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10 February 2023

Submissions
Regulation Branch
Commerce Commission
PO Box 2351
Wellington

Via email: im.review@comcom.govt.nz

**TLC Submission: IM review – Options to maintain investment incentives in the context of declining demand**

## 1. Introduction

The Lines Company Limited (TLC) thanks the Commerce Commission (Commission) for the opportunity to submit on the Part 4 Input Methodologies Review – Options to maintain investment incentives in the context of declining demand.

TLC acknowledges the Commission is seeking feedback on the implementation of the principle of ex-ante financial capital maintenance (FCM) through a building block model (BBM) in the context of declining or expected declines in consumer demand.

We understand that the consultation focuses on gas pipelines and issues and options are more applicable/relevant to the sectors with overall declining demand. However, the consultation seeks feedback on changes to Input Methodologies (IM's) for regulated industries in general, and on that basis, we feel it is important to provide our views on specific aspects of IM's that may impact electricity distribution. We have taken this opportunity to share our concerns on RAB indexation.

In contrast to the gas industry, the electricity industry is expected to see a sharp increase in demand rather than a decline, so asset stranding risk is not yet an electricity industry issue. However, changes to RAB indexation applied across regulated industries could have an impact on small electricity distributors.

In this letter, we briefly discuss the key concerns we have identified.

**RAB Indexation**
Removing RAB indexation would have a material impact for smaller electricity distribution businesses (EDB's) with smaller customer bases, because it can potentially result in price shock for the customers.

With an unindexed RAB, the Commission would apply a nominal rate of return which is more volatile, and the businesses would recover a greater proportion of revenues sooner. This would mean revenues and prices would increase in the near to medium term but would materially increase when a major network investment is made. Therefore, **TLC's view is that it is imperative that the Commission retains RAB indexation** in the IM's for electricity distribution.

Our rationale is explained as follows:

- **Step changes in renewal and growth investments are proportionally higher for small EDB's.**

  Investments in renewal and growth made by small EDB's are significantly higher (measured in terms of investment per customer) than larger EDB's.

  There are two main drivers:
  - The customer density is lower. For example, TLC has approximately 5.4 customers per km of line compared with large urban EDB's that have around 30 customers per km.
  - Renewal and growth investment creates can crate proportionally higher step changes in capex. As an example, TLC's largest point investments are typically substation renewals at circa $5m which is around 25% of TLC's total annual capex. While these occur relatively infrequently, they are becoming more common, driven by decarbonisation and asset lifecycle. When they are required, they emerge as short but material step changes in expenditure.

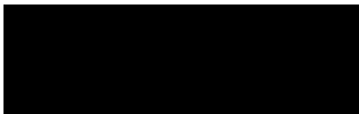
- **Volatility in recoverable revenues translates into volatile prices**

  The issues above flow on to become recoverable revenue changes for EDB's. We understand that cost recovery is accelerated with an un-index RAB, as a higher return is earned on the assets early in their life. However, when the assets are replaced at end of life, or when large investments are made to support decarbonisation, it results in a notably higher step increase in the recoverable revenue than under an indexed RAB, leading to volatile recoverable revenue for smaller EDBs, and the volatility flows through to consumer prices. On the contrary, RAB indexation leads to a somewhat higher asset valuation during an asset's life and, therefore a higher overall RAB value. However, the negative revenue adjustment applied to the depreciation component results in NPV=0, saves customers from price shocks and leads to smoother revenue recovery and, therefore, prices. It significantly mitigates the potential for a sharp increase in revenues and, thus, price shock resulting from asset replacement at the end of their useful life.

**Consideration for an adjustment mechanism when inflation is higher than the allowed return (WACC)**
TLC also believes there must be a wash-up mechanism for the situations where the Commission's inflation forecast, and allowable rate of return (WACC) are lower than actual inflation.

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



Craig Hackett
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