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Draft Fibre IM Determination

Submission to the Commerce Commission

Final

From the Electricity Networks Association

Contents

1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission to the Commerce Commission (Commission) on the consultation paper, **Draft Fibre input methodologies determination 2020. 11 December 2019,** and accompanying support papers.

2. The ENA represents all of New Zealand's 26 electricity distribution businesses (EDBs) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network) electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

2. Submission summary

3. This submission is prepared in response to the Commission's draft determination on fibre regulation Input Methodologies.

Approach to draft IM determination

4. ENA members are now fully focussed on implementation issues following the recent DPP3 final decision and have not had much time to consider the draft Fibre IM decisions, especially given that a significant proportion of the fibre IM consultation timetable has been over the Christmas holiday period.

5. Partly because of this, we have focussed on a small number of issues in this submission. Where we have not commented on other aspects of the draft determination, this should not be taken as EDB's tacit endorsement of the Commission's draft IMs. We consider that ENA members have not had the ability to engage fully in the fibre IM process, given competing regulatory issues.

6. **We therefore submit that the Commission should ensure that the decisions it makes on fibre IMs are not seen as a precedent for the next EDB IM Review in 2023.**

Investment incentives and WACC uplift

7. ENA members are concerned about the implications of the draft fibre IMs for EDBs, especially the proposal to not adopt a percentile uplift to the WACC because, (from our reading), the

Commission does not consider that there would be a significant loss from under-investment, and/or that quality issues could be addressed by specific quality incentives for fibre services. Although the Commission has recognised that quality incentives should not be used to compensate for a WACC that is too low, (in 3.1212), our read is that the Commission's considers quality incentives would hold the regulated supplier to account for the opex and capex allowances that have been given. It is the ENA view that it would be unreasonable to see the quality incentive regime that uses an accountability tool such as this to compensate for a WACC that is set too low.

8. The presumption that precisely set quality outputs can be established by regulation risks setting levels that are misaligned to the long-term needs of consumers and unfairly prejudicing suppliers. This is because highly prescriptive quality standards which do not have capex and opex levels established to deliver the programmes will result in suppliers breaching their quality standards because trade-offs have not been effectively considered to deliver the output.

9. This is in fact the case with the most recent DPP3 reset where a planned SAIDI/SAIFI penalty regime for cancelled works has created a volume of work that requires new arrangements with field service providers with no commensurate funding through the set opex allowances for electricity distributions businesses.

10. On the other hand, highly prescriptive quality standards administratively set and funded, suffer from the risk of not being in the long-term interests of end-users. This has in fact been the case for electricity networks in Australia where rolling blackouts in Brisbane and Sydney caused governments to introduce more onerous supply standards and a consequential ramp up in supplier investment. This ramp up increased the capital value of the businesses and has now resulted in a concerted campaign for the capital write-downs for lines businesses.

11. Through-out the past and existing application of Part 4 regulation to lines companies and Transpower, (and Part 4A previously), the Commission has used a WACC percentile to ensure that there is adequate incentive for regulated businesses to invest in essential infrastructure. This has been a key feature of the landscape because it promotes dynamic efficiency and avoids the adverse consequence of poor quality or under-delivered services.[1]

12. Chorus and its predecessor Telecom were active participants in WACC discussions during the period when Part 4A was in play, as well as when the IMs were being developed. Given that a WACC uplift was a core component of the regulatory architecture at the time UFB roll-out bids

[1] The probability distribution is a distribution of estimates of the true mean. The 67th percentile is a level where there is only a 33% chance that the true mean is above this level, giving EDBs a better than even chance of earning an adequate return if the Commission's WACC estimate is too low.

were being prepared, it is unfathomable to us that a WACC percentile would not factor in their bids given the knowledge that regulation would determine prices in the "post-contract" period.

13. It is the ENA view that there is a strong likelihood of a "regulatory mugging" (in Professor Yarrow's terminology), if the Commission fails to continue with the WACC uplift - investors in LFC's could rightly feel that there has been a significant and un-expected break in the regulatory settings that undermines overall confidence in regulatory stability and predictability. We think that the Commission needs to look at the loss function more broadly, such that losses due to under-investment in other complementary sectors for fibre-based regulation are considered when determining the fibre IM loss function.

14. In this regard, the ENA notes that the Commission has stated that it does not consider that IMs represent a regulatory compact. If the Commission considers that the long-term benefits of EDB consumers would be promoted in the future by abandoning the WACC percentile (e.g., because the losses due to potential under-investment in distribution networks are no longer considered as impactful) then we are concerned that the core IM assumption of NPV = 0 for investments is undermined.

15. We consider that applying this threat to Chorus through the fibre IM would be a palpable demonstration that once investments are sunk and future investment is no longer so important, that investors are subject to an ex post appropriation of value. **We strongly recommend that the Commission include in the loss function the risk of capital withdrawal from other regulated sectors if it does not include a WACC percentile for Chorus.**

Cost of capital components

16. *Risk free rate* – ENA remains concerned that the approach to determining the risk-free rate and cost of debt do not represent best-practice Treasury Management and exposes consumers to unnecessary long-term instability because it does not compensate EDBs for an efficient cost of debt.

17. Including a component (the real risk-free rate) in the calculation of WACC that implies investors in risky assets are willing to destroy a component of value by accepting a negative real return is not plausible in the ENA view, which leaves us concerned that a negative real risk-free rate is not consistent with finance theory. As CEG has expressed, there is a real absence of risk-free investments and there is a flight to relative safety of Government stock.[2]

18. The Commission's letter in response to Vector in the DPP3 reset, noted that the possibility of negative real interest rates existed during the IM Review, but the Commission letter does not

[2] Refer page 2, 'CEG-on-behalf-of-Vector-Submission-on-IM-amendments-for-DPP-and-IPP-5-July-2019.pdf'

state whether the Commission itself considered this potential (EDB's certainly didn't), nor does it state how the Commission evaluated this potential and why no adjustment needs to be made if negative real rates arise.

19. *TAMRP* – **ENA submits that there needs to be consideration whether this WACC element is hard coded as a numeric value in the IM or as a value to be updated each time WACC is reset.** It appears to us that EDBs have lower cost of capital in DPP3 than is implied by the 7.5% value that has been calculated for the fibre WACC by Lally – this being based on data contemporaneous to the DPP3 final determination

20. *Debt premium* – the approach to setting the debt premium allowance does not match the cost of debt achievable over the regulatory period, and the ENA considers that indexation is appropriate. There needs to be a mechanism to make an annual adjustment to the debt component (Kd), such that the oldest period rolls out of the calculation and the latest year rolls in. This could, though need not, result in an adjustment to the revenue cap or at the end of the DPP period, in an NPV neutral wash-up. From a practical viewpoint, the Commission calculates new debt premia every year anyway, and we don't consider that the administrative burden would be problematic for them.

Appendix - member support

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

1. Alpine Energy
2. Aurora Energy
3. Buller Electricity
4. Counties Power
5. Eastland Network
6. Electra
7. EA Networks
8. Horizon Energy Distribution
9. Mainpower NZ
10. Marlborough Lines
11. Nelson Electricity
12. Network Tasman
13. Network Waitaki
14. Northpower
15. Orion New Zealand
16. Powerco
17. PowerNet
18. Scanpower
19. The Lines Company
20. Top Energy
21. Unison Networks
22. Vector
23. Waipa Networks
24. WEL Networks
25. Wellington Electricity Lines
26. Westpower