue and prices at regulatory resets, including potential trade-offs and added complexity.

We assessed both the five and ten-year trailing average options against the current method. What we found is that the benefits of change, in terms of pricing smoothing effects, are very modest.

The real risk-free rate used in setting the cost of debt makes up generally less than 10% of revenue allowances, so smoothing it via trailing average approaches makes relatively little difference to aggregate revenue outcomes. As we demonstrated in the 2024 DPP reset, smoothing revenues at the aggregate level across the regulatory period achieved a significant level of price smoothing.

On balance we found:

A **ten-year trailing average** may reduce investment incentives and would likely to increase regulated prices because ten-year interest rates are generally higher than five-year rates. It may be less suited to supporting healthy competition in telecommunications. For these reasons, we think it may not deliver the best long-term outcomes for consumers.

A **five-year trailing average** performs very similarly to the current method: both can encourage investment, help manage the risk of excessive profits, and support workable competition where relevant. The difference between them is small.

Adopting a trailing average would add complexity to our regulatory regimes.

To achieve the benefits of a trailing average it could mean annual updates to revenue allowances and several changes to keep the framework conceptually sound, increasing administrative and compliance costs for both regulators and suppliers. We may need to design a transition mechanism to change to a trailing average approach, which may be complex. These costs don't decide the issue on their own, but they are part of the overall picture.

As noted above, we already have other tools that can smooth revenues effectively across regulatory periods, which reduces the need to change this part of the framework.

Our draft decision

The evidence from the review suggests the existing rules are performing well—they continue to produce accurate, robust, and fit for purpose weighted average cost of capital (WACC) estimates across sectors.

Our draft decision is that the current cost of capital rules are largely fit for purpose and should remain in place. The papers are published on our website.

We are proposing refinements to the tax adjusted market risk premium (TAMRP) estimation method—specifying the method within the IMs and clarifying the timing of updates. These refinements ensure the IMs remain clear, current, and effective.

The Commission emphasises that the draft decision on the choice between a prevailing versus trailing average for the real risk-free rate incorporated in the cost of debt is finely balanced.

Inviting further feedback

Consultation on our draft decision is now open and submission are due by 5:00pm, 16 April 2026, with cross submissions due by 6 May 2026.

One of the things we aim to do through the consultation process is to show you and other stakeholders the empirical analysis we have done. We want to ensure a good understanding of the real, measurable effects of a change in approach, including what it could mean for how complex the regulatory regime becomes.

A change like this is not straight-forward and some stakeholders may have potentially over-estimated the revenue smoothing benefits of a change to a trailing average for the cost of debt.

We want to ensure stakeholders have a clear understanding of the quantitative impacts and trade-offs required.

To support this, we've published an Explanatory Overview that explains how the cost of capital works in practice and what the different approaches could mean for real life outcomes.

Next steps

We want to actively engage with you on this. Receiving considered and constructive feedback will be vital to informing our final decision.

We are open to discussing this with you in person or hosting a group meeting to present our analysis and findings. You're welcome to contact us for further discussion.

Yours sincerely,

Nathan Strong, Associate Commissioner, Convenor Infrastructure Regulation Committee
Commerce Commission