10 December 2018

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Dear Dave,

Default price-quality paths for electricity distribution businesses from 1 April 2020

Thank you for the opportunity to comment on the Commerce Commission's (Commission) consultation on the 2020 reset of the default price-quality path (DPP) for electricity distribution businesses (EDBs) for the third regulatory period beginning 1 April 2020 (DPP3).

Forecasting capital expenditure

The Commission notes in the issues paper that it is considering alternative options to the use of each EDB's 2018 and 2019 Asset Management Plan (AMP) forecasts for the development of regulated capex forecasts. One of these options involves the Commission deriving its own capital expenditure forecasts. We believe such an approach has merit, especially for larger EDBs, and warrants serious consideration.

If the EDBs AMPs continue to be used, we support the approach used by the Commission in the 2017 Gas DPP reset, which involved comparing the AMP forecasts to a historical baseline, using qualitative and quantitative analysis to review the material contained in the AMP, and requesting further information where the AMP did not justify the forecast expenditure.

Incentives to improve efficiency

We agree with the submission[1] made by the Energy Networks Association (ENA) in response to the Commission's November 2017 open letter on its priorities for the distribution sector, which stated:
The other key area that the Commission needs to address is incentives to procure rather than own. Procuring network alternatives from third parties provides the network with no return, and indeed there is an opex Incremental Rolling Incentive Scheme (IRIS) penalty from procurement relative to direct investment. The Commission needs to eliminate the current bias towards capital expenditure otherwise EDBs will rationally want to own their own network alternatives rather than procure (even from its own affiliate).

The Commission noted in the issues paper that the capex and opex incentive rates should be broadly similar (noting that Transpower's base capex incentive rate of 33% is approximately consistent with the opex incentive rate). The Commission justified the use of an approximately 34% opex incentive rate with a lower 15% capex incentive rate in DPP2 on the basis that a higher capex rate may cause a risk that EDBs will inflate their capex forecasts. The Commission also noted that applying a higher level

[1] https://comcom.govt.nz/__data/assets/pdf_file/0034/87982/ENA-Response-to-open-letter-on-priorities-20-December-2017.pdf

of scrutiny to EDB capex forecasts in DPP3 will mitigate the concern that led to a lower capex incentive rate. We believe a higher level of scrutiny will be an important part of the solution for aligning capex and opex incentive rates.

It is important to recognise that aligning the capex and opex incentive rates will not in itself eliminate the current capital expenditure bias. In past submissions[2] we have commented extensively on the Commission's use of a 67th percentile weighted average cost of capital (WACC) introducing a bias towards capital expenditure due to the excess capital returns provided to EDBs by design.

The issues paper also recognises concerns around a capital expenditure bias and advises that a number of overseas regulators, including Ofgem and the Australian Energy market Commission (AEMC) have moved to a 'totex' approach (rather than individual capex and opex allowances). We believe the 'totex' approach provides greater focus on setting an appropriate overall cost allowance that ultimately benefits consumers. The proposed two to three years to develop the approach is a small amount of time relative to the development of regulatory settings. The Commission's consultation paper states that '*rather than proposing to shift to a full totex approach for DPP3, we believe that it is appropriate to consider the [capex] retention rate to be used for DPP3.*' We are surprised that the Commission appears to have dismissed the totex approach with minimal consideration of the actions of regulatory peers around the world or consultation with interested stakeholders. We encourage the Commission to reconsider this approach.

Demand-side management

Demand side management is another important tool to support New Zealand's growing electricity demand and the government's commitment to transition to a carbon-neutral economy. The paper briefly mentions demand-side management incentive schemes have been introduced in regulatory regimes around the world, including in Australia since December 2017, but then proposes a "wait and see" approach for New Zealand. We recommend it is timely for the Commission to provide an overview of the various schemes implemented, identify benefits and be guided by stakeholders on the appropriate timeframe for implementation. We recommend that incentives for demand-side management should be strengthened at the beginning of the DPP reset process rather than be delayed for another five years or longer.

We would be happy to discuss or engage further with the Commission if it would be of assistance.

Yours sincerely,

MJHassall

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[2] For example: https://comcom.govt.nz/__data/assets/pdf_file/0018/61128/Contact-Energy-Submission-on-IM-review-draft-decision-4-August-2016.pdf