Entrust
Majority shareholder of Vector

19 July 2023: SUBMISSION TO THE COMMERCE COMMISSION REGARDING THE 2023 INPUT METHODOLOGIES REVIEW DRAFT DECISIONS

New Zealand’s energy future is arriving faster than expected

The energy sector is very different today than when the Commerce Commission (Commission) last reviewed the Input Methodologies (IMs) in 2015/16 and when they were introduced in 2010.

It is important to take into account New Zealand’s climate and energy response and technological change and that these changes could accelerate rapidly. A lot of new infrastructure investment is going to be needed. Regulatory settings need to allow lines companies to respond flexibly and quickly to changing technologies and changes in consumer demand and expectations.

Climate change, the energy transition, increasing reliance on electricity, and the power outages due to storms and cyclones the North Island experienced this year, all highlight the importance of investment in network reliability and resilience as well as consumer and consumption growth.

Summary of Entrust’s submission

- We need to be cognisant of the changes and challenges lines companies are facing. The Part 4 settings and IMs need to provide lines companies with the right incentives to invest and maintain or strengthen service quality and network resilience.
- It is clear financeability is a major concern amongst regulated suppliers. The Commission should address these concerns to ensure a successful energy transition.
- We consider the suggestion lines companies can deal with financeability by “reducing dividend payments or raising debt and/or equity” to be problematic. Foregoing dividends is not a sustainable long-term strategy for the energy transition.
- Expecting lines companies to take a hit on profits because a large amount of investment is needed is very different from a temporary reduction to help protect consumers from price shock or to smooth prices.
- Adopting an unindexed regulatory asset base (RAB) and accelerated depreciation would both help with cash-flows by bringing revenue recovery forward. An unindexed RAB and accelerated depreciation are complementary tools which are both net present value (NPV) neutral for consumers.
- The Commission’s decisions on WACC percentiles should reflect the increasing importance lines companies invest to improve and maintain reliability and network resilience. Entrust doesn’t support the proposed WACC percentile reductions.
- We support submissions advocating replacement of the current rate of the day (ROTD) approach with a trailing average cost of debt (TACD) in the WACC IM. We consider a TACD would benefit both regulated suppliers (lower cost risk management) and consumers (less price volatility between regulatory periods).

- We support providing greater flexibility in the IMs, including amending the WACC IM to cater for 4- and 5-year regulatory periods.

Entrust’s submission

Lines companies need to be able to adapt

Entrust welcomes that “The Commission is conscious of the changing landscape for EDBs and consumers” and recognises “New Zealand’s response to climate and technological change” is starting “to take shape and accelerate”.[1]

We agree with the Commission “In an environment where suppliers of electricity lines services are expected to deliver large volumes of investments in this decade to meet New Zealand's emissions targets and transition our economy, it is important that the pace of network growth broadly matches consumers' demand for electricity lines services”.

The electrification of the economy will require substantial network investment. The extent and timing of much of this growth will be uncertain, including how rapidly New Zealanders switch to electric vehicles and away from gas. These changes are being reflected in line company asset management plans (AMPs), and expenditure forecasts.

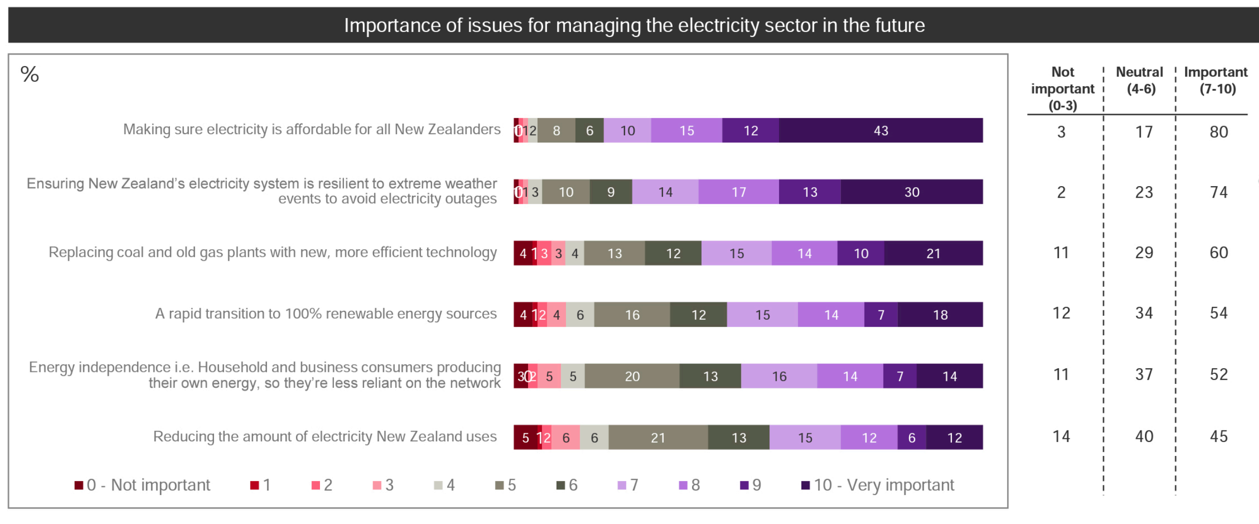
Electricity is an essential service for Kiwi households and businesses

It is becoming increasingly important that electricity networks are reliable and resilient, as the New Zealand economy electrifies. It is no use having an electric vehicle if you can’t travel because it’s sitting in the garage, and you can’t charge it.

The storms and cyclones the North Island experienced this year highlight the vulnerability of communities and businesses to power outages.

[1] Commerce Commission, Default price- quality paths for electricity distribution businesses from 1 April 2025, Proposed Process, 23 May 2023.

The Consumer Advocacy Council recently released a residential consumer survey which showed the key issues for Kiwi households are affordability (80%) followed closely by resilience to extreme weather events and outages (74%).[2]



KANTAR PUBLIC | Consumer Advocacy Council

Q22 Thinking about how the electricity sector is managed in the future, how important are the following issues to you?
Base: Total New Zealanders (n=1,026)

25

The survey results on affordability are an issue for the whole supply chain. The regulated sectors are already helping as revenue caps limit impacts on consumers. It cannot just be the regulated parts that do the heavy lifting. Affordability needs to be addressed in other areas of the supply chain i.e. generation and retail.

Regulatory settings need to change

We agree with the Climate Change Commission (CCC) that:[3]

> "The regulatory regime must continue to adapt and respond to innovations, to ensure it can deliver abundant, affordable, and reliable low-emissions electricity.
>
> "It must be able to deliver the services that will be needed to support the electrification of different parts of the economy. …
>
> "Traditional ways of operating may not deliver the most efficient solutions at the pace required for the transition. The capacity and capability of electricity distribution businesses (EDBs) or lines companies will be important."

We also agree with the CCC that there is a "need to ensure the overall regulatory regime is sufficiently adaptive to enable EDBs to undertake the innovation and investment required to meet climate change outcomes".[4]

The CCC's advice to the Government highlights the importance that industry regulators recognise the need for regulated lines companies to adapt to new technologies, and environmental imperatives e.g. investment to meet demand growth following electrification.

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[2] Kantar Public, Electricity consumer sentiment survey residential consumers and small businesses 2022: baseline survey results, March 2023.

[3] Climate Change Commission, Ināia tonu nei: a low emissions future for Aotearoa Advice to the New Zealand Government on its first three emissions budgets and direction for its emissions reduction plan 2022 – 2025, 31 May 2021.

[4] Climate Change Commission, Ināia tonu nei: a low emissions future for Aotearoa Advice to the New Zealand Government on its first three emissions budgets and direction for its emissions reduction plan 2022 – 2025, 31 May 2021.

The Electricity Authority has similarly commented to the Economic Development, Science and Innovation Select Committee that it wants to "[harness] the role of distribution in the transition" and "ensure that there aren't barriers to that occurring".

The changes to the IMs should reflect the fast-changing economic environment

The draft decisions principally amount to incremental changes or a 'steady as she goes' approach. This includes many worthwhile changes to remove ambiguities and other adjustments.

In an environment with little change this would make sense and stability of regulatory settings would help provide certainty. However, Entrust sees a risk the changes will be too conservative for the IMs to provide for the changes needed for a successful energy transition.

It is imperative to recognise the risks and challenges lines companies face and provide for these to be efficiently managed.

As the majority shareholder in Vector, Entrust participates in regulated activities with the expectations of a reasonable investor that we will recover the costs of prudent and efficient investments, including a reasonable annual return on those investments. Entrust is acutely aware of the importance of our annual dividend to Aucklanders within the Entrust District of central, east, and south Auckland. The Entrust dividend payment helps provide some relief and helps to cover everyday costs, such as rent, petrol or groceries, or it may be used as a power bill credit.

The suggestion lines companies can deal with financeability issues through "a range of tools … including reducing dividend payments or raising debt and/or equity" is problematic. We do not consider this to be a stance which promotes incentives to invest or to be consistent with outcomes in workably competitive markets. It is one thing to expect lines companies to take a temporary reduction in revenue or profits to help mitigate consumer price shock or to smooth prices which is explicitly provided for in the Commerce Act. It is a very different proposition to expect a reduction in profits because a lot of investment is needed.

Foregoing dividends is not a sustainable long-term strategy for the energy transition. It should not be assumed investors are indifferent to cash-flow timings simply because they may be NPV neutral in the long-run. Nor should Part 4 regulation dictate equity funding requirements.

In a workably competitive market ceasing to pay dividends and then hoping to raise equity is not likely to be successful or efficient. The investment is not likely to be attractive to investors if the chances of dividends in the short-term is nil. If it's not equity, then investment will be from debt. This increased leverage will incur higher rates of servicing which will impact consumer affordability.[5]

Entrust submits that the Commission should ensure cashflows can provide appropriate returns to investors (both debt and equity) while maintaining credit metrics that enable access to capital essential for financing of the future network investment required for electrification.

[5] The WACC IM adopts the assumption that for every $1 invested $0.41 is funded by debt and $0.59 is funded by equity. If due to credit metrics being breached the whole $1 needed to be funded by equity, the equity investor would have to also be happy that the return on $0.41 of the investment would be at the cost of debt not the cost of equity as the DPP would have funded revenues on that basis. Effectively the equity investor has to accept a return that is lower than required to compensate them for the investment risk they are taking.

Entrust supports the Commission's approach to accelerated depreciation in the gas DPP3 reset

Entrust considers the adoption of accelerated depreciation is an NPV neutral, no-regrets, option for the Commission to adopt for both electricity and gas.

We supported the approach the Commission took to accelerated depreciation in the last gas reset and consider this should now be adopted for electricity. The best way to do so would be to lock-in provisions allowing accelerated depreciation in the IMs.

Unfortunately, we do not believe the application-based approach introduced for electricity has been successful. There has only been one, unsuccessful, application by Vector and a consequent reluctance by other lines companies to apply.

Entrust agrees with Mercury that adoption of mechanisms such as accelerated depreciation will "ease concerns over the risk of partial capital recovery of long-life assets".[6] Accelerated depreciation can help investors build confidence they will be able to recover their prudent and efficient investment costs.

The approach of RAB indexing can impact risk

Matters such as the current approach of RAB indexing and depreciation rates can impact the cost recovery profile and, particularly for gas pipelines, revenue recovery risk. For example, RAB indexing delays capital cost recovery and could work against accelerated depreciation.

We consider the situation lines companies and Transpower are now in, with the projected increase in network investment requirements, parallels the justification the Commission originally provided for adopting an unindexed RAB for Transpower.

The Commission should consider how the current approach of RAB indexing versus adopting an unindexed RAB in conjunction with accelerated depreciation would impact the cost recovery profile over-time.

A trailing average cost of debt should be adopted

We share the concerns of a wide range of stakeholders that the current ROTD approach to setting WACC results in unnecessary price volatility between regulatory periods and exposes consumers to unnecessary price risk.

We are particularly concerned about price volatility. It is unclear how much of lines company price reductions are being passed to consumers. Price volatility between regulatory periods is particularly harmful for consumers if lines company price increases are more readily passed through to consumers than reductions.[7] The Electricity Authority had intended to look at the extent of pass-through following the last electricity price reset but has not done so.[8]

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[6] Mercury, Resetting default price-quality paths for gas pipeline businesses from 1 October 2022, 26 August 2021.

[7] We raised concerns about pass-through in our submission on the draft electricity price reset for 2020: Entrust, Price-quality regulation settings need to ensure lines companies can invest, adapt and meet changing consumer needs, 18 July 2019, at: https://www.entrustnz.co.nz/media/r3rat1bu/submission-on-edb-dpp-reset-draft-decisions-paper-18-july-2019.pdf.

[8] The "Review how the network price changes that took effect on 1 April 2020 passed through into the retail electricity market" has been on the EA work programme in 2020 and 2021. The Authority also committed to looking at pass-through further in December 2021 (in its updated Distribution Pricing Practice Note) and reconfirmed this intention following e-mail query in March 2022. From the Director, Network Pricing: "The Authority has confirmed that it is considering pass-through of lines charges by retailers to consumers in its distribution pricing reform work programme. This will encompass both existing line charges and changes to

Even if consumers benefited from low interest rates suppressing prices at the last electricity and gas resets, this won't always be the case. The lower network charges under ROTD due to low interest rates will be offset by higher network charges when interest rates are high (particularly when interest rates are high at the start of a regulatory period but are expected to decline over the regulatory period).

We consider the best way to deal with this is to recognise lines companies' debt funding occurs over multiple years and regulatory periods, with multiple different interest rates.[9] This is efficient and consistent with the outcomes of a workably competitive market. A TACD approach achieves this. An ROTD does not.

In response to submissions that TACD is better than ROTD for price smoothing across regulatory periods, the Commission argued "we can apply the rate of change mechanism across a control period to smooth prices to mitigate any significant impacts on consumers".

Entrust has advocated price smoothing in this kind of way but the Commission hasn't done so. The last Part 4 regulatory price resets provided an opportunity to 'bank' the WACC reduction through accelerated depreciation e.g.:

> "Current low interest rates provide an opportunity to bring forward investment cost recovery, while avoiding "price shocks" for consumers. This could help smooth prices over subsequent regulatory periods. Even though the Commission is proposing to allow prices to be increase they will still be about 25% lower in real terms than they were a decade ago.
>
> "The Commission could adopt a more aggressive acceleration and/or removal of RAB indexing, and prices would still be low."[10]

This would be no different to a household paying off their mortgage faster when interest rates are low.

There could have been particular benefit from price smoothing between the current and next price resets. As the Commission has noted the "substantial growth in regulated suppliers' expenditure" and "inflation-driven higher cost of capital mean it is likely that the revenue required to pay for the cost of electricity lines services needs to increase substantially, and with it, consumer bills".

The optimal Efficiency Sharing Rate warrants additional attention

We agree with the Commission that "Ensuring that regulated suppliers have incentives to innovate, invest and operate efficiently is perhaps more important now than at any point since Part 4 of the Commerce Act 1986 (the Act) was introduced".

We consider this warrants giving additional attention to the optimal balance between the strength of incentives for lines companies to improve efficiency, how long they are able to benefit from cost savings they make, and how rapidly these are shared with consumers (the "retention period" or 'Efficiency Sharing Rate').

Given the increasing importance of efficient investment and innovation, it may be useful to take a quantified, evidential-based approach to the optimal Efficiency Sharing Rates just as the Commission has done for WACC percentiles. The benefits for consumers from

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lines charges. You are correct that the Authority is particularly interested in how price signals are passed through, but we expect that any aspect of pass-through that concerns affected parties will be put on the table."

[9] Debt financing is not undertaken in one-off 'big bang' refinancing implied by ROTD.

[10] Entrust, SUBMISSION TO THE COMMERCE COMMISSION REGARDING THE GAS DPP3 RESET: Entrust supports the Commission's focus on investment cost-recovery, 14 March 2022, at: https://www.entrustnz.co.nz/media/bl2erq0q/submission-on-the-gas-dpp3-reset-14-march-2022.pdf.

stronger efficiency and innovation incentives could be far more significant than a reduction in prices from setting the WACC percentile at 65th instead of 67th.

The review of WACC percentiles in 2014 highlights that the Commission can undertake substantive reviews in relatively short periods of time, including within the time available to complete the IMs review.

Innovation and non-traditional solutions should be encouraged

We support the draft decision "to amend and expand the current innovation project allowance (IPA) into the 'innovation and non-traditional solutions allowance' to enable more scope and flexibility to set a wider range of schemes to provide better incentives for innovation and non-traditional solutions, at DPP resets or when setting a CPP".

This is consistent with the Commission's recognition of the increasing importance of incentives to efficiently invest and innovate.

It would be useful for the Commission to also consider further the level of this allowance. We previously raised concern that the allowance was set too low and "a higher allowance would better encourage lines companies to innovate, and to meet the Commission's section 54Q obligation to promote energy efficiency and demand side management".[11]

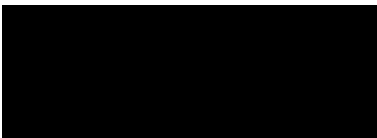
Concluding remarks

Change has and is coming to the energy sector. This is driven by climate change, electrification, new technology, more consumers, and changing consumer demand and expectations.

Successful adaption to climate change will require greater electrification and increased network investment. Electricity network reliability and resilience is becoming increasingly important as consumers switch from other fuels e.g. petrol and gas, to electricity.

Changing technology and consumer preferences create challenges and opportunities for both lines companies and industry regulators. Lines companies can't continue to do things the way they have historically without changes to asset planning, investment choices and innovation. This is reflected in Vector's latest AMP. The same is true for the Commission's IMs. Our submission highlights some key changes that are needed to regulatory settings.

Kind Regards,



Alastair Bell
Chair of Regulation and Policy Committee

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[11] Entrust, Price-quality regulation settings need to ensure lines companies can invest, adapt and meet changing consumer needs, 18 July 2019, at: https://www.entrustnz.co.nz/media/r3rat1bu/submission-on-edb-dpp-reset-draft-decisions-paper-18-july-2019.pdf.