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#### **Part 4 Input Methodologies (IMs) Review 2023, draft decisions**

Mercury welcomes the opportunity to provide feedback to the Commerce Commission (the Commission) on its consultation on the *Part 4 Input Methodologies Review 2023 draft decisions* (Draft Decisions), 14 June 2023.

Mercury is committed to decarbonizing the sector and enabling emissions reduction in New Zealand by ensuring the energy transition is affordable, and the energy system is secure, resilient and supports economic development and productivity growth.

The Commission proposes that the IMs broadly remain fit for purpose and are flexible enough with some focused amendments to cope with the changing operating environment. Mercury considers, however, that it is not clear the current IMs with proposed focused amendments will address exposure of networks to the risks associated with the decarbonization and electrification of New Zealand and promote outcomes for the long-term benefit of consumers.

Mercury agrees with the Commission that businesses have always operated under some degree of uncertainty, including over the scale and pace of change in demand, the necessary level of resilience, and in the development and deployment of new technologies. Looking forward, however, Mercury considers that the response to climate change, the electrification of the New Zealand economy, and the development of associated Government policies expands the scope of risks that networks are exposed to. That is, these factors are expected to result in changes across the energy sector that are greater than the incremental growth in electrification implied by the Draft Decisions.

As such, Mercury proposes that the IMs in general should support the electrification of the New Zealand economy for the long-term benefit of consumers by:

1. Enabling investment in network capacity ahead of demand that underpins confidence in the electrification of the economy;
2. Enabling investment in emergent, innovative flexible demand-side resources that in turn reduce the need to invest in network capacity; and
3. Minimizing price shocks and ensuring that the transition is affordable now and into the future.

In addition, Mercury has a concern regarding the Commission's proposal to introduce a large connection contracts (LCC) mechanism. The Commission proposes to allow assets for connections greater than 10MW to be excluded from the regulated asset base (RAB). It anticipates that the ability of EDBs to utilize their bargaining power when negotiating such large contracts is limited. Mercury does not agree with this view.

The following submission expands on these points.

#### **Accelerating investment in distribution network capacity**

The Boston Consulting Group (BCG), under its preferred decarbonization pathway titled Smart System Evolution, proposes the required level of transmission and distribution infrastructure investment during the 2020s of:

- “\$8.2 billion in transmission infrastructure to enable new renewable and flexible generation. Investments in key projects like Central North Island, Wairakei Ring and an additional HVDC cable will be critical
- \$22 billion in distribution infrastructure to enable electrification in the 2020s and prepare networks for rapid electrification and multi-directional flows of electricity in the 2030s. **Total investment need in 2026–2030 is forecast to be 30% higher than 2021–2025 [emphasis added].**<sup>1</sup>

With respect to the regulatory framework required to enable this investment, BCG also highlight:

*“Today’s just-in-time approach to transmission and distribution network investment won’t be suitable for the expected rapid electrification and renewable generation development. The existing regulatory system supports just-in-time investment decisions in a relatively stable environment, waiting as late as possible to achieve confidence before each increment of investment. However, with rapid electrification and renewable generation development on the horizon, **a significant increase in network investment is needed under conditions of higher uncertainty, ahead of time.** Late investment will stall low-cost renewable generation development and electrification, increasing emissions and net prices for consumers. [emphasis added]”<sup>2</sup>*

In other words, climate change, electrification, and government policy are resulting in changes across the energy sector that are more significant than an incremental growth in network capacity.

For instance, BCG’s forecast growth of 30% in distribution network investment in the period 2026–2030 compared with 2021–2025 is not incremental. This investment, as highlighted above, is expected to be made under conditions of higher uncertainty and ahead of time – i.e. ahead of demand.

The Commission has addressed analogous economic issues – i.e. where network investment is made under conditions of higher uncertainty and ahead of demand – in case of price-quality regulation of Chorus’ regulated asset base under Part 6 of the Telecommunications Act 2001. As a part of the Government’s ultrafast broadband (UFB) initiative, local fibre companies (LFCs), including Chorus, were required to deploy a fibre access network to meet specified deployment targets that were ahead of demand. Furthermore, the price of wholesale services providing access to Chorus’ fibre network was capped at levels agreed between Chorus and the Government.

The deployment of fibre ahead of demand coupled with the cap on the price of wholesale services resulted in Chorus incurring a financial loss. This loss was captured in Chorus’ “initial RAB value” as a “financial loss asset” (FLA). Furthermore, the Government provided financing to enable the deployment of the fibre network and cover the cost that LFCs, including Chorus, incurred during the deployment of the UFB network.<sup>3</sup>

Mercury notes that while Part 4 of the Commerce Act and Part 6 of the Telecommunications Act have similarities, Part 4 of the Commerce Act does not provide the same mechanisms as Part 6 as the Telecommunications Act for addressing network investments made under conditions of higher uncertainty and ahead of demand. Mercury does not suggest that the Commission should try to adopt such mechanisms for transmission and distribution networks.

This example, however, suggests that the Commission should give thought to the application of its available tools so that its decisions enable investment in network capacity ahead of demand that would underpin confidence in the electrification of the economy.

<sup>1</sup> BCG report, *The Future is Electric*, page 3

<sup>2</sup> Ibid. page 11.

<sup>3</sup> Commerce Commission’s Reasons paper, Chorus’ initial regulatory asset base as at 1 January 2022 – Draft Decisions, date 19 August 2021, paragraph 2.49 states: *The background to the FLA is that it was expected that Chorus and the other LFCs that deployed fibre access networks under the Government’s UFB initiative would incur financial losses during their initial period of operation. That is, despite the provision of partial funding via concessionary Crown financing, it was expected that the initial uptake of UFB services would generate insufficient revenue to cover the costs that the LFCs incurred during that period.*



### **Investment in innovative demand-side flexibility services**

BCG also emphasize “...that the pipeline of flexible, demand-side resources is occurring at a sufficient pace to meet demand. However, the pace of change required to enable a smart system is likely to accelerate over the 8 years and the sector will need to increase efforts by 2030.”<sup>4</sup>

Two features of flexible, demand-side resources that are relevant to the IM are, firstly, that they may substitute for and reduce the need for investment in network capacity where the resources reduce peak demand. However, secondly, there is presently uncertainty regarding how and when particular flexible, demand side resources will be available compared with the certainty provided by investing in network capacity.

Flexible demand-side resources contribute, therefore, to the uncertainty in investment in distribution networks, which may reduce the incentive to invest in network capacity ahead of demand that would underpin confidence in the electrification of the economy. Whereas over the long-run flexible, demand-side resources in general may enhance economic efficiency.

It is unclear how the IMs presently address this dual challenge of maintaining the incentive to invest in network capacity ahead of demand while promoting the incentive to invest in new, innovative flexible, demand-side resources. The Commission should give thought to the application of its available tools so that its decisions incentivize regulated suppliers to make decisions that enable the development of flexible, demand-side resources and promote economic efficiency in the long run.

### **Minimizing price shocks and ensuring energy prices during the transition are affordable**

Minimizing price shocks and maintaining affordability will also be crucial for a successful transition. Significant and unexpected increases in prices risk reducing demand and stalling the electrification of the economy. This, however, needs to be addressed while also maintaining the incentive to invest in transmission and distribution infrastructure.<sup>5</sup>

Returning to the price-quality regulation of Chorus referred to above, Mercury notes that it provides an example of maintaining prices and the incentive to invest. At the commencement of UFB initiative, Chorus and the Government agreed wholesale access price, which helped minimize price shocks and ensure broadband services remained affordable. In addition, Government funding coupled with the financial loss asset, as already discussed, maintained the incentive to invest.

To reiterate, Mercury does not suggest that the Commission should try to adopt such mechanisms for the regulation of transmission and distribution networks. This example, however, suggests that additional care should be taken when implementing the IMs and using the available tools.

### **Large Connection Contracts**

As noted above, the Commission has proposed to introduce an LCC mechanism. The Commission proposes to allow assets for connections greater than 10MW to be excluded from the RAB in order to take pressure off the number of default price path (DPP) price-quality path reopener applications.

Mercury's key concern with the Commission proposal is the expectation that EDBs' ability to utilize their bargaining power when negotiating such large contracts to be limited. Mercury's view is that the fact that a connection contract may be greater than 10MW does not mean that EDBs' ability to utilize their bargaining power is limited.

Mercury considers that larger connection contracts do not limit EDBs' bargaining power. In fact, the larger contracts may increase EDBs' bargaining power particularly if an EDB's customer is investing in larger generation or load assets that potentially could be placed at risk if a network connection is not provided. Furthermore, there is often little flexibility as to where the generation or load is located as it is often set by resource, availability of other infrastructure,

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<sup>4</sup> Ibid, page 15.

<sup>5</sup> Commerce Act, Section 53P(8)(a) notes that the Commission may set alternative rates of change for a particular supplier where “... in the Commission's opinion, this is necessary or desirable to minimise any undue financial hardship to the supplier or to minimise price shock to consumers.”



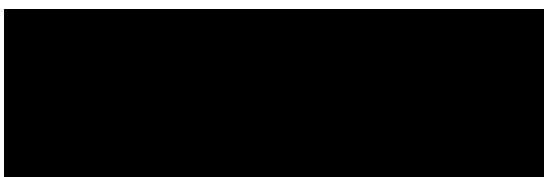
agreements and consents. This gives an EDB bargaining power as in practice there is often no practical alternative to connecting other than via the EDB.

Mercury also notes that the proposed LCC mechanism would be implemented by a large number of EDBs that are likely to take different approaches to implementing it. This would significantly raise the transaction cost of EDBs' customers seeking new connections, particularly those with assets distributed across the country and therefore need engage in these different approaches.

Mercury, therefore, proposes that the assets for connections greater than 10MW are included in the RAB. Mercury considers that if the Commission is minded to continue with the proposal to exclude connections greater than 10 MW from the RAB that the Commission considers a mechanisms that limit EDB's bargaining power.

Mercury looks forward to engaging with the Commission and industry stakeholders on the implementation of the IMs.

Yours sincerely,



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