Submission on Part 4 input methodologies review

11 July 2022

C H O R U S

Overview

1. This is Chorus' submission on the consultation papers published by the Commerce Commission (**Commission**) on 20 May 2022 as part of its first phase of the 7-yearly review of input methodologies (**IMs**) under Part 4 of the Commerce Act 1986:

   a. **Draft Framework Paper** – describing the legal framework the Commission intends to apply in undertaking its review of IMs; and

   b. **Process and Issues Paper** – setting out key topics and issues identified by the Commission for the IM review so far, and the process for completing the review by the end of 2023.

2. The majority of our feedback relates to topics or issues relevant to the discussion in the Process and Issues Paper. We also comment below on the framework and contextual factors we consider important for the IM review.

3. Our submission is accompanied by two expert reports from Incenta addressing the technical aspects of recommendations on the methodology for estimating the cost of capital and for protecting against errors in forecast inflation.[1]

4. The tables below provides an overview of the topics and issues we recommend be addressed in the IM review.

	Key topics and issues	Chorus comments
1	Cost of capital: Weighted average cost of capital (**WACC**) parameters	The Cost of Capital IMs should be reviewed to improve stability of WACC estimates. Incenta have observed that greater stability can be achieved by adopting a trailing average approach for the risk-free rate and a Total Market Returns approach for equity costs.
2	Risk allocation and incentives: Protecting against inflation risk	The policy intent of protecting suppliers and consumers against inflation risk, and promoting real financial capital maintenance (**FCM**), can be achieved by ensuring the wash-up for CPI covers the first year of the regulatory period as well as all subsequent years.
3	Risk allocation and incentives: Mitigating network stranding risk	Chorus supports consideration of the full suite of risk mitigation measures to address the possibility of network stranding; settings need to be adjusted regularly in light of up-to-date information.

	Other topics and issues	Chorus comments
4	Risk allocation and incentives: Incentive mechanisms	We agree that a review of workability/effectiveness of incentive mechanisms in the IMs to better promote efficiency, investment and innovation is needed.

[1] Incenta, Measures to improve the stability in WACC estimates, July 2022; Incenta, Options to address the gap in CPI inflation correction, July 2022; Incenta, Inflation simulation workbook, July 2022.

5	Cost allocation approaches over time	The right balance between flexibility and predictability is needed, and the IMs should clarify expectations that cost allocators should routinely be reviewed to appropriately reflect forward-looking cost drivers.
6	CPPs and in-period adjustments/re-openers	We support reviewing types/extent of re-openers to address uncertainty, and clarifying which PQ determination changes would constitute re-openers.
7	Transpower investment: Investment tests	It is helpful to explore how investment tests in the IMs and other expenditure criteria can best reflect changing market conditions across multiple regulated sectors, and how other IMs can assist with desired outcomes.

Ongoing improvement of regulatory settings is vital across all sectors

5. We support the review of the IMs to ensure that incentives-based economic regulation remains effective for all regulated sectors. Effectiveness can be measured both in terms of the suitability of particular rules in their technical context as well as the predictability of the overall regime, including how transitions to new IMs or regulatory settings occur.

    a. The nature of ex-ante incentives-based regulation requires the Commission to be forward-looking. As the Commission notes in its Process and Issues Paper, there are significant structural and operational challenges on the horizon for infrastructure providers. It is important for IMs to be fit-for-purpose in the face of anticipated changes – providing regulated firms the confidence that they are reasonably able to manage the economic risks allocated to them.

    b. An objective of IMs is to contribute to a stable and predictable regulatory environment for both regulated firms and their customers. A reasonable level of certainty in how rules will be applied, and their material effects, allows suppliers to respond appropriately to incentives to achieve a fair return on and of capital and provide quality, innovative services to consumers. Predictability also sends important signals regarding the regulatory treatment of all infrastructure investment in Aotearoa New Zealand, and encourages new investment and innovation enhancing our economic future and social/environmental wellbeing.

6. Chorus is a keen observer of how IMs operate as part of overall regulatory packages – which includes legislative requirements and the decisions made by the Commission as part of PQ and ID regulation. The Part 4 IMs for energy and airports sectors are similar in many respects to the fibre IMs set under Part 6 of the Telecommunications Act 2001. Chorus is well placed to offer insights into improving both, especially given its experience in navigating dynamic markets and engaging with investors and customers who value certainty and no-shocks transitions.

7. As detailed below, the current challenges identified by the Commission require IMs and/or other regulatory settings to be evaluated and improved upon to enhance the effectiveness of the regulatory regime across all sectors. We expect changes made

to make Part 4 regulatory settings fit-for-purpose to eventually flow across into Part 6 fibre regulation where relevant, including changes to the fibre IMs in time to be applied for Chorus' PQP2 regulatory period.

Key topics and IMs to address in the review

8. Below we outline key issues for the Commission to consider when developing the problem definition and emerging views papers due for publication later this year.

9. Improvements in these areas are warranted to better reflect the current economic environment and the goal of providing forward-looking, fit-for-purpose IMs. Changes would provide a more predictable regulatory regime and more effective regulatory outcomes; left unresolved, these issues mean that suppliers will likely face uncertainty and poor incentives for investing for the long-term benefit of consumers.

Cost of Capital: WACC parameters

10. We agree with the Commission that refinements to increase predictability of WACC estimates are likely needed in light of significant recent divergences in forecasts of the risk-free rate vs out-turn. A stable and commercially realistic WACC is important to give confidence for suppliers to invest and innovate, promoting desirable long-term outcomes for consumers consistent with regulatory purpose statements.

11. The current cost of capital IMs do not appear to be appropriately achieving this policy intent. We attach an expert report from Incenta highlighting evidence that the cost of debt and TAMRP calculations can be improved to reduce WACC variability.

12. Two key refinements to the cost of capital IM that would increase the stability while also being likely to improve the accuracy of the WACC estimation, and therefore result in a materially better cost of capital IM, are:

    a. **Moving to a full trailing average approach** – for estimating the cost of debt, replacing the current prevailing rate (3-month average) methodology that applies to the risk-free rate component, with a trailing average that reflects the average term of debt that an efficient firm would face (e.g., 5 or more years). This avoids exposing firms such as Chorus to the unrealistic assumption that its entire debt portfolio can be periodically hedged to prevailing interest rates, and is consistent with the method applied by the Australian Energy Regulator; and

    b. **Moving to a Total Market Return (TMR) approach** – for estimating the TAMRP, amending the method such that the TAMRP is derived as a residual from a stable TMR and a risk-free rate of return. This is the standard approach applied by all UK regulators. The results could be cross-checked against other methods currently employed by the Commission in its 'averaged' approach to determining the TAMRP.

13. The Incenta report discusses how the changes could best be implemented in the IMs for regulated firms. With respect to the introduction of the trailing average approach for the cost of debt, Incenta concludes that implementation needs to be by way of a forward-looking staged transition (as was done in Australia) in order to avoid windfall gains and losses accruing to suppliers or consumers from incorporating past "known" information, consistent with NPV=0.

14. Incenta details how these approaches promote a stable WACC that better reflects real-world financing conditions that efficient firms can reasonably be expected to face, improving how the cost of capital IMs allocate risk, achieving an expectation of ex-ante real FCM, and promoting price stability.

Risk allocation and incentives: Inflation risk

15. Chorus agrees with the Commission's framing of the inflation risk problem and relevance to regulated firms – especially those subject to PQ regulation – and supports this area being reviewed, particularly in light of recent CPI volatility. We agree with the policy intent that suppliers and consumers should be protected against forecast errors in inflation when setting PQ paths based on building blocks in order to achieve real FCM.

16. This policy intent, unexpectedly, is not being achieved for Chorus. In summary, protection from inflation risk is currently implemented through an annual MAR wash-up for out-turn CPI vs forecasts used when setting the PQ path. However, the lack of a wash-up for year 1 of a regulatory period, combined with the recent spike in CPI compared to forecasts poses a risk of not delivering real FCM.

17. We understand this issue also affects non-exempt EDBs and the gas transmission business (First Gas Transmission) so has direct relevance to the review of Part 4 regulatory settings.[2]

18. Chorus' view is that the gap in the CPI wash-up, if not corrected, can have a substantial impact on suppliers and consumers where inflation shocks occur in the first year of a regulatory period and the issue needs to be resolved as a priority.

19. We attach an expert report (and accompanying worksheet) from Incenta illustrating the technical problem faced and suggesting some solutions for closing the current gap. Incenta concludes that at least two relatively straightforward options exist to remedy the situation going forward:

    a. Extend the current inflation wash-up for the MAR to cover year 1 of the regulatory period, such that differences in measures of actual vs forecast CPI affecting that year are corrected for (in practice this could encompass accumulated differences between forecast and actual inflation in the year prior to the start of the regulatory period where they affect revenues); or

    b. Replace the existing MAR wash-up with one that calculates a wash-up amount by re-running the building blocks model for the regulatory period in question, using actual CPI in place of the forecasts used originally.

20. Incenta also notes that the issue cannot be expected to correct itself with 'unders and overs' balancing out over time. It is possible, for instance, that low or high points in inflation cycles continue to coincide with future WACCs and PQ path-setting. A systematic exposure also exists where RAB values fluctuate (e.g. due to the depreciation of Chorus' financial loss asset or other declines in RAB values).

[2] Gas distribution businesses are not exposed to inflation forecasting risk as their Default PQ Paths currently employ lagged measures of CPI allowing actuals to be applied in price path-setting. For Transpower, the Commission notes at paragraph 5.192 of its Process and Issues Paper that current regulatory settings are not intended to protect Transpower or its consumers against inflation forecasting error.

Risk allocation and incentives: Mitigating asset stranding risk

21. Chorus supports the Commission's three key economic principles applied in incentive-based utility regulation, in particular the commitment to ex ante real FCM.[3]

22. Asset stranding is a material concern for most, if not all, regulated infrastructure providers in achieving real FCM, and it is important that allowable revenues accurately reflect risks investors are exposed to over the lifecycle of assets.

23. As the Commission notes, risks include new or previously unquantified uncertainties arising from the impact of impact of climate change and the transition to a low carbon emissions economy, changing consumer preferences, new technologies, government policies, ongoing impact of COVID-19 and other global/national issues.

24. Chorus supports the Commission's willingness to mitigate the risk of economic network stranding for suppliers, including by undertaking depreciation profiling or providing an ex ante stranding allowance (where the risk has not been adjusted for via the WACC). In the fibre context:

    a. The risks of competition to the recovery of fibre network costs built by the private sector ahead of demand in partnership with the Crown, were specifically recognised, and a 10 bps ex ante annual allowance was provided for ('hard-coded') in the fibre asset valuation IMs;

    b. Accelerated depreciation for Chorus' financial loss asset was specified in the PQ decisions, applying the asset valuation IMs which permitted the Commission to adjust the profile of depreciation for some or all assets.

25. These types of mitigation measures work together as a package with other regulatory mechanisms and decisions, including in-period reopeners, revenue smoothing, wash-ups, and the length of the regulatory period (in Chorus' case, an initial three-year regulatory period).

26. In periods of significant change, appropriate flexibility is paramount and our view is that we need the ability to propose/apply regulatory settings to respond to current information and changing expectations and evidence – ensuring that combined mitigation measures are appropriately calculated and applied to reflect the risks.

27. Having the available mitigation mechanisms specified in the IMs, but with the extent of mitigation decided upon periodically as part of consultative PQ-setting processes (rather than hard-coded) seems to strike the right balance when dealing with the dynamic nature of stranding risk. We encourage the Commission to consider this.

28. Lastly, we note that the Commission's suggestion of disallowing certain type of capex from the RAB (e.g., growth capex) as a means for avoiding stranded asset values seems a blunt instrument for forcing consideration of prudency of investment.[4] As a general measure it is unsuited to an incentives-based regime, and

[3] Chapter 4 of the Draft Framework Paper.
[4] Paragraph 5.173 of the Process and Issues Paper.

may only be relevant to industries in expected decline or which otherwise lack scrutiny over investment plans.

Other topics and issues to consider

29. There are also a range of other topics and issues that we consider the Commission could explore as part of its review. Past experience, and consideration of anticipated new circumstances, suggests that many IMs could be clarified or improved to produce better outcomes.

30. The topics and issues include:

    a. **Risk allocation and incentives: Incentive mechanisms** – We agree that a workability/effectiveness review of incentive mechanisms should also be included. Shortcomings in the existing IRIS mechanisms / IMs for energy sectors have been identified by the Commission and previous submitters.[5] We encourage the Commission to review these with the aim of better promoting incentives for cost efficiency, investment and innovation is needed. Consideration of other, complementary, means for promoting objectives (e.g., setting of innovation allowances).

    b. **Cost allocation approaches over time** – Given the likelihood of a step-change in (or new types of) forecast expenditure or large-scale investments made ahead-of-demand, the role of cost allocation in risk allocation should be examined to ensure the right balance of flexibility and predictability. The IMs should encourage the review and adoption of forward-looking cost drivers and metrics – reflecting anticipated causal activities or best available proxies occasioned by new circumstances.

    c. **CPPs and in-period adjustments/re-openers** – We support reviewing types/extent of re-openers to address the anticipated greater-than-normal uncertainty and provide greater flexibility – e.g., from a transition to a low carbon emissions economy and associated changes in the demand.[6] It is important that these mechanisms are streamlined in order to be considered effective. Chorus also supports consideration of other forms of in-period adjustments, allowing rapid and predictable responses to events that are uncertain at the time of setting the PQ path. This could include 'use-it-or-lose-it' allowances or other allowances contingent upon a trigger event. We also suggest clarifying in the IMs that re-openers apply to substantive changes to the PQ path, but not to changes in the administrative terms or form of determination itself.

    d. **Transpower investment: Investment tests** – We agree it would be helpful to explore how investment tests in the IMs and other criteria that influence regulatory approvals of forecast expenditure can best reflect changing market conditions across multiple regulated sectors.[7] Proposed spend on resilience, innovation and trials, diversifying the regulated product set, intensifying network use, and connecting higher cost consumers are examples where criteria need to be considered. Issues such as how wider social or economic benefits are

[5] Chapter 5 of the Process and Issues Paper.
[6] Chapter 7 of the Process and Issues Paper.
[7] Chapter 8 of the Process and Issues Paper.

included, and how an energy-conservation and sustainability lens is best applied are also important to examine. We also urge the Commission to consider how other IMs (e.g., for the treatment of public grants/capital contributions) can assist in providing appropriate incentives to invest.