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DPP4 Issues Paper

Thank you for the opportunity to respond to the Default price-quality paths for electricity Distribution businesses from 1 April 2025 – Issues Paper (the Issues Paper).

No part of our submission is confidential, we are happy for it to be publicly released.

Network Tasman supports the Electricity Networks Aotearoa's (ENA) submission to the Issues Paper, and in this submission raises two particular areas about the voluntary undercharging amount foregone mechanism and the specification of the incremental rolling incentive scheme. Specifically, Network Tasman submits the Commission should:

- remove, or significantly amend, the voluntary undercharging amount foregone mechanism.
- consider mechanisms to moderate the strength of the incentives created by the IRIS.

The voluntary undercharging amount foregone mechanism is designed to address theoretical risks that are unlikely to occur in practice

The Commission developed the voluntary undercharging amount foregone mechanism as part of DPP3 to complement the introduction of the revenue cap.

The Commission's rationale for introducing the mechanism was to mitigate the risk that a distributor may accrue a large wash-up balance and then create a price shock when it is passed through to consumers.

In its analysis of the risks, the Commission's mistakes a theoretical risk for an actual risk.

Network Tasman submits is no basis for the Commission to cap the value of an EDB's wash-up balance because the risk of an EDB accruing a large wash-up balance and then subsequently creating a price shock for consumers is either non-existent or immaterial.

It is also not clear why it is in the long-term benefit of consumers for the Commission to artificially suppress an EDB's allowable revenues below the threshold the Commission itself has determined are appropriate for an efficiently managed EDB. Suppressing revenues below this threshold carries several material risks that the Commission doesn't appear to have taken into account.

Network Tasman encourages the Commission to apply a risk-based approach to applying the voluntary undercharging amount foregone mechanism.

The risks of an EDB accruing a large wash-up balance and subsequently creating a bill shock for consumers is non-existent

The Commission is concerned that an EDB could accrue a large wash-up balance and then subsequently create bill shock for consumers by recovering this wash-up balance over a short period.

However, the Commission has not considered the circumstances under which an EDB will price below its revenue cap and whether an EDB systematically pricing below its revenue cap is likely to subsequently introduce price changes that would result in bill shock for its consumers.

There are no obvious incentives for a profit-maximising distributor to systematically price below their revenue cap. It is not in shareholder interests to do so. This is borne out in the revenues non-exempt EDBs have recovered (or intended to recover) during DPP3.[1]

Accordingly, the voluntary undercharging amount foregone is highly unlikely to apply to a profit maximising EDB.

To Network Tasman's knowledge, the only EDBs that have materially priced below their revenue allowance over the past two regulatory periods (DPP2 and DPP3) are those that are consumer-owned.[2] Network Tasman submits that the reason consumer-owned EDBs price below their revenue allowances is because it is in their consumers' best interests to do so.

The concern about EDBs accruing large wash-up balances to then subsequently create a price shock when it is passed through to consumers is theoretically possible but is highly unlikely in practice. It is unrealistic (and inconsistent) for an EDB that is demonstrably acting in their consumer's best interests to then abandon that principle entirely by significantly increasing prices to recover the accrued wash-up balance.

As such, Network Tasman submits the Commerce Commission should remove the voluntary undercharging amount foregone mechanism from DPP4.

However, should the Commission still consider the risk of price shock material, there are more appropriate ways to directly address the price shock risk than artificially suppressing an EDB's revenues below the level determined by the Commission to represent a fair return for an efficient EDB.

For example, the Commission could apply a *limit on annual percentage increase in forecast from prices* that applies to EDBs with a wash-up balance exceeding a set proportion of their revenue cap (forecast or actual).

Alternatively, there is a possibility that a change in EDB ownership will alter an EDB's incentives and result in the EDB subsequently seeking a quick recovery of the wash-up balance. In this circumstance, the Commission could introduce a mechanism that applies in the event of a change in ownership that would mitigate against the risk of the wash-up balance being recovered in a manner that creates undue price shock for consumers.

An additional benefit of removing the voluntary undercharging amount foregone mechanism the Commission will allow EDBs to better manage inter-regulatory period price volatility.

The current revenue cap mechanism provides EDBs with tools to manage price volatility within a DPP period, but it is insufficient to allow EDBs to manage the volatility between DPP periods.

Allowing EDBs to carry forward a greater value wash-up balance provides them with better tools to manage intra-period WACC volatility and provide consumers with greater price stability.

Network Tasman encourages the Commission to apply a more critical lens to the materiality of the risk it has sought to mitigate with the introduction of the *limit on annual percentage increase in*

[1] For the purpose of this submission the Price Setting Compliance Statement is the relevant information source here as it demonstrates the EDB's revenue recovery intentions.

[2] Consumer-owned in practice, not as defined in clause 54D of the Commerce Act.

forecast from prices and if so whether there are more appropriate, targeted and proportionate tools to mitigate these risks.

The strength of the incentives created by the IRIS are disproportionate for the circumstances

Network Tasman submits that there are several shortcomings with the IRIS mechanism that may be addressed as part of the DPP4 determination.

Network Tasman supports the presence of mechanisms designed to encourage EDBs to operate more efficiently. However, it is fundamental that these incentives are appropriately designed to achieve the desired outcomes.

Most importantly, is the Commission's objective to provide EDBs with incentives to operate more efficiently. The IRIS is a key mechanism in the Commission's framework to encourage EDBs to improve their efficiency.

However, the IRIS provides EDBs with incentives to minimise expenditure. Expenditure minimisation is not the same as efficiency. In many cases expenditure minimisation can be counterproductive to efficiency.

The stronger the incentives created by the IRIS mechanism, the higher the likelihood that EDBs supress their expenditure below the efficient level.

Commission must recognise its forecasts aren't perfect

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 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 efficiency levels. 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 inefficiently reducing its expenditure to avoid/minimise an IRIS penalty or efficiently investing in its network and incurring a larger IRIS penalty. Neither outcome is in the long-term interests of consumers.

To Network Tasman's knowledge, the Commission has not provided any evidence or analysis assessing the accuracy of its current or past expenditure forecasts.[3] 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 the accuracy of the Commission's forecasts, Network Tasman submits that the Commission should be cautious about the strength of the incentives provided by the IRIS.

[3] By accuracy Network Tasman means how closely the Commission's forecasts reflect the efficient level of each distributor's expenditure.

IRIS incentives can be significant

It is worthwhile putting some context around the strength of the incentives provided by the IRIS mechanism.

As part of the modelling for the DPP3 final decision the Commission published analysis of the IRIS incentives as a proportion of each EDB's BBAR.[4] In the DPP3 reasons paper, the Commission stated that for most distributors, the impact of the IRIS is modest.[5] Network Tasman does not agree.

When considered against BBAR, the impact of the IRIS does generally appear to be modest, although the fact this conclusion qualified should give pause for thought. However, when considered against the return on capital allowance only, the effect of the IRIS is significantly more material.[6] The table below displays both metrics.

EDB	Total incentive amount (% of BBAR)	Total incentive amount (% of return on capital)
Alpine Energy	-3%	-20%
Aurora Energy	-15%	-90%
Centralines	-3%	-13%
Firstlight	-3%	-14%
Electricity Ashburton	-2%	-9%
Electricity Invercargill	2%	9%
Horizon Energy	0%	-2%
Nelson Electricity	1%	3%
Network Tasman	0%	1%
OtagoNet	-4%	-19%
The Lines Company	-7%	-41%
Top Energy	0%	-1%
Unison	-2%	-10%
Vector	0%	-2%

If you take the other factors the contribute to BBAR (opex, depreciation, etc), the effect on of the IRIS on the return on capital is significant. Seven EDBs had penalties of 10% or more. In an environment where the WACC is set at 4.57%, reductions of this magnitude are significant.

The table above also highlights a number of other issues with the IRIS.

Firstly, the IRIS is asymmetric. There is a floor to the potential benefits of the IRIS mechanism (there is a natural limit to the degree expenditure can be reduced) but there is no ceiling to the potential penalties.

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[4] See *Calculations-of-IRIS-recoverable-costs-for-DPP3-EDB-DPP3-final-determination-27-November-2019*, Row 47 of the Outputs tab.

[5] Commerce Commission, *Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision, Reasons Paper*, X71, page 29, 27 November 2019.

[6] This analysis is based on the models published to support the Commission's DPP3 final decision. Network Tasman recognises that IRIS incentives will have subsequently been adjusted with more up-to-date data since these models have been adjusted. Figures taken from Row 32 of the BBAR tab of the *Financial-model-EDB-final-determination-27-November-2019* model.

This creates asymmetric risks for EDBs because there is considerably more scope for costs to exceed forecasts particularly given the environment DPP4 will occur, when considered against the degree to which costs can fall.

Secondly, when considered as a proportion of the total return on capital allowance, it is worth questioning whether the strength of the incentive is proportionate to the degree of control an EDB has over its costs.

There are a range of drivers to EDB expenditure, a number of which EDBs have limited control over. For example, the supply chain effects of the Covid pandemic and recent severe weather events offer two examples of events that have occurred during DPP3 that significantly affected expenditure that EDBs had limited control over. For EDBs to be penalised for to events outside their control is likely to create unintended consequences and unlikely to result in efficient outcomes for consumers.

Looking forward, there is considerable uncertainty about the costs of emerging services, such as flexibility services. To Network Tasman's knowledge, there are no publicly available details about any flexibility projects undertaken in NZ (cost or operational requirements). The market is nascent, and it is unrealistic for EDBs to have a sufficiently robust understanding of the specific operational capabilities and the associated costs of those capabilities to be able to include such details in their AMPs, especially for projects occurring at the back end of the DPP4 period.

There is significant uncertainty about the magnitude and timing of load growth, both on aggregate and in terms of individual decarbonisation projects. These uncertainties make it challenging for EDBs and the Commission to accurately forecast likely expenditures, this uncertainty grows as the DPP period progresses.

Network Tasman submits that given the uncertainty involved in forecasting expenditure for DPP4 that the Commission needs to be able to articulate explain why it considers the IRIS incentives it is providing are appropriately specified and account for the issues outlined above.

Network Tasman also submits that these uncertainties have increased significantly from DPP3 to DPP4 and that the Commission should reduce the strength of the incentives provided by the IRIS mechanism. Maintaining the current incentives increases the likelihood that EDBs are unduly penalised (or rewarded) for expenditure outcomes over which they have limited control over or for forecast errors in the Commission's expenditure allowances.