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By email to [regulationbranch@comcom.govt.nz](mailto:regulationbranch@comcom.govt.nz)

**Re: 2020 DPP draft Decision submissions - cross submissions.**

Dear Dane

Thank you for the opportunity to cross submit on matters raised in other party submissions on the Commission's 2020 DPP Reset Issues paper, 15 November 2018.

Our review of stakeholder submissions resulted in the following comments.

### IRIS retention rate

In its submission, ERANZ questions whether the IRIS retention rate should be higher than 26 per cent. ERANZ submits that in its judgement a 26 percent retention rate does not give distributors a large enough incentive to become more efficient.

As the opex retention ratio is set exogenously, this cross-submission focuses solely on the capex retention ratio.

In principle, Network Tasman supports mechanisms that encourage distributors to operate more efficiently. As a trust owned network, Network Tasman's objectives align closely with the Commission's statutory objective. That is, to operate in a manner that is in the long-term interests of consumers (our owners).

However, Network Tasman notes that:

- The purpose of the IRIS mechanism is to reward distributors that develop genuine efficiency gains, penalise distributors for losses in efficiency and allow distributors to retain the benefits of any efficiency gains for a fixed number of years.
- For the IRIS mechanism to operate as desired, the Commission's capex forecasts must accurately reflect the statically efficient level of capex expenditure for every non-exempt distributor.<sup>1</sup>

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<sup>1</sup> Statically efficient capex forecasts assume the distributor retains its current levels of capex efficiency. The IRIS mechanism is designed to ensure that distributors have incentives to improve the efficiency of their capex, that is, to be 'dynamically efficient'. For the purposes of this cross-submission, any reference to an efficient forecast refers to static efficiency.

- If the Commission's capex forecasts do not accurately reflect the efficient level of capex expenditure, the capex IRIS mechanism will create incentives for distributors to inefficiently invest in capex and may unduly penalise distributors for maintaining their existing levels of capex efficiency.
- The Commission has undertaken no assessment of whether its capex forecasts accurately reflect the efficient level of capex spend for each non-exempt distributor.
- In the absence of such analysis the likelihood that the Commission's capex forecasts reflect efficient levels of expenditure are virtually nil.
- The capex retention rate acts to amplify the inefficiency in the Commission's forecasts, the higher the retention rate, the more the inefficiency is amplified.

Given these circumstances, Network Tasman submits that the only consideration the Commission should be giving to the capex IRIS retention ratio is how much it should be reduced from its current level of 15 percent. Increasing the capex IRIS retention ratio cannot be justified until the Commission can demonstrate that its capex forecasts are accurate.

### The capex IRIS is contingent on the Commission having efficient capex forecasts

When designing any incentive, the Commission must consider not only the principle of what it is attempting to achieve, but also if and how the incentive works in practice.

The effectiveness of the IRIS mechanism is predicated on the assumption that the Commission can accurately forecast the efficient level of capex expenditure for each distributor. The theory is that any difference between a distributor's actual costs in any given year and the forecast for that year is due to the distributor's performance in the year in question. However, if the forecast over-estimates a distributor's costs, the distributor will receive a windfall gain simply for retaining its existing levels of efficiency. Similarly, should the forecast under-estimate a distributor's costs, the distributor will be penalised in the event it maintains its existing level of capex efficiency.

In the event of an under-estimate, a distributor faces the choice of under-investing in its network to avoid an IRIS penalty or efficiently investing in its network and having its revenue cap reduced by the value of the IRIS penalty. Neither outcome is in the long-term interests of consumers – the Commission's statutory objective. In the extreme, distributors will be forced to choose between dramatically cutting their capex spending or breaching their price path.

To Network Tasman's knowledge, the Commission has not provided any evidence or analysis assessing the accuracy of its current or past capex forecasts.<sup>2</sup> The Commission appears to simply assume that its forecasts accurately reflect the efficient level of expenditure for each non-exempt distributor.

In the absence of this information, the Commission is unable to say with any certainty whether the incentives it is creating for distributors will encourage them to operate more or less efficiently.

Given the absolute uncertainty about accuracy of the Commission's capex forecasts, Network Tasman submits that the capex IRIS mechanism is overwhelmingly expected to provide distributors with incentives to do the exact opposite of what is intended. That is, to invest inefficiently.

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<sup>2</sup> By accuracy Network Tasman means how closely the Commission's forecasts reflect the efficient level of each distributor's capital expenditure.

This inefficiency increases in parallel with the retention rate because the retention rate increases the relative reward/penalty. Only with a retention rate of 0% can any inherent forecasting error be eliminated.

### The DPP framework makes it difficult for the Commission to accurately forecast capex

It should not come as a surprise that it is difficult to forecast the efficient level of each non-exempt distributors' capex within the DPP framework.

The DPPs must be set in a relatively low-cost way, and are not intended to meet all the circumstances that a distributor may face.

It would be challenging for any party to develop a generic model that can accurately forecast the efficient level of capex for the 17 different distributors that are, or will be, subject to a DPP. Trying to do so within the bounds of a "low cost" framework is unrealistically ambitious.

### The Commission is forecasting Network Tasman's capex to decrease by 40 percent

In DPP2, the Commission's forecast allowed Network Tasman an average annual capex of \$8.3m (constant 2018 dollars). For DPP3 this has fallen to an annual average of \$5m (constant 2018 dollars). This represents a 40 percent reduction in capex between the Commission's forecast in DPP2 and DPP3. Nowhere in the draft report does the Commission provide any explanation for why Network Tasman's capex needs have changed so dramatically between DPP2 and DPP3.

Given Network Tasman's average actual capex spend for DPP2 was \$8.9m per year<sup>3</sup>, this represents a considerable reduction in capex for DPP3.

Nowhere in Network Tasman's 2018 (or 2019) AMP does Network Tasman forecast a reduction in capex spending over the DPP3 period.

The Commission's forecast implies that the Commission expects Network Tasman's RAB to shrink over DPP3, as the forecast capex spend of \$5m/year is less than the Commission's \$9m/year allowance for depreciation. A decreasing RAB is generally associated with static or negative ICP and/or load growth. However, the Commission has forecast Network Tasman will experience strong population growth - the 6<sup>th</sup> highest population growth of the non-exempt distributors.

The implications of the Commission's current capex forecast for Network Tasman are stark. Network Tasman's 2019 AMP forecasts annual capex of approx. \$14m per year. Should Network Tasman spend what it has forecast, it will incur IRIS penalties of more than \$3.2m per year in years 2-5 of DPP4. This is more than 10 percent of Network Tasman's revenue cap in period five of DPP3.

Even if Network Tasman were to simply retain a static RAB by matching capex with depreciation, it would incur IRIS penalties of around \$1.25m a year in years 2-5 of DPP4. This would represent 4.3 percent of Network Tasman's allowable revenue in 2020/21.

Given the outcomes outlined above, Network Tasman considers that there is no basis to conclude that the Commission's capex model is producing efficient capex forecasts. As the IRIS mechanism is specified in the Input Methodologies, the Commission is unable to remove the IRIS as part of the DPP process. Accordingly, the only option the Commission has to mitigate its capex forecasting errors is to reduce the

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<sup>3</sup> This includes Network Tasman's forecast capex for 2019/20.

capex IRIS retention rate, as that is specified as part of the DPP framework. Network Tasman submits that until such time that the Commission can categorically show that its forecasts represent the efficient level of capex for each non-exempt distributor, the only course of action it can realistically consider is to reduce the capex retention rate from its current level of 15 per cent. Failure to do so would only amplify the Commission's forecasting error, and encourage outcomes that are not in the long-term interests of consumers.

Please feel free to contact me with any queries you may have relating to anything raised above.

Kind regards,

Daniel Vincent

Regulatory and Commercial Manager