vector

Vector Limited
101 Carlton Gore Road
PO Box 99882
Newmarket
Auckland 1149
+64 9 978 7788 / vector.co.nz

19 July 2023

Dr John Small
Chair
Commerce Commission
44 The Terrace
Wellington 6140
By email: john.small@comcom.govt.nz

Dear John

Consultation on Input Methodologies Regulatory Draft Decision

The Commerce Commission's draft Input Methodologies (IMs) decision is hugely important to New Zealand. Whilst lengthy at over 1000 pages and highly technical in nature, the outcome of this process deserves to attract significantly greater interest, and consideration, than usual. It will set the key regulatory principles that will then bind the way electricity networks can operate and invest for the next seven years and possibly even beyond that to 2035. These seven years are crucial for the energy sector, as the impacts of climate change force the need for significant and rapid action.

Over that same period, it is estimated that network companies will need to invest more than $30 billion. This is to meet an expected increase in New Zealanders' electricity demand, power electric vehicles, ensure electricity networks are resilient as we face an increasing number of severe weather events brought about by climate change, ensure an orderly transition away from fossil gas, and keep pace with increasingly complex consumer needs. The global recognition of the impacts of climate change, including New Zealand government legislative and international commitments to meet carbon targets, is strong evidence of what undoubtedly must be considered to be in the long-term interests of consumers.

In many ways it is hard to overstate how critical the next decade is for electrification, coupled with the expectation of delivering electricity networks that can enable this in terms of resilience, security of supply and capacity. The IMs play a vital role in this and need to evolve so to avoid compromising a network business' incentive to invest or ability to fund such investment. The failure to address some fundamental regulatory principles in the Commission's process to date risks holding the country back.

As the country's largest electricity distributor Vector absolutely wants to continue to play our part in enabling electrification and doing it in the most affordable way possible for our consumers. However, alongside other electricity network companies, we can only do so within the bounds of the Commission's strict regulatory returns and funding regime.

There is no obligation to invest in network businesses. Like any other commercial entity, investments can only be made where it is both commercially attractive and financeable. Unfortunately, the draft decision does nothing to enhance either. In fact, it does the reverse. The marginal lowering of incentives to invest and failing to address funding concerns associated with rapid and significant increase in electrification and resilience expenditure, will compromise New Zealand's progress towards electrification and therefore not meet the long-term interests of consumers.

We were expecting the regulatory input methodologies to evolve in recognition of the imperative for enabling investment, as opposed to remaining largely static. The regulatory framework (established in the early 2000s) and the input methodologies (last reviewed in 2016), may have worked for a 'business as usual' period, but now would appear not fit for purpose as we enter a period ahead that requires significantly more investment and adaptation to customer and other critical imperatives. We have four key areas of concern, which we expand on in this letter:

- Benefits of electrification investment are far wider and more significant than in the past, where the goal was simply to balance price and reliability. The draft IM decision remains narrowly focussed on traditional reliability. This comes at the expense of recognising significant resilience and electrification benefits and, as such, the regime risks underweighting the value of investment to support better outcomes on both fronts.

- Funding the investment profile of such significant investment has consistently been raised as a concern with the Commission. The decision not to provide confidence in adopting a financeability test as standard regulatory practice fails to alleviate serious funding concerns. The Commission, almost flippantly, is advocating that such investment needs to be funded by the suspension of dividends, while companies, somewhat paradoxically, are seeking to raise equity.

- The Commission's unwillingness to consider expert opinions and leading international regulatory best practice where it differs from the Commission's own entrenched views.

- Energy affordability being an industry and government-wide issue and not one that constraining network pricing from 2025 – particularly via an arbitrary and artificial pricing constraint created by the Commission outside of any statutory affordability mandate - is beyond the Commission's remit in our opinion.

1. **While the world is having a conversation about enabling new investment for better resilience for communities and electrification for consumers, the Commission has confirmed that a fundamental aspect of incentivising investment in its regime is for BAU network reliability only**

We are very concerned to see how narrowly the Commission has interpreted its own regulatory framework at such a critical juncture of the electrification investment cycle. For example, in relation to incentivising investment and avoiding the high costs to society of networks under-investing (a policy known as "aiming up" on targeted returns), the Commission says that such a policy:

- is only "*to mitigate against the risk of under-investment relating to service quality generally and contributing to major supply outages*"; and

- is "*the wrong tool to incentivise these types of [electrification, decarbonisation, smart networks] investments*".

Such a narrow view on traditional reliability only puts the Commission's regulatory regime out of step with broader government objectives and ambitions for consumers and the electricity sector. There are substantial and increasing costs to consumers of under-investing for electrification. The draft decision doesn't appear to give any weight to significant consumer benefits that would stem from networks' investment to enable electrification and is out of step with leading international regulatory best practice.

We cannot reconcile how the Commission can define its purpose statement (acting in the *long-term interests of end-users*) so narrowly to one of simply network quality/reliability. This is at a time when we are seeing consumer and government expectations clearly articulated to ensure an investment profile to adapt to climate change and deliver decarbonisation. As a result, we do not understand how the Commission can take such a narrow view and be unwilling to demonstrate greater conviction to evolve its regime. This puts it out of step with best regulatory practice, including leading regulators such as the UK's Ofgem energy regulator.

We had expected the Commission to adapt its thinking and incorporate decarbonisation and resilience investment to address climate change as integral to consumer interests. In the draft decision, the Commission instead gives greater focus and weight to potential short-term pricing impacts. As such a focus on the impact of short-term prices does not appear to match the Commission's own prior statements around the value of investment for consumers in the long-run.

2. The Commission is pairing the greatest investment challenge for electrification for 50 + years with the weakest financing plan

Another key aspect the Commission fails to transparently address or demonstrate in its draft decision is financeability – the ability for network companies to fund the step change in investment needed to meet electrification and resilience objectives. Funding of such high levels of investment is a critical piece of the complex puzzle required to progress the energy system's transition to net zero at the pace required to meet emissions objectives and community resilience expectations.

The impact of the current IMs review is far-reaching as the process provides a fundamental examination of the key regulatory principles that will be applied for at least the next seven years. So it is of concern that the Commission doesn't appear to have undertaken even a cursory examination of whether network companies will be able to fund the investment that is needed.

It is of particular concern that expert analysis commissioned by the six largest EDBs shows a forecast 2030 balance of over $1.5 billion in unrecovered revenue being denied to EDBs through the Commission's application of an arbitrary 10% revenue increase limit. In the absence of any

affordability statutory mandate on the Commission, and with the increase limit being applied at the whim of the Commission's discretion outside of the "promoting certainty" objective of the IMs, the Commission's practice of constraining revenue recovery neither aligns with good legal or regulatory practice.

The draft decision, rather than providing analysis or an evidential basis for a funding discussion, instead makes assertions that lack commercial reality. Cursory treatment of such a fundamental topic underscores the need for the Commission to openly commit to a regulatory principle that it *will assess and correct for* key financial metrics in setting future network revenue allowances. In failing to do so, the Commission is risking the ability to attract much-needed capital to support Aotearoa's energy transition. Insufficient or delays in sourcing capital will slow down and hinder the transition, making it harder for Aotearoa to achieve its international and legislative net zero commitments and targets.

Nor should funding concerns be a surprise for the Commission. Network companies have clearly highlighted the funding challenge caused by the Commission's approach to back-ending recovery cashflows for investments over some 40-50 years (a practice called "indexation"). This makes the cashflow profile for new investment highly unattractive by reducing cashflow revenue on the premise that inflation will instead provide a paper revaluation of assets over time.

Vector has long advocated that indexation's back-ending of cashflows is not realistic in times of high investment requirements, nor appropriate given demonstrated inflation forecast errors. We find it surprising that the Commission is now attempting to justify and distinguish its own prior decision to historically not index Transpower's assets due to prior high investment needs - the very same situation and circumstances network companies are now facing.

While indexation remains a serious concern and undeniable drag on new network investment, a separate and additional challenge to adequate cashflow funding has arisen due to recent high levels of inflation. High inflation within the regulatory model translates into significant catch-up amounts that network companies have not charged customers and which they must carry forward into future pricing periods. Should the Commission continue to apply its arbitrary 10% per annum revenue adjustment limit to all future pricing periods (a limit that translates to an approximate 3% price adjustment for residential consumer bills), the cashflow concerns of networks will be further challenged - to the point that it could well impact on a network's ability to fund and invest in regulated assets. We note that the Commission has failed to demonstrate any analysis of the interaction of such limits with key financeability metrics.

In cascading unrecovered amounts further and further into the future (such amounts subject to future regulatory discretion and rule changes) the regulatory investment model starts to look, from an investor lens, like a hope strategy. The confidence in a regulatory regime to deliver expected returns and appropriate levels of cash funding in a timely manner is paramount. It ought to be uncontroversial for the Commission to commit to internal consistency in its own decision making by:

- providing categoric assurance within a regulatory principle that the annual regulatory revenues it determines will be sufficient to support, as a minimum, the key benchmark financing parameters it targets; and

- setting out in advance an objective, predictable and replicable process for addressing any identified funding problems in the future.

A network is only 'financeable' if regulated revenues, as determined by the Commission, are sufficient to support certain financial metrics of a notional efficient network that the Commission bases its regulatory allowances on. An assurance of internal consistency in regulatory decisions would not only be good regulatory practice but would provide both investors and consumers greater certainty over how the Commission intends to deal with funding issues when they arise, given the step-change in investment levels required.

It is not correct, as the Commission repeatedly suggests, that any funding shortfalls caused by its regulatory framework can be addressed simply by equity investors foregoing dividends or injecting additional equity. Rather, this could have a damaging effect on a network's ability to attract capital in the future. Additional equity (or suspension of dividends), while the network company still receives the same permitted allowances, is asking equity holders to sacrifice the minimum level of return that the Commission itself has determined as a fair *minimum* return for such investors. Any future equity investor, looking to commit scarce capital to New Zealand projects (which could easily be invested elsewhere globally), is unlikely to be attracted to a regime where any cashflow shortfall will be made up by equity investors sacrificing some of their allowed return. In applying its regime, and in electing to speculate about the availability of capital, we would encourage the Commission to appreciate that not only do investors have options on where to place capital, but that shareholders rightfully expect fair and sustainable returns. It is clear to us that the Commission has failed to take account of the credit rating risks arising from cashflow profiles against debt levels.

Even the Minister of Energy and Resources, Hon. Megan Woods, has recently raised the prospect of the need for a reliance on government funding for network investment, such as in resilience electricity investment – acknowledging the limits or gaps in how regulation currently funds networks. While we welcome Ministerial recognition of the challenge, government intervention is a clear second-best solution that would be necessary only because the regulatory framework has failed to address an investment problem that it both created and, bluntly, really ought to fix. Public funds should not be required to address cashflow issues for needed network investment, given such public funds are better used to address other government infrastructure priorities. This government funding could be otherwise avoided through correcting the regulatory model.

We only need to look to the UK for good regulatory practice as it relates to financeability. The UK energy regulator must have regard to the need for networks to able to finance their activities and is transparent about the financial ratios it monitors. This obligation on the Commission is absent in the New Zealand regime but could be provided for by the Commission simply adding a financeability test as part of an IM.

3. In fundamental areas the Commission is ignoring leading expertise

The complexity of the issues at play in the draft decision attracts much academic and expert thinking. Without wanting to go into the substantive details of any issue in this letter, there are three examples that demonstrate a wider challenge that stakeholders have faced in their efforts to have constructive engagement and dialogue with the Commission.

Industry has proactively provided several global and domestic expert reports to the Commission prior to this draft. A collection of network companies also initiated and hosted a series of six online workshops, where leading experts and thought leaders discussed some of the key issues for the review.

However, aside from one relatively minor issue, the Commission has taken on none of the substantive inputs from this collection of leading and international expert reports. This is both disappointing and disillusioning. We provide three examples to illustrate our concerns about the Commission's willingness to engage with expert material and challenge or evolve its views as circumstances and best regulatory practice develop internationally that are clearly materially better than the Commission's draft positions

Example 1

The first example relates to a key input into the allowance for the cost of debt provided to network companies. The Commission has long been out of step with international regulatory best practice in using a five-year interest rate on the advice of its expert, Dr Martin Lally. This is despite overseas regulators adopting 10+ year periods for the same input. Recently, Dr Lally similarly was advocating his approach being a 5-year term to the Australian Energy Regulator and stated his opinion was based on earlier work undertaken by Emeritus Professor Richard Schmalensee, of Massachusetts Institute of Technology.

Professor Schmalensee came forward to clarify for the AER that his work had been misapplied and that Dr Lally had fundamentally misunderstood and misinterpreted his paper. Rather Prof. Schmalensee confirmed that the appropriate regulatory task is for the regulator to set the allowed return equal to the return that *real-world investors actually require* and one that reflects what they are *actually doing*. Yet, despite such a public rebuking (and the AER being unpersuaded by Dr Lally's theory) the Commission has again shown an unwillingness to engage on the topic or even attempt to understand why no overseas regulator follows the Commission's position and has retained Dr Lally's theory.

Example 2

A second example relates to views provided to the Commission from New Zealand expert John McDermott, Executive Director of Motu and former Assistant Governor of the RBNZ. Vector sought his expert advice on how the Commission currently uses the RBNZ inflation because it is different to how the RBNZ itself sets and utilises such a forecast and because it has such a significant bearing on cashflows for network companies in the regulatory model. For over a decade, inflation has been both persistently over forecast (post GFC, pre-Covid)

and wildly under forecast (post Covid). Given the large discrepancies between actual and forecast inflation, Vector and the wider EDB industry has proposed an alternative model – a model to date applied for Transpower - which does not link asset value to inflation.

Despite there being strong logic to move towards a materially better model (and which has already applied to Transpower for over a decade) that delinks inflation forecasts from revenue, the Commission refuses to reconsider its approach. McDermott details fundamental concerns with the Commission's approach:

- the Commission's inflation forecasting approach *"risks generating significant forecasting errors and is undoubtedly not fit for purpose"*
- "*the fundamental problem with using the RBNZ projections is that they are a tool designed for near-term planning and signalling, not for long-term regulation*"
- "*the RBNZ only provides a genuine inflation forecast six months ahead. The remaining 30 months of their projections reflect an assumed transition to two percent. The RBNZ always shows inflation heading to two percent, irrespective of the circumstances*".

Example 3

A significant amount of expert analysis has also been provided to the Commission on one key variable going to the core of a network company's incentive to invest (called the WACC percentile). No expert opinion or analysis provided to the Commission could establish any ground for lowering the percentile from its current 67th point.

In fact, all experts could readily establish credible cases for raising the percentile above the current 67th percentile, principally on the grounds of the increasing importance of electrification and resilience investment. Among the experts who provided an opinion on raising, not lowering, the percentile was the same UK economic expert firm (Oxera), who previously assisted the Commission in establishing the basis to assess the appropriate percentile figure.

Despite a wealth of comprehensive and compelling expert analysis and logic, the Commission has moved in the opposite direction to expert analysis and proposed reducing the percentile below 67th to 65th. It is unfathomable to us how the Commission can justify its position in lowering the percentile in the face of such expert views.

We raise each of the three examples above not only to ask the Commission to reconsider its position on each, but also to raise the more fundamental issue of the Commission's increasingly narrow approach to engaging with any expert opinions other than its own.

4. **Energy affordability is an industry-wide and government issue to address; regulated EDBs cannot be the industry shock absorber at a time of needed investment**

Vector acknowledges that energy affordability is an increasing challenge for consumers, but we also note that it is a collective industry, and even government-wide, issue to address. It cannot be the case that only the regulated network part of the electricity value chain provides a cushion for changing costs and prices to fund greater electrification and resilience.

Already subject to detailed regulation and revenue limits, the Commission further overlays an arbitrary price limit constraint for annual EDB revenue adjustments (currently set at 10% p.a.). For clarity, this equates to less than 3% of a consumer's electricity bill and is separate to generation and retail price changes which are unconstrained.

The challenge with such a crude and arbitrary 10% constraint is that current high inflation means the constraint will bind and additionally constrain networks' allowable cash revenues in coming years. Network companies have already been constrained in passing on the impact of today's high inflation to consumers. This materialises in large "wash up" balances being rolled forward to be recovered from future consumers. Combined with a periodic regulatory reset next year - which will update for higher market interest rates and inflation - the 10% limit will artificially constrain the ability of EDBs' to recoup efficient costs, including prior under-recoveries. Our experts forecast that just for the six largest network companies such a wash-up balance will be over $1.5 billion in unrecovered revenue by 2030.The magnitude of this situation will clearly compound the issues of investment and create a plethora of issues, such as credit rating downgrades, leading to higher interest costs etc.

Best regulatory practice generally ensures that regulated businesses are permitted to recover all their efficient and prudent costs in each regulatory period, with the overarching principle of financial capital maintenance being a critical component of regulation. The Commission's current application of the 10% per annum adjustment will risk the efficient recovery of an EDB's costs as catch-up costs would be pushed repeatedly and very far into the future. Such a risk is exacerbated by the Commission currently limiting revenue increases to nominal (rather than real) price increases that overlook current high inflation.

The Commission needs to ensure that any attempt to smooth regulated EDBs' prices does not compromise EDBs' ability to recover their efficient costs or dampen incentives for EDBs to improve efficiency or service quality. This is because such outcomes would undermine, rather than promote, investment for electrification and the long-term interests of consumers.

Closing

We attach our submission and key expert reports. Given the substantive issues identified in our submission we call on the Commission to step back, engage and carefully consider its decision, to avoid putting at risk the investment in infrastructure required for resilience, security of supply and decarbonisation.

We would also encourage the Commission to initiate workshops and meaningful engagement to address such a short period for industry and consumers to engage on such a complex yet important draft decision. Our international experts advise us that the magnitude and breadth of topics the Commission is attempting to canvas would, in most other jurisdictions, be consulted on progressively over at least a 12-month period.

We remain keen to constructively engage with the Commission toward seeking a better outcome given the criticality of this review for electricity infrastructure investment and the role it has in enabling Aotearoa New Zealand to meet its decarbonisation and resilience objectives. We would welcome any opportunity to discuss the contents of this letter with the Commission.

Yours sincerely

Simon Mackenzie
Chief Executive Officer