

11 July 2022

Commerce Commission
44 The Terrace
Wellington, 6140

By email: im.review@comcom.govt.nz

Horizon Energy Distribution Limited (Horizon Networks) submission on process and issues for the Part 4 Input Methodologies review

1. Thank you for providing us the opportunity to make a submission on the process and issues, and the decision-making framework for the *Part 4 Input Methodologies (IM) Review 2023*.
2. Horizon Networks is a small trust-owned Electricity Distribution Business (EDB) serving over 25,000 consumers in the Eastern Bay of Plenty region. As a trust-owned EDB, we have a strong consumer focus and seek to benefit both our Shareholder Trust Horizon and the communities it serves.
3. We recognise the need for EDBs to demonstrate they are providing the best value service to consumers through the IMs while still generating a consistent return that enables Trust Horizon to help the communities within the Eastern Bay of Plenty.
4. It is timely to be reviewing the IMs now as climate change and the transition to a low carbon economy through electrification are challenges EDBs and all New Zealanders face right now. These new challenges were not envisaged when the IMs were last reviewed and highlight the need for IMs to be flexible and future focused to remain relevant for future regulatory periods.

Input Methodologies need to recognise the diverse needs of the consumers it is designed to benefit

5. The purpose of IMs is to promote:
 - certainty for regulated industries (such as EDBs)¹; and
 - the long-term benefit for consumers by supporting outcomes that are consistent with competitive markets²
6. For the IMs to be effective, IMs need to consider the range of EDBs they regulate, the motivations of each EDB and the differing needs of the communities each EDB serves.
7. The electrification of process heat, transport, space heating and distributed energy resources in New Zealand as it shifts to a low carbon economy will affect each EDB differently. Some EDBs may observe an increase in household load and solar connections on the low-voltage (LV) network as the number of solar installations and EVs rise. Other EDBs may find challenges with large connections as existing industrial load seeks to electrify its process heat or large-scale renewable generation seeks to connect to the network.
8. The input methodologies need to be flexible enough to handle unexpected changes and recognise the differing needs of EDBs without requiring EDBs to develop an expensive customised price path.

¹ 52R: *The purpose of input methodologies is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part.*

² 52A: *The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—*

(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
(b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
(c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
(d) are limited in their ability to extract excessive profits.

9. The current IRIS mechanism needs to be reviewed as it is overly complex and does not provide sufficient long term benefits for consumers.
10. As we head into a period of significant change and disruption EDBs driven by increasing costs and fixed returns, EDBs are having to spend more to ensure that our networks remain safe, reliable and resilient. This is not captured by the current IMs.

Horizon Energy Distribution Limited wishes to provide targeted feedback on the Input Methodologies

11. As a small EDB, we must focus our limited resources on the IM issues that are most meaningful to us and for our communities. In general, Horizon Networks does not support any change that will add an administrative burden and increase the cost to consumers without delivering a clear net benefit to consumers.
12. While we are supportive of the Electricity Networks Association (ENA) submission across all the issues raised, there are five items that we consider most important to consumers and should be the focus of the IM review:
 - new, uncontrollable costs may drive a misconception that EDBs are inefficient
 - there is an opportunity for IM's and reopeners to better handle unpredictable and rapid changes
 - there is an opportunity to reduce volatility in annual network charges by improving the IRIS mechanism
 - there is an opportunity to drive efficiency gains and support New Zealand's net zero carbon future through improvements to better support innovation initiatives
 - there is an opportunity to reduce the impact of climate change on consumer bills by allowing self-insurance

New, uncontrollable costs may drive a misconception that EDBs are inefficient

13. 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.
14. It is true that the costs for EDBs to operate have increased at a rate that is higher than inflation, this is driven by costs and regulatory changes outside of EDBs control, including:
 - more onerous health and safety obligations, including traffic management requirements
 - increasing number of severe weather events and growing vegetation risk due to climate change
 - increased resource and environmental consent and management obligations
 - impact of COVID-19 isolation protocols on-field staff availability
 - ongoing shortage of skilled staff, such as engineers
 - increased supply chain costs
15. All of these issues combine to increase the cost for EDBs to deliver the same level of service to consumers.
16. **We recommend** the Commerce Commission engage with the ENA and EDBs to better understand our businesses and the underlying productivity challenges EDBs face.

There is an opportunity for IM's and reopeners to better handle unpredictable and rapid changes

17. Price-quality paths operate on a 5-yearly cycle and rely on forecasts of inflation and network growth to set revenue based on Operational Expenditure (OPEX) and Capital Expenditure (CAPEX) assumptions for EDBs.
18. Inaccurate inflation forecasts result in EDBs under or over recovering costs. This leads to a variability in the Incremental Rolling Incentive Scheme (IRIS) outcomes and creates ongoing pricing volatility for consumers.
19. Two key areas where Horizon Networks is currently impacted by these unpredictable and rapid changes are:
IRIS is limiting our ability to support decarbonisation efforts and un-forecast large connections
20. The IRIS includes incentives on Horizon Networks to optimise its CAPEX expenditure. This incentive means it can be beneficial for us to require new connections such as large generation developments and major customers to fully fund the cost of new connections to avoid IRIS penalties for over-spend of CAPEX. This limits growth and decarbonisation efforts by forcing the connecting customer to fund the cost of connection up-front, in addition to the costs the customers face to develop the sites in the first place.

Inflation forecasts resulting in shrinking OPEX targets

21. Most recent inflation figures have annual inflation sitting at 6.9%³, materially higher than the current default price path (DPP3) forecast inflation. This impacts Horizon Network's ability to operate and maintain the network because actual OPEX costs outstrip the OPEX allocated under the DPP leading to IRIS penalties in future.
22. While there are several solutions that could address the problems with the inflation forecasting, Horizon Networks supports flexible solutions such as:
 - a. a streamlined reopener process that recognises when there is a material impact on EDB's CAPEX or OPEX and can quickly adjust the relevant OPEX and CAPEX targets based on new information; and
 - b. adjusting key metrics annually through a pass-through balance mechanism.
23. These options benefit consumers through more use of updated macroeconomic indicators.
24. **We recommend** the Commerce Commission refresh the reopener process to allow it to consider any material change in OPEX and CAPEX that is outside EDBs control for the price path to be easily adjusted so that it remains fit for purpose and focussed on delivering net consumer benefits.
25. **We recommend** the Commerce Commission consider allowing key metrics to be adjusted annually through a pass-through balance mechanism.

There is an opportunity to reduce volatility in annual network charges by improving the IRIS mechanism

26. The current DPP mechanism recognises that in any one year there may be an over or under-recovery of allowable revenue, relative to pass through and recoverable costs. The IRIS incentive / penalty value in the recoverable costs also influences the price setting volatility. This 'wash-up amount' is carried over into the following year and used as an input to determine the following year's prices.
27. This wash-up amount can create a cycle where price adjustments swing around the target revenue values because over and under-collection of revenue is fully compensated for in the later year's prices.
28. This variability in consumer bills creates uncertainty for consumers and makes it difficult for households to predict future years energy bills.
29. **We recommend** the Commerce Commission consider allowing any wash-up amounts to be spread across the proceeding five years (including across regulatory periods). This will reduce the variability in consumer bills between years and provide a more predictable price to consumers.

There is an opportunity to drive efficiency gains and support New Zealand's net zero carbon future through improvements to better support innovation initiatives

30. Innovation is necessary for EDBs to adapt and overcome the challenges of change, such as the push to electrify more of New Zealand's energy sector as we transition to a net-zero carbon economy as well as managing the ever-increasing impact of climate change on our networks.
31. There are two issues preventing innovation initiatives from being better utilised by EDBs:

The current innovation allowance arrangements are complex and do not provide sufficient incentives for EDBs to innovate

32. The current innovation regime requires EDBs to fund the innovation programme and once it is complete to seek approval from the Commerce Commission to access the innovation allowance for a portion of the costs. This is a risky process for EDBs, which may face short term cashflow issues, IRIS impacts as well as the possibility that the Commerce Commission will not approve access to the innovation allowance.
33. The risks and complexities of the current innovation allowance regime mean many EDBs, particularly small EDBs with limited resources will choose a low-cost, low-risk approach to innovation thereby avoiding the need to access the innovation allowance.
34. This slows the pace of innovation risks poor consumer outcomes as NZ transitions to a low carbon economy through electrification.
35. **We recommend** the Commerce Commission consider simplifying the rules around the innovation allowance to enable the innovation allowance to be accessed as part of project initiation and to provide incentives for EDBs to collaborate on major, long-term innovation projects that have the potential to benefit all New Zealand.

³ <https://www.stats.govt.nz/news/annual-inflation-reaches-30-year-high-of-6-9-percent>

IRIS penalties discourage innovation spending

36. Currently innovation spending is captured by the IRIS regime. Increasing spending on innovation can result in IRIS penalties or loss of IRIS incentives for EDBs.
37. This discourages EDBs from investing in innovation projects, resulting in lost opportunities for EDBs to improve consumer outcomes through innovation projects.
38. **We recommend** the Commerce Commission consider excluding expenditure on innovation projects from the IRIS regime.

There is an opportunity to reduce the impact of climate change on consumer bills by allowing self-insurance

39. Climate change risks and changing insurance industry practices have resulted in more and more EDB assets becoming uninsurable.
40. Uninsured assets shift the risk (and cost) of replacement onto consumers. Following a major event, such as an earthquake, the costs of replacing damaged, uninsurable assets will be borne by consumers. Consumers in Eastern Bay of Plenty are amongst the lowest socio-economic group in NZ and cannot afford any significant increases in prices due to a significant asset rebuild that may be permitted under a CPP. EDBs would be better equipped to manage this risk on behalf of consumers by self-insuring assets, however the costs for this are not permitted within the DPP framework.
41. **We recommend** the Commerce Commission considers allowing self-insurance to be a pass-through cost for assets that are otherwise uninsurable.

We appreciate the opportunity to provide feedback to help shape the future of the IM's. Please feel free to contact me directly if you would like to discuss this letter further.

Yours Sincerely



Jonathon Staite
Regulatory Manager

Jonathon.Staite@hegroup.nz

HORIZON ENERGY DISTRIBUTION LIMITED