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Submission on EDB DPP4 Draft Decision

Background

1. The Commerce Commission (the Commission) published the “Default price-quality paths for electricity distribution businesses from 1 April 2025 – Draft decision” on 29 May 2024.
2. The Commission requested stakeholder feedback.
3. Orion, Vector and Wellington Electricity (together “we”, or “our”) have collaborated on the matter of cost escalators and jointly provide this submission to the Commission’s questions numbered C6 and O4.1 and O4.2.
4. In support of this submission, we **attach** an expert report from Oxford Economics Australia (OEA).

Capital Expenditure - C6: Use the All-Groups CGPI forecast with an additional adjustment to escalate the constant price capex allowance to a nominal allowance

5. In summary, the Commission’s decision on capex escalators is to apply ‘All-Groups CGPI + 0.8%’ to restate capex allowances from constant to nominal terms.
6. Evaluation of this draft decision requires consideration of three matters:
 - a) Is the use of the All-Groups CGPI forecast the most appropriate means to escalate the capex allowance?
 - b) Recognising that energy infrastructure is likely to face higher inflation over DPP4, is the use of a factor based on the historical difference between the EDB-specific CGPI and the All-Groups CGPI appropriate to determine the additional adjustment?
 - c) How should the historic difference between the EDB-specific CGPI and the All-Groups CGPI be determined?

Is the use of the All-Groups CGPI forecast the most appropriate means to escalate the capex allowance?

7. Our view is that the use of an All-Groups CGPI forecast is an appropriate base measure to apply for DPP4 given the present absence of widespread forecasting for a more specific and appropriate Stats NZ published index. This recognises the present complexity of developing a customised index for EDBs compared to the relative simplicity of using All-Groups CGPI.

8. We consider that the EDB-specific CGPI would be a more appropriate measure of cost escalation relating to electricity distribution assets than the use of All-Groups CGPI, and we note that OEA agree. OEA note on page 35 of their report that:

“the historic volatility in the EDB CGPI is considered a detractor by the Commission in the draft decision, whereas we would consider this a more accurate reflection of cost escalation pressures in the sector. The historic volatility in index growth is likely reflecting actual volatility in cost escalation – this is supported by the correlation between the EDB CGPI and key commodity cost inputs (i.e., periods of high or low index growth are underpinned by input cost movements)”

9. We agree with OEA’s argument that historic volatility is not a reason to dismiss an index, as the use of long-term averages can address such volatilities, and we also appreciate, as do OEA, that forecasting of an EDB-specific CGPI is more complex and less widely undertaken. For this reason, we consider the use of an All-Groups CGPI forecast an appropriate base measure to apply for DPP4 as compared to an EDB-specific CGPI.

Recognising that energy infrastructure is likely to face higher inflation over DPP4, is the use of a factor based on the historical difference between the EDB-specific CGPI and the All-Groups CGPI appropriate to determine the additional adjustment?

10. The Commission confirms that an additional adjustment to All-Groups CGPI is appropriate given that energy infrastructure is likely to face higher inflation than the general economy, over DPP4. OEA concluded the same. In OEA’s Executive Summary they conclude:

“Inflationary pressures which impact the operating and capital expenditure of EDBs is likely to outpace economy-wide inflationary pressures over the forthcoming regulatory period (2025-2030)...there is substantial upside risk to inflationary pressures which are targeted towards the electricity and construction sectors.”

11. With the need for an additional allowance established and given the complexity at present of developing another approach, the historical difference between the EDB-specific CGPI and the All-Groups CGPI is an appropriate means to determine the additional inflation EDBs are highly likely to face in DPP4.

12. As OEA note on page 10 of their report:

“...the key issue remains that the All-Groups CGPI does not account for the historically elevated cost escalation pressures which EDBs have faced..... The Commission acknowledges this and has adjusted the methodology to include a 0.8% increase above the forecast of All-Groups CGPI per annum”

The Commission’s 0.8% uplift factor is based on the historical difference, over the five-year period from 2019 to 2023, between annual EDB-specific CGPI and the All-Groups CGPI.

How should the historic difference between the EDB-specific CGPI and the All-Groups CGPI be determined?

13. In the draft decision the Commission considers it appropriate to use an average of the annual difference between the EDB-specific CGPI and the All-Groups CGPI over the five-year period from 2019 to 2023, to determine the additional inflation allowance that should be added to the All-Group CGPI. The Commission in its decision does not consider any other period, nor give any reason for why it has selected a five-year period from 2019 to 2023. We submit this is inappropriate and not in keeping with considered analysis.

14. While we note that the decision to utilise a five-year period aligns with the Commission’s capex allowance C3 decision, this is not a necessity. Setting allowances and setting cost escalators could/should use different reference periods.

15. A relatively short period is appropriate in the deliberation of allowances as there is a need to look at what is happening most recently in the sector to pick up latest investment needs. However, in the deliberation of cost escalators, for multiple reasons set out below, consideration of a longer period is more appropriate.
16. The below table sets out the average annual difference between the EDB-specific CGPI and the All-Groups CGPI for differing historic periods. These figures are copied from the Commerce Commission’s ‘Attachment B – Capex Additional supporting information workbook – EDB DPP4 draft determination – 17 June 2024’ published on 18 June 2024.

Period	Average annual difference in growth rates between EDB-specific CGPI and the All-Groups CGPI
30 years (1994 to 2023) <i>(1993 in the first full year that the EDB-specific CGPI index is available from Stats NZ; this period is shown in Figure B13 in the draft decision)</i>	3.1%
15 years (2009-2023) <i>(1 April 2009 was the start of default price-quality paths for EDBs)</i>	1.8%
5 years (2019-2023)	0.8%
2023	3.9%

17. As can be seen from the above table, the reference period selected by the Commission, namely the five-year period from 2019 to 2023, results in a % adjustment figure (0.8%) markedly lower than if other periods were used.
18. As previously noted, the Commission in its draft decision did not comment on why the five-year period from 2019 to 2023 was chosen, nor why the five-year period from 2019 to 2023 is more appropriate than utilising a longer-term figure.
19. We submit that the Commission should not adjust the methodology to include a 0.8% increase above the forecast of All-Groups CGPI per annum over the regulatory period, but rather include a 3.1% increase above the forecast of All-Groups CGPI per annum over the regulatory period.
20. Such 3.1% figure being the average annual difference in growth rates between EDB-specific CGPI and the All-Groups CGPI over the long term, specifically since these two indexes were first measured by Stats NZ.
21. Use of longer-term averages are generally recognised as the best averaging method to employ when the objective is to remove the issue of volatility – which the Commission appears to support when considering other matters in its draft decision¹.
22. Further, if the Commission’s Part 4 purpose objective is to achieve regulatory certainty, then the use of a short-term average approach to determine cost escalation measures is unlikely to achieve such stability.
23. Rather, it is quite possible that when EDBs move from DPP4 to DPP5 the application of the short-term average approach proposed by the Commission for DPP4 will not be sustainable. This is because of the volatility of short-term averages in the EDB CGPI. For example, if the approach the Commission presently proposes, namely the use of a short-term five-year average approach

¹ Examples of a seeming desire by the Commission to remove volatility are at 3.27, 3.52.2, B189, B190, B193, E20, E48, E56, E65, E90, E317, E326.2, E433, E444.5, F167 of the draft decisions.

to determine the cost escalation uplift factor, was utilised during other historic DPP resets then the cost escalation uplift factor would vary greatly from one DPP period to the next. Where such an approach generates a figure of 0.8% for the DPP4 reset, the same approach if used at the DPP3 reset would have resulted in an uplift factor of -2.3%, and if used at the DPP2 reset would have resulted in an uplift factor of 6.9%. Such volatility in uplift factors is unlikely to be tolerated long term and hence use short-term average approach to determine cost escalation is unlikely to achieve the objective of stability and regulatory certainty.

24. We also note that the use of a short term 5-year average period appears at odds with a principle that the Commission has previously relied on. In its 13 December 2023 decision on Cost of Capital² the Commission wrote:

“Considering the asymmetric consequences of over- and under-investment over the long term is one of the economic principles that we use as a guide to best promote the Part 4 purpose.”

If the cost escalation allowance is set too low, there is obviously the potential that EDBs will underinvest, to maintain sustainable businesses. To best ensure long-term appropriate investment, long-term cost pressures must be recognised. Long-term cost pressures are best measured by long-term inflation averages as opposed to short-term inflation averages.

25. To further support the argument for a shift away from utilising the five-year period from 2019 to 2023, OEA noted:

“Considering cost escalation for CAPEX, we consider that the upwards adjustment of 0.8% may underestimate the increased inflationary pressures faced by EDBs over the remainder of the decade” and the adjustment of 0.8% “is below the long term historical disparity between the closest Australian equivalent of these two indices (GFCF IPD and Electricity IPD, +1.9%)”. (page2)

and from page 39:

“... the historical reference period used to calculate the size of the adjustment is unlikely to provide the most accurate representation of the potential disparity between the All Groups CGPI and the EDB CGPI over the 2025-2030 regulatory period. As stated previously, the average long term disparity between the two price measures is 3.0% (FY1993-2024) – if the highly volatile FY2007-2009 period is removed from the long term average, then the disparity is 1.8% which is more than double the proposed upwards adjustment.

The historical ‘closeness’ of the reference period (2020-2024) is not necessarily good reasoning for the calculation of the potential future disparity between the All Groups CGPI and the EDB CGPI. The inflationary pressures which impacted domestic and global economies in the past three years have been uniquely far-reaching across many aspects of the economy.

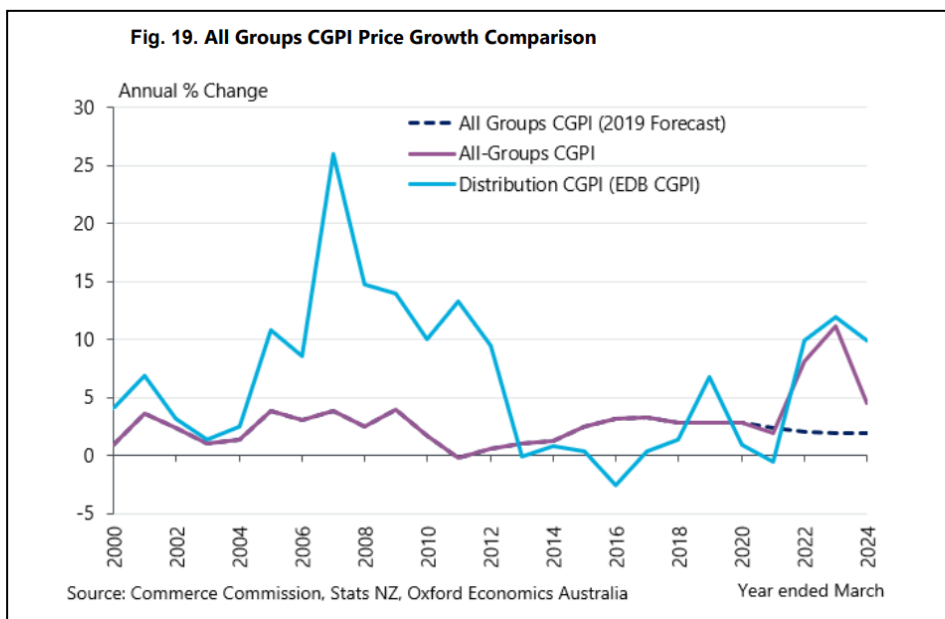
This is evidenced in the scale of growth in the All Groups CGPI – the index reached record levels of annual growth in FY2022 (+8.1%) which grew further in FY2023 (+11.2%). Recent growth outcomes in the All Groups CGPI are relatively extreme compared to historical growth (see Figure 24) whereas recent growth outcomes in the EDB CGPI are well beneath historical peaks in escalation.

² [Part-4-IM-Review-2023-Final-decision-Cost-of-capital-topic-paper-13-December-2023.pdf \(comcom.govt.nz\)](#) – paragraph 6.10

The historical reference period used for the calculation of the 0.8% adjustment covers a period where the disparity between the two indices is at its lowest. The historical disparity between the two indices has been at its highest during periods of surging commodity prices that are directly related to the cost inputs or materials used in construction – that is, during periods of more targeted inflationary pressures to the construction (or electricity construction) sector.

As discussed in Section 4, we would suggest that the forthcoming regulatory period (2025-2030) has more targeted inflationary risks for (electricity) construction cost inflation relative to the broader economy. There is the risk that the 0.8% upwards adjustment will significantly underestimate the actual disparity in growth outcomes between the All Groups CGPI and the EDB CGPI over the 2025- 2030 regulatory period.”

26. Should any underestimation of cost escalation occur, this will compound the substantial disparity between the regulated cost inflator rates and actual escalation rates that applied to EDBs in DPP3. The Commission recognises in their draft decision that the DPP3 escalation factors for operating and capital expenditure did not capture the severe inflationary pressures seen throughout the global and domestic economy in recent years. The figure below from page 32 of the OEA report demonstrates this DPP3 disparity.



27. The concern that EDBs will, if All-Groups CGPI + 0.8% is applied for capital expenditure in DPP4, again see a substantial disparity between the regulated cost inflator rates and actual escalation rates is further heightened by OEA’s commentary that in their opinion:

“there is strong possibility of supranormal escalation pressures reemerging in forthcoming years” (page 2)

and:

“...there is substantial upside risk to inflationary pressures which are targeted towards the electricity and construction sectors. This includes a significant ramp-up in the global demand for materials and equipment required for constructing or maintaining electricity assets...” (page 2)

28. In summary, we submit there are strong arguments that the Commission's draft decision to utilise All-Groups CGPI + 0.8% to escalate capex allowances should be replaced with a final decision to utilise All-Groups CGPI + 3.1%. Use of an uplift figure of 3.1% would better:

- reflect long term averages, thereby removing volatility impacts,
- support the objective of regulatory certainty,
- reduce the risk of over or under investment by EDBs over the long run,
- reduce reliance on figures during the 'covid supply years'. Years where inflationary pressures uniquely impacted domestic and global economies,
- help mitigate that there is more upside risk to inflation compared to downside risk,
- ensure the Commission's decision meets its objective to incentivise EDBs to invest and innovate during the decarbonisation transition.

Opex trend factors – O4.1 and O4.2: Escalate all opex costs using the same cost escalator, and escalate opex using the all-industries labour cost (60% weighting) and a producers' price (40%) indices, plus a 0.3% uplift to reflect EDB-specific inflation.

29. The Commission's decision, in summary, on opex escalators is:

- to restate opex allowances from constant to nominal terms, by applying a 60/40 split of All-industry LCI and PPI indices, and add a 0.3% uplift to both to reflect the higher inflation that EDBs are likely to face in the future, and
- apply the above cost escalator (namely $0.6*(LCI+0.3%) + 0.4*(PPI+0.3%)$) to all opex

30. Our view is that the Commission's decision is appropriate for application to non-network opex.

31. Whilst there is some evidence to increase the uplift factor beyond 0.3%, the evidence to support such an increase is not as compelling as the evidence we previously detailed to support an increase to the capex uplift factor. As OEA note on page 3 of their report:

"the EGWWS LCI has outperformed the All Industries LCI by....0.2% since the inception of the index (FY2011). However, this long term average doesn't consider that there is likely to be increased wage pressure on the utilities sector over the next decade (related to heightened demand for electricity-related skills, both domestically and globally)"

Given this, a cost escalation factor of 0.3% appears reasonable.

32. Consequently, we support the use of application of $0.6*(LCI+0.3%) + 0.4*(PPI+0.3%)$ for non-network opex.

33. However, we do not support the use of this approach for network opex.

34. For network opex, we advocate for an approach that recognises non-labour inputs for network opex are more closely aligned to non-labour inputs used in/for network capex rather than non-labour inputs used in/for non-network opex. We believe the network opex escalator should be:

$$0.6*(LCI+0.3%) + 0.4%*the\ capex\ escalator$$

with the capex escalator being All-Groups CGPI+3.1% (rather than the draft decision of All-Groups CGPI+0.8%).

35. The approach we propose would avoid significant additional complexity (as the final capex escalator would already be calculated) and better reflect that the type of materials used in network opex are of a similar nature to network capex. Non-labour inputs for network opex are

generally either electrical materials costs or other in-field costs like plant and traffic management. This aligns with non-labour inputs for capex, rather than non-labour inputs for non-network opex, which are items more related to 'office based' activities, like IT, insurance, and costs of operating a building.

36. We note that in the Electricity Distribution Information Disclosure Determination the definition of 'network' is applied equally to 'network opex' and 'network capex'.
37. The Commission in its draft decision said that it considered applying different cost escalators for non-network and network opex but rejected this based on:
 - lack of evidence that the inputs required for different categories of expenditure differ significantly, and
 - lack of evidence that the relative proportions of these categories change materially over time between suppliers.
38. The disclosure definitions negate the argument that there is a 'lack of evidence' on expenditure differences. EDBs are required to take into account the nature of expenditure that is incurred when it allocates costs between network opex and non-network opex.
39. We also do not believe that the issue of whether the relative proportions change materially over time is particularly relevant when deciding on applying a different cost escalator to non-network compared to network opex. There is no reason why the same 60/40 split cannot be applied to both categories of opex, but simply reconsider whether use of the PPI index for the 40% factor is appropriate to both categories of opex. An approach that considers network opex separately to non-network opex, means that the issue of whether the relative proportions change materially over time becomes moot.

Summary

40. We consider that the Commission's final decision on escalators should be:

- a) for capex, All-Groups CGPI + 3.1%
- b) for network opex, $0.6*(LCI + 0.3%) + 0.4*(All-Groups\ CGPI + 3.1\%)$
- c) for non-network opex, $0.6*(LCI + 0.3%) + 0.4*(PPI + 0.3\%)$

Concluding Remarks

We do not consider any part of this submission to be confidential. Please do not hesitate to contact Kelly Chapman, Regulatory Lead- Commerce Commission, on 03 363 9898 should wish to discuss our submission.

Yours sincerely



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