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Commerce Commission

Wellington 16 April 2026

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Common cost of capital input methodologies review

Transpower New Zealand Limited (Transpower) welcomes the opportunity to submit on the Commerce Commission's draft decision on the common cost of capital input methodologies (IMs) published on 10 March 2026 (draft decision).

Transpower supports the Commission's objective of maintaining durable, predictable and credible cost of capital settings across regulated sectors. Regulatory stability and investment certainty are particularly important for long-life electricity transmission assets, where financing and investment decisions are made over several decades.

We agree with the Commission's overall conclusion that the existing cost of capital framework is largely fit for purpose. We:

- support the proposed changes to the Tax-Adjusted Market Risk Premium (TAMRP); however
- disagree with the Commission's draft decision not to adopt a trailing average cost of debt (TACD.

Provided with this submission is an independent expert report prepared by NERA for Transpower, Electricity Networks Aotearoa, and Chorus.[1]

We support the changes to the TAMRP methodology

We generally support the move to specify a transparent methodology for estimating TAMRP, rather than relying on a fixed parameter value. We also recognise the Commission's intent to ensure the allowed return on equity remains anchored in long-run evidence while being responsive to changes in financial market conditions.

Transpower supports the Commission's proposal to replace the fixed TAMRP value with a clearly specified estimation methodology embedded in the IMs. We agree this improves transparency and makes explicit how judgments about equity risk are formed.

[1] NERA April 2026, *Trailing average vs prevailing approach to the cost of debt* Regulatory submissions | Transpower

Behaviour of the draft methodology

Transpower's internal analysis indicates that the draft TAMRP methodology is mechanically more symmetric in its sensitivity to changes in the risk-free rate than the current median-based approach. In higher interest-rate environments, the draft methodology—including the Siegel 2 component—responded more consistently and proportionately to movements in the risk-free rate. By contrast, the current median-of-five approach exhibited greater path dependency and step-change effects, reflecting the reduced influence of Siegel 2 when it lay at an extreme relative to other estimators.

Conversely, Transpower's analysis also indicates that in lower interest-rate environments, such as the period from 2019 to 2021, the draft TAMRP methodology may produce a higher TAMRP than the current approach. This reflects the fact that a lower risk-free rate increases the Siegel 2 estimate, which under the draft methodology feeds directly into the TAMRP with a one-third weight. Under the current median-based approach, the influence of Siegel 2 is more likely to be muted where it represents an extreme value relative to other estimators.

The key advantage of the draft approach is therefore greater regularity and predictability, rather than a consistently higher or lower outcome. Its relative impact depends on the interest-rate environment at the time of assessment and the direction of subsequent movements. In this sense, the draft approach should be understood as altering the behavioural properties of TAMRP, not as a simple adjustment that is uniformly favourable or adverse to suppliers or consumers.

Unresolved implementation and design issues

While supportive of the direction of change, Transpower considers the draft decision leaves several implementation questions insufficiently resolved, including:

- how conditioning variable adjustments—particularly those relating to dividend growth model (DGM) inputs—will operate in practice;
- how point-in-time inputs interact with the proposed 24-month reassessment window; and
- whether timing or lag effects could arise if market conditions move materially between reassessments.

We consider that the Commission should provide more guidance on how, when it thinks it is needed, it will use the Dividend Growth Model (DGM) and the survey to moderate the mechanistically generated TAMRP. It could be appropriate for the Commission to update the estimates more frequently than every 2 years. If there isn't agreement on the use of a historical TAMRP between regulated suppliers and the Commission, then the Commission should update it within 6 months of issuing a determination of a 5-year regulatory period reset.

We see merit in allowing some discretion in the application of the methodology as market conditions evolve but considers that further clarification is required to ensure the approach is robust, predictable, and administratively workable before finalisation. For example, further explanation of how alternative historical averaging periods for Siegel 2 would affect TAMRP behaviour would help stakeholders assess whether the methodology remains appropriate across different monetary policy regimes.

We continue to support the use of a TACD and disagree with the draft decision

Transpower has consistently supported a trailing average approach to the cost of debt, on the basis that it more closely reflects how large, regulated businesses finance debt in practice and can reduce windfall gains and losses caused by short-term interest-rate movements. Nevertheless, we acknowledge the Commission's conclusion that:

- the relative merits of the prevailing and trailing average approaches are balanced; and
- smoothing the cost of debt allowance is likely to have only a limited impact on overall allowable revenue when compared with other revenue-smoothing tools.[2]

While we continue to see merit in a trailing average approach, we accept that—based on the Commission's analysis and subject to expert assessment—the revenue impacts of retaining the prevailing approach may be immaterial.

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.

We also note that the Chorus–Incenta report[3] on macro-WACC issues prepared for the Commission emphasises that the stability of the regulatory WACC over time is materially influenced by the treatment of the cost of debt. The report observes that the debt risk premium, when estimated using a trailing average, has historically changed only gradually over time and therefore contributes to greater stability in the allowed cost of debt across regulatory periods. The report also identifies a trailing average of sufficiently long duration and effectively acknowledges issuing longer term debt is appropriate —through a five-year trailing average—as a means of reducing volatility arising from short-term movements in market interest rates, thereby supporting more stable prices and a closer alignment with debt financing practices observed in competitive markets. We note that the Commission has pointed out that outcomes can be quite sensitive to reset timing and small shifts can drive quite different BBAR step changes.

Consistent with this evidence, we maintain the position set out in its earlier submission on the Fibre IM Review – Issues Paper (Tranche 1)[4] that adopting a trailing average cost of debt would help reduce volatility in regulated prices over time by smoothing short-term fluctuations in market interest rates, and thereby better promote predictable price paths for consumers.

Yours sincerely

David Knight

Executive General Manager
Strategy, Regulation & Governance

[2] The disadvantage of smoothing is that it can delay cost recovery. The Commission has indicated that it will delay cost recovery in the case of an increase but will pass through decreases in full.
[3] Chorus-Incenta-Report-2025-on-Macro-WACC-Issues-23-July-2025.pdf
[4] Transpower Fibre IM Review – Issues Paper (Tranche 1)

Attachment A:

Transpower's sensitivity analysis of the Trailing Average Market Risk Premium (TAMRP) under the current (old) and draft Commerce Commission methodologies.

Purpose

The analysis is intended to inform the Commission's consideration of how each approach responds mechanically to changes in the risk-free rate (RF), and the implications for symmetry, predictability, and stability of TAMRP outcomes over time.

This should be read alongside Transpower's main submission on the cost of capital input methodologies.

Approach

- The analysis uses a simplified mechanical sensitivity test to compare how changes in the current risk-free rate flow through to TAMRP under the old and draft methodologies.
- Published annual estimates from Lally for the relevant years are used as the base case.
- A risk-free rate shock is applied using each methodology's formula-implied pass-through, for the Siegel 2, DGM and Survey methods
- All other inputs are held constant.
- The purpose is to compare how changes in the risk-free rate flow through to TAMRP under the old and draft approaches, rather than to re-estimate absolute levels of the market risk premium.

Limitations

- This is not a full historical reconstruction of TAMRP from underlying inputs.
- The analysis isolates changes in the current risk-free rate only, and does not capture the effect of other market variables changing at the same time.
- Results should therefore be interpreted as illustrative of the methodologies' mechanical properties, particularly symmetry, predictability and path dependence, rather than as point estimates of TAMRP in practice.
- Rounded results should be interpreted with care, as the rounding conventions can create step changes that differ from the underlying unrounded response.
- The analysis does not test how conditioning-variable adjustments or timing effects over the assessment period may affect outcomes in practice.

Key conclusion

- The draft TAMRP methodology is mechanically symmetric in its response to changes in the risk-free rate.
- The current methodology is not symmetric, because outcomes depend on which estimator sits at the median and on rounding effects.
- The primary advantage of the draft methodology is therefore greater symmetry and predictability,

rather than consistently producing higher outcomes in all high-rate environments.

- Whether the draft method produces higher or lower TAMRP estimates relative to the current method depends on:
    - the starting interest rate environment, and
    - the direction of the rate shock.

Results by starting interest rate environment

1. Low-rate starting point: 2019 (5-year RF = 0.88%)

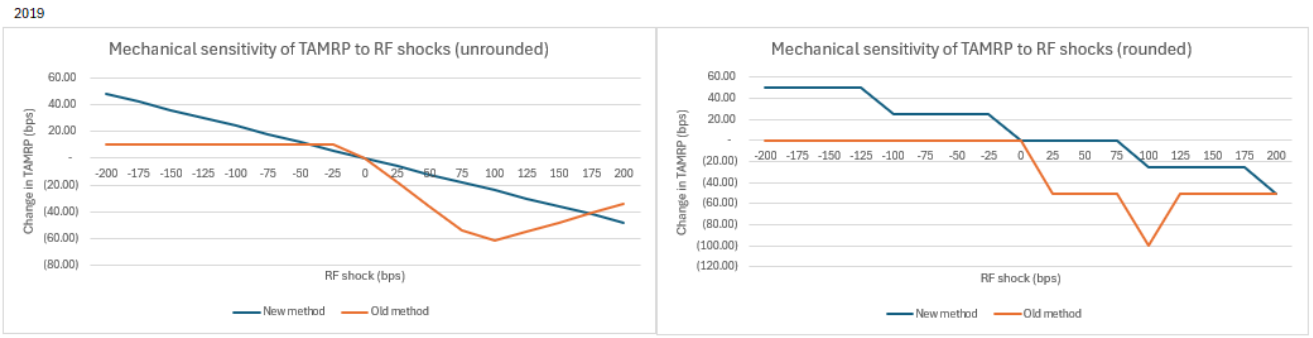
Interpretation

- 2019 represents a clear **low-interest-rate environment**.
- From this starting point:
    - If rates **increase**, the current methodology results in TAMRP falling faster and further.
    - If rates **decrease**, the current methodology provides relatively limited upside.
- The draft methodology produces a **more linear and symmetric response** to both upward and downward rate movements.

Implication

- In a low-rate environment, the draft methodology appears **more stable** and less exposed to adverse outcomes if rates subsequently rise.

Figure 1: TAMRP sensitivity to RF shocks – 2019



Note: The downside-rate scenario is illustrative only. A 200 bps fall from a 0.88% starting point is unlikely to represent a realistic market outcome.

2. High-rate starting point: 2023 (5-year RF = 4.25%)

Interpretation

- 2023 represents a clear **high-interest-rate environment**.
- In this case, the draft methodology's advantage is **not** that it always delivers higher TAMRP outcomes if rates continue to rise.
- Instead, its key benefit is:

- continued **symmetry and predictability**, and

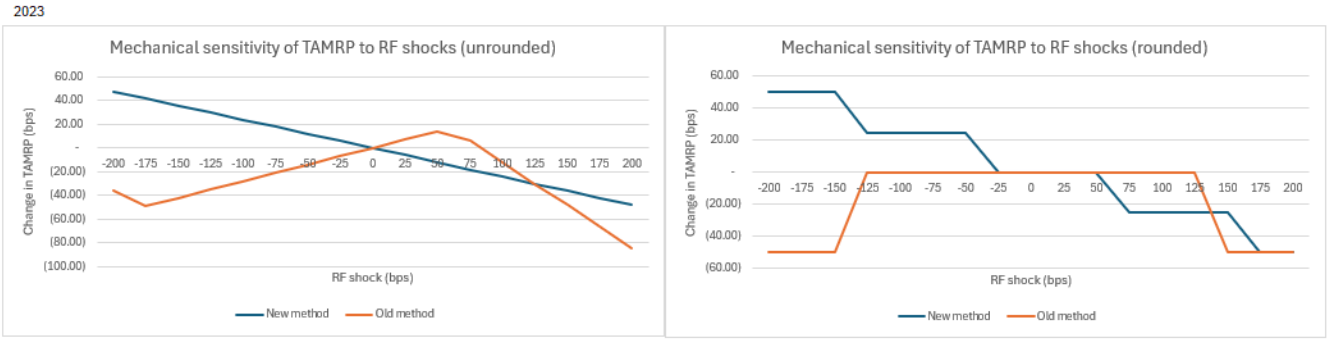
- avoidance of uneven behaviour caused by median switching under the current methodology.

- When rates fall from an already high level, the draft methodology allows TAMRP to adjust **more evenly** than the current approach.

Implication

- The draft methodology performs better in terms of stability when interest rates reverse from elevated levels.

Figure 2: TAMRP sensitivity to RF shocks – 2023



3. Mid-rate starting point: 2015 (5-year RF = 2.74%)

Interpretation

- 2015 sits between the low- and high-rate cases.

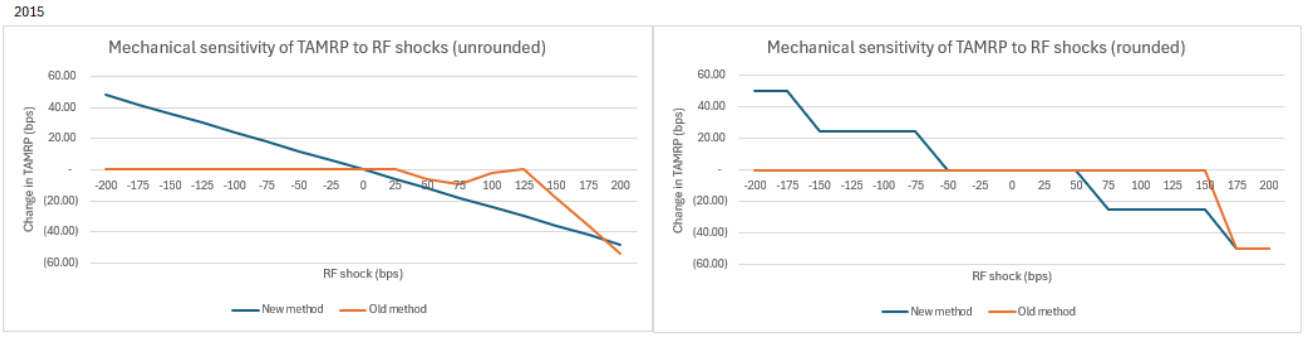
- The results do not provide as clear a directional story as 2019 or 2023.

- Instead, they reinforce the broader pattern that:

- the draft methodology behaves in a **more regular and symmetric** manner across shocks, while

- the current methodology remains **path-dependent** and subject to flat spots or abrupt changes driven by the median-of-five structure and rounding.

Figure 3: TAMRP sensitivity to RF shocks – 2015



Revenue impacts

- This attachment focuses on **mechanical TAMRP sensitivity** only.

- Translation of these effects into **revenue impacts** will require layering the adjusted TAMRP outcomes into the relevant RCP models.
- Once those results are available, Transpower expects to be able to provide quantified dollar impacts and peer review the final estimates.

Additional implementation issues for consideration

As discussed internally, there are several further issues that Transpower considers important for the Commission to address if the draft TAMRP methodology is adopted:

1. **Conditioning variable adjustment for the Dividend Growth Model (DGM)**
    - It is currently unclear how conditioning variables would operate in practice.
    - Greater clarity is needed on how and when adjustments would be made within the methodology.
2. **Timing and lag effects over the 24-month assessment period**
    - There is a risk that DGM-related variables could be set at a specific point in time, while macro-economic conditions move materially before the next assessment.
    - This may reduce the responsiveness or intended symmetry of the methodology in practice.