electricity networks aotearoa

# ENA submission on the Input Methodologies review draft decision

## Submission to the Commerce Commission

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# 1 Introduction

Electricity Networks Aotearoa (ENA) represents the 27 electricity distribution businesses (EDBs) in New Zealand (see Appendix A) which provide local and regional electricity networks. EDBs employ 10,000 people, deliver energy to more than two million homes and businesses and are expected to spend $22 billion over the next six years[1] to ensure that New Zealand has reliable, resilient and secure electricity to enable its decarbonisation.

The electricity distribution sector is about to face the biggest transformation in its century-long history. To enable the sector to deliver this transformation it is essential to have a regulatory regime that is flexible and fit for purpose. The 2023 Input Methodologies (IM) review provides a one-off opportunity for the Commission to put in place a regime that will meet the needs of New Zealanders during this transition and deliver the long-term benefits of decarbonisation including mitigating the worst effects of climate change.

The IM review process is a critical piece of the regulatory puzzle. The short timeframe set out by the Commission for stakeholders to respond to the more than 1,000 pages of draft decision restricts stakeholders' ability to provide comprehensive and reasoned responses befitting the importance of the IMs. ENA adds its voice to that of other stakeholders[2] in calling for the Commission and other regulators to better coordinate their consultations to enable consumers and stakeholders to fully and actively engage with each.

# 2 Executive summary

New Zealand homes, businesses, and communities have a critical reliance on a safe, secure, resilient, and affordable supply of electricity for their health and wellbeing. In addition to directly powering communities, electricity is critical to the operation of many other essential services, such as telecommunications and water reticulation. Exacerbating this critical reliance is the increasing importance of electricity to New Zealand's transition to a decarbonised energy system, where public and private transport and warm homes will be reliant on a secure electricity supply.

It is disappointing that the Commission has largely chosen to lock in the status quo when the electricity distribution sector is about the face the biggest transformation in 100 years.

The distribution sector is about to face its biggest transformation in more than a century. ENA and its members have been consistent in their call for the IM regime to evolve and adapt to ensure it is fit for purpose and up to the challenge of decarbonisation. ENA is concerned that the Commission has in its draft decision largely chosen to lock in the status quo and not take steps to ensure the IM regime is fit for purpose for the coming economy-wide transformation.

The majority of the Commission's proposed amendments to the IMs are supported by ENA as they are appropriate and help better achieve the purposes of Part 4 as set out in Section 52 A of the Commerce Act 1986 (Act).

ENA disagrees with several of the Commission's draft decisions on the weighted average cost of capital (WACC). ENA is concerned the Commission has chosen to base crucial decisions on "regulatory precedent" when it suits - specifically the decision to move away from the 67th percentile - but has ignored it for others including the term of debt and the use of the trailing average which are almost universally adopted by regulators in other jurisdictions, and advance the objectives of Part 4.

[1] Boston Consulting Group, 2022, The Future is Electric, available at https://www.bcg.com/publications/2022/climate-change-in-new-zealand

[2] Major Electricity Users Group, 2023, Update from the Chair, July 2023

ENA in its submission to the Commission in May 2023, set out a comprehensive approach to incorporate flexibility in the IM regime to allow it to efficiently and effectively deal with the uncertainty posed by the transition to an electrified and decarbonised economy. ENA understands that this submission was not taken into consideration for the draft decision. ENA stands by the recommendations set out in that submission and calls for the Commission to adopt them in its final determination, particularly the three-phase approach.

The Commission's proposal to include a 'large connection contract' mechanism is a positive step, but ENA is of the view that a more holistic approach to building flexibility into the regime must be adopted.

# 3 Balancing flexibility and certainty

## 3.1 Uncertainty mechanisms

ENA notes that the Commission has not taken the opportunity to consider, in its draft decision, the ENA's detailed proposals to improve the IM's flexibility to deal with uncertainty as set out in our submission of May 2023. ENA understands that the Commission did not have the capacity to consider this submission before the publication of the draft decision.

ENA stands by the analysis and recommendations set out in that submission and calls upon the Commission to give it full and proper consideration in the preparation of the final determination. In summary, the May ENA submission recommended that the Commission adopt the following three-stage approach.

**Stage 1**: Reform the existing reopener structures to:

- remove the artificial distinction between unforeseen and foreseen reopeners
- introduce a process to streamline reopeners for when
  - a. there is no price impact on wider consumers and
  - b. updating pre-approved models
- allow collective reopeners
- alter the system growth reopener to allow for demand management spending.

**Stage 2**: If residual problems remain after adjusting reopeners, ENA recommends the Commission introduce new uncertainty mechanisms including:

- an opex-specific reopener
- new reopener triggers for digital-specific or regulatory change
- a connections volume driver to allow connections capex to adjust with actual rather than forecast connections
- use-it-or-lose-it allowances to capture necessary but uncertain opex that crystallises during the period (avoiding the need for a burdensome reopener).

**Stage 3**: Reform the IRIS only if material problems remain after stages 1 and 2 by:

a) applying asymmetric rates (lower penalty rates and higher benefits rates) or

b) weighting the incentive rate by uncertainty.

While the Commission has in its draft decision given some consideration to the introduction of flexibility mechanisms, ENA is disappointed the Commission has rejected the use of contingent allowances and the introduction of reopeners for Government policy, and rule changes that affect others in the supply chain. These common-sense mechanisms have been adopted in comparable regulatory regimes where regulators have recognised the benefits they deliver in building flexibility into their regimes to respond to events beyond the control of regulated businesses and consequently, enhance their ability to deliver long-term benefits to consumers.

The introduction of a 'large connection contract' mechanism for EDBs, is a significant step forward and is a measure included in Stage 1 above. However, ENA is concerned that the threshold for the minimum contract size is too high and will preclude almost all large connections. ENA notes that the Transpower New Investment Contract mechanism has no such threshold. ENA recommends that the minimum contract threshold be removed or at a minimum reduced to 1MW.

ENA welcomes the Commission's proposed minor IM changes to improve flexibility including to:

- allow opex solutions for system growth
- allow consequential opex and consequential capex for foreseeable major capex project (FMCP) and unforeseeable major capex project reopeners (UMCP)
- include an allowance for resilience-related expenditure in EDB FMCP and UMCP reopeners.

These decisions represent a small step forward but do not materially address the need for a regulatory regime with sufficient flexibility to strike a balance between providing regulatory certainty and being able to deal effectively with the uncertainty over the timing and pathway for New Zealand's electrification and decarbonisation.

ENA does not support the proposed amendment P01.1 Reconsideration of default price-quality path (DPP)—System growth capex which, explicitly removes general growth from the UMCP. General growth can, in certain circumstances, lead to unforeseen capex during the regulatory period. While general growth is more likely to give rise to an FMCP, there may be occasions where events outside the control of EDBs give rise to unforeseen general growth in localised areas of the network that subsequently lead to unforeseen capex projects such as the commissioning of a new substation.

Another reopener and uncertainty mechanism amendment that ENA does not support is RP01.4 the reconsideration of DPP—consideration of whether an application is better suited to a customised price-quality path (CPP). ENA is opposed to this amendment as it believes the change will effectively give the Commission carte blanche to reject valid reopener requests and force EDBs to go through the costly and time-consuming CPP process. The decision to pursue a CPP is a commercial business decision for the governance and management of an EDB to make.

## 3.2 Price-quality path reopener processes

The Commission has proposed various amendments to improve the price-quality path reopener process. ENA supports these initiatives but is disheartened that the Commission has not established timeframes to evaluate reopener applications or prescribe the information required for a reopener application. These two changes would have made a material difference to the usability, predictability and practicality of the reopener provisions.

Much of the investment by EDBs for decarbonisation will involve large multi-year projects which may span more than one regulatory period. Under the current approach, the Commission will not approve a reopener for a customer project unless that project can be designed, built, and commissioned within the same regulatory period.

These regulatory rules also mean there is no point in the Commission approving a reopener that's not commissioned within the regulatory period as capex allowances are applied on asset commissioning, not capex expenditure, and an asset commissioned outside of a regulatory period would have no impact on a price path or allowances.

To address the potential for the unnecessary delay of significant, prudent, and efficient multi-year projects to fit within a single regulatory period, ENA recommends that the Commission either apply allowances based on expenditure (not commissioned assets) or allow a reopener to apply across regulatory periods.

## 3.3 Reopener thresholds

ENA welcomes the Commission's decision to amend a number of the reopeners thresholds to move from an impact on revenue test to an incurred cost test as this greatly increases the simplicity of the reopeners.

The Commission's decision to remove the $30 million upper threshold for the FMCP and UMCP reopeners is a positive move and is supported by ENA.

ENA's view is that the lower thresholds for the FMCP and UMCP reopeners should remain at 1% of the EDBs revenue allowance or $2 million (whichever is lower). ENA's view is that there is no justification for a specific, higher threshold for Powerco and Vector.

# 4 Cost of capital

The cost of capital is an extremely complex and technical area in which both the Commission and stakeholders rely heavily on the advice of external experts. ENA is frustrated with the Commission's process for reviewing the cost of capital provisions of the IMs. The Commission's process before its draft decision has been limited to publishing a narrowly focused consultant's report, which has not provided stakeholders with the opportunity to understand and engage with the Commission's views before the draft decision and its short consultation period.

The Commission has opted not to use of concurrent expert advice sessions (also known as 'hot tubbing') and has failed to meaningfully engage with stakeholders or release a cost of capital issues paper. The Commission's approach has resulted in the return to an "exchange of letters" approach whereby the Commission and stakeholders hire expensive independent experts to write highly technical reports that critique and respond to each other's points of view. This cumbersome process is not to the benefit of consumers, the Commission, regulated businesses nor other interested stakeholders.

ENA calls upon the Commission to, before its final decision, hold a concurrent expert advice session on the following topics:

- WACC percentile
- debt tenor
- use of the trailing average approach to debt

On the surface, the Commission has chosen to keep the cost of capital framework stable but in doing so has made critical decisions that represent a material departure from the status quo.

ENA is concerned with the Commission's selective use of regulatory precedent to support its views and make significant changes while at the same time setting it aside when it conflicts with its rigid support for the status quo specifically in its use of a 5-year term of debt which has been recently abandoned by regulators such as the QCA and ERA and rejected by the AER in what was a substantial back down.

ENA engaged CEG to respond to the technical cost of capital issues raised in the Commission's draft decision and accompanying expert advice from Dr Martin Lally. This CEG report is attached at Appendix B with the key points summaries below.

## 4.1 WACC percentile

On the surface, the Commission's decision to move to the use of the 65th rather than 67th WACC percentile seems a minor change. However, ENA is concerned that it represents the Commission's apparent undermining of its long-standing empirical model in favour of "regulatory precedent" and is the first step in the abandonment of its empirical model.

ENA notes that none of the regimes that use mid-point WACC are analogous to the light touch industry-wide DPP and each of those regimes includes a vast array of flexibility and uncertainty mechanisms that are not present in the New Zealand regime.

In its draft decision, the Commission has incorrectly interpreted the result of CEG's update of the 2014 Oxera model. The draft decision erroneously stated that CEG observed an optimal percentile of 56% (at the 1% threshold) and 74% (at the 0.5% threshold) associated with a cost of blackouts equal to 6.8% of the RAB.

As demonstrated in CEG's report (Appendix B), the correct interpretation of the CEG model (at a 6.8% of RAB cost blackout cost) is for an optimal percentile of :

- 67th percentile assuming a 1.0% threshold; and
- 82nd percentile assuming a 0.5% threshold.

Substituting the correct CEG model outputs into the range of thresholds put forward by submitters and the Commission's consultants (CEPA & ASCE) results in an average threshold of 67% (see table below). The percentile currently prescribed in the IMs.

**Percentile ranges submitted to the Commission including correct CEG outputs**

| SUBMITTER | 1.0% THRESHOLD (LOWER ESTIMATE) | 0.5% THRESHOLD (UPPER ESTIMATE) |
|---|---|---|
| CEPA | 68% | 83% |
| Oxera | 48% | 67% |
| ASCE | 52% | 70% |
| **CEG (corrected)** | **67%** | **82%** |
| Average | 56% | 72% |
| Average | **67%** | |

Source: CEG

The Commission's draft decision selects a wide, and somewhat arbitrary, range (0.55 to 0.75) where the 2014 decision (67th percentile) is very close to the middle of that range (65th percentile).

Instead of concluding that this supports retaining its previous decision, the Commission concludes that it supports a change to its previous decision (a drop in the percentile from 67th to 65th percentile). While at the same time noting "the significant degree of uncertainty in our empirical estimate of the appropriate percentile."[3]

In doing so, the Commission does not present any evidence that there have been changes since its 2014 decision that would justify a reduction in the percentile. Rather, the Commission appears to have:

- formed a view 2023 range is essentially the same as the 2014 range and is based on largely the same evidence that existed in 2014;
- then choose a different point in that range than was chosen in 2014 without explaining what was wrong with the 2014 decision that it now wishes to depart from it.

In our opinion, absent any evidence supporting a change in the percentile, the Commission should have simply retained its 2014 decision.

ENA notes that the Commission has not given proper consideration to the issues raised by CEG and ENA in its February 2023 WACC submission that support the use of a higher percentile. Specifically the:

- materially higher uncertainty around demand growth now than in 2014 and why this was likely to lead to a greater risk of underinvestment if the WACC was too low;

[3] Commerce Commission, 2023, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Draft decision p139

- materially higher expected demand growth now than in 2014 and why this was likely to lead to a greater risk of underinvestment if the WACC was too low;
- changing role of EDBs means that blackouts were no longer the only, or even the major, source of cost from underinvestment by EDBs in their emerging roles as DSOs.

The Commission's draft decision does not disagree, or grapple in any way, with CEG's evidence of the above. Consequently, ENA can't critique why the Commission has given zero weight to that evidence in the draft decision.

ENA's firm view is that the Commission has not adequately demonstrated that its decision to amend the IMs to reduce the WACC percentile from the 67th percentile meets any of the overarching objectives of the IM review which are :

*"1.24.1 promote the Part 4 purpose in section 52A more effectively;*

*1.24.2 promote the IM purpose in section 52R more effectively (without detrimentally affecting the promotion of the section 52A purpose); and*

*1.24.3 significantly reduce compliance costs, other regulatory costs, or complexity (without detrimentally affecting the promotion of the section 52A purpose)."*[4]

## 4.2 Term of debt

In the face of both strong theoretical arguments and the near-universal regulatory precedent for a longer term of debt, the Commission has proposed to retain the use of a 5-year debt. The Commission has once again relied on Dr Lally's advice and his interpretation of the Schmalensee landmark 1989 work[5].

The Commission's paper overlooks the AER's abandonment of its push to adopt a 5-year term of debt and Schmalensee's clear rejection of Dr Lally's interpretation of his work[6].

CEG has, in its report, set out detailed responses to the issues, questions and critique of its analysis and the ENA's term of debt position including the "debt tenor anomaly" posed by the Commission and its consultant Dr Lally in the draft decision and supporting documents. [7]

CEG demonstrates that debt beta increases with the tenor of corporate debt. Longer-term debt shifts risks from equity holders to debt investors and, in return for this, debt investors demand higher returns.

CEG's view is that "to argue against, or to obfuscate, the proposition that longer-term debt has higher (debt beta) risk is, in my view, unreasonable."[8]

ENA submits that there is sufficient evidence to demonstrate that long-term debt has a higher debt beta than short-term debt and, as a result, the Commission should adopt a longer benchmark tenor assumption (e.g., 10 years) to reduce the magnitude of the bias in its current method as identified by CEG.

ENA notes there is strong regulatory precedent for this approach with a 10-year term of debt adopted by the AER and all other Australian regulators along with several UK regulators.

CEG identified a second option to address the debt tenor anomaly without changing the benchmark tenor. ENA recognise that this approach addresses the debt tenor anomaly but views it as a second-best option due to the complexity of its implementation.

This less preferred approach is to retain a 5-year benchmark tenor but apply a separate adjustment such as:

[4] Commerce Commission, 2023, Context and summary of Draft decisions Part 4 Input Methodologies Review p11

[5] Schmalensee, 1989, An expository note on depreciation and profitability under rate-of return regulation," Journal of Regulatory Economics

[6] Schmalensee, 2022 Statement of Richard Schmalensee, Ph.D to the Australian Energy Regulator

[7] CEG, 2023, Response to 2023 IM draft decision on cost of capital

[8] Ibid

- de-levering its equity beta estimates (based on firms that issue long-term debt) using a positive debt beta); but
- re-levering its equity beta estimates (based on firms that issue 5-year debt) using a lower or zero debt beta.

If the Commission rejects the proposition put by CEG that long-term debt has a higher risk (debt beta) than short-term debt and decides that no adjustment is required. ENA would want to understand the following:

a. Why the Commission believes that long-term debt has a higher cost than short-term debt? That is, why do lenders demand higher returns on long-term debt if long-term debt does not allocate more risk to them than short-term debt?

b. Why the Commission believes that businesses rationally borrow at long-term rates if the equity holders receive no benefit, in the form of lower equity risks, to offset the higher cost of long-term debt?

c. Why the CEPA model that relates debt beta to tenor, and Oxera's estimate of a 0.02 increase in debt beta for a 2-year increase in tenor, is not informative?

## 4.3 Trailing average debt

The Commission has rejected the use of a trailing average cost of debt, despite Dr Lally agreeing that the approach more closely represents the function of a workable competitive market and is in the long-term interest of consumers. Dr Lally's only criticism is that the trailing average approach would create more work for the Commission and regulated businesses. That is not the case as the Commission already makes annual WACC determinations for all businesses covered by the IMs, and this WACC is subsequently, used for information disclosure reporting and analysis.

Further, the Commission's analysis found "The trailing average has the advantage of smoothing the volatility in the estimated risk-free rate between regulatory periods, which tends to lead to more stable allowed cost of debt and prices for consumers over time. The trailing average approach also reduces the need for regulated suppliers to hedge the interest rate exposure as the allowance aims to match their efficient costs under the assumed benchmark debt portfolio."[9]

ENA believes that the advantages of the trailing average approach as set out by Dr Lally and the Commission deliver greater benefits in achieving the purpose of Part 4 set out in the 52A more effectively than the proposed continuation of the on-the-day approach.

## 4.4 TCSD

ENA's preference is for the Commission to move to a 10-year trailing average cost of debt (See section 4.3 above), thus avoiding the need for a TCSD allowance.

Nonetheless, CEG has reviewed the Commission's TCSD methodology and spreadsheet model. In its report, CEG identifies a computational error within the Commission's spreadsheet model that relates to the importation of bond data from external sources.

CEG notes that effect of this is to overestimate the 5-year debt risk premium (DRP) and, therefore, in the TCSD calculation, underestimate the extent to which bonds with maturity above 5-years have higher DRP than 5-year bonds.

The solution to the issue identified by CEG is to sort the government bonds by maturity or change the function to correctly identify the relevant government bonds. ENA is happy to make CEG available to the Commission to help resolve this issue.

Having corrected the above errors in the spreadsheet calculations CEG found that the best estimate of TCSD is 8.9 basis points per annum.

[9] Commerce Commission, 2023, Cost of capital topic paper Part 4 Input Methodologies Review 2023 – Draft decision, page 34

ENA recommends that if the Commission ignores the ENA advice on adopting a 10-year debt tenor and chooses to retain the 5-year tenor, a TCSD allowance of 8.9 basis points per annum be adopted.

## 4.5 Equity issuance

ENA does not agree with the Commission's view that raising equity is costless. The AER approach put forward by ENA assumes that EDBs would, in the first instance, raise equity at no cost via reductions in dividends. However, the AER approach also recognises that there may be instances where it is necessary for regulated businesses to raise equity via other means which incurs a cost. The Commission should reconsider its decision and implement the AER approach to equity issuance costs.

CEG, disagreed with the Commission's view that no equity-raising costs are incurred until dividends fall to zero. However, even if the Commission's view was correct, it is still important for the Commission to set out and include in its IMs what happens when retained earnings cannot fund equity raising and a firm is required to raise equity externally.

The CEG model adopted the AER's estimates of the cost of equity raised via external sources (specifically 2% costs associated with external equity raising).

CEG has clarified it was not asking for EDBs to be compensated in the current DPP for equity raising costs but was putting forward a model (based on the AER model) of equity raising costs to be applied in the future – including when the RAB begins to grow at a fast rate with electrification.

ENA is concerned that the Commission has missed the opportunity to respond with a fully considered approach to equity-raising cost that goes beyond the myopic view that dividends are an endless source of equity to be mined.

# 5 Revenue cap

## 5.1 Proposed changes

The Commission has proposed to change the revenue cap component of the EDB IMs to:

a) provide a revenue wash-up for inflation for the first year of a regulatory period.

b) introduce a nominal debt wash-up, which is an amount that is the difference between:

- the return on debt for the year based on the cost of debt assumed in the price-quality (PQ) determination; and
- the return on debt where the cost of debt is adjusted for actual CPI inflation;

c) allow for a demand volume wash-up mechanism for CPPs, but not DPPs

d) amend the 'secondary' revenue control to give greater flexibility in how it is expressed, and to apply it only to net revenue and recoverable costs;

e) make a package of changes to move the wash-up mechanism from a rolling basis to an account basis; and

f) change the timing of the CPI wash-up from a two-year lag to a one-year ahead forecast which involves:

- first, an annual update to forecast allowable revenue at the start of each regulatory year using the most up-to-date Reserve Bank of New Zealand (RBNZ) forecasts of inflation; and
- second, a residual wash-up for differences between these updated forecasts and actual inflation.

We respond to each in turn below and have included specific comments on the drafting of the revenue cap IM clauses in Appendix C.

ENA continues to support a revenue cap that reflects an ex-ante compliance test, and an ex-post wash-up. In principle, we support changes to the revenue path wash-up which reduce pricing volatility, and significant

build-up of deferred revenue which negatively impacts cashflow and the ability to finance investment in regulated services. We also support changes to reduce complexity and have made some suggestions for further improvements to the draft determination in this respect.

We note that the revenue cap rules are partly specified in the IMs, and partly specified in the relevant PQ determination. However, it is only the IM clauses that are available for review at this time, which makes responding to the draft decision challenging. It would be useful if the final decision included a numerical worked example of each element of the revenue path limits and wash-up, and the PQ clauses which will give effect, along with the IM clauses, to the revenue cap. This is consistent with the s52R purpose of IMs to promote regulatory certainty and for stakeholders to have sufficient information to understand the material impact of the IM decision, as required by s52T(2)(a).

## 5.2 Inflation wash-up in year 1 of a regulatory period

We support the proposal to extend the inflation wash-up to the first year of each regulatory period, which will align the treatment of inflation forecasting risk across the regulatory period. A one-year wash-up is appropriate given inflation is not known for the first year when the PQ path is set. It also ensures EDBs that transition between DPPs and CPPs during a regulatory period are not exposed to additional inflation forecasting risk. The experience of Wellington Electricity in the roll-off from its CPP demonstrates the crucial need for this change.

## 5.3 Nominal debt wash-up

ENA welcomes the Commission's recognition that EDBs should target a nominal return on debt. The proposed nominal debt wash-up mechanism endeavours to achieve this by adjusting revenues within the regulatory period to, for the debt portion of the RAB, correct for the difference between forecast and actual inflation in previous years.

ENA notes that this is an untested approach to addressing the issue and would like to better understand its impact on volatility cashflow and its interaction with the broader revenue wash-up. ENA is eager to hear the views of other stakeholders on the novel nominal debt wash-up mechanism and looks forward to providing further comment and analysis on the issue in the course of the cross-submission process.

An alternate approach to resolving the nominal debt issue is to apply the same forecast inflation used in the financial model in the RAB roll-forward model. As noted by CEG, this approach would significantly reduce the risk of large price volatility.

## 5.4 Demand volume wash-up for CPPs

ENA supports the proposed demand volume wash-up, for CPPs, to address the increasing uncertainty when forecasting connection volumes when the PQ paths are set. We understand that the purpose of this mechanism is to wash up for forecasting error for general, not large connections, as the large connections can be addressed via reopeners and large connection contract mechanisms.

It is proposed that this mechanism will apply only to CPPs because the basis of the connection forecasts is better understood at the time the CPP is determined than the DPP. However, as the same level of uncertainty applies at the beginning of DPPs and CPPs, we submit that the wash-up mechanism should also apply to DPPs.

The 2020 EDB DPP decision included an analysis of forecast EDB connection numbers (general and large connections) and connection costs as part of the capex gating analysis[10]. It would be possible to use actual data once available for each year of the regulatory period to calculate the variance to this data (or similar data used to determine the connection capex underpinning the price-quality path) to derive the wash-up.

This approach would better promote the 52A purpose because it would ensure suppliers are compensated for the actual connections which are made to the network during the regulatory period, and arbitrary gains

[10] Refer Commerce Commission, Capex-projections-model-EDB-DPP3-final-determination-27-November-2019.xlsx

or losses, which may arise from forecasting uncertainty are avoided. This is consistent with promoting appropriate incentives to invest and meet customer demand.

If the demand volume wash-up is not included in DPPs, then ENA submits that connection capex must be excluded from the capex IRIS to address the concerns raised above.

## 5.5 Secondary revenue control limit

ENA supports modifications to the secondary revenue cap limit to address the unforeseen circumstances which emerged during DPP3 resulting in a build-up of unrecovered revenue. Currently, the 10% p.a. DPP3 cap has led to significant uncertainty about the transition of the revenue cap between DPP3 to DPP4, which is contrary to the purpose of the IMs. This reflects uncertainty about when the deferred revenue will be able to be reflected in prices, and therefore what cashflow and funding requirements each EDB will have. This is contrary to promoting incentives to invest at a time when there is increasing demand requiring additional network investment.

The Commission proposed that a revenue smoothing limit term is included in the IMs, defined as 'a maximum limit on revenue (excluding the recovery of pass-through costs) specified by the Commission in a DPP or CPP Determination'.

The draft decision paper suggests this may be expressed in a number of ways (e.g.: dollar, percentage, real, and nominal terms). It does not state whether this will be specific to each EDB or common to all EDBs subject to a PQ determination. We suggest that the approach should be common to all EDBs subject to a DPP determination, which would help to promote regulatory certainty. Modifications can be made for CPPs consistent with the more tailored CPP determinations.

However, as currently drafted, the proposal does not significantly improve regulatory certainty. We suggest this could be achieved by describing in the final decision paper, the policy intent of the limit, and the criteria which the Commission will use to set the limit at each PQ determination. For example:

- to manage undue price shock and pricing volatility for customers
- to ensure suppliers have sufficient cashflow to deliver regulated services and invest in regulated infrastructure
- to ensure suppliers have an expectation of earning a real return within each regulatory period by minimising wash-up carry forward between regulatory periods.

ENA also supports the proposal to exclude pass-through costs, including transmission charges, from the revenue smoothing limit.

## 5.6 Wash-up account

It is proposed to change the wash-up account mechanism to reduce volatility and complexity by:

- combining forecasting wash-ups into a single mechanism
- allowing the Commission to determine the pace of the draw-down
- allowing suppliers to make early drawdown subject to revenue smoothing limits
- simplify relevant IM clauses
- include a transitional wash-up accrual for the first two years of DPP4.

The regulatory incentive recoverable costs would remain outside the general wash-up.

ENA supports proposals to simplify the wash-up and the presentation of the wash-up requirements in the IMs. As noted above, the PQ determination will include some elements of the wash-up, so it is not possible to get a full understanding from the IMs. We have included drafting suggestions in Appendix C.

In principle, we support the proposed wash-up accrual approach which tracks balances, drawdowns, and time value of money adjustments. ENA supports the proposal to clarify that the wash-up balance from the previous

year carries forward when transitioning from one DPP to the next, and between DPPs and CPPs. The wash-up could also apply to the transition between DPP3 and DPP4, avoiding the need for the proposed 'transitional revenue accrual'.

In Appendix C we raise issues with restrictions on drawing down the wash-up balance in years 1 and 2 of DPP4 which could lead to revenue volatility during DPP4 and contribute to a wash-up account build-up as a result. ENA's preferred approach is a smooth transition of the wash-up balance between DPP3 and DPP4, which is consistent with promoting regulatory certainty and managing revenue and cashflow volatility.

ENA supports the option for EDBs to drawdown the wash-up balance early, subject to the revenue smoothing limits, but submits that this mechanism should also be available in years 1 and 2 of DPP4. Currently, this is not possible as per the draft IM determination.

ENA does not support the proposal for the Commission to specify the pace of the drawdown of a wash-up balance within a regulatory period. This is unnecessary given the compliance limit, the revenue smoothing limit, and the cap on the accelerated wash-up. This adds regulatory uncertainty which is contrary to the purpose of the IMs, and the revenue cap wash-up works well without the proposed term. We submit that EDBs are best placed to manage their cashflows within regulated revenue limits. We also note that the draft decision papers include very little information about the purpose of the base wash-up drawdown and what criteria the Commission will apply when determining the value of the drawdown for each EDB. Without adequate information about the role of this mechanism, it is difficult to support it. For example, is it intended to address any wash-up balance at the beginning of the regulatory period, or is it intended to address wash-up which may build up or down during a regulatory period? It appears that the mechanisms could conflict with the intent of the accelerated wash-up drawdown mechanism.

### 5.7 Change the timing of CPI wash up

ENA supports the proposal to reduce the CPI wash-up lag in the price path by allowing a one-year ahead forecast to be included in forecast allowable revenue when setting prices, with a residual wash-up in the following year once actual inflation is known. This should help to avoid the significant build-up of inflation wash-up and hence deferred revenue that has occurred during DPP3. This supports providing the cashflow necessary to invest in regulated services, which helps to avoid significant pricing volatility and price shocks between regulated periods.

### 5.8 Classify transmission costs as pass-through costs

ENA supports the proposal to classify transmission charges as pass-through costs and allow those costs to be passed through in the year incurred, i.e. pass-through costs will not be subject to the secondary revenue control limit. Pass-through costs are beyond the control of EDBs and reflect costs that are not directly incurred by the EDB.

We support the rationale in the decision paper acknowledging that it should not be EDBs that are forced to defer recovery of transmission charges. Rather, the TPM and/or Transpower's PQ limits are the appropriate mechanisms for smoothing transmission charges if necessary.

## 6 Incentives and risk

ENA acknowledges the Commission's analysis of the issues related to incentives and risks and notes the Commission has found no evidence that EDBs have a preference for capex over opex or have incurred imprudent or inefficient expenditure.

### 6.1 Financeability

ENA welcomes the Commission's recognition that financeability is a concern for EDBs in the face of the increased expenditure to enable New Zealand's electrification. While, as the Commission notes financeability,

is not a problem faced by EDBs to date, ENA is concerned that it will become a material issue within the next regulatory period.

ENA's view is that the Commission must ensure that every PQ determination gives rise to revenues and cashflows, for all EDBs, that are consistent with the credit rating assumed in the cost of capital set out in the IMs.

To ensure that this test of financeability occurs at each and every PQ determination, the Commission should enshrine into the IMs, a test of the equivalence between, the Commission-approved revenue allowances with cashflows that would result in that EDB achieving a BBB+ credit rating.

### 6.2 Inflation forecasting

The Commission has once again in its draft decision elected to retain an inflation forecasting method that depends solely on the accuracy of the RBNZ CPI forecast. Which, despite the RBNZ's best endeavours has proven to be inaccurate[11].

As highlighted in ENA's submission on the cost of capital from March 2023[12], this single-point forecast risk can easily be mitigated by averaging the RBNZ forecast with a second forecast of inflation derived from the market expectation of inflation. ENA submits that the Commission should reassess its draft decision on the inflation forecasting method.

### 6.3 IRIS

As noted above and in ENA's submission on uncertainty mechanisms, changes should be made to the IRIS only in situations where other mechanisms are not available or do not fully address the issue. The Commission has not proposed any material amendments to the core functions or design of the IRIS. ENA supports this decision.

The Commission has made some minor changes to the IRIS's operation. ENA supports the draft decision proposed changes to the treatment of inflation within the IRIS allowances. These changes should be viewed as a stopgap with the Commission's future efforts and resources put to best use by focusing on delivering mechanisms that can better resolve the uncertainty implicit in New Zealand's electrification.

ENA disagrees with the proposed amendment to use the mid-point WACC for the IRIS calculations. ENA's view is that the IRIS should use the WACC used to set the revenue allowance for regulatory and internal consistency.

### 6.4 Innovation allowance

While ENA supports the Commission's proposed changes to the innovation allowance, these changes do not go far enough to remove the barriers to the uptake of it or to strongly signal and support innovation in our sector through available funding. As a result, the innovation allowance will likely remain a tool of limited use to EDBs.

## 7 Drafting and other issues

### 7.1 Non-policy drafting and practical issues

ENA and its members have conducted a comprehensive review of the existing IMs to identify practical and, drafting issues/errors and a series of changes to the IMs to address these. A log detailing each of these issues and recommendations to address them is contained in the spreadsheet attached in Appendix D.

[11] The scale of this forecasting error is laid out in section 9 of the ENA 2023 rate of return submission

[12] Electricity Networks Aotearoa, 2023, Submission on rate of return issues

### 7.2 Definition of operation costs

ENA does not support the proposed amendment to the definition of operating cost to exclude the costs of appeals under sections 52z, 91 of the Act. The cost of an appeal should be shared with consumers who could ultimately benefit from the EDB having appealed. This change comes across as a way for the Commission to reduce the chance of appeals against its decisions and is not in the long-term interests of consumers.

# 8 Contact

ENA's contact person for this submission is Keith Hutchinson (keith@electricity.org.nz or 04 555 0074).

# Appendix A – ENA Members

The Electricity Networks Association makes this submission along with the support of its members, listed below.

Alpine Energy

Aurora Energy

Buller Electricity

Centralines

Counties Energy

Electra

EA Networks

Firstlight Network

Horizon Energy Distribution

Mainpower NZ

Marlborough Lines

Nelson Electricity

Network Tasman

Network Waitaki

Northpower

Orion New Zealand

Powerco

PowerNet

Scanpower

The Lines Company

Top Energy

Unison Networks

Vector

Waipa Networks

WEL Networks

Wellington Electricity Lines

Westpower

# Appendix B – CEG response to 2023 IM draft decision on cost of capital

# Appendix C – Revenue Cap drafting comments

| IM CLAUSE | TERM | COMMENT |
|---|---|---|
| 3.1.1(1)(b) | revenue smoothing limit | It is not clear whether the revenue smoothing limit will apply in year 1 of a regulatory period. As there is discretion for the Commission to determine the first year allowable revenue, we suggest that regulatory certainty would be improved if the limit was defined with reference to the first year allowable revenue, i.e.: did not apply in year 1 |
| 3.1.1(3) | wash-up accrual amount | The cost of debt wash-up amount should be added not subtracted, as the amount correctly returns a negative value (in cl 3.1.1(9)) if revenue is to be reduced |
| 3.1.4 (1), (5) and (12) | transitional revenue accrual | As drafted it appears that the transitional revenue accrual is not available for drawdown in years 1 or 2 of DPP4. This is because the wash-up drawdown is limited by the t-2 wash-up balance as per 3.1.4(5)<br><br>As the transitional revenue accrual is the carry forward of the wash-up balance from DPP3 this will create a disjoint in the price path which introduces volatility. It also potentially defers revenue recovery again.<br><br>We suggest that instead of the transitional accrual, the wash-up balance drawdown formula for the start of DPP4 simply links to the wash-up balances in years 4 and 5 (i.e.: t-2) in DPP3. This is consistent with how the mechanism is intended to apply in future transitions between regulatory periods.<br><br>In addition, subclause 3.1.4 (12) needs to be consistent with subclause 3.1.4 (1)(f) which implies there are two transitional revenue accrual amounts – this is not clear under subclause 12. |
| 3.1.4(4) | actual allowable revenue | We understand the intent to combine the factors leading to wash-ups into one account. However there is a sequence required to do this correctly, and to make this easier to apply, and therefore to improve regulatory certainty and reduce complexity, we suggest separating clause 3.1.4(4) into two sub-clauses, reflecting:<br>• those wash-ups which only impact year 1 actual allowable revenue, which is the part that needs to be calculated first, and<br>• those which apply in subsequent years using the actual allowable revenue derived under the first sub-clause. |
| 3.1.4(5)(b) | accelerated wash-up | As drafted it appears that the accelerated wash-up is only available after year 3 of DPP4. This mechanism should also be available in years 1 and 2.<br><br>In addition, although there is a cap and collar specified with reference to the t-2 wash-up balance, there is no cap or collar in the other direction, which should be zero. |

# Appendix D – IM practicality issues log