T +64 4 471 1335

Level 5, Legal House
101 Lambton Quay
Wellington 6011

PO Box 1017
Wellington 6140
New Zealand

12 August 2019

Dane Gunnell

Manager, Price Quality Regulation
Commerce Commission,
PO Box 2351,
Wellington 6140.

By email to regulationbranch@comcom.govt.nz

Re: 2020 DPP draft Decision submissions - cross submissions.

Dear Dane

Thank you for the opportunity to cross submit on matters raised in other party submissions on the Commission's 2020 DPP Reset Issues paper, 15 November 2018.

ENA members generally remain supportive of the Commission approach to the matters that need attention for the 2020 DPP reset and, over the last 12 months, have sought to provide the Commission with both members' views on specific issues as well as external expert advice that we consider would improve the effectiveness of this reset for both consumers and EDBs.

Our review of stakeholder submissions resulted in the following comments.

Opex IRIS incentives

We respond to some of the points made by Pat Duignan ("Duignan"). He argues that the strength of opex IRIS incentives is determined by the discount rate at any point in time.

ENA submits that the opex IRIS incentive mechanism has been designed around ensuring that over the five-year regulatory period, an EDB does not face any distorted incentive to time an opex saving to the first year of a regulatory period, in order to maximise the proportion of benefit retained by the EDB.

The proportion of the NPV of a permanent saving in opex received is determined by the WACC, but this does not impact on incentives to reduce operating expenditure. The fallacy of Duignan's argument that EDBs will face weaker opex efficiency incentives in DPP3 is shown in the following table. At the lower DPP3 WACC (5.13%), an EDB gains a higher NPV of an equivalent saving than in DPP2 in dollar terms – the incentive has gone up, not down! Unless the Former Commissioner is suggesting that EDBs are driven to make opex savings out of a sense of fairness in the proportions of benefits achieved, his argument holds no logic.

	Discount rate	
	7.19%	5.13%
Total NPV of $1 saving per annum in perpetuity	$13.91	$19.49
EDB retained value of NPV saving	$4.08	$4.31

ENA rejects Duignan's assertion that the opex IRIS scheme has been ineffective during DPP2 because actual expenditure has exceeded the DPP2 allowances after adjusting for variances in scale and input prices from those assumed in forecasting opex.

As the ENA established at the time of setting the DPP2 opex allowances, the industry was experiencing a trend decline in measured opex partial productivity, which the Commission increased from the trend identified in the Economic Insights 2014 study of at least -0.8% per annum to -0.25% per annum. No allowances were made for non-scale factors driving aggregate increases in expenditure, such as from rising cyber-security costs, health and safety, regulatory requirements, and the like.

Regarding the strength of the capex IRIS incentive, Duignan argues that the WACC uplift impacts on the evaluation of the strength of the retention factor, because an EDB would consider the loss of the WACC uplift on foregone capex. Duignan observes that it is an assumption that the 50th percentile of the B-L CAPM is an unbiased estimate of the cost of capital, such that at the 67th percentile, EDBs receive an advantage of the uplift.

In effect, it is assumed that EDBs regard the 50th percentile WACC as representing their true cost of capital. ENA members submit that this assumption is erroneous. ENA members consider that a WACC of 5.13% (real return of 3.13% that is dropping and likely to be around 4.7%, 2.7% real, in the final decision) is not in any way, an incentive for investment, given the long-term risks of the business.

At these levels of WACC, (where the real risk-free rate is now negative) there is strong risk of incentivising under-investment during this regulatory period. We note Duignan's comment that with a low risk-free rate, EDBs would be more incentivised to invest. We can assure the Commission that the situation is very much the opposite!

Innovation allowance

As a general comment, the ENA is very encouraged by the wide range of stakeholders who support the proposal in the draft decision to include an opex allowance for innovation investments in the DPP3 reset. We also note that submitters (Lord Consulting, Callaghan Innovation, emh-Trade and

ETNZ) are suggesting the allowance that the Commission included in the draft decision is too small to be effective and that a larger percentage should be included in the final decision.

The ENA provided a report from Brattle group with its submission on the DPP3 Issues paper in October 2018. Brattle described the well-established precedents for regulators to sponsor innovation in regulated industries and for electricity a number of jurisdictions have set up funded regulatory processes to drive innovative outcomes for consumers. (The Brattle case studies were drawn from Great Britain, Australia, California, New York and Illinois and discussed incentive mechanisms for losses, connecting DERs, promoting non-wires alternatives, energy efficiency and innovation)

The ETNZ submission usefully reminds the Commission of its obligations under Section 54Q of Part 4 of the Commerce Act - the Commission is to ensure that suppliers of regulated services must:

> *"(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
> *(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands …"*

In their submission ETNZ have particularly strong words regarding the Commission's inclusion of only a 0.1% allowance as evidence of under-performance regarding the s54Q requirements while they point to the removal of the 'D factor' as further support of their criticism.

Partial productivity factor and EDB efficiency

Both ERANZ and several retailers have expressed strong views regarding the efficiency of EDBs and have cited price trend data from the MBIE quarterly survey of retail price as evidence of poor performance by EDBs over DPP2, and earlier.

We do not consider that this sort of analysis is appropriate for a consultation regarding a draft decision on the revenue building blocks for DPP3. There are other forums and submission opportunities for these stakeholders to put forward advocacy positions – now is not the time.

ERANZ also makes another play for ratcheting up the partial productivity factor in the Commission final decision on the DPP3 reset. This advocacy position appears to be consistent with the position that they took on the DPP3 Issues paper where they advocated for a partial productivity factor for opex at a value of +1.5%.

The ENA engaged NERA to provide expert advice and evidence to the Commission as to what an appropriate factor would be, and the NERA report was provided with our submission on 18 July 2019. From the analysis, NERA made two important observations;

- The 'partial productivity factor' is better thought of as the portion of opex that <u>cannot</u> be explained by changes to line length or ICP numbers (these are the drivers that the Commission use in the opex model), and

- Based on its analysis, this residual factor should be set at a figure between -1.7% and -3.1% for DPP3.

ENA submits that the Commission needs to clear up the confusion of what the partial productivity factor allowance is providing for by relabelling it for the final decision. Terminology such as "non-scale operating expenditure allowance," would be a much better descriptor of what the "partial opex productivity" factor is in fact covering - this would cover both partial productivity and other drivers of opex unrelated to scale.

ENA reiterates the significant concern that its members have that there is zero allowance for any increased obligations on EDBs during DPP3. In our view NERA has conclusively shown that the net cumulative trend in the myriad factors that EDBs have to manage in their operating environment (including any offsetting productivity improvements) has been between -1.7% and -3.1% over a lengthy period.

None of these myriad changes in the operating and legislative environment during DPP2 have been sufficient to trigger DPP reopeners. ENA submits that the Commission must have strong evidence and reason to depart from adopting the evidence-based analysis of trends in NERA's report, especially in light of growing expectations on EDBs as expressed through IPAG's recommendations to the EA and the Government's climate change objectives, which will only serve to drive EDB's costs higher.

Wage rate inflation

Statistics NZ recently release shows a 3.4% increase in electricity/gas workers labour index during the June 2019 quarter compared to the same period in 2018. This data, (the trend is increasing over time) reinforces our previously stated concerns that there is a high risk EDBs will be materially undercompensated for labour cost increases.

(https://www.stats.govt.nz/information-releases/labour-market-statistics-june-2019-quarter)

Increasing concerns about low WACC

As noted in the ENA's submission, our members are becoming increasingly concerned about the low level of WACC, which continues to drop significantly with the declining 5-year Government stock rate. Expected real yields on 5-year Government stock are now negative (of the order -1% pa). ENA has noted the expert report by CEG on IM Changes for the DPP.[1] ENA strongly supports consideration of the issues raised in that report.

Negative real bond rates are unprecedented. The ENA submits that where IM changes are necessary to address such an unprecedented issue, the Commission must not shy away from making urgent IM changes, particularly as these effects are locked in for five years without prospect of re-opening the DPP.

---

[1] https://comcom.govt.nz/__data/assets/pdf_file/0017/160163/CEG-on-behalf-of-Vector-Submission-on-IM-amendments-for-DPP-and-IPP-5-July-2019.pdf

An additional and increasing concern is the substantial proportion of equity returns that flow through in the form of capital gains (revaluations) as a result of indexation of the RAB. The proportionate risks to equity holders of inaccurate CPI forecasts are magnified at such low levels of WACC and we are seriously worried that any bias in the RBNZ's CPI forecasts will result in under-compensation of EDBS during DPP3.

An example serves to illustrate this point. If the WACC ends up at 4.7%, and CPI is forecast at 2%, more than 50% of returns to equity are in the form of revaluation gains[2]. If CPI turns out to be only 1%, then more than 25% of equity returns would be wiped out just due to CPI forecast error.

We appreciate that indexation of the RAB is an IM issue, as is the selection of RBNZ forecasts for CPI, but that does not lessen the implication that EDBs face a WACC and risk to returns that does not incentivise investment.

We note that despite the worsening economic outlook, RBNZ's CPI forecasts have barely changed since the previous OCR and still show an uptick in inflation to the 2% level within DPP3. We think the Commission should consider whether there are mechanisms within the DPP to true-up forecast error in the CPI, as the exposure to CPI risk to returns on equity is a potentially a serious detriment to investment incentives.

Planned outages

In its submission MEUG questioned the target performance for planned outages that the Commission has included in the draft decision. MEUG are of the (misguided) view that the 3x historical average "*exposes customers to a significant reduction in reliability quality standards without a clear explanation of why such a large increase Is necessary".*

The ENA does however share some of MEUGs concerns – in our submission, at para 115, we noted –" *it is not clear why the limit has been set a 3x the target, and therefore it is not possible to comment on this aspect of the proposals. We do however agree with the intent to enhance distributors' flexibility in managing planned work or to respond to emerging needs on the network, which will be in the longer-term interest of consumers".*

Closing comments

Again, ENA members are appreciative of the opportunity to provide the Commission with feedback on stakeholder submissions regarding the 2020 DPP3 draft decision. While we do not want to reiterate material from our 18 July submission, we would bring the Commission's attention to the strong consensus that has emerged from the submissions of other EDBs.

Our members have concerns with aspects of the quality standards proposal (such as the 5% inter-period limit, move away from 2-out-of-3 to annual rests and the lack of clarity on enforcement

[2] Because interest rates on debt are nominal.

approach). They also support linking quality targets to customer preference (we note that ERANZ and MEUG favour this approach too).

The last point to note in this regard are the concerns raised by EDBs that a number of factors are conspiring to place considerable pressure on cash flows and regulated returns, leaving a number quite concerned about their ability to finance their businesses in DPP3.

Yours sincerely

David de Boer

Principal Advisor Regulation and Pricing