networktasman
Your consumer-owned electricity distributor

Network Tasman Limited
52 Main Road, Hope 7020
PO Box 3005
Richmond 7050
Nelson, New Zealand

Phone: +64 3 989 3600
Freephone: 0800 508 098
Email: info@networktasman.co.nz
Website: www.networktasman.co.nz

12 July 2024

Ben Woodham
Electricity Distribution Manager; Commerce Commission
Wellington 6140
By email: infrastructure.regulation@comcom.govt.nz

Submission to the Commerce Commission on the DPP4 draft decision

Network Tasman appreciates the opportunity to submit on the Commerce Commission's DPP4 draft decisions.

In addition to endorsing ENA's submission, Network Tasman wishes to elaborate on a couple of matters the ENA does not address in its submission.

These issues relate to the mechanism for calculating the wash-up account balance and the application of the undercharging limit.

With respect to the wash-up account balance, Network Tasman has identified errors with how the wash-up account balance calculation operates and a mismatch between how the wash-up drawdown amount is derived and the wash-up account balance calculation that creates unnecessary volatility in the wash-up account balance.

Network Tasman also submits that the Commission should (effectively) remove the undercharging limit from the DPP. This is because in the event the limit binds, which is a significantly more likely prospect under DPP4, the DPP will no longer provide EDBs with an ex-ante expectation of real financial capital maintenance. The consequences of this are significant and undoubtedly outweigh the perceived risks of an EDB accruing a large wash-up account balance.

Wash-up account balance calculation

The *wash-up account balance* calculation appears to be inconsistent with the *revenue drawdown amount* calculation.

The purpose of the *wash-up drawdown amount* appears to be to allow EDBs to nominate how much of their *wash-up account balance* they wish to draw down for the year. The limit on how much an EDB can drawdown being the *wash-up account balance* from two years prior.

As an aside, neither the IMs or the DPP determination (draft DPP4 or current DPP3) specify a *wash-up account balance* for RY24 – the period two years prior to the opening period of DPP4. There is a definition for RY25 that carries forward the wash-up amounts from periods 4 and 5 of DPP3. Network Tasman submits that the Commission should define the *wash-up account balances* for RY24 and RY25 with reference to the wash-up amounts from period 4 and period 5 in DPP3, respectively.

The two-year lag recognises that the *wash-up account balance* for the year prior will not be known when an EDB is completing the first Price Setting Compliance Statement of DPP4, of which the *wash-up drawdown amount* is an input.

The use of a two-year lag for the *wash-up drawdown amount* is inconsistent with the *wash-up account balance* calculation which uses a single year lag when carrying forward past *wash-up account balances*.

The purpose of the *wash-up account balance* calculation is to determine the value of revenue and EDB has under/over-recovered each year and to carry this value forward to future revenue allowances to ensure the EDB is 'made whole'.

In practice, an EDB is generally expected to draw down all its available *revenue wash-up drawdown amount* each year. On this basis, it would be expected that an EDB's *wash-up account balance* would be equal to their *wash-up accrual*, i.e. the difference between their actual revenue and their actual allowable revenue because the amount being carried forward into the *wash-up account balance* calculation should match and offset the amount being drawn down.

However, this doesn't occur because the *wash-up drawdown amount* is set according to the EDB's *wash-up account balance* from two years prior, but it is the *wash-up account balance* from one year prior that is carried into each annual *wash-up account balance* calculation.

This mismatch creates volatility in the *wash-up account balance* that an EDB has limited control over.

Using a stylised example to highlight the issue, consider an EDB that recovers the full value of its allowable wash-up balance each year.

For simplicity, actual revenues/costs are assumed to equal forecast revenues/costs and there are no time value of money adjustments.

The table below illustrates the key inputs to the annual wash-up account balance calculation.[1]

[1] Note, the table below uses the current definition of the wash-up account balance for RY25. The issue persists if the wash-up account balances for RY 24 and RY25 are redefined as proposed earlier in this submission.

Forecast allowable revenue	2024	2025	2026	2027	2028	2029	2030
Forecast net allowable revenue			30	35	40	45	50
Forecast pass-through costs			11	12	12	13	13
Wash-up drawdown amount			2	8	6	-2	-8
Forecast recoverable costs (other)			2	2	2	2	2
Forecast large connection revenue			0	0	0	0	0
Forecast allowable revenue			45	57	60	58	58
Forecast revenue							
Forecast revenue			45	57	60	58	58
Wash-up accrual							
Actual allowable revenue			45	57	60	58	58
Actual revenue			45	57	60	58	58
Wash-up accrual			0	0	0	0	0
Wash-up account balance							
Wash-up account balance (t-1)			10	8	0	-8	-8
+ Wash-up accrual			0	0	0	0	0
- Wash-up drawdown			2	8	8	0	-8
- Revenue foregone			0	0	0	0	0
Wash-up account balance	2	8	8	0	-8	-8	0

In this example, an EDB is limited to a maximum wash-up drawdown amount of $2, but the wash-up account balance carried into the end of year account balance calculation is $10 - the sum of the two DPP3 balances as per cl 3.1.4(2) of the IMs. This mismatch continues throughout the period and creates material volatility in the wash-up balances that the EDB is unable to eliminate.

This volatility can be addressed by amending the definition of the *wash-up account balance* so that the *wash-up account balance* from two years prior, rather than one year prior, is carried into the wash-up account balance calculation [IMs cl 3.1.4(1)] and defining 'wash-up account balances' for 2024 and 2025 separately so they are equal to the wash-up amounts for the fourth and fifth periods of DPP3, respectively. The 2024 figure being adjusted for the time value of money.

The example below replicates the example above if these changes are applied.

Forecast allowable revenue	2024	2025	2026	2027	2028	2029	2030
Forecast net allowable revenue			30	35	40	45	50
Forecast pass-through costs			11	12	12	13	13
Wash-up drawdown amount			2	8	0	0	0
Forecast recoverable costs (other)			2	2	2	2	2
Forecast large connection revenue			0	0	0	0	0
Forecast allowable revenue			45	57	54	60	66
Forecast revenue							
Forecast revenue			45	57	54	60	66
Wash-up accrual							
Actual allowable revenue			45	57	54	60	66
Actual revenue			45	57	54	60	66
Wash-up accrual			0	0	0	0	0
Wash-up account balance							
Wash-up account balance (t-2)			2	8	0	0	0
+ Wash-up accrual			0	0	0	0	0
- Wash-up drawdown			2	8	0	0	0
- Revenue foregone			0	0	0	0	0
Wash-up account balance	2	8	0	0	0	0	0

The result of these changes is that, in the event an EDB draws down their full wash-up balance each year, the value of the wash-up account balance will be equal to the difference between actual revenue and actual allowable revenue.

Network Tasman submits that these changes will reduce wash-up account balance volatility and provide EDBs with greater revenue certainty.

Voluntary undercharging limit

Network Tasman believes the voluntary undercharging limit may be incorrectly specified and may not result in the outcomes the Commission intended.

Network Tasman submits that the Commission should effectively remove the voluntary undercharging limit from the DPP determination because:

- The presence of the undercharging limit constrains EDBs ability to respond to specific circumstances faced by consumers on the EDBs network.
- The purpose of the undercharging limit is to prevent EDBs ability to accrue a large wash-up balance that allows it to later recover the accrued wash-up balance in a manner that creates bill shock for consumers.
- However, the outcome cannot occur because the Commission has introduced the revenue soothing limit to prevent consumer bill shock by constraining the annual price increases an EDB can implement.
- The risk of the behaviour the undercharging limit is designed to prevent occurring is negligible, but the risks of the undercharging revenue limit binding are significant because it would reduce an EDB's revenues below the level set by the Building Blocks Method and no longer provide EDBs with an ex-ante expectation of real financial capital maintenance.

The Commission has chosen to set the voluntary undercharging limit at the lesser of 90% of forecast allowable revenue or 90% the revenue smoothing limit.

Network Tasman submits that the limit should be removed entirely to provide greater flexibility for EDBs to smooth revenue recovery according to the specific circumstances faced by consumers in their distribution region. This suggested change would be in the interests of consumers.

The Commission's reasoning for its choice of a 90% limit is that:

> *There is no evidence that the 90% undercharging limit under DPP3 is currently causing any detriment to suppliers or consumers; accordingly, we have decided to retain it under DPP4. This is consistent with our decision to retain approaches from the DPP3 where they remain fit for purpose.*[2]

DPP4 provides a materially different context than DPP3, which means that observations on the undercharging limit for DPP3 have little relevance for DPP4. DPP3 commenced with a reduction in distribution revenue caps, whereas DPP4 will entail significant distribution revenue increases, even after the Commission smoothing. The significant increases in distribution revenue come at the same time as an increase in transmission grid charges – after smoothing, transmission grid revenue increases are proposed to be 15.43% for each of the first two years, followed by 5% increases for three years.[3]

In some cases, these significant increases will also be accompanied by large increases in pass-through costs. For example, Network Tasman is currently investigating the construction of a new GXP to accommodate load growth and provide additional network resilience. If the GXP is built, the expectation is that it would be commissioned within the DPP4 period. The cost of which would likely result in a material increase to Network Tasman's transmission charges.

In addition, EDBs continue to evolve their pricing towards having a more cost-reflective structure in accordance with the Electricity Authority's pricing principles and expectations for pricing reform which can also increase power bills for some customers.

All these changes coincide with a cost-of-living crisis for residential consumers and economic pressures affecting business consumers, which means that the likelihood of EDBs choosing to voluntarily undercharge in some periods to alleviate price impacts for consumers through further revenue smoothing is substantially higher than for DPP3.

It is important to note that while the revenue smoothing limit does not apply to transmission charges, EDBs are still conscious of the effect of total lines charges (distribution and transmission combined) on consumers.

We appreciate that the Commission's draft decisions on DPP4 and the RCP4 IPP include significant smoothing to reduce consumer bill impacts. However, we submit that EDBs ought to have the flexibility to further significantly smooth revenue and price impacts, given the circumstances in their region that affect the level of cost increases and capacity of customers to absorb price increases. As a consumer-owned lines company we are particularly focussed on the impact that our price changes have on our customers.

Given that the DPP4 context is very different from DPP3, we consider that there is a strong justification for removing the voluntary undercharging limit to avoid a situation where an EDB is

---

[2] Commerce Commission (29 May 2024), *Default price-quality paths for electricity distribution businesses from 1 April 2025 - Draft decision: Reasons Paper*, p. 405, para F193.
[3] Commerce Commission (29 May, 2024), *Transpower's individual price-quality path for the regulatory control period commencing 1 April 2025 - Draft decision paper* p. 13.

incentivised to increase prices more sharply than it considers to be appropriate in the specific context of its region.

Removing the voluntary undercharging limit would be in the interests of consumers and would have no downside—the Commission has set limits on what it considers acceptable price increases via the revenue smoothing limits, which guard against future price shocks.

In the draft decision, the Commission states the purpose of the undercharging limit is to limit the potential for an EDB to accrue a large wash-up balance by substantially under-recovering allowed revenue in one year, with the revenue being recovered, on a NPV neutral basis, through the wash-up mechanism in future years.

Although it is unsaid, the concern is presumably not that an EDB will accrue a large wash-up balance, a large wash-up balance is not, in itself, a risk for consumers, but that the accrued wash-up balance will be recovered in a manner that creates bill shock for consumers.

Given the revenue recovery is NPV-neutral and the revenue smoothing limit caps prevent consumer bill shock, it is not clear what outcome the Commission is attempting to protect against with the undercharging limit.

It is incongruous for the Commission to set a cap on how much an EDB can increase its year-on-year revenues for the explicit purpose of managing consumer bill shock and then apply an undercharging limit on EDBs because not doing so risks enabling consumer bill shock.

Finally, any analysis of the undercharging limit should be informed by the relative risks associated with the application of the undercharging limit compared to those of the counterfactual.

Currently, the Commission has justified the undercharging limit on the basis of a theoretical risk associated with the counterfactual without considering the risks associated with the use of the undercharging limit.

There is a theoretical risk that an EDB will accrue a significant wash-up balance and then elect to recover that balance via a string of large price increases is close to zero.

Firstly, as discussed above, the Commission has specified a limit on price increases that it considers appropriately constrain EDBs from introducing price increases that create undue consumer bill shock.

Secondly, there should be no incentive for a purely profit-maximising EDB to systematically recover less than its annual revenue cap. If there is, there will be much bigger issues with the DPP framework than the need for an undercharging limit.

There may incentives for EDBs with a broader objectives than simply profit maximising to recover less than their revenue cap if they believe it is in the best interests of their consumers. However, those same incentives stop the EDB from recovering any accrued wash-up balance from those same consumers in a manner that is not in their best interests.

Network Tasman submits that the likelihood of a purely profit-maximising EDB systematically accruing a large wash-up account balance is nil. The likelihood of any other EDB accruing a large wash-up balance is small, but non-zero. However, the risks associated with an EDB of this nature accruing a large wash-up balance and recovering it in a manner that is not in consumers interests are negligible.

As such, is it highly unlikely that the scenario the undercharging limit was introduced to protect will actually occur. Even in the event this highly unlikely scenario does occur, the revenue smoothing limit protects against consumer bill shock in such a manner that mitigates the risks of such an outcome.

The risks associated with the undercharging limit binding, however, are material and potentially significant.

In the draft reasons paper, the Commission states:

> "To enable EDBs to invest in their networks and earn a normal return on their investment, we set their revenue allowance on a 'building blocks' basis so that forecast revenues equal forecast costs (including the cost of capital)"[4]

Ensuring EDBs can recover sufficient revenues to cover their costs is a fundamental aspect of price regulation. This is the principle of ex-ante real financial capital maintenance (FCM).

The Commission has long recognised the material and asymmetric consequences to consumers over the long term of setting an EDB's revenues too low compared to too high. This has been a long-standing economic principle used at the Commission to inform decision-making, most recently as a key economic principle guiding the analysis in the Cost of Capital topic paper of the 2023 IMs review (along with FCM).[5]

Should the undercharging limit bind for an EDB, that EDB's forecast revenues will no longer be equal to its forecast costs. This outcome undermines the integrity of the Building Blocks Method to deliver an ex-ante expectation of real FCM. The risks of this are significant, self-evident and entirely outweigh the risks the Commission perceives with removing the undercharging floor.

On this basis, Network Tasman submits that the Commission should remove the undercharging floor from the DPP Determination.

Network Tasman acknowledges that due to the undercharging floor being specified in the IMs, it is not possible for the Commission to remove the limit entirely as part of the DPP reset. However, it is possible to do this in practice by setting the undercharging limit, which is specified in the DPP Determination, to zero.

---

[4] Commerce Commission (29 May 2024), *Default price-quality paths for electricity distribution businesses from 1 April 2025 - Draft decision: Reasons Paper*, p. 73, para 4.6.
[5] Commerce Commission (13 December 2023), *Cost of capital topic paper: Part 4 Input Methodologies Review 2023 – Final decision*, p. 19, Para 2.9.