18 July 2019

Dane Gunnell
Manager
Price-Quality Regulation
Commerce Commission
Wellington

Email: regulation.branch@comcom.govt.nz

Dear Dane,

Price-quality regulation settings need to ensure lines companies can invest, adapt and meet changing consumer needs

Entrust agrees with the Commerce Commission (Commission) that operation of price-quality regulation should "align the interests of EDBs with those of consumers". In order to meet the current and future needs of households and businesses, lines companies need to be able to invest and innovate, while ensuring their networks are resilient and reliable.

Summary of Entrust's views

- **Care is needed to ensure Part 4 regulation does not inhibit needed investment:** The Commission faces a difficult balancing act between operating Default Price-Quality Path (DPP) regulation in a low-cost manner, while recognising 'one size does not fit all'.

  Particular care is needed around elements of price-quality regulation which impact the extent lines companies can invest and maintain or improve network resilience and reliability.

- **Decisions should be based on up-to-date information:** While Entrust welcomes the Commission's commitment to provide an updated draft DPP determination based on 2019 Asset Management Plans (AMPs) the September timing is too late in the process. This timing would provide limited opportunity to scrutinise the Authority's proposed treatment of 2019 AMPs.

- **There are new challenges due to technology and changing consumer demand and preferences:** Changing technology and consumer preferences create challenges for both lines companies and regulators. Lines companies can't continue to do things the way they have historically without changes to asset planning, investment choices and innovation. This is reflected in Vector's latest AMP. The same is true for the Commission. Changes are needed to regulatory settings.

  While the Commission is exploring how lines companies are adapting to new technology, its adjustments to regulatory settings to facilitate these changes have been overly cautious and tentative. The Commission's draft decision on Vector's application for accelerated depreciation brings into question whether lines companies will be able to utilise this new mechanism in practice, while the proposed innovation allowance capped at 0.1% of revenue appears tokenist at best.

- **The Commission should ensure decisions are evidence based and aren't overly reliant on subjective judgement:** Entrust recognises the Commission has been grappling with how to best set capex allowances, and wants to avoid repeat situations where actual capex is materially below the levels provided for in the DPP revenue allowances. The proposed cap on capex appears to be based on subjective judgement, rather than evidence and we consider it warrants further attention.

- **Service-quality measures warrant further refinement:** Entrust supports the split between planned and unplanned outages, and allowing planned outages to be assessed over the entire five-year regulatory period. We would like to see the unplanned standards reflect reasonable and prudent changes to operating practices e.g. the move away from live wire work for health and safety reasons. The '2 out of 3' rule should also be retained to reflect the natural variation in service quality due to weather conditions etc.

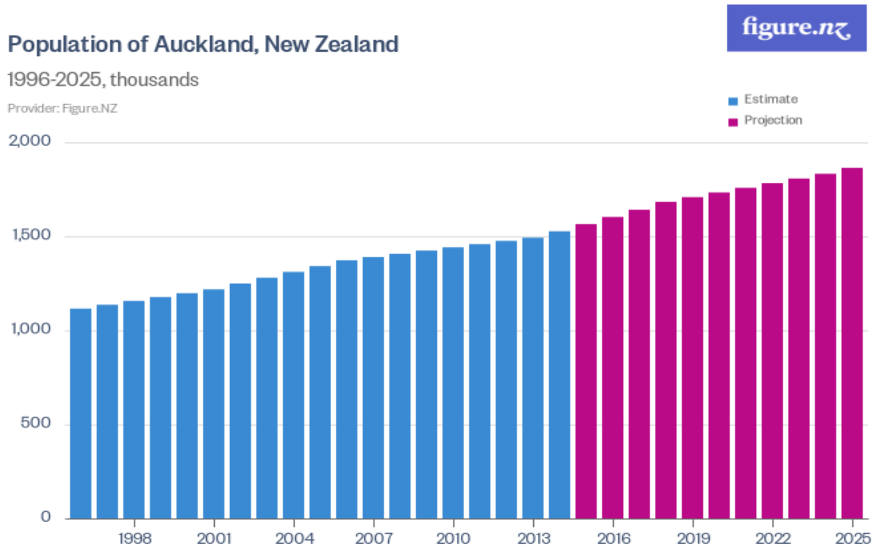
  We note Vector's submission advocates for changes to service level requirements (including guarantees) aimed at making the requirements more relevant to consumers, than the current blunt System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI) measures. We consider this is an area which warrants further consideration.

- **Pass-through of network price reductions:** Low interest rates mean there will be network price reductions in most regions in 2020. Retailers should pass any price reductions on to consumers in Auckland, just as quickly as they pass on increases to consumers in Dunedin and Queenstown where the biggest price increases are likely. The benefits from price-quality regulation to consumers will be undermined if this doesn't happen. We consider pass-through to be an area that warrants scrutiny and transparency.

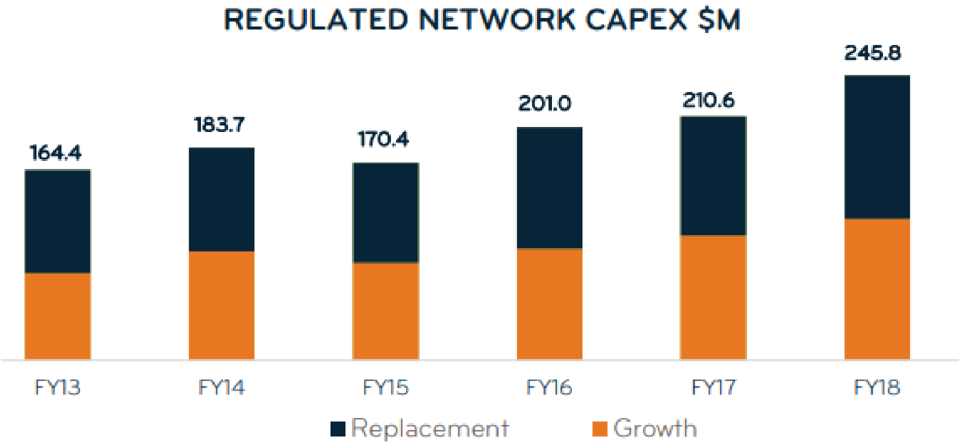
Building Auckland's future

It is important to recognise when determining network revenue allowances that significant investment is required across all infrastructure in Auckland to cater for growth. Electricity network reinforcement is no exception and the DPP regulation should reflect this.

Vector connected over 11,000 new homes in the last year alone. There were 205 new subdivisions, up from 84 in 2013. Auckland is expected to grow by the size of Tauranga city every three years. Vector expects investment to support new housing connections will be nearly $57 million per annum.



To meet the needs of growing network demand and increasing customer expectations, Vector will need to continue to invest significant capex in the Auckland network. Growth in capex has already been occurring over the last decade and will need to increase further in the future to meet the needs of projected growth.[1]



These are known investment requirements which should be accommodated by DPP regulation.

Decisions should be based on up-to-date information

Entrust welcomes the Commission's commitment to provide updated draft DPP determinations based on capex forecasts in each of the lines companies' 2019 AMPs. Given that the capex forecasts are a critical part of the DPP resets we would prefer this to happen prior to the planned September date. This timing would provide limited opportunity to scrutinise the Authority's proposed treatment of 2019 AMPs, compared to the time available for submissions on the initial draft decision.

At the time Vector published its 2018-28 AMP, they detailed why it would not be the appropriate plan to inform the price-quality reset in 2020.

[1] Capex is based on Vector's financial year, and therefore differs from Information Disclosures.

For the 2019 AMP, Vector has expanded the scenario modelling that underpins the asset management and investment plans, and the load and expenditure forecasts are more robust because of this modelling.

Entrust fully recognises the importance of asset management practices to the performance of lines companies. The investment forecasts in Vector's 2019 AMP reflect the need to meet future Auckland growth, and to ensure service quality and resilience meets the expectations and needs of consumers. As a consumer trust, Entrust considers service quality and network resilience to be critical elements of good asset management planning practices.

Asset management planning needs to adapt to changes in technology and consumer demand

Vector's asset management planning and business operation reflects the fact that the long-term interests of Auckland's energy consumers cannot be served by a traditional view of what a network is and needs to deliver.

Vector does not favour building a network that leverages high capital intensity based on historic paradigms. Entrust is supportive of this change in approach and philosophy to network service delivery.

It is important regulation and policy do not obstruct the sector's natural evolution and ability to invest, innovate and embrace new technology. Lines company engagement in new and emerging technology provides opportunity for more efficient service provision and consumer choice.

Vector's asset management planning undergoes scrutiny and review

Entrust recognises the value of independent review of AMPs, consistent with the Commission's own adoption of Independent Verification for Customised Price-Quality Paths (CPPs) and Transpower's Individual Price-Quality Path (IPP).

Under the Deed Recording Essential Operating Requirements (DREOR) held between Entrust and Vector, we require Vector to provide reports from an independent expert to advise on the state of the network.[2]

Vector has also sought other external reviews of the network and its asset management practices relating to specific events, such as the April 2018 storm and the Commission's investigation into quality breaches. All findings and recommendations from such reviews are carefully considered and included in the asset management policies and practices where appropriate. The expenditure associated with these programmes and projects has been included in Vector's latest AMP.

Decisions should be evidence based, and not overly reliant on subjective judgement

The Commission placed a lot of focus prior to the last electricity DPP reset on ensuring its WACC percentile decision wasn't overly reliant on subjective judgement, and was appropriately evidence based.[3] The Commission has made other subjective and arbitrary judgements which warrant similar focus and attention. For example, the balance between the strength of incentives for lines companies to improve efficiency, how long

[2] Summaries to the reviews are provided at: https://www.entrustnz.co.nz/resource-library/network-security-reports/
[3] In response to commentary in the High Court Part 4 Input Methodologies Merit Appeals decision 2013.

they are able to benefit from cost savings they make, and how rapidly these are shared with consumers (the 'Efficiency Sharing Rate').

Similarly, the Commission appears to have made an arbitrary judgement that a cap on capex should be applied and it should be set at 120% of historic investment. Entrust is concerned setting a cap at 120% of historical expenditure could impede or delay needed investment, particularly in regions with high growth rates. By way of example, in the last year Vector added 11,135 new properties to its network, a 22% increase compared with the previous year and the biggest leap in growth in Vector's history.

A lines company needing to invest above 120% of historic capex levels would need to balance the trade-offs between: (i) limiting expenditure to the 120% provided for in the DPP, (ii) undertaking the investment under the DPP and not fully recovering the cost of prudent and efficient investment, or (iii) the cost and uncertainty of a full CPP application.

The issues with over reliance on subjective judgement apply equally to the Commission's decisions on Efficiency Sharing Rates and the proposed cap on capex. We would like to see the Commission follow WACC percentile precedent and undertake work to develop evidence on the optimal efficiency and investment incentives. The review of WACC percentile in 2014 highlights that the Commission can undertake substantive reviews in relatively short periods of time, including within the constraints of the time available to make final price-quality reset decisions.

The Commerce Commission initiatives for dealing with adaption to technological change warrant refinement

Entrust supports the Commission's initiatives to provide for accelerated depreciation and an innovation allowance. We respectfully question whether the tentative way they both are being introduced will deliver the most benefits to consumers.

The accelerated depreciation mechanism could be helpful for managing the heightened risk arising from technology innovation in the energy sector. Suppliers have a legitimate concern about investing in long-life physical assets for only partial capital recovery. This is especially the case given standard physical lives in the Input Methodologies for most network assets are between 20-60 years. The adoption of an accelerated depreciation mechanism is consistent with "reasonable investor expectations"[4] and the Commission's real Financial Capital Maintenance principle.

The accelerated depreciation mechanism is not an impost on consumers. Rather, accelerated depreciation is neutral on a present value basis as it brings forward the depreciation lines companies are entitled to in future regulatory periods. It is likely to provide an element of price smoothing where it is adopted during periods of low interest rates.

Entrust considers that Vector provided strong and compelling evidence, specific to Auckland's circumstances, which justify accelerated depreciation. We are disappointed the draft rejects the application, without detailing any detriments to consumers. Consideration of accelerated depreciation is particularly relevant in the context that the Commission has rejected applying the RAB indexing approach for electricity transmission to electricity distribution or Vector.[5]

[4] As defined in the High Court Part 4 Input Methodologies Merit Appeals decision 2013.
[5] Commerce Commission, Input methodologies review decisions, Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower, 20 December 2016.

It is not clear to us why the Commission's "provisional judgement is that the long-term benefit of consumers is better served by retaining the standard depreciation treatment for Vector's assets".

We consider it would be desirable to revisit the draft decision and provide clear guidance and criteria for approval of accelerated depreciation applications. Entrust supports Vector's view that "The more transparent the Commission is able to be around its treatment of an accelerated depreciation claim, the greater likelihood it will maintain the incentive for suppliers to keep investing in their regulated services. Transparent criteria will provide EDBs with confidence about the action they can prospectively take to mitigate the likelihood of partial capital recovery".[6]

Entrust expects that if the Commission sticks with a decision to reject Vector's accelerated depreciation application it will be unlikely other lines companies will attempt to use the mechanism.

The new innovation allowance should be more than a token gesture

Entrust welcomes the Commission's proposal to introduce an innovation allowance recoverable cost.

Vector's investment in Research and Development (R&D) and innovation is important for delivering quality services and new efficiencies, including work to put in place new technology options that will flatten peak demand and deferred infrastructure investment, thereby keeping costs for consumers down.

We question whether the innovation allowance should be capped at 0.1% of revenue or come with the proviso that the recoverable cost needs to be matched by the lines company, which would effectively come off their investment returns. Setting the innovation allowance at 0.1% of revenue appears to be tokenist at best.

Vector's R&D budget alone is approximately the amount the Commission is proposing to allow for the innovation allowance for ALL lines companies. We consider a higher allowance would better to encourage lines companies to innovate, and to meet the Commission's section 54Q obligation to promote energy efficiency and demand side management.

Network price reduction pass-through remains unresolved

Entrust has previously raised concerns about whether network price reductions are fully passed through to consumers by retailers.[7]

We agree with the Commission that "the proposed RCP3 price path would promote the long-term benefit of consumers <u>if</u> electricity retailers and local lines companies pass on to retail consumers the price reductions from Transpower" [emphasis added].[8] ENA has noted "this comment applies only to retailers. Distributors revenues will next year be capped by the commission, and EDBs are already required to transparently pass through transmission changes. Retailers, especially the larger retailers, routinely bundle distribution and transmission charges into their own price plans, which makes it difficult or impossible to unpick any movements in regulated pricing".[9]

---

[6] Vector, Submission to Commerce Commission on the IM review draft decision and IM report, 4 August 2016.
[7] For example, Entrust, Submission to Commerce Commission: Open letter on distribution sector work priorities and 2020 DPP reset focus areas, 18 December 2017.
[8] Commerce Commission, Transpower's individual price-quality path from 1 April 2020 Draft decisions and reasons paper, 29 May 2019, paragraph X9.
[9] ENA, Transpower's individual price-quality path from April 2020, 27 June 2019.

Entrust doesn't believe the state of competition in any of the regional retail markets is strong enough to ensure retailers fully pass-through reductions in network prices. We are conscious there are issues with high market concentration, and vertical-integration of the big five incumbent retailers, that are hampering competition from working properly.

The Electricity Price Review reinforced our concerns about how competitive the electricity retail market is. Notably, the submissions from 'challenger' or independent retailers raised concerns about the market being oligopolistic with substantial barriers to growth. The market penetration of challenger retailers remains very low compared to telecommunications.

The following diagram highlights that residential retail prices have been outstripping changes to the lines component since introduction of price-quality control under Part 4A, and then Part 4, of the Commerce Act.[10]

Entrust is uneasy there is no transparency about the extent retailers are passing through network price reductions, and how quickly pass-through occurs. This is needed if consumers are to have confidence in the market and that they are getting a fair deal from their retail suppliers.

We consider it would be beneficial to start by looking at the extent to which gas retailers passed through the substantial reductions in gas distribution and transmission charges at the 2017 gas DPP reset. We are aware, for example, that despite these very large reductions in cost, Trustpower recently announced increases in its residential gas prices. It isn't good enough for retailers to simply say the cost reductions mean they won't have to raise their own prices.[11]

Another useful check is whether retailers pass on network price reductions as quickly as they pass on the increases.

Consistent with our concerns about pass-through, Vector now passes through Loss Rental Rebates directly to consumers. This resulted in a $30 rebate in addition to our

[10] Entrust's submissions to the Electricity Price Review provided further details of this trend, including breakdown of retail, distribution and transmission, and details of the trends on the Vector Auckland and Vector Northern networks: Entrust, Electricity Price Review submission including consumer concerns about retailers' power pricing, 23 October 2018, Appendix 2.
[11] Trustpower, for example, provided this explanation in relation to its residential gas pricing.

$350 Entrust Dividend last year. For customers in the Entrust District, it has been added to their Entrust dividend. The previous arrangements where Loss Rental Rebates were passed on to retailers provide no surety consumers would get any of the benefits from them.

Genesis' price increases highlight that consumers are missing out on the benefits of network price reductions

The 3% price increase Genesis announced that would apply across the country from January 8, except in Timaru and the Far North where prices will rise 4.5%, is illustrative of our concerns. The price hike came on top of rises between 2% and 4% earlier in the year.

Vector's prices were reduced for all residential consumers in April last year, including for both standard and low-user customers.[12] Overall, Vector reduced its line charges by a weighted average of approximately 1.4%, with another 1.4% reduction in April this year.

Genesis' effective increase is higher once Vector's price reductions are taken into account. Genesis' price increase to Auckland households is about 7% of the energy component of the bill (generation and retail) or $58 per annum excl. GST.[13]

Genesis blamed everything from the cost of carbon to network costs for the increase. This was misleading. Genesis is increasing its retail profit margins and brought forward the price increases from April 2019 to the Christmas period. On Genesis' Investor Roadshow they detailed for each 1% increase in its residential prices results it gets $7 to $8 million more revenue.[14]

It looks like Genesis is keeping network price reductions for its shareholders. This is not to the long-term benefit of consumers and undermines the benefits of price regulation.

Concluding remarks

The Commission faces a difficult balancing act: (i) ensuring DPP regulation is operated in a low cost manner, while (ii) recognising 'one size does not fit all', and (iii) satisfying the Commission's cornerstone principle that investors should expect to recover the costs of their prudent and efficient investments (the Financial Capital Maintenance principle).

These tensions are reflected in the fact there is substantial variation in demand growth in different regions of New Zealand, with very different investment requirements to meet consumer needs. These differences sit awkwardly with broad brush rules, such as the Commission's proposal to cap capex at 120% of historical level. Particular care is needed around elements of price-quality regulation which impact the extent regulated suppliers can invest and maintain or improve network reliability and resilience.

We are sympathetic that this is a difficult area of price-quality regulation which the Commission has been grappling with at each of its price resets.

---

[12] https://blob-static.vector.co.nz/blob/vector/media/vector-regulatory-disclosures/180201_annual_price_review_1_apr-2018.pdf

[13] $\text{Generation \& Retail Price Change} = \frac{\text{Total Price Change} - \text{Network Proportion} \times \text{Network Price Change}}{\text{Generation \& Retail Proportion}} = \frac{3\% - 43.1\% \times -1.4\%}{51.7\%} = 7\%$

The average breakdown of power bill is from https://www.ea.govt.nz/consumers/my-electricity-bill
Vector's average lines charge per residential ICP is $696 per annum exc. GST (https://blob-static.vector.co.nz/blob/vector/media/vector-regulatory-disclosures/edb-id-determination-templates-for-schedules-1-to-10-31-march-2018.pdf) which would make the average household bill $1,615 and the generation and retail component $835 using the aforementioned breakdown. 7% effective price increase results in $58 per annum increase.

[14] Genesis, Investor Roadshow, November 2018.

Low interest rates mean there will be network price reductions in most regions in 2020.

Entrust would like to see consumers get the full benefit of these network price reductions, and that this is reflected in reductions in retail tariffs. To the extent there is cost ‘leakage’ and retailers don’t fully pass the reductions on to consumers the benefits of price-quality regulation will be undermined.

We fully expect retailers will rapidly raise their retail tariffs, in areas such as Dunedin and Queenstown where network prices will go up. Auckland electricity consumers should be able to expect symmetric treatment with network price reductions passed through just as quickly as price increases.

For further information, contact:
Helen Keir, Chief Operating Officer, Entrust
Phone: 09 929 4567

Kind Regards

William Cairns
Chairman