

Part 4 Input Methodologies Review 2023

Final Decisions

13 December 2023

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Today's briefing

- About the Input Methodologies (IMs)
- Our review process and decision-making framework
- Stakeholder engagement
- Setting the scene
- How the IMs are applied
- Our decisions
- Questions
 - Please use QR code to access chat



About the Input Methodologies

- IMs are upfront rules and processes we set to help provide certainty about how we will regulate specific services under Part 4
- Part 4 of the Commerce Act requires us to promote the long-term benefit of consumers of regulated services. We promote outcomes so suppliers:
 - have incentives to innovate and invest
 - have incentives to improve efficiency and provide services at a quality that reflects consumer demands
 - share the benefits of efficiency gains with consumers, including through lower prices
 - are limited in their ability to extract excessive profits.



Our review process

- We must review all IMs at least once every seven years
- Changes made are likely to meet at least one of the overarching objectives:
 - More effectively promote the purpose of Part 4 (s52A)
 - More effectively promote the purpose of the IMs (s52R)
 - Reduce cost or complexity
- We have had regard to other considerations where these were relevant and did not detract from the Part 4 purpose – for example, s5ZN of the Climate Change Response Act
- An extensive process of consultation has helped refine our understanding and informed our final decisions
- We adopted a cross-sector approach as some of our decisions affect multiple sectors regulated under Part 4

Stakeholder engagement

- Notice of Intention published—23 Feb 2022
- Process and issues paper published—20 May 2022
- Draft Decision-Making Framework paper published 20–May 2022
- Confidential debt survey issued to relevant stakeholders—15-16 Sept 2022
- Decision-Making Framework paper published—13 Oct 2022
- Workshops held—7-29 Nov 2022
- Expert report on cost of capital published—29 Nov 2022
- Paper on options for maintaining investment incentives in the context of declining demand published—20 Dec 2022
- Decision-Making Framework Clarification note published —21 Dec 2022
- Updated Notice of Intention published—1 Mar 2023
- Draft Airports, Electricity distribution, and Gas pipeline Input Methodology Amendment Determinations published—14 Jun 2023
- Draft Topic Papers, Report on the IM Review, Context and Summary of Draft decisions published—14 Jun 2023
- Draft Transpower and Transpower Capex Input Methodology Amendment Determinations published—21 Jun 2023
- Further updated Notice of Intention published—22 Aug 2023
- Cost of capital: Invitation to cross-submit on specific matters—24 Aug 2023
- Invitation to submit on further consultation relating to our draft decision on the cost of debt wash-up for EDBs and GTBs—29 Sept 2023
- Invitation to submit on proposed change to the effective dates in draft Airport IM amendment determination—10 Oct 2023
- Final Topic Papers, Report on the IM Review, Context and Summary paper and Amendment Determinations published—13 Dec 2023

Setting the scene

- Sectors face significant change and uncertainty
 - From decarbonisation, electrification, resilience to climate and other risks, and cost pressures.
- Technology and consumer preferences are evolving
 - Changes in demand are expected
- Our rules must be robust and allow the Commission and suppliers to respond appropriately in a timely way
- IMs are just one part of the regime, that also includes:
 - Information disclosure requirements
 - Price-quality path determinations.

Strengthening our regulatory foundations

- IMs are robust and remain broadly fit for purpose
- Made some minor improvements with a few more significant changes to strengthen the regulatory foundations:
 - Ensure the Commission has appropriate flexibility to address uncertainty
 - Provide suppliers appropriate incentives to invest, innovate and improve efficiency
 - Minor changes reduce cost and complexity

Applying the IMs

- Changes to input methodologies will be applied in our future price-setting decisions and information disclosure requirements.
- Work on the price-quality paths of electricity networks is underway – decisions are due by 30 November 2024 and will take effect on 1 April 2025.
- Decisions on the price-quality paths for gas pipeline businesses are due in May 2026 and will take effect in October 2026.
- Most airport input methodologies changes will apply from disclosure year 2026. Changes to the input methodologies for airports that relate to cost of capital will apply immediately.



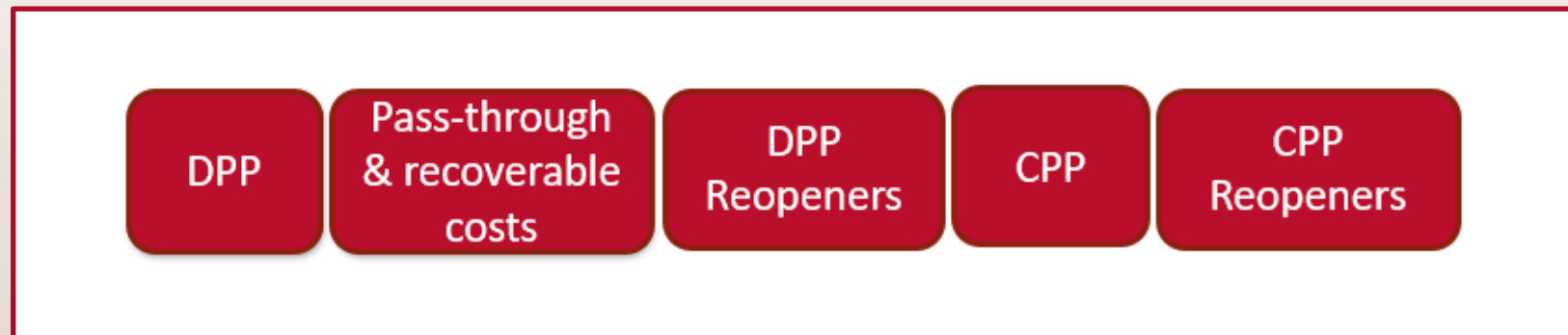
Key decisions

- Adopted indexation of asset values for Transpower consistent with EDBs and GPBs
- Reduced percentile for cost of capital for gas (50th) and electricity (65th)
- Confirmed the ability to adjust asset lives for gas suppliers to reflect economic lives
- Confirmed a weighted average price cap for gas distributors
- Confirmed a specific input methodologies is not required for financeability which remains a consideration at resets
- No new cost of debt wash-up*
- Improvements to Major Capex Proposal (MCP) process for Transpower*
- Improvements to reopeners for EDBs including introducing a Large Connection Contract mechanism*
- Re-estimated equity beta for airports, electricity and gas*

**updated since the draft decision*

Dealing with change and uncertainty

- Increased uncertainty over scale and pace of demand changes, resilience needed, new technologies
- Our rules deliver a stable and predictable regime, including the ability to address change in an appropriate and timely way
- The regime provides a broad toolkit to respond to different circumstances and change.



Change and uncertainty—reopeners

- Reopener processes improve clarity, consistency and ease of use
- Extended system growth reopener to opex solutions
- Limit on general growth not introduced
- Allowed for consequential opex and capex
- Included resilience-related expenditure
- New risk event reopener for EDBs
- New Large Connection Contract mechanism for EDBs

Change and uncertainty—Transpower



- Clarified and streamlined the Capex IM investment test and MCP process:
 - introduced a cost estimation incentive deadband
 - revised the Capex IM discount rate
 - clarified scenarios Transpower must analyse in support of MCP proposals
 - allowing MCP outputs following submission of a proposal.
- Require independent verification of base capex proposals to improve individual price-quality path (IPP) process certainty
- Include reconductoring projects and large non-recurring information systems technology projects as listed projects
- Anticipatory connection assets (ACA) are subject to the Capex IM economic test
- Introduced reopener provisions for ACA capacity investments and resilience

Incentivising efficient investment

- Material increase in investment expected for EDBs and Transpower
- For gas suppliers, expect declining demand over coming years
- Important to ensure suppliers have incentives to invest efficiently - in the right things, at the right time, and at the lowest lifetime cost to meet consumer demands
- We considered the combination of existing tools that incentivise businesses to invest and innovate efficiently

Cost of capital decisions

- Methodology unchanged; key parameters updated
- Updated the equity beta estimates
- Re-estimated economy-wide tax adjusted market risk premium (TAMRP)
- Uplift to estimate (weighted average cost of capital, or WACC, percentile) reflects risk and cost of under-investment
 - Electricity 65th percentile
 - Gas 50th percentile

Incentivising efficient investment— other decisions

- Expenditure and innovation incentive mechanisms for EDBs and Transpower:
 - Targeted changes to improve incremental rolling incentive scheme:
 - Removing CPI inflation effects from IRIS amounts (real IRIS)
 - Amended Transpower’s opex IRIS to improve predictability
 - Expand the ‘innovation project allowance’ into the ‘innovation and non-traditional solutions allowance’; move implementation details to price-path decision
- Asset stranding risk for gas pipeline businesses:
 - Retain current IMs relating to economic asset lives
 - Continuing to retain assets in the RAB until they are fully depreciated.

Cashflows and inflation

- Efficient prices broadly reflect the flow of benefits to consumers over time
- Regulation should not prevent suppliers financing necessary investments
- Some supplier concerns about cashflows and financeability during the energy transition
- We considered the tools we have to influence cashflows, including their:
 - overall level
 - recovery over time
- Reviewed our approach to inflation forecasting

Cashflows & inflation–decisions

- Tools for influencing supplier cashflows are generally sufficient:
 - Customised price-quality paths are available to manage specific financeability issues
 - Retain our current method for forecasting inflation
- Financeability test IM is not needed
- Targeted changes:
 - Indexing Transpower’s regulatory asset base to inflation
 - Improvements to the revenue path and wash-up mechanism
 - First year inflation wash up, other minor changes to mitigate forecasting error

Decision package

- Context and Summary report
- Report on the review
- Topic papers
 - Financing and incentivising efficient expenditure during the energy transition
 - Cost of capital
 - Customised price-quality paths and in-period adjustments
 - Transpower investment
- Amendment determinations

Questions



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