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Fibre IMs: emerging views

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, **Fibre regulation emerging views: Technical paper. 21 May 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 emerging views on fibre regulation.

Approach to IMs

4. The purpose of IMs is to promote regulatory and hence investment certainty in regulated markets.

5. Given the similarities in the legislative frameworks for the regulation of electricity, gas and specified airport services under Part 4 and FFLAS services under Part 6, regulatory certainty will be promoted with consistent approaches to IMs, where appropriate.

6. However, where the characteristics of the FFLAS market differ to those regulated under Part 4, we expect that the IMs will reflect them.

Asset stranding

7. We support the consideration of regulatory tools to address the potential for asset stranding, for example due to demand risk through competition and/or technological obsolescence.

    - We note that the EVP has identified a number of tools for this purpose including:
        - Maintaining assets in the RAB
        - Accelerated depreciation

- A compensation fund.
- An adjustment to the WACC.

- In addition to these, we note that an unindexed RAB approach could also mitigate stranding risk by front loading capital cost recovery, compared to an indexed RAB approach.
- The ENA supports ex-ante methods to address stranding risk, particularly partial stranding risk. This is in the long-term interests of end-users because it spreads this risk over time, and over the useful life of the assets/services. It avoids significant burdens on end users in the future, while compensating investors for the risks they face in providing regulated services.
- Ex-post methods are not supported because they are not consistent with regulatory certainty, or the long-term interests of end users. There is less certainty that ex-post methods will be able to be utilised, as these risks may not be able to be compensated for if demand substantially reduces. They also assign this cost to those end users who are reliant on the service.
- A WACC adjustment appears to be the most straight-forward mechanism, and could be implemented immediately, with a relatively small impact on end-users in the short term. Other options include shorter asset lives, and no RAB indexation.

8. At a general level we have concerns with any mechanism that transfer the costs of stranding risk to the future and onto other consumers because it creates an inefficient subsidy arrangement and shifts the burden of a lack of competition to those who are reliant on non-stranded assets. That is inequitable and not consistent with competitive markets.

Cost of capital

9. We support establishing cost of capital estimates for FFLAS services with reference to the models and methods employed under Part 4.

10. Adopting a substantially different approach could undermine regulatory certainty for EDBs.

11. Where relevant we support applying consistent methods for each parameter to those applied under Part 4 but recognise that the data sources and timeframes will need to be those best suited to FFLAS markets, the regulated providers and the relevant form of regulation.

12. We acknowledge that there are specific circumstances which need to be taken into consideration such as the emerging threat of competition, the requirement to back-cast the cost of capital to derive estimates of past financial losses, and shorter initial regulatory periods.

WACC percentile

13. If there are residual risks that are not able to be adequately reflected in the WACC parameter estimates, then a percentile above the midpoint will be required. This is also appropriate if there is significant uncertainty in estimating the appropriate cost of capital. The Commission exercised its judgement in this way when establishing the WACC uplift for EDBs under Part 4.

14. We note that the WACC percentile decision is only one component of the regulatory framework and cannot be assessed in isolation. As the Commission has previously stated:

    - *there are potentially complex interactions between investment, capital expenditure incentives, quality incentives, innovation and the uplift on WACC; and*
    - *the percentile was, and continues to be, the last decision made regarding the WACC (after reaching a view on all other parameters)*.[1]

15. It is therefore important that the Commission take all relevant considerations into account when determining the WACC parameters and percentiles.

16. The WACC IM for Part 6 must reflect the risks that fibre service providers face in the FFLAS market. These risks are expected to include the risks of competitive substitution, such as demand and asset stranding risk. These risks may differ to the risks faced by industries regulated under Part 4. As stated in the EVP, the WACC percentile uplift for EDBs and GPBs reflects the asymmetric risks of under investment in energy networks for electricity and gas consumers.

17. There may be similar considerations for FFLAS services as access to high quality, reliable data/telecommunications services has become increasingly important to businesses and households.

18. However, we note (what we think is) the Commission preference to not use WACC uplift in the FFLAS IM because it perceives that there is less consequence of under-investment due to the availability of alternatives if fibre services quality degrades. The Technical paper also seems to be saying that the Commission has the ability to penalise Chorus which it sees as a better mechanism to force investment and avoid poor and/or constrained services. We are very surprised that the Commission would suggest that it can use the threat of penalties to coerce investment, as a means of compensating for a WACC that Chorus considers too low.

19. ENA also submits that the Commission should be extremely cautious in departing from adopting a percentile above WACC due to the fact that the LFCs have already committed significant sunk

[1] NZCC, Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services, Reasons Paper, 30 October 2014

capital to the fibre roll-out. While we can't speak for Chorus, the use of a WACC percentile has been an enduring feature of the regulatory landscape in New Zealand since at least 2003, so may well have featured in the financial models underpinning the bids Chorus and other LFCs made in securing the contracts with CFH.

20. To abandon WACC uplift in setting the WACC for the regulated period, may well undermine the original business cases for CFH bids and cause general loss of confidence in the regulatory environment. From the ENA member perspective there has already been an erosion of regulatory confidence with the reduction in the percentile from the 75th to 67th, and the potential abandonment for FFLAS is seen as a concerning development, particularly on the justifications that have been advanced.

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