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Submissions  
Regulation Branch  
Commerce Commission  
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**TLC Submission: Part 4 Input Methodologies Review 2023 Draft Framework paper and Part 4 Input Methodologies Review Process and Issues paper**

**1. Introduction**

The Lines Company Limited (TLC) thanks the Commerce Commission (Commission) for the opportunity to submit on the Part 4 Input Methodologies Review 2023 Draft Framework paper and Part 4 Input Methodologies Review Process and Issues paper.

TLC acknowledges the Commission is seeking feedback on both papers, welcoming views on the topics the Commission has identified and any other issues relating to the IMs that warrant further consideration. The key topics the Commission has identified for the IM review are:

- Risk allocation and incentives under price-quality regulation;
- Issues relating to the cost of capital;
- CPPs and in-period adjustments to price-quality paths;
- Transpower investment; and
- Effectiveness of the IMs for each sector

TLC firstly discusses issues important to TLC and our customers, then some of the issues identified by the Commission. Our submission, in principle, supports and broadly aligns with the Electricity Networks Association (ENA)'s submission.

**2. The Part 4 regulatory regime**

TLC is owned by the Waitomo Energy Services Community Trust (WESCT) and is in the fortunate position of being a community-owned distributor of which we are very proud. As such, we consider the requirements of the community, particularly pricing and quality of supply, and provide support to the King Country community including through sponsorships, scholarships, communication, education, and the MARU Trust. However, TLC does not meet the criteria in the Commerce Act to be considered 'consumer-owned' and is non-exempt from price-quality regulation.

Being price-quality regulated means that the Commission sets the total revenue TLC can recover from its consumers and sets standards for the quality of service that TLC must meet. The incremental rolling incentive scheme (IRIS) within the regime does not however cater for TLC's circumstances. The IRIS provides a mechanism by which suppliers subject to price-quality regulation can retain the benefits of efficiency gains

beyond the end of a regulatory period. During the regulatory period, the supplier is rewarded with higher profits if the expenditure is controlled whereas, at the end of the regulatory period, the benefits of any efficiency gains are shared with consumers, including through lower prices<sup>1</sup>.

The IRIS model anticipates that all regulated distributors price to their allowable revenues. However, where a distributor, such as TLC, chooses or cannot price to allowable revenue (for example, for community affordability reasons), the impact of the IRIS mechanism is perverse and compounds, i.e. if a distributor does not price to allowable revenue during the regulatory period, the distributor is not 'rewarded' but still must share the efficiency gains through lower prices in future periods.

At E128 of the Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision, Reasons paper, the Commission, "want distributors to continue to undercharge their allowable revenue where it is in the best interests of consumers and the wider community. However, distributors looking to undercharge should consider the IRIS impact when considering the level of undercharging."

We encourage the Commission to consider this situation further in this review as commenting that consideration by distributors of IRIS impacts for undercharging does not provide a solution and does not incentivise distributors to do so (voluntarily undercharge)<sup>2</sup>.

### **3. IM Regulatory Definitions**

We encourage the Commission to provide refined definitions in the IMs particularly as they relate to regulated revenues.

### **4. Innovation Investments and Incentive Mechanism**

Electricity Distribution Businesses (EDBs) will unquestionably play a pivotal role in the transition to a low-carbon economy by implementing innovative ideas and developing smart energy systems to improve the functioning of distribution networks to benefit customers in the long term.

The transitional phase, however, has some challenges. The transition will necessitate increased investments in innovation to support increased demand and technological change. The networks must be future-ready to support small-scale decentralised power generation and enable effective Distributed Energy Resources (DERs) integration.

As noted in TLC's recent submission to the Commission<sup>3</sup>, "aggressive DER uptake has the potential to develop a decentralised/competitive energy market, empower consumers, and create a relatively elastic demand". Integration of DER into the network could also have dramatic implications for consumer pricing and hence, on consumers' affordability. Unlocking the full potential of DERs will see efficient investments by the EDBs. Investments will be required to connect DERs to the network and to develop the necessary information and communication technology infrastructure to control the higher volatility of flows and peak demand fluctuations. Investments will also be needed for potential storage technologies and demand management. It must be recognised that EDBs need more innovative investments to support the transformation. Innovative concepts must be developed under a regulatory framework that incentivises them.

The IMs provide for a recoverable cost to allow any innovation allowance the Commission approves in a DPP to be recovered from consumers via increased revenue. They also define what an innovation project can be. However, the process, approval requirements, and the amount at stake is set out in the DPP decision/determination. TLC recommends that the Commission provide greater certainty for innovation

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<sup>1</sup>[https://comcom.govt.nz/\\_data/assets/pdf\\_file/0028/62659/Final-reasons-paper-Incremental-rolling-incentive-scheme-IRIS-27-November-2014-.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0028/62659/Final-reasons-paper-Incremental-rolling-incentive-scheme-IRIS-27-November-2014-.pdf)

<sup>2</sup>[https://comcom.govt.nz/\\_data/assets/pdf\\_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF](https://comcom.govt.nz/_data/assets/pdf_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF)

<sup>3</sup> [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0020/276032/The-Lines-Company-Feedback-on-the-impact-of-decarbonisation-on-electricity-lines-services-28-January-2021.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0020/276032/The-Lines-Company-Feedback-on-the-impact-of-decarbonisation-on-electricity-lines-services-28-January-2021.pdf)

funding by revisiting the current mechanism and increasing the size of funding available, reducing administrative burden, and moving to an ex-ante conditional approval or 'use it or lose it' framework. This would simplify access. The current funding and process, particularly for smaller EDBs, is inadequate and the post-approval nature of any project is not inviting and introduces undue risk, i.e. that a project may not eventually be granted approval by the Commission.

TLC suggests that knowledge-sharing is also encouraged via an incentive scheme so that smaller EDBs can not only learn from larger EDBs' innovation successes but also from trials and failures across the industry.

## **5. Incremental Rolling Incentive Scheme (IRIS) Mechanism to Improve Efficiency**

We support the ENA's take on IRIS reform and emphasise removing expenditures due to consumer connections, system growth, asset relocation and capacity building to support decarbonisation (e.g., electrification of process heat and public transport and rise in EV uptake) from Capex IRIS calculations so that distributors are not penalised for facilitating demand growth. It will also remove incentives for distributors to alter the timing and quantum of these expenditures. Distributors should not be penalised for building extra capacity to support the electrification of process heat and meet increased electricity demand from mass-market due to a reduction in the usage of other energy sources, e.g., fuel, coal, and gas. We suggest that the Commission take a long-term view on building additional (future) network capacity. If there happens to be a short-term redundant capacity in parts of the networks, increased electricity demand (from EVs, electrification of public transport, consumers switching to electricity from gas, etc.) will catch up in the long term.

The Commission discussed Chorus's connection Capex mechanism as an alternative solution that maintains efficiency incentives under a revenue cap. However, it is not as simple for distributors with details being different. Firstly, variable connection cost (due to increased customer connections, electrification of industrial heat, relocation of assets, etc.) is not a linear function of demand. It is a multi-variate non-linear function as several other factors are involved: location of the connection, existing capacity, upstream capacity, connecting assets' age and health, etc.

## **6. Building Future Capacity in the short term**

There will be long lead times in developing capacity after the security of supply has been compromised. We want the ability to proceed with required upgrades to support increased electrification and decarbonisation. We encourage the Commission to give distributors appropriate incentives to implement the necessary innovative initiatives that support this transformation. Although short-term redundancy built into network capacity may mean little or no change in network performance over the short term due to load and non-load investment, the electricity demand will grow substantially in the long term. Building capacity in advance is better than building it after service quality declines. We understand that it will lead to an increase in the cost to customers, but it is unavoidable. The Commission notes in the Process and Issues paper on page 54, "...underinvestment that leads to outages is often worse for consumers than high prices. An expensive service is often better than no service".

## **7. WACC's building blocks**

Maintaining an appropriate level of equity to finance the investments needed to support electrification and decarbonisation will require an adequate rate of return to reduce the risk of under-investment. We have a few comments that relate to the inputs of WACC calculations.

### **WACC percentile**

The hurdle rate should be enough to compensate for all the risks attached to the investment. We understand that the Commission is concerned with ensuring that the profits made by the regulated businesses are not excessive of what an average commercial entity would have earned on a similar investment. At the same time, the Commission must allow investors to get a fair return on their investment. If the return on investment is

inadequate, there is a chance that the industry will see reduced investment, ultimately deteriorating the quality of services that the customers receive.

Setting the WACC above the mid-point has been well supported in literature: “... the welfare losses arising from ‘under-investment’ when setting too low an allowed rate of return (AROR) are likely to be greater than from some degree of ‘over-pricing’ when setting it ‘too high’, and that this motivates setting an AROR above the mean value of the WACC distribution<sup>4</sup>.” The two main reasons for the above mean WACC are i) above mean WACC distribution maximises the economic welfare as compared to the below mean WACC and, ii) as the economic loss is asymmetric, therefore when the WACC is set above the mean value, the welfare loss is much less than it would have been when it was set below the mean value<sup>4</sup>.

We recommend maintaining the current 67th percentile of WACC and not reducing it to a lower percentile. The drawbacks of a lower percentile will outweigh the benefits the consumers will receive with a lower WACC. In contrast, a higher percentile will provide an incentive for the investment that will ultimately improve the service quality for the consumers, which is in line with s52A.

## 8. Asset Betas

Since the COVID pandemic, the volatility of different sectors has flipped completely. Sectors such as Information Technology and Pharmaceuticals were considered more volatile than those such as Energy or Consumer Staples. Table 1 below reports the sector betas listed on S&P500 before and after COVID for US firms. The results of betas for the companies listed in the US stock market are a good benchmark as the Commission also uses the US electric companies as a comparator<sup>5</sup>. Table 1 below shows that the energy sector’s beta has increased from 1.26 to 1.44. This increase in the beta explains how the investors perceive the risk when evaluating the energy sector<sup>6</sup>. We believe adjustments should be made to the asset betas of distributors, which appropriately reflect the risk and reward relationship.

**Table 1: COVID-Induced Beta Inversions**

Sector	COVID Beta	2019 Beta	Change in Beta
Pharmaceuticals	0.81	1.11	-0.30
Information Technology	1.11	1.37	-0.26
Health Care	0.90	0.98	-0.08
Communication Services	0.90	0.97	-0.07
Industrials	1.07	1.14	-0.07
Materials	1.08	1.06	0.02
Consumer Discretionary	1.19	1.06	0.13
Energy	1.44	1.26	0.18
Consumer Staples	0.73	0.54	0.19
Financials	1.30	1.06	0.24
Real Estate	1.16	0.44	0.71

<sup>4</sup>Dobbs, I. M. (2011). Modeling welfare loss asymmetries arising from uncertainty in the regulatory cost of finance. *Journal of Regulatory Economics*, 39(1), 1-28.

<sup>5</sup>[https://comcom.govt.nz/\\_data/assets/pdf\\_file/0032/95576/Cost-of-Capital-Straw-Person-Example-Electricity-Distribution-Industry.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0032/95576/Cost-of-Capital-Straw-Person-Example-Electricity-Distribution-Industry.pdf)

<sup>6</sup> <https://blogs.cfainstitute.org/investor/2020/07/14/stocks-turned-upside-down-the-covid-19-beta-effect/>

## 9. Cost of Debt

The Commission has asked for views on the prevailing “on-the-day” approach compared to the “trailing average” for calculating the future cost of debt. While both approaches have pros and cons, our view is to keep the prevailing method for setting the cost of debt. The issue has been discussed rigorously, and the following points bend our opinion towards using the prevailing approach.

As shown in Figure 1 below, the current risk-free rate is higher than the trailing average of the daily risk-free rate. This means that firms will require an allowance based on the current interest rates. This will not be an issue with the on-the-day methodology as it will be based on the current market conditions. As the cost of debt is an essential component of the WACC, a lower risk-free rate will mean that the WACC estimate does not reflect the current market conditions.

**Figure 1**

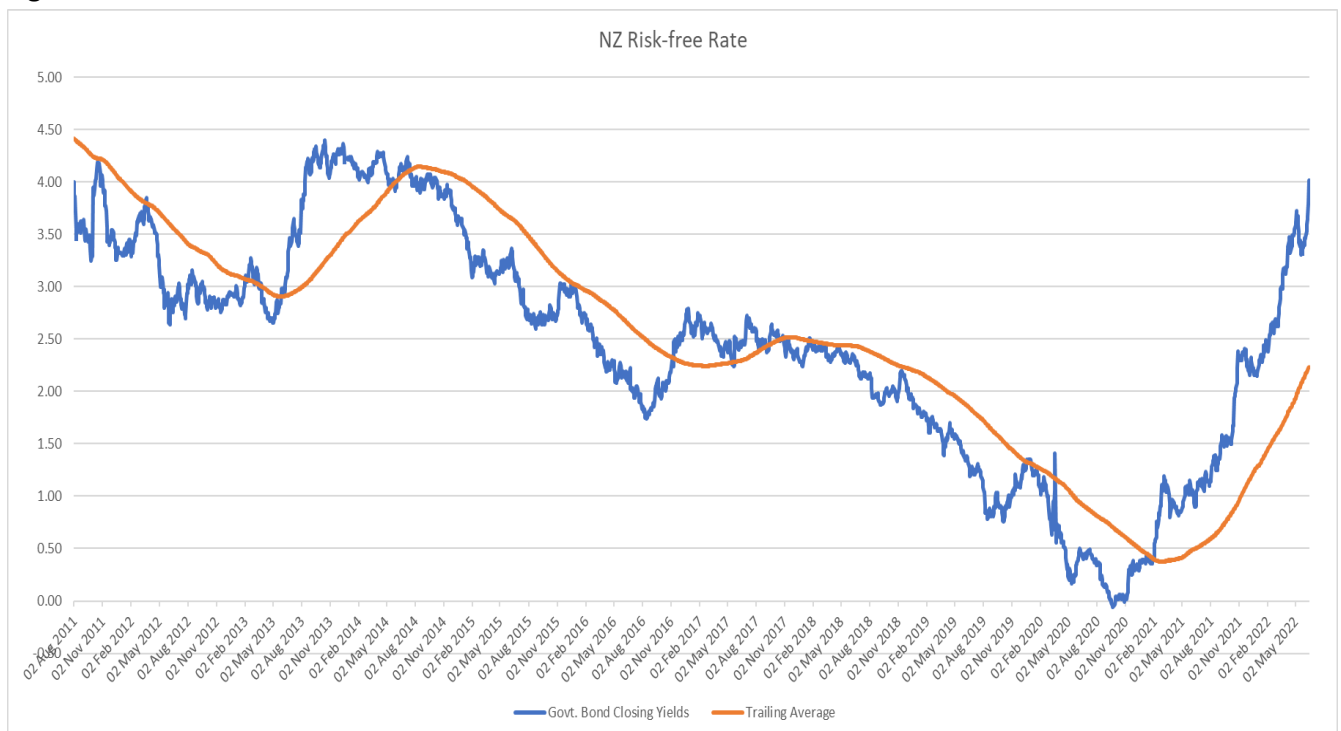


Figure 1: The daily Risk-free rate on a 5-year gov. bond vs the trailing average (Data Source: RBNZ)

Appropriate and accurate signalling for the future is essential for investors. The investment opportunities should always be evaluated under the current market conditions. The on-the-day approach reflects the current market conditions in a much better way as compared to the trailing average method. Since the trailing average is based on past data, it has a high chance of over/underestimating the cost of the debt for the current market conditions. This will eventually lead to an over/under-estimation of the allowable revenue.

No part of this submission is confidential. If the Commission has any queries, please contact Saba Malik at (Saba.Malik@thelines.co.nz).

Yours sincerely

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