

Amendments to input methodologies for gas pipeline businesses related to the 2022 default price-quality paths – weighted average cost of capital

Reasons paper

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Associated documents

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| 10 February 2022 | ISBN 978-1-869459-79-6 | Proposed amendments to input methodologies for gas pipeline businesses related to the 2022 default price-quality paths |
| 10 February 2022 | ISBN 978-1-869459-74-1 | [DRAFT] Gas Distribution Services Default Price-Quality Path Determination 2022 – 10 February 2022 |
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Contents

| | |
|-----------|--|
| Glossary | 3 |
| Chapter 1 | Introduction.....4 |
| Chapter 2 | Decision-making framework7 |
| Chapter 3 | Amendments to the GDB and GTB Input Methodologies Determinations12 |

Glossary

| Acronym | |
|----------------|---|
| DPP | Default price-quality path |
| DPP3 | Default price-quality path for the third regulatory period (1 October 2022 – 30 September 2026) |
| the Act | Commerce Act 1986 |
| CPP | Customised Price-quality Path |
| EDB | Electricity Distribution Businesses |
| FCM | Financial Capital Maintenance |
| Gas IMs | Input Methodologies for gas pipeline services |
| GDB | Gas Distribution Business |
| GPB | Gas Pipeline Business |
| GTB | Gas Transmission Business |
| ID | Information Disclosure |
| IMs | Input Methodologies |
| Part 4 | Part 4 of the Commerce Act 1986 |
| TAMRP | Tax Adjusted Market Risk Premium |
| WACC | Weighted Average Cost of Capital |

Chapter 1 Introduction

Purpose of paper

- 1.1 This paper provides our decisions and supporting reasons on amendments to the cost of capital input methodologies for gas pipeline services (**Gas IMs**):
 - 1.1.1 for Gas Distribution Businesses (**GDBs**) contained in the Gas Distribution Services Input Methodologies Determination 2012 (**GDB IM Determination**)¹; and
 - 1.1.2 for the Gas Transmission Business (**GTB**) contained in the Gas Transmission Services Input Methodologies Determination 2012 (**GTB IM Determination**).²
- 1.2 The proposed amendments to the GDB and GTB IM determinations involve correcting for a technical error and changes that do not involve policy decisions and have been assessed in accordance with the decision-making framework, such as updating the parameter estimate for the tax-adjusted market risk premium (**TAMRP**) in the Gas IMs to 7.5%. TAMRP is an economy wide parameter and therefore should be the same across all sectors. The changes are outlined in Chapter 2.
- 1.3 A subsequent paper will outline our decisions on non-cost of capital IM amendments. This paper and the related determinations are being published now to allow for the weighted average cost of capital (**WACC**) estimate used for the default price-quality path for the third regulatory period (1 October 2022 – 30 September 2026) (**DPP3**) final decision to be determined by 31 March 2022 and published by 30 April 2022 as required by the Gas IMs.

The process we followed

- 1.4 The IM amendments made in the GDB and GTB IM amendment determinations, and described in this paper, are made in accordance with s 52X of the Commerce Act 1986 (**Act**).

¹ Prior to the amendments outlined in this paper, the principal determination was most recently amended in 21 December 2017 by Gas Distribution Services Input Methodologies Amendments Determination 2017 [2017] NZCC 31. [An unofficial consolidated version of the principal determination and all subsequent amendments was published by us on 3 April 2018.](#)

² Prior to the amendments outlined in this paper, the principal determination was most recently amended in 21 December 2017 by Gas Transmission Services Input Methodologies Amendments Determination 2017 [2017] NZCC 32. [An unofficial consolidated version of the principal determination and all subsequent amendments was published by us on 3 April 2018.](#)

- 1.5 In accordance with section 52V of the Act, we published a notice of intention relating to the proposed Gas IM amendments set out in this paper on 4 February 2022.³
- 1.6 We then proposed amendments and sought stakeholder views in our IM amendments draft reasons paper “Proposed amendments to input methodologies for gas pipeline businesses related to the 2022 default price-quality paths – Draft reasons paper” on 10 February 2022. The draft decision was accompanied by draft amendment determinations showing how we proposed to give effect to the proposed changes.⁴
- 1.7 In reaching the decisions outlined in this paper, we have taken into account submissions and cross-submissions received from stakeholders in response to our draft decisions referred to in paragraph 1.6. In reaching these decisions, we have also considered submissions received as part of the DPP3 reset consultation process insofar as they related to the GDB and GTB IM determinations.

Structure of paper

- 1.8 This paper explains:
- 1.8.1 the decision-making framework we have applied to reach our decisions (Chapter 2); and
 - 1.8.2 the amendments to the cost of capital IMs that we decided to make, as well as those that we decided not to make (Chapter 3).

Effective dates for IM amendments

- 1.9 Section 52W of the Act requires us to publish, by way of notice in the *Gazette*, a brief description of any IM amendment and the goods and services to which it applies, the reasons for determining that IM amendment and how we are making it publicly available.⁵
- 1.10 The amendments discussed in this paper take effect on the day following publication in the *Gazette* under the Legislation Act 2019 in accordance with s 52W.
- 1.11 This means that the amendments will apply to any WACC determinations made after the date on which the amendment takes effect. This includes the WACC

³ [Commerce Commission “Notice of Intention for potential amendments to IMs for Gas in 2022” \(4 February 2022\).](#)

⁴ [DRAFT] Gas Distribution Services Input Methodologies Amendment Determination 2022 – 10 February 2022 and [DRAFT] Gas Transmission Services Input Methodologies Amendment Determination 2022 – 10 February 2022.

⁵ Section 52W(1)(b) states that IM amendments are secondary legislation which means that the publication requirements for secondary legislation under the Legislation Act 2019 apply.

determination for the Gas DPP3 scheduled to be made by 31 March 2022 and the WACC determination for information disclosure (**ID**) for Vector and GasNet (in respect of gas distribution services) scheduled to be made by 31 July 2022.

Materials released alongside this paper

1.12 Alongside this paper, we have published a:

1.12.1 Gas Distribution Services Input Methodologies Amendment Determination (**GDB IM amendment determination**);⁶ and

1.12.2 Gas Transmission Services Input Methodologies Amendment Determination (**GTB IM amendment determination**).⁷

Publishing a consolidated determination

1.13 We intend to publish consolidated versions of the GDB and GTB IM determinations that incorporate the changes made by the GDB and GTB IM amendment determinations after 31 May 2022.

⁶ *Gas Distribution Input Methodologies Amendment Determination (No.1) 2022*

⁷ *Gas Transmission Input Methodologies Amendment Determination (No.1) 2022*

Chapter 2 Decision-making framework

Purpose of this chapter

- 2.1 This chapter describes:
- 2.1.1 our framework for considering the scope of potential Gas IM amendments, which is relevant in considering what IMs it may be appropriate to amend outside of the statutory IM review cycle in s 52Y of the Act; and
 - 2.1.2 the decision-making framework we have applied in deciding the Gas IM amendments.

Framework for considering the scope of potential Gas Input Methodologies amendments

- 2.2 Our framework considers:
- 2.2.1 the statutory context
 - 2.2.2 our specific powers to amend Gas IMs; and
 - 2.2.3 what we must take account of when amending Gas IMs outside of the statutory IM review cycle under s 52Y.

Statutory context

- 2.3 When considering amendments to IMs, we must consider the purpose of IMs and the purpose of Part 4. This section discusses the tensions between making changes to improve the regime and the certainty intended by the IMs.
- 2.4 The purpose of IMs, set out in s 52R of the Act, is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to the regulation, or proposed regulation, of goods or services under Part 4. To that end, s 52T(2)(a) requires all IMs, as far as is reasonably practicable, to set out relevant matters in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier. In that way, the IMs constrain our evaluative judgements in subsequent regulatory decisions and increase predictability.⁸

⁸ *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para [213].

- 2.5 However, some uncertainty remains inevitable.⁹ As the Court of Appeal observed (in relation to a judicial review against decisions made in the IMs under Part 4) “certainty is a relative rather than an absolute value”,¹⁰ and “there is a continuum between complete certainty at one end and complete flexibility at the other”.¹¹
- 2.6 The s 52R purpose is primarily promoted by having the rules, processes and requirements set upfront prior to being applied by regulated suppliers or ourselves.
- 2.7 However, as recognised in ss 52X and 52Y, these rules, processes and requirements may change over time.
- 2.8 The power to amend an IM must be used to promote the policy and objectives of Part 4 of the Act as ascertained by reading it as a whole. It is clear that Parliament saw the promotion of certainty as being important to the achievement of the purposes of price-quality (**PQ**) regulation. While this is to an extent implicitly inherent in s 52A (for example, providing suppliers with incentives to invest in accordance with s 52A(1)(a)), it is also expressed in s 52R in relation to the purpose of IMs, but also in other aspects of the regime, such as the restrictions on reopening default price-quality paths (**DPPs**) during their regulatory periods.¹²
- 2.9 When considering IM amendments, we must therefore be mindful that this may have a detrimental effect on:
- 2.9.1 the role that predictability plays in providing suppliers with incentives to invest in accordance with s 52A(1)(a); and
 - 2.9.2 the role that the IMs play in promoting certainty for suppliers and consumers in relation to the rules, requirements, and processes in advance of being applied by us and suppliers in setting the DPP.
- 2.10 At times there will be a tension between making changes to improve the regime and better promote the s 52A purpose on the one hand, and certainty on the other.
- 2.11 While we will have regard to the s 52R purpose (and the other indications of the importance of promoting certainty), ultimately, we must nevertheless make decisions that we consider promote the s 52A purpose.

⁹ *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para [214].

¹⁰ *Commerce Commission v Vector Ltd* [2012] NZCA 220, para [34].

¹¹ *Commerce Commission v Vector Ltd* [2012] NZCA 220, para [60].

¹² For further discussion see *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para [213]-[221].

- 2.12 Section 52A governs all our decision-making processes under Part 4, including our IM decisions. The other purpose statements within Part 4 are relevant matters but they should be applied consistently with s 52A.¹³
- 2.13 When making our decisions we must only give effect to these other purposes to the extent that doing so does not detract from our overriding obligation to promote the purpose set out in s 52A.
- 2.14 Therefore, where the promotion of s 52A requires amendment to an IM, s 52R does not prevent us from making a change that is consistent with s 52A.

Amendments inside and outside the Input Methodologies statutory review cycle

- 2.15 This section considers the circumstances in which IMs may be amended and what must be taken into account when making amendments to IMs outside of the statutory review cycle.
- 2.16 All IMs must be reviewed at least once every seven years, as mandated by s 52Y. This process is key to delivering on the s 52R certainty purpose of IMs, while at the same time allowing the regime to mature and evolve in response to changing circumstances.
- 2.17 Given the certainty purpose of the IMs and the scheme set out in the Act to promote this purpose, we must carefully assess what amendments are appropriate to consider outside the statutory IM review cycle. Additionally, as noted previously, the predictability the IMs provide is key to promoting the s 52A purpose and, in particular, incentives to invest as required under s 52A(1)(a).
- 2.18 On the other hand, it is important that the IMs are fit-for-purpose going into a DPP reset, as under s 53ZB(1) IM amendments made after a PQ path is determined will generally not affect the PQ path until the next reset.¹⁴
- 2.19 Leading up to a DPP reset, we may therefore need to consider which topics are appropriate to consult on as potential s 52X amendments in order to identify changes to the IMs that are necessary to ensure that the DPPs are able to be workable and effective in promoting the outcomes in s 52A, as we have done in this case.

¹³ We note that the High Court, in *Wellington International Airport Ltd & Ors v Commerce Commission* considered that the purpose of IMs, set out in s 52R, is “conceptually subordinate” to the purpose of Part 4 as set out in s 52A when applying the “materially better” test. See *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, para [165].

¹⁴ Under s 53ZB(2) we must reset a PQ path we have previously set if an IM changes as a result of an appeal under s 52Z and using the changed IM would have resulted in a materially different PQ path.

- 2.20 The next statutory IM review is due for completion by December 2023.¹⁵ It should be noted that the IMs that we are proposing to amend could be further amended at that stage. However, as noted above, given s 53ZB(1), we may not reopen the DPP3 PQ path to implement any IM amendments made as part of the statutory IM review after DPP3 takes effect.

Amendments outside of the statutory IM review cycle

- 2.21 We focus on two types of amendments outside the statutory IM review cycle:
- 2.21.1 those that support incremental improvements to PQ paths; and
 - 2.21.2 those that enhance certainty about – or correct technical errors in – the existing IMs.
- 2.22 We do not generally consider it to be appropriate to consider 'fundamental' changes outside the statutory IM review cycle. Fundamental IMs are generally those that define the fundamental building blocks used to set PQ paths (listed in s 52T(1)(a)), and that are central to defining the balance of risk and benefits between suppliers and consumers.
- 2.23 However, we can and will reconsider fundamental building blocks where there is a compelling and urgent rationale for doing so.¹⁶

The decision-making framework we have applied

- 2.24 In deciding whether to amend IMs as part of the DPP3 setting process, we have used a decision-making framework that we have developed over time to support our decision-making under Part 4 of the Act.¹⁷ This has been consulted on and used as part of prior processes, and helps provide consistency and transparency in our decision-making.
- 2.25 Specifically, in respect of each potential IM amendment we have considered whether they would:
- 2.25.1 promote the Part 4 purpose in s 52A of the Act more effectively;

¹⁵ Commerce Commission "Notice of Intention Input Methodologies Review" (17 February 2022).

¹⁶ An example of this was the re-consideration of the Part 4 WACC percentile decision in 2014. The compelling reason for this was criticism by the High Court of this decision in the IM merits appeal process, and the urgency was due to the upcoming default price-quality path and individual price-quality resets for EDBs and Transpower New Zealand Limited.

¹⁷ See, for example, [Commerce Commission "Input methodologies review decisions: Framework for the IM review" \(20 December 2016\)](#), para 59 and [Commerce Commission "Amendments to Electricity Distribution Services Input Methodologies Determination – Reasons paper" \(26 November 2019\)](#), para 2.17-2.20.

- 2.25.2 promote the IMs purpose in s 52R of the Act more effectively; or
 - 2.25.3 reduce compliance costs, other regulatory costs or complexity (consistent with the purpose of DPP regulation in s 53K).
- 2.26 As part of these considerations, we have also considered whether a potential IM amendment would detrimentally affect any of the matters in paragraph 2.25. As discussed in paragraphs 2.12 to 2.14 above, while the other purpose statements in Part 4 of the Act (including s 52R and s 53K) are relevant matters, s 52A governs our decision-making process under Part 4. We may, therefore, make an IM amendment that does not promote the IM purpose in s 52R more effectively than the current IM where we consider that would promote the s 52A purpose more effectively. We further consider that we must generally only make IM amendments to promote the IMs purpose in s 52R, or to reduce costs or complexity, where this does not detract from our obligation to promote the purpose in s 52A.
- 2.27 We refer to the outcomes specified in paragraph 2.25 as the 'IM amendments framework outcomes' in this paper.

Chapter 3 Amendments to the GDB and GTB Input Methodologies Determinations

Purpose of this chapter

- 3.1 This chapter describes our amendments to the cost of capital IMs in the GDB and GTB IM Determinations. The proposed amendments are the same for the GTB and the GDBs.
- 3.2 For each of these amendments, we explain:
 - 3.2.1 the previous IM requirement;
 - 3.2.2 our draft decision;
 - 3.2.3 submitters' views;
 - 3.2.4 our final decision; and
 - 3.2.5 how the amendment is likely to promote an IM amendments framework outcome, as defined in Chapter 2, para 2.25-2.26.

Summary of amendments

- 3.3 We are amending the GDB and GTB IM Determinations as follows.

Tax adjusted market risk premium

- 3.4 We are increasing the tax-adjusted marked risk premium (**TAMRP**) parameter in the WACC calculation from 7.0% to 7.5% to reflect our most recent decisions on this parameter when we set the cost of capital IMs for fibre regulation in October 2020.¹⁸

Weighted average cost of capital estimates for a four-year and five-year regulatory period

- 3.5 Our draft decision for DPP3 was to set a four-year regulatory period. If this draft decision is maintained, we consider this requires a WACC estimate that reflects a four-year regulatory period.
- 3.6 The parameters that change depending on the length of the regulatory period are the risk-free rate which is estimated when we make the determination, and the debt issuance costs which are set in the Gas IMs.
- 3.7 The IM amendments will allow WACC estimates that reflect both a four-year and a five-year regulatory period. The WACC estimates that will apply when we

¹⁸ Commerce Commission "Fibre input methodologies – Main final decisions – reasons paper (13 October 2020).

determine the DPPs by 31 May 2022 are those that reflect our final decision on the length of the regulatory period.

3.8 We expand on each of these IM amendments below.

Tax adjusted market risk premium

Previous IM requirement

3.9 The TAMRP represents the additional return, over and above the risk-free rate, that investors look for to compensate them for the risk of holding a portfolio of average risk (more precisely the market portfolio which is the average risk portfolio). It is one of the parameters in the Part 4 cost of capital IMs that is used when we determine the WACC for regulated suppliers. The previous parameter estimate for the TAMRP in the cost of capital IMs for GPBs was 7.0% and that is the figure which currently applies under the Part 4 cost of capital IM.

3.10 The TAMRP is an economy wide parameter and therefore should be the same across all sectors. Our most recent estimate of TAMRP was for Fibre IMs in 2020 and that arrived at a best estimate of 7.5%.¹⁹

Our draft decision

3.11 In our draft decision, we proposed to:

3.11.1 update the parameter estimate for the TAMRP in the Gas IMs to 7.5% which would align it with the TAMRP used in the Fibre IMs; and

3.11.2 remove the reference to the five-year period.

Submitters' views

3.12 Vector, Powerco and First Gas supported the change of TAMRP to 7.5%. Greymouth Gas did not support the change to 7.5% given the significant upwards trajectory of prices signalled in the Draft DPP decision.²⁰

3.13 While MEUG supported changing the TAMRP, it did not support rounding our estimate of TAMRP to the nearest 50 basis points:

¹⁹ Commerce Commission "Fibre input methodologies – Main final decisions – reasons paper (13 October 2020).

²⁰ [Powerco "Submission on proposed cost of capital amendments"](#) (24 February 2022); [MEUG "Submission on proposed cost of capital amendments"](#) (24 February 2022); [Greymouth Gas "Submission on proposed cost of capital amendments"](#) (25 February 2022).

“MEUG recommends the Tax Adjusted Market Risk Premium (TAMRP) change to 7.3%. The reasons for our objection and proposed alternative TAMRP value were set out in our submission on the same proposed change to the fibre WACC IM on 28 January 2020.”

Final decision

- 3.14 Considering all the evidence before us and the submissions received, we have maintained our draft decision to increase the TAMRP parameter in the WACC calculation from 7.0% to 7.5% to reflect our most recent decision on this parameter when we set the cost of capital IMs for fibre regulation.²¹
- 3.15 While Greymouth Gas argued there should be no increase in TAMRP, given the TAMRP is a market wide estimate, we consider it reasonable to incorporate the best estimate available to us to better maintain expectation of a normal return.
- 3.16 In response to MEUG’s submission on rounding our TAMRP estimate, we have previously sought advice and responded to the views on the rounding methodology.
- 3.17 As MEUG has noted, their submission was originally made as part of the Fibre IM process and was considered in full alongside other submissions at the time. No new evidence has been offered and we remain of the view that rounding the TAMRP to the nearest 50 basis points remains appropriate.²² We remain open to considering further evidence and submissions on this point within the statutory IM review which commenced in February 2022.
- 3.18 We consider it appropriate to make this change outside of the statutory review cycle as it does not involve a new policy decision and we have a better estimate available to us. Where a better estimate is not available, we consider it more appropriate to reconsider the TAMRP as part of a statutory IM review.

How the amendment is likely to promote an IM amendments framework outcome

- 3.19 The TAMRP is an economy wide parameter that is not specific to a particular sector. We are amending the parameter estimate for the TAMRP, which was last updated in 2015, to align with the updated estimate made when determining the Fibre IMs in October 2020. We published our analysis and consulted extensively on that decision as part of that process. Our conclusion from that work was to increase the estimate of the TAMRP from 7.0% to 7.5%. We also considered determining TAMRP estimates for three, four and five-year regulatory periods. We found that the

²¹ Commerce Commission “Fibre input methodologies – Main final decisions – reasons paper (13 October 2020).

²² Commerce Commission “Fibre input methodologies – Main final decisions – reasons paper (13 October 2020), paras 6.558 to 6.570.

TAMRP estimate does not vary between these three potential terms, concluding that a single rate for TAMRP is appropriate for all regulatory periods.²³

- 3.20 To be consistent with the financial capital maintenance (**FCM**) principle, we consider that we should use our best estimate of the TAMRP as it is a component of our estimate of a normal return.
- 3.21 We therefore believe that amending the Gas IMs to increase the TAMRP from 7.0% to 7.5% will promote the Part 4 purpose in s 52A of the Act more effectively than the current IMs, as using the latest estimate of this parameter better supports the provision of ex-ante real FCM.
- 3.22 A full review of all the cost of capital IMs (including the TAMRP) will occur as part of the next statutory IM review cycle, which we have recently commenced.

Weighted average cost of capital estimate for a four-year and five-year regulatory period

Previous IM requirement

- 3.23 The Gas IMs require us to determine the WACC estimates for a DPP no later than six months prior to the start of the regulatory period.²⁴ The IMs previously only provided for a five-year regulatory period for some of the parameters used to estimate the WACC. These parameters are:
 - 3.23.1 the risk-free rate;²⁵
 - 3.23.2 the debt premium;²⁶ and
 - 3.23.3 the debt issuance costs.²⁷

²³ Commerce Commission “Fibre input methodologies – Main final decisions – reasons paper (13 October 2020).

²⁴ Commerce Commission “Gas Distribution Services Input Methodologies Determination 2012 and Gas Transmission Services Input Methodologies Determination 2012 (3 April 2018), clause 4.4.1(1)(c).

²⁵ Commerce Commission “Gas Distribution Services Input Methodologies Determination 2012 and Gas Transmission Services Input Methodologies Determination 2012 (3 April 2018), clause 4.4.3.

²⁶ Commerce Commission “Gas Distribution Services Input Methodologies Determination 2012 and Gas Transmission Services Input Methodologies Determination 2012 (3 April 2018), clause 4.4.4.

²⁷ Commerce Commission “Gas Distribution Services Input Methodologies Determination 2012 and Gas Transmission Services Input Methodologies Determination 2012 (3 April 2018), clause 4.4.2.

- 3.24 If we determine a four-year regulatory period for DPP3 this requires amendments to the IMs to enable the estimation of a WACC that reflects a regulatory period of four years.²⁸

Our draft decision

- 3.25 While the Act allows for a regulatory period shorter than five-years (but not less than four-years), the current cost of capital IMs for GPBs only provide for a WACC estimate that reflects a five-year regulatory period. In our original IM decisions, we discussed that the WACC should align with the term of the regulatory period. However, the IMs as drafted only provided for a WACC estimate that reflected the usual five-year regulatory period.²⁹
- 3.26 In our draft decision, we proposed correcting for this error by amending the IMs to enable the setting of a WACC estimate for DPPs that reflects the term of the relevant DPP regulatory period. This requires amendments to the IMs, specifically changes to some IMs that reflect a five-year regulatory period including the following parameters used to estimate the WACC.
- 3.27 We also proposed amending the WACC IMs for ID to allow for the determination of an ID WACC estimate that reflects the term of the DPP regulatory period. We did not propose changing the IMs for the WACC estimate for customised price-quality paths (**CPPs**). The WACC for CPPs would operate as currently designed. In the last statutory IM review, we aligned the CPP WACC with DPP so that suppliers were not incentivised to apply to get a different rate of return.³⁰ In our draft decision, we did not propose changing this decision.
- 3.28 In our draft decision, we proposed not to amend the methodology for estimating the average debt premium. We proposed to amend the methodology for estimating the risk-free rate, and the estimate for debt issuance costs, as follows:
- 3.28.1 aligning the risk-free rate with the regulatory period (i.e. calculated against a four-year or a five-year bond);
 - 3.28.2 debt issuance costs are for 0.20% for a five-year regulatory period and 0.25% for a four-year regulatory period.

²⁸ We may need to estimate both a four-year and five-year WACC given the IM requirement that we must determine the WACC estimate to be used in DPP3 two months before our DPP3 final decision, ie, by 31 March 2022.

²⁹ Commerce Commission "Input Methodologies Reasons Paper" (December 2010), p. 138-139.

³⁰ Commerce Commission "Input Methodologies Review Decisions: Cost of Capital" (20 December 2016), p.160-161.

Submitters' views

3.29 Powerco, MEUG and Greymouth gas supported our draft decisions to align the WACC parameters with the regulatory period.³¹

3.30 Vector stated:³²

“We have reservations with the current IM approach tying the term of the risk-free rate to the regulatory period. We note the Commission’s reasoning that aligning the risk-free rate to regulatory period allows suppliers to hedge interest rate risk for the length of the period. However, this is linked to a specific debt hedging strategy and is out of step with international regulators which recognise efficient debt management strategies will involve debt being raised using different products and maturity periods. We consider the estimate of the risk-free rate should use a bond with a longer term to maturity than the regulatory period to better align with the investment period of the asset. A ten-year government bond is most commonly used by overseas regulators.”

3.31 Vector also submitted that we should consider using a trailing average approach when estimating the cost of debt.

Final decision

3.32 Given the evidence before us, our final decision is to maintain our draft decision to amend the methodology for estimating the risk-free rate, and the estimate for the debt issuance costs in the Gas IMs, to align with the term of the regulatory period.

3.33 Despite these changes being related to the cost of capital IM (one of the foundational building blocks IMs listed in s 52T(1)(a)), we consider it appropriate to make the changes outside of the statutory IM review process because the nature of the changes are to correct a technical error that do not involve a policy change.

3.34 We are not amending the methodology for estimating the cost of debt as part of this process. We consider Vector’s suggested change to be outside the scope of this IM amendments process and that this proposed change would be better considered as part of the statutory IM review we have recently commenced.

3.35 The WACC determination for the Gas DPP will be determined by 31 March 2022 and published before 30 April 2022, following the IM amendments, and will consist of estimates for both a four-year and five-year regulatory period term. Once the final decision on the appropriate term of the regulatory period is taken the relevant WACC will apply.

³¹ [Powerco “Submission on proposed cost of capital amendments”](#), (24 February 2022); [Greymouth Gas “Submission on proposed cost of capital amendments”](#) (25 February 2022).

³² [Vector “Submission on proposed cost of capital amendments”](#) (24 February 2022)

- 3.36 In the case of Vector and GasNet (in respect of gas distribution services) the IM amendments to the debt issuance costs and methodology for estimating the risk free rate give rise to a transitional issue for the ID WACC for disclosure year 2023 (the 12 month period ending on 30 June 2023), because the regulatory years and disclosure years are misaligned by 3 months. Their disclosure years start on 1 July while the regulatory period and regulatory years start on 1 October.
- 3.37 If we change the regulatory period to four years in our final DPP3 decision this means there will be different regulatory period terms during disclosure year 2023, i.e., a five-year regulatory period for July, August and September 2022 and a four-year regulatory period for October 2022 to June 2023. In that case we will estimate blended rates for the debt issuance costs and risk free rate for disclosure year 2023 based on the proportion of the disclosure year the length of the regulatory period was five years and the proportion of the disclosure year the length of the regulatory period was four years.

How the amendments are likely to promote an IM amendments framework outcome

- 3.38 Our final amendments resolve a technical error in the Gas IMs. In our view the amendments promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it ensures the long-term workability of this IM.
- 3.39 We consider that the amendments improve certainty for consumers and suppliers about how the cost of capital will be calculated when we come to set PQ paths and enables suppliers to employ the necessary strategies to mitigate the effects of prevailing external market conditions; for example, when putting in place financing arrangements.
- 3.40 We consider that these amendments will promote the Part 4 purpose in s 52A of the Act more effectively than the current IMs. A WACC that is aligned with the length of the regulatory period better supports the provision of ex-ante real FCM and provides incentives for GPBs to invest in and maintain an efficient and reliable network.