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Commerce Commission
Wellington 6011
By email: im.review@comcom.govt.nz

Dear Andy

Vector cross submission on IM review 2023: Draft Framework Paper & Process and Issues Paper

1. This is Vector's cross submission on the Commerce Commission's (Commission) *Part 4 Input Methodologies (IM) Review 2023: Draft Framework Paper and Process and Issues Paper*. Our submission is in four parts: the first will address the IM Review process, the second the Decision-Making Framework, the third the Process and Issues Paper and the fourth further topics for consideration.

I. IM Review Process

Engagement

2. There is a clear message from the six largest Electricity Distribution Businesses (EDBs) as well as FirstGas that the Commission's engagement model needs to be addressed.

3. Aurora believes a more fulsome engagement approach is needed and, before reviewing the input methodologies, the Commission should work with the industry and key stakeholders to reflect on the Part 4 purpose statement. They would like to see the Ministry of Business, Innovation and Employment (MBIE), Energy Efficiency and Conservation Authority (EECA), Climate Change Commission (CCC) and the Infrastructure Commission more deeply involved in the conversation. Vector supports this initiative and encourages the Commission to organise with some urgency.

4. PowerCo sees a role for Commission and/or industry-led stakeholder engagement in whichever way is sensible (e.g. workshops, webinars) to facilitate knowledge-sharing and understanding across all stakeholders.

5. Orion advocates face-to-face consultation and collaborative engagement with the Commission.

6. Unison thinks the approach taken in previous resets using expert workshops should again be considered.

7. Wellington Electricity (WELL) explains that the solution to some of the issues are likely to be complex. They believe an additional process step is needed to work through these complexities. WELL suggests using industry working groups, with representatives from the Commission, to develop potential solutions.

8. Finally, FirstGas encourages the Commission to use a mixture of delivery options (webinars, in person meetings) to ensure that all stakeholders have opportunities to both hear from the Commission and experts and engage in discussions.

9. The Commission must respond to these statements, which echo Vector's concern over the lack of engagement, by scheduling workshops with the relevant experts and stakeholders to tackle each of the topics which make it through to the 'emerging views' phase of the IM Review process. Vector can and is happy to facilitate such workshops if necessary as we believe significantly greater dialogue is fundamental to exploring forward looking solutions where such uncertainty exists.

Timing of IM Reviews

10. A couple of respondents including Unison and Orion submitted that the Commission should consider the merits of scheduling IM reviews to take place every five years, with a view to aligning the reviews to Default Price-Quality Path (DPP) resets. Vector accepts that revising the timings makes sense given a one in seven-year review may be too long to adequately acknowledge the pace of change the energy sector is likely to face over the coming decades.

II. Draft Framework Paper

11. There appears to be consensus amongst respondents on the Commission's adoption of the same Decision-Making Framework that was used in the 2016 IM Review. We have outlined under the headings below some further points for consideration.

Part 4 and the Climate Change Response Act

12. There is a notable signal from the sector that Climate Change legislation must be a mandatory, not an optional consideration in the Commission's decision making. Both PowerCo and WELL have supported Vector's viewpoint on this.

13. Meanwhile Aurora and the ENA (Electricity Networks Association) are concerned that, while the Commission has noted the permissive considerations in section 5ZN of the Climate Change Response Act 2002, it has given itself considerable leeway to disregard those considerations if the Commission feels that they conflict with the Part 4 purpose. This undermines the legislative purpose of promoting certainty and cuts across the investment ambitions of the sector as it leaves unanswered questions on where the Commission positions itself on investing for the future, of supporting the long-term interests of "energy wallet" savings by customers, of supporting digitalisation and data transformation and other key enablers of decarbonisation. Meanwhile regulators overseas are moving to ensure such investments are at the heart of their regulatory frameworks to meet their net zero ambitions.

14. Transpower believes that the IMs review framework supports the Commission fully taking into account the dynamic changes in relation to the impacts of climate change, the transition to a low carbon economy, and the ongoing impact of COVID-19 and also changes to consumer preferences, technology, and government policy.

15. With this resounding support, we would like to repeat our suggestion that the IM review requires an additional overarching objective: to promote the Emission Reduction Plan (ERP) Pathway and the net zero target more effectively. The Commission should be willing to amend an IM on the basis it will better promote the outcomes of the ERP and net zero target if this does not detrimentally affect the Part 4 purpose. The crucial timing of this review means that the Commission must consider resolving its narrow statutory interpretation to avoid long term harm being inflicted on consumers.

S54Q of the Commerce Act

16. In Vector's submission we outlined that the Commission should place greater weight in its decision making on s54Q of the Commerce Act. This requires the Commission to "promote incentives, and must avoid imposing disincentives, for suppliers of electricity lines services to invest in energy efficiency and demand side management, and to reduce energy losses" when applying Part 4 regulation to Electricity Distribution Businesses (EDBs) and Transpower.

17. Energy Trusts of New Zealand (ETNZ) also relayed this point: "ETNZ has submitted several times on the minimal acknowledgement given to achieving the requirements of s 54Q of the Commerce Act"

Key economic principles

18. Vector stands by its statement from our response to the Draft Framework Paper, that we do not consider there could be a justifiable reason to depart from the principle of ex ante financial capital maintenance (FCM).

19. PowerCo agrees by explaining that FCM is core to incentivising investment. While they agree with the Commission that there is no absolute guarantee of ex post FCM, they consider it is critical that any actions, or any inactions, by the Commission do not compromise ex ante FCM as this would undermine investment incentives in all sectors the Commission regulates.

20. However, we disagree with their additional stance that the methodology used to calculate the IM parameters should only be changed if doing so would result in a material improvement in the promotion of the 52A purpose.

21. We note and concur with FirstGas that "As recognised by the Commission in its 2022 gas DPP draft decision, it is important that it continues to provide a reasonable expectation of FCM for the Gas Pipeline Businesses (GPBs), which in turn provides incentives for investment to maintain safe and reliable networks".

Financeability

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22. Vector was not alone in suggesting financeability should be explored in the next phase of the IM Review. WELL and the ENA recommended adding a financeability arm to the principles used to guide how the purpose of Part 4 52A is promoted. They also suggest a financeability assessment like that used by overseas regulators like Ofgem and Ofwat, which tests whether regulatory allowances enable a network to finance their business activities and to stay solvent.

23. Meanwhile Transpower have submitted several statements on the importance of funding investment:

> "In the context of the Government's policy to reach net zero emissions by 2050, we need the IMs Review to provide certainty: 1. that we can plan and invest to meet the future needs of our customers and end consumers, today and in the future; and 2. around financing these investments."
>
> "Shifting Transpower from an unindexed RAB would have material administrative costs, would materially impact Transpower's cash flows over the short term, and, with the probable need to shorten depreciation profiles, ultimately lead to a similar outcome as an unindexed RAB. These decisions were made in 2016, and, as we note above, since then Transpower's need for investment has only increased. […] The step-change that would be required to shift to indexing Transpower's RAB would have substantial cash flow implications and may cause financeability concerns."

Whole of system costs

24. We were encouraged by Orion's suggestion that the Commission needs to take an energy centric view on energy usage. They explained that the "lowest line charge" does not necessarily result in the "lowest total energy bill" across electricity, gas and fossil fuels usage for households and businesses. Vector agrees and re-iterates our position that the Commission considers the Whole of System Energy Cost (WESC) approach to regulation.

25. The Consumer Advocacy Council (CAC) also seem to be alluding to the above when they state that "A more integrated approach is required amongst transmission, distributors, generators, the system operator, and retailers to achieve our targets."

III. Process and Issues Paper

Efficiency

26. None of the respondents to the Process and Issues Paper outwardly agreed with the Commission's presumption that EDBs are inefficient. In fact, the majority of submitters who were outspoken on this matter believed that the Commission must look again at their analysis or to direct their focus elsewhere.

27. Horizon Network outlined: "This is a key issue, and we are concerned that the Commerce Commission may conclude that a productivity decline means that EDBs are less efficient.

Without a full understanding of the underlying reasons for EDBs increased costs of doing business, this conclusion could lead to unnecessary regulatory intervention that is underpinned by less informed assumptions."

28. Unison gave an astute counter argument to the Commission's productivity reporting explaining that, Aurora will go from being highly productive prior to its Customised Price-Quality Path (CPP) to show a substantial decline in productivity as considerably more will be expended on delivering similar levels of kWh and customers served. But from an efficiency perspective, Aurora's end-state will be a more resilient, safer, and reliable network, with a well-informed community on how Aurora has planned and delivered its approved expenditure programme.

29. WELL also provided some examples of EDBs' cost increases reflect the increasingly complex operating environments such as investment in preparing for the ERP, developing cyber security measures to mitigate the increasing cyber risk, Increasing traffic management costs in response to changes in the Health and Safety at Work Act, and developing sustainability functions and carbon reduction programmes in response to the ERP.

30. For this IM review, and going forward, the Commission needs to place paramount emphasis in the role of dynamic efficiency in promoting the Part 4 purpose. As Vector and other submitters have previously raised, the world has changed since the Part 4 framework was enacted and assumptions around a 'steady state' and backwards looking regulation no longer apply.

31. One respondent who called out areas where EDBs could make efficiency gains was Meridian. We will address this claim under 'Flexibility markets' in section IV of our response.

Innovation

32. EDBs who responded to the Process and Issues Paper are united in their views that the current innovation project allowance is not fit for purpose.

33. The Lines Company (TLC) recommends that the Commission provide greater certainty for innovation funding by revisiting the current mechanism and increasing the size of funding available, reducing administrative burden, and moving to an ex-ante conditional approval or 'use it or lose it' framework.

34. WELL believes customers should bear more of the risk of innovation give the cost and reliability benefits will flow to customers. Customers also benefit from the ERP benefits that flexibility services will help enable.

35. An EDB who has gone through the application process, Orion, believes we need innovation mechanisms, intra-regulatory period, to be more flexible (such as regulatory sandboxes) in our approach to consumer demands going forward and adapt to the changing environment in which we will be operating.

36. Other non-EDB stakeholders have also emphasised the importance of innovation given the scale of the decarbonisation objectives ahead.

37. The CAC believes it is critical to allow distributors the ability to invest in pilots, trials, and their networks to support decarbonisation and energy transition requirements. Pilots and trials can be relatively expensive, and there should be sufficient allowance in network cost recovery to facilitate these, and some for extended periods.

38. Our Energy & Cortexo referred to a statement by Randolph Brazier from the UK's Electricity Networks Association (ENA), to the FlexForum, that there needs to be a conscious effort to encourage distributors to innovate and invest in new ways of doing things. New Zealand EDBs currently do not have the funding, risk tolerance or capacity to do so.

39. As part of the ongoing IM Review, Vector will be exploring different mechanisms used overseas, and how more useful innovation tools could be adopted here in New Zealand.

Regulatory Asset Base (RAB) indexation

40. The ENA's submission listed RAB indexation and inflation forecasting as an area the Commission should give high priority to in this review. As set out in our submission, we consider EDBs and GDBs should have the option to choose an indexed or an un-indexed approach.

41. Transpower submitted an expert report from Frontier Economics that considered the difference between the indexed and un-indexed approach, summarised developments since the 2016 IM review and estimated cashflow implications on Transpower if it moved to an indexed approach.

42. We consider Frontier's expert report for Transpower also provides strong arguments to support an un-indexed approach for EDBs and GDBs. Frontier noted the following recent regulatory developments as providing support for Transpower remaining unindexed:

- *"Acknowledgement of the 'debt compensation issue.'*
  The Commission has acknowledged a 'debt compensation issue' that applies to EDBs that are subject to full RAB indexation. The core of this issue is that EDBs tend to issue nominal debt that requires nominal interest payments. But the current regulatory framework provides a cash allowance for only the real component of those interest payments, resulting in a cash flow shortfall. By contrast, Transpower receives a cash flow allowance that is sufficient to pay the full nominal interest bill each year – because there is no deduction in relation to forecast inflation. Thus, simply maintaining the current approach means that the debt compensation issue has already been resolved for Transpower.
- *Recent Australian transmission project examples.*
  In Australia, there have been some recent examples where the regulatory framework (with full RAB indexation) has impacted the commercial viability of major new transmission projects. Under the Australian framework, full RAB indexation has resulted in the speed of cash allowances being so slow that investment in major new projects would cause a significant credit rating downgrade. This is not such an issue for Transpower under the current nominal framework, because the allowed cash flows are not reduced by forecast inflation.
- *Increased need for major transmission projects.*
  As governments seek to decarbonise their economies, there is a need for significant investment in new transmission assets. Any move away from Transpower's current nominal framework towards RAB indexation would reduce the speed of

cash flow allowances raising the prospect of the cash flow timing issues identified above. Indeed, the need to support significant new transmission investment was one of the key reasons for the Commission maintaining the nominal framework for Transpower in the 2016 IMs review…. The need for major transmission investment, to support decarbonisation objectives, has intensified since the 2016 IMs review.

- *Recent high inflation outcomes.*

In recent months, observed inflation has been relative to the Commission's forecasts that were locked into regulatory decisions even two or three years ago. In such market conditions, the result is that what is 'added back' via RAB indexation will be materially higher than what was 'taken out' via forecast inflation. Thus, EDBs are currently benefitting from actual inflation exceeding the Commission's forecast."[1]

43. These developments also suggest EDBs and GPBs need the option to un-index their RABs –

- **Acknowledgement of the 'debt compensation issue'**: We are pleased the Commission has recognised the 'debt compensation issue.' As set out in our submission, we consider the only realistic way to solve this is by un-indexing the RAB (or at least a hybrid approach of un-indexing the debt portion of the RAB) or to provide actual debt costs. We note the ENA, Unison and Aurora also supported consideration of a hybrid approach.
- **Australian transmission project examples**: There is a real risk of similar financing issues arising for EDBs owing to their backloaded cashflow profile. This also highlights the importance of introducing financeability testing to the regime.
- **Increased need for major transmission projects**: As raised by a number of submitters (and acknowledged in the Process and Issues Paper), decarbonisation is also driving significant increased need for investment by EDBs. This has increased since the 2016 IM review. Consistent with the Commission's approach to Transpower, EDB investment programmes should be supported by a front loaded cashflow profile.
- **Recent high inflation outcomes**: We note that, although EDBs are currently benefiting from actual inflation exceeding the Commission's forecast, this contrasts with years of lost revenue from inflation under-forecast. Furthermore, as Unison's submission noted, while equity holders benefit from recent high inflation, equity holders still must bear 100% of inflation forecast risk since EDBs are unable to issue inflation indexed bonds to hedge inflation risk. We also note the impact of high inflation also does not alleviate the cashflow timing issue nor investment constraints created by the backloaded cashflow profile.

44. We note Mercury and Contact submitted on the differing approach to indexation between Transpower and EDBs.

45. Mercury noted this, "raises a concern that the energy sector may be exposed to risk by this divergence, particularly as inflation is likely to remain high." We see no justifiable reason for the regulations to impose different treatment for Transpower and EDBs.

46. Contact explains: "Transpower is the only company subject to price-quality regulation by the Commission whose RAB is not indexed. It is past time that this anomaly is resolved. The lack of indexation of Transpower's RAB has contributed to the large increase in lines costs since

[1] Frontier Economics, RAB Indexation: Report for Transpower (7 July 2022), page 7-8.

2008. […] Indexing the RAB would better spread the costs of the grid over the life of the assets, reducing the up-front burden on consumers as we transition into a more electrified economy."

47. We acknowledge Transpower's concern around cashflow and financeability if it moved to an indexed approach. However, the current approach of providing different treatment to indexation imposes pressure on EDB cashflow and financeability. This is exacerbated by the inclusion of transmission costs in EDBs limit on forecast revenue from prices.

48. Accordingly, our view remains that the Commission should provide an option for EDBs and GPBs to un-index their RABs. To resolve the cost of debt issue, at a minimum a hybrid approach is needed. However, if the Commission is not willing to change the approach to EDB RAB indexation, it should amend the Transpower IMs to provide a consistent approach between EDBs and Transpower. The concerns around cashflow and financeability are equally relevant to EDBs.

49. To inform the debate on indexation we believe it would be useful for the Commission to clearly set out how it historically reached this view in the context of not indexing Transpower's RAB. The decision-making criteria used by the Commission to determine Transpower's un-indexed cashflow profile and/or provide airports with the flexibility to determine the appropriate indexation approach, is an important starting point for an informed review of this important area.

Inflation forecasting

50. The ENA, Orion and Aurora recommended the Commission review its approach to inflation forecasting. Aurora suggested the Commission consider whether there are effective options to wash-up variations from forecast. We are concerned that introducing a wash-up to correct variances from forecast could lead to unmanageable volatility in revenue.

51. We agree the Commission should review its inflation forecasting approach. As raised in our submission, we consider a market-based approach may produce a more accurate forecast.

52. However, we also recognise it is likely impossible to determine an approach that results in a completely accurate forecast every time.

53. Accordingly, a further advantage of an un-indexed approach is that it removes the impact of inflation forecast error or indeed the need to forecast inflation at all.

Weighted Average Cost of Capital (WACC)

54. TLC and Orion recommend maintaining the current 67th percentile of WACC and not reducing it to a lower percentile. TLC explains that the drawbacks of a lower percentile will outweigh the benefits the consumers will receive with a lower WACC. In contrast, a higher percentile will provide an incentive for the investment that will ultimately improve the service quality for the consumers, which is in line with s52A.

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55. Meanwhile Transpower and Aurora have repeated Vector's opinion that with electrification and decarbonisation the consequences of under-investment, relative to the consequences of over-investment, means that a reversion to the 75th percentile should not be dismissed.

56. Conversely MEUG appears to expect a regulatory WACC set at the 50th percentile and assumes that with a decade of experience with a higher WACC, the Commission may consider changes going forward. However, MEUG has not put forward any explanation nor robust evidence that lowering the WACC percentile would benefit the sector in a tangible way.

57. MEUG also suggests an example to avoid a mis-specified WACC leading to under-investment, whereby the regulated WACC could be set at 50th percentile and EDBs given the option to apply for a WACC with a higher percentile. We question how this application would work and be introduced.

TAMRP

58. We agree with submissions from Aurora, NZ Airports Association, and the ENA that the TAMRP should be updated to 7.5% for consistency between regulated sectors.

Asset beta

59. The ENA submission listed the approach to the beta as a low priority for the IM review. Transpower's submission noted that – if the Commission decides to further consider asset beta samples – it would likely face the same issues that arose when it was previously considered.

60. We agree with these submissions. If the Commission does review its approach to the beta, we recommend it consider –

    - Adopting two 7-year estimation periods instead of the 2016 practice of using two 5-year estimation periods for asset beta. The current approach has the effect of overweighting certain years in the estimation window. In particular, this currently results in double weighting the pandemic period (being the 4 years prior to the 2023 decision). In contrast, if two 7-year estimation windows are used then all years will be given equal weight; and
    - Whether other methods to adjust the equity beta to estimate future beta value (for example, the Blume, Dimson and Vasicek methods) would provide a better estimate.

Term of the risk-free rate

61. Submitters such as Transpower and the ENA advocated consideration of a trailing average cost of debt. Transpower noted this better matches how efficient businesses finance.

62. Transpower quoted Vector's submission on the Fibre IM that, "Vector has serious reservations about this approach as it relies on a very specific debt hedging strategy which is artificial and specifically linked to the regulatory control period."

63. Relatedly, we have concerns with the Commission's use of a risk-free rate of the same maturity of the regulatory control period. This is notably shorter than what is common across the other regulators.

64. The shorter maturity does not match the life of the property, plant and equipment used to provide service, which results in re-financing risk. This aspect is especially challenging in times of low financial market liquidity as seen, for example, during the financial crisis of 2008-2009. It may be that the cost of debt at the time of the re-financing comes at a higher price than originally envisioned or worse, is not available. Second, the reliance on a shorter-term maturity for the risk-free rate may not incentivise long-term debt financing even if advantageous to the regulated business and its customers. Third, shorter government bond yields can be more susceptible to being influenced by short-term shocks and monetary policy, such as quantitative easing, than longer term government bond yields. Longer bond yields may better reflect fundamental market conditions than shorter term bond yields.

65. We recommend, in line with academic consensus and international regulatory precedent, a longer maturity risk-free rate be considered.

Form of control

66. Vector is united with FirstGas and PowerCo in supporting/ offering the move to a revenue cap for Gas Distribution Businesses (GDBs). A revenue cap (in contrast to a weighted average price cap (WAPC)) is a better form of control given the volume uncertainty as a result of net zero challenges.

67. While the Major Gas Users' Group (MGUG) does not consider that there is any new evidence that suggests that changes in form of control are needed for GDBs. Vector maintains that a revenue cap would appear more supportive of New Zealand's climate change objectives, the ERP, and the Gas Transition Plan (GTP), which all encourage a reduction in fossil gas use. And as PowerCo has outlined gas demand may be affected by further policy decisions within the DPP3 regulatory period which can affect the incentives to invest and alignment with the policy environment.

68. Meanwhile for EDBs, introducing the revenue cap has delivered the benefits foreseen at the time of introduction. However, we agree with the ENA that there is scope for refining the revenue cap, in particular, the 10 per cent Maximum Allowable Revenue (MAR) cap at times of high inflation and significant movements in passthrough costs including the new Transmission Pricing Methodology (TPM).

69. The issue is also raised by WELL by detailing that under the current revenue cap, inflation and increases in Transpower costs are also included in the revenue cap – EDBs will have to find further funding if increases to these cost inputs outside of a networks control contribute to revenue exceeding the 10 per cent limit.

Incremental rolling incentive scheme (IRIS)

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70. There is an unmistakable message from respondents that the IRIS mechanism needs to be looked at. For example, Unison believes it should form an extensive part of the review. In particular, the inclusion of customer capex within the mechanism needs to be reconsidered. TLC agrees with the Electricity Networks Association (ENA) and emphasises removing expenditures due to consumer connections, system growth, asset relocation and capacity building to support decarbonisation from Capex IRIS calculations so that distributors are not penalised for facilitating demand growth.

71. Meanwhile Orion and WELL that the mechanism is complex and often not well understood by EDBs, therefore we should take the opportunity to simplify it and reduce revenue volatility.

72. Orion has outlined how IRIS makes it challenging for EDBs to make trade-off decisions on expenditure needed to address the immediate needs of customers, legislative compliance, and the expectation to provide open network access. The increased expenditure needed for common assets on the distribution network has a trade-off against the impact of IRIS. This makes it ineffective in the sense that there are IRIS consequences of overinvesting even in service of the customer.

73. Vector agrees that a review of whether IRIS is working as intended is welcomed but rather than concentrate on complexity other issues could be addressed. As mentioned in our response to the Process and Issues Paper, IRIS penalties can deter expenditure that would benefit consumers but that was not foreseen during the AMP period and so has not been included in the allowances. There needs to be more in-period flexibility around unforeseen expenditure to address this. IRIS also does not incentivise suppliers to make investments where savings will only materialise in later regulatory periods nor investments that share costs and benefits across the value chain. This view is shared by WELL who has suggested amending the IRIS mechanism so that EDBs can share the in the benefits of the cost savings the services provide to allow EDBs to benefit from capex savings from future regulatory periods.

Totex

74. A complementary offer to IRIS that has been put forward by multiple respondents is to explore a totex approach to expenditure. Orion and Amazon Web Services give similar examples with the flawed choices EDBs face to substitute capital expenditure (e.g. in-house software or infrastructure build) with operational expenditure (e.g. cloud-based services or flexibility services).

75. Transpower and WELL agree that a totex approach could be a more effective alternative, but both caution against the complexity and material shift from the current arrangements.

76. Vector agrees with this standpoint, the ability to swap between capex and opex more easily is essential, whilst IRIS is complex, moving to totex in a rushed fashion could have unintended consequences. We propose a workshop to explore what a totex regime could look like in New Zealand with experts offering their views so that EDBs and stakeholders can better understand the implications.

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Incentives

77. Mercury has proposed that the Commission could consider regulatory incentives to encourage EDBs to trial flexibility services and third-party services. Vector agrees that more needs to be done in terms of promoting flexibility within the regime. As we have noted under the 'Innovation' heading, more adequate tools and funding could help in this respect.

78. EDBs are the catalyst for change in emerging markets but they will also carry the associated risk, in particular from a performance perspective. With that in mind, it makes sense that as enablers, EDBs receive the appropriate levels of compensation for the risk they take on with these emerging markets.

CPPs and in period adjustments

79. Vector agrees with Aurora that reopener mechanisms need to be improved by: specifying more workable thresholds; prescribing the specific minimum information the Commission requires in a reopener application in order to make a decision; and enhancing timeliness of decision-making (three month maximum). And with Orion that reopeners need to take account of both opex and capex expenditure.

80. FirstGas says the Commission should consider providing in the revised 2023 GPB IMs some form of reopener that allows for amendments to DPP and CPP determinations to address any "material change" arising from Government policy or other relevant matters related to the future of reticulated gas.

81. Orion submits that there should be provision in the IMs for the price-quality path to be reviewed across all EDBs from a single application where common step changes impact the majority or a significant subset (perhaps based on ICPs served) of EDBs. This idea could be explored to avoid the burden of individual applications if the step change affected all EDBs.

82. WELL proposed an overall regulatory framework that allows investment profiles to flex and adjust to changes in the underlying investment drivers and the ability to move investment packages between regulatory periods in response to those changes.

83. Vector is keen to explore a trigger mechanism for high uncertainty investments to better facilitate uncertainty within the DPP period. FirstGas also floated a comparable mechanism – "to ensure such a reopener were used only where appropriate, the IMs amendments should include criteria and materiality thresholds that would trigger a reopener."

IV. Further topics for consideration

Expenditure setting

84. The Commission must respond to calls to review the method used to set expenditures for EDBs. Although this issue may fall under the remit of the next Default Price-Quality Path (DPP) reset, we must take stock of the proposals to ensure future allowances are not set on historic expenditure profiles.

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85. We agree with Meridian who "understands that EDBs and Transpower may need to use a more forward-looking approach to forecasting for price-quality paths rather than historic expenditure. In some cases where there is high confidence of demand growth, it may be prudent to enable investment to occur ahead of demand".

86. Methanex has suggested that the building block model where 'BAU' variance triggers of 5 per cent and 10 per cent above historical average opex and capex, should be re-evaluated. They believe that the prospect of increased network stranding risk warrants a lowering of the threshold for undertaking detailed scrutiny.

87. Vector disagrees with Methanex's proposal to lower the threshold for undertaking detailed scrutiny. Given that DPP regulation is light touch and relatively low cost, increasing the level of scrutiny would play against those principles.

Digitalisation and data

88. The inability to easily access data to unlock consumer benefits is an embarrassing hurdle for the sector.

89. As SmartCo put it: "without access to appropriate metering data, EDBs are unlikely to be in a position to develop effective non-network alternatives". They see the timely access to relevant information spanning both the Electricity Authority (EA) and the Commission with the requirement existing under the EA but the consumer benefit existing under the Commission. Similarly, the CAC recommends timely access to data and network resilience on low voltage networks and Mercury insists that the regulatory regime should not act as a barrier to distributors purchasing information from metering equipment providers (MEPs).

90. Vector fully supports bringing this issue to the Commission and believes access to data can be achieved through reasonable commercial terms, funded through the DPP. The Commission cannot ignore the regulator's role in ensuring these arrangements are facilitated and needs to bring digitalisation and data to the forefront of the IM review.

Flexibility markets

91. ETNZ opines that neither the EA nor the Commission should restrict investment behaviours that are consistent with the Climate Change Commission's objectives for example on restricting EDB involvement in Distribution Energy Resources (DER) where this can support climate change.

92. On the other hand, Contact recommends that the Commission immediately revive the 'Spotlight' project with the Electricity Authority as a critical input into the IM review. In particular, they would like the Commission to clarify whether DER assets are within the s54C definition of lines services and can therefore be included in EDBs' RAB.

93. Meridian believes that EDBs should collaborate on how to price and dispatch flexibility services 'rather than reinventing the wheel in every EDB', we would point them to the FlexForum. This forum, set up earlier this year, is a collaborative group with the goal of creating 'A set of actions

to integrate distributed energy resources (DER) into the electricity system and markets to maximise the benefits for Aotearoa New Zealand[2]'.

94. Meridian also points towards additional value being unlocked for customers if EDBs are able to quantify the value of flexibility to help reduce capacity constraints and avoid network investment.

95. Mercury is of the view that supporting markets for flexibility means requirements for arm's length procurement for flexibility, competitive tenders for flexibility for ancillary services and ringfencing.

96. From Vector's perspective we are supportive of market testing for non-wired alternatives (NWAs), as per our recent exploration of NWAs in Warkworth. However, such testing is resource and time intensive, and is therefore only justifiable for a proportion of our investments – e.g. the larger ones. For all others, such as transformer replacements, self-supply is the most rational and sensible.

97. Once DERs become more ubiquitous, and the systems and processes required to engage and aggregate them are more developed, the cost of third-party NWAs should become cheaper. But we are not at that point now.

98. For many of the investments Vector does, there may never be a liquid or deep market of DERs (e.g. for the upgrade of an LV transformer serving a small number of consumers) EDBs shouldn't be precluded from engaging directly with consumers to harness their DER, if the consumers themselves choose that option – e.g. for ripple, or larger industrial consumers.

99. Unless and until the supply side of the market develops, EDBs should not be forced out of self-supply. Even then, it would not be in consumers' interests for us to be required to go with a more costly investment by a third party when we can do it cheaper ourselves. Any market testing we do should always be against a baseline of us delivering a traditional investment or NWAs ourselves.

100. Along with our cross submission we have sent an independent report by Competition Economics Group (CEG) on "The relative efficiency of self-supply vs arm's length supply of flexibility". In this paper Dr Tom Hird explains that costs in eliciting flexibility services should be recoverable in the EDB's regulated cost base so long as:

- the costs incurred by an EDB are necessary to elicit the relevant flexibility service (i.e., the EDB is not paying more than is necessary to elicit the relevant value of the flexibility services); and
- the expected benefits from the relevant flexibility service (e.g., in avoiding/delaying substitute grid investments) exceeds the costs of eliciting the flexibility service.

101. The report also elaborates on why CEG considers that the self-supply of flexibility services by EDBs will often be lower cost than purchasing those services at arm's length.

[2] https://www.araake.co.nz/services-projects/flexforum

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Reporting requirements

102. Meridian supports Quality standards or reporting requirements that encourage Transpower and EDBs to fully resource new grid connection enquiries. We believe this is testament to the effort required by EDBs to effectively propose connection offers, especially when it comes to our large commercial users.

103. We believe this request should have been put forward in the Information Disclosure review not in response to the IM review. That said, if the Commission is minded to bring the suggestion into consideration, they must also ensure that EDBs are adequately funded to a) resource operationally to meet any new targets, service level agreements 2) put in place the necessary systems, people and processes to report and audit any new standards or reporting requirements.

Dynamic regulation

104. For Orion, the concept of dynamic regulation is needed. The notion is defined by the Council of European Energy Regulators (CEER)[3] "as 'adaptive regulation', stimulating regulators to be enablers of the adaptation of the energy regulatory framework, in connection with the society-wide digitalisation trend, smart technologies, decarbonisation policies and decentralisation of energy generation".

105. Vector welcomes Orion pointing towards overseas regulatory approaches that are flexible and focused on future technologies including digitalisation. We have advocated that the Commission should learn from other jurisdictions for best practice when it comes to tackling the challenges of achieving net zero.

Closing remarks

106. To conclude we are sharing Our Energy & Cortexo's paragraph which we believe captures how we should be approaching the next phase of the IM Review and indeed the next DPP reset:

107. "We caution against too strong a preference for incremental change to provide regulatory certainty and predictability in a changing environment. Stability in a time of transition is most likely to result in inertia and therefore less efficient investment, because investors are not provided the flexibility to manage the increased risks which come with change. The value lost from investing too soon is the cost of bringing forward investment. The value lost from investing too late is the cost of unnecessary (traditional) investments made in the meantime, less innovation, diminished consumer amenity because they cannot use the network as they'd prefer, slower uptake of DER and electric vehicles, reduced reliability and resilience and slower emissions reduction."

[3] https://www.ceer.eu/documents/104400/-/-/70634abd-e526-a517-0a77-4f058ef668b9

Yours sincerely

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GM Economic Regulation and Pricing