



TRANSPOWER

Keeping the energy flowing

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Cross-submission in response to Input Methodologies Review 2023: Draft Decisions

1. Transpower welcomes the opportunity to cross-submit in response to the Commerce Commission's (the Commission's) 2023 Input Methodologies (IMs) and Transpower IMs Review draft decisions.

The energy transition

2. A clear theme from submissions is the importance of recognising the energy transition and that there will need to be a substantial uplift in investment by regulated suppliers in the electricity industry in the face of much more uncertainty about how demand for electricity will grow and change. Submissions from various regulated suppliers and stakeholders, such as FlexForum and solarZero, have also emphasised the importance of flexibility and innovation.

3. Powerco has summed up the position of regulated suppliers succinctly:

... we urge the Commission to take a long-term view about the nature and pace of decarbonisation when setting incentive and uncertainty mechanisms so that we can meet the needs of our customers in their timeframes. While we don't know how the future will play out, we do not expect it to be steady state for the periods the IMs will apply to. We back ourselves to direct our investment wisely and meet customer needs in a timely manner – the challenge is for economic regulation to match it.

4. Similarly, by way of example, PowerNet submitted:

we do not believe that the proposed changes to the IM's adequately reflect the changes that are required to prepare the networks we manage for future-proofing the region's electricity needs. This is particularly in relation to the investment required to support decarbonisation and increasing electrification that will go towards reaching the Government's aspiration of net zero emissions by 2050. The industry, and in particular the electricity distribution sector, has started to undergo transformational change, not seen since the electrification of New Zealand. The proposed changes to the IMs are however very minor and do not reflect the environment we now find ourselves in.

5. This is not just a sentiment expressed by regulated suppliers.

6. MEUG has acknowledged *“Regulated energy businesses and their customers are now facing a much stronger focus on decarbonisation to meet New Zealand’s climate change targets, with the move towards greater electrification and distributed energy resources” and that “This is coupled with a greater focus on the need for adaption and resilience to increasing natural hazard events (such as Cyclone Gabrielle) ...”*
7. FlexForum has submitted that the IMs need to provide greater flexibility: *“The IMs need to provide network operators and the Commission with the ability to be more agile and adaptable to fast-evolving consumer preferences, and the associated implications for network operations and investment” and “The IMs have a critical role in the uptake of flexibility and the pace of electrification by providing incentives for network operators to efficiently deliver distribution and transmission services”.*
8. The BusinessNZ Energy Council is concerned *“the existing input methodologies (IMs) were designed during a more stable and predictable industry environment”.* The BusinessNZ Energy Council recognises the requirement for *“significant investment in New Zealand’s transmission and distribution infrastructure”* and *“The need for investment extends to the resilience of network infrastructure, especially in the face of extreme weather arising from climate change”.*
9. We welcome and agree with BusinessNZ view that EDBs and Transpower need *“to have the means to fortify the grid and invest in the necessary upgrades to the network”* and *“Businesses and households need confidence that they can electrify at pace in their timeframes, not the networks”.*
10. We share the BusinessNZ Energy Council concerns that:

... despite the Commission acknowledging the changing circumstances in the sector, the draft decision largely retains the current IM. This may not be prudent in the medium to long-term considering the evolving needs of electrification. Notwithstanding several welcomed changes proposed in the draft decision, we are concerned that necessary adjustments to promote the long-term interests of consumers and adapt to the changing energy landscape is missing.

There are instances where the Commission proposes changes that are retrograde steps, such as reductions to the weighted average cost of capital (WACC) percentiles for EDBs, which seem questionable given the need for investment in decarbonisation and the transition away from being less dependent on thermal generation. The WACC impacts financiability by acting as a building block for the rate of regulated return – the return that a regulated network can earn on investments.

11. Mercury and Meridian’s submissions included similar sentiments.

12. Transpower welcomes and agrees with the comments made by Mercury:

Mercury considers ... 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.

... Looking forward... 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.

...

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, innovate flexible, demand-side resources. 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.

13. Transpower also welcomes and agrees with the comments made by Meridian:

Like most other participants in the electricity sector, Meridian expects an increase in electricity demand over the seven years covered by this IM review. It is critical that network companies are able to invest to meet expected demand growth as this will be an enabler of decarbonisation. As the Commission notes, regulated network companies always face uncertainty in forecasting the extent, timing, and location of increased demand. While forecasting uncertainty is not new, the scale of expected growth is more significant than in recent history due to the decarbonisation and electrification of the economy, in particular transport, industrial process heat, and space heating.

WACC percentiles

14. It is not surprising different views were expressed in relation to WACC percentiles given the clear linkage between decisions on this matter and regulated revenue paths. While the commentary and evidence in support of the Commission position (or that WACC percentiles should be lower than proposed) were limited, we have the following observations and responses.
15. Counties Energy expressed the view that EDBs should have an above mid-point WACC, but Transpower's WACC should be set at mid-point. We do not consider Counties stated reasons to be well founded e.g. the Transmission Pricing Methodology does not lower Transpower's risk profile let alone result in "a much lower risk profile". Also, while Counties' asserts "the risk of under-investment ... doesn't exist" it is notable that Transpower has undertaken a substantial investment programme due to historic underinvestment.
16. Counties Energy has not pointed to any empirical basis for adopting different WACC percentiles for EDBs and Transpower. Effectively, they are asking the Commission to rely on subjective judgement in relation to Transpower and to set aside the evidence that supports uplift for both EDBs and Transpower.
17. MEUG's principal reason for supporting mid-point WACC appears to be a judgement about the balance between service quality and affordability with MEUG comfortable trading off risk of underinvestment in favour of lower cost electricity. While we do not agree with the Commission's judgement about lowering the WACC percentile, the Commission has provided sound evidence and basis justifying a WACC uplift.
18. Contact Energy claims their submission "show[s] that the WACC percentile, used for setting prices should be set at 60th percentile". Nothing in their submission substantiates this claim. Contact Energy also claims, "All of the updated analysis, new evidence, and evolved regulatory settings point to the current 67th percentile WACC being too high". Regardless of what assessment you make about the WACC percentile, any reasonable or objective consideration of the new evidence highlights that most of it points to retention of the current 67th percentile or raising the percentile.
19. We instead agree with ENA that "the Commission does not present any evidence that there have been changes since its 2014 decision that would justify a reduction in the percentile". ENA also expressed concern "the Commission has chosen to base crucial decisions on "regulatory precedent" when it suits - specifically the decision to move away from the 67th percentile - but has ignored it for others including the term of debt and the

use of the trailing average which are almost universally adopted by regulators in other jurisdictions, and advance the objectives of Part 4”.

20. Similarly, FirstGas has expressed concern *“The Commission’s draft decisions ... lack the rigorous justification and evidence that s 52A demands”*. We agree with FirstGas that the *“Asymmetric risk principle has broader application than merely avoiding outages and extends to investments to maintain reach, quality and innovation”* and *“any investment that benefits consumers is relevant to WACC percentile if the forgone benefits of that investment would exceed the disbenefit of higher prices in the short term”*. We consider it could be worth revisiting whether the WACC percentile decision should be based solely on reliability.
21. We reiterate *“The need for investment is now higher than when the Commission made its decision to set the percentile at 67th the case is now stronger for this percentile level”* and *“the focus on the transition to a low emissions economy, and electrification of the New Zealand economy... heightens the importance of investment in network capacity and resilience and in incentives to invest”*.¹

RAB indexation

22. Contact Energy asserts *“The request from EDBs to remove indexation of the RAB is a crude measure to bring forward cash-flows”* without substantiating this claim or indicating what a less crude measure would be. Contact goes on to suggest the draft decision *“will also help soften the sharp price rises expected in the next RCP”*. We consider this to reflect a very short-term perspective on price rises and should be balanced with consideration of the longer-term implications of the dual impact of substantial increase in investment requirements and RAB indexing resulting in higher future RAB values.
23. MEUG’s support for RAB indexing essentially mirrors and agrees with the Commission’s reasoning and is therefore already addressed by submissions opposing the Commission’s position.
24. The only regulated suppliers that offered support for the Commission’s position on RAB indexing were Horizon Networks and Powerco.
25. We consider their support for RAB indexing reflects, consistent with outcomes in a workably competitive market, that different investors and suppliers will have different appetite for risk and different views about risk management. Just because Horizon and Powerco are comfortable with RAB indexation – though notably not in relation to Powerco’s gas network – does not negate or invalidate the concerns expressed by other regulated suppliers. Horizon and Powerco’s views reflect there is a near consensus rather than full consensus amongst regulated suppliers.

Other IMs matters

26. Contact submitted *“A more consumer centric approach”* means *“it may be appropriate to set a ‘revenue smoothing limit’ on Transpower that applies at a regional level”*.

¹ Transpower, Submission on IM Review Process and Issues paper and draft Framework paper, 11 July 2022, p. 29.

27. Applying a limit on price changes at a regional level would require changes to the TPM and could not be achieved under Part 4 of the Commerce Act. Contact is essentially expressing concerns about the TPM and the transitional price cap which would need to be directed to the Electricity Authority, not the Commission or the IMs review.

Transpower IM determinations: independent verification

28. Vector *"welcomed the Commission's draft decision to introduce an independent verification process in the Capex IM"*. We also support introduction of independent verification requirements in the Capex IM.
29. We agree with the Commission that our voluntary use of a verifier for RCP3 (and for RCP4) has been beneficial and assisted Transpower in providing a proposal, and *"reduced the time and cost for [the Commission] to evaluate the expenditure proposal"*.
30. However, we consider that the draft independent verification rules provide a clear example whether the Transpower IM requirements are far more, and unnecessarily, prescriptive relative to the Chorus Fibre IM requirements. For example, Schedule J includes 2 pages of rules for determining an independent verifier for Transpower but there are no equivalent rules for Chorus. Schedule K similar includes 7 pages of rules for the terms of reference for verifiers but there are no equivalent rules for Chorus.

Transpower IM determinations: Information provided to support capex proposals

31. We note Vector has submitted *"We also believe stakeholders could benefit from a suite of tools being made available by Transpower to enable stakeholders to undertake their own analysis of Transpower's capital proposals. ... "*
32. Transpower already provides extensive information in support of our capex and RCP4 proposals and doubt that there would be much, if any, efficacy in providing additional information. We understand much of the information we already provide is not widely used by stakeholders. For example, despite publishing our asset management plan alongside our RCP4 consultation and referencing it as the supporting source of information for most of our RCP4 expenditure we have not received any questions / comments from stakeholders about it.
33. We are always keen to improve the accessibility of information we provide, and we have worked hard to provide a range of different channels and material for stakeholders to engage with. We receive very little written feedback on different types of information or how our customers would like to engage with it. We always welcome specific feedback on what additional information our stakeholders would like.

Transpower IM determinations: regulatory focus

34. While not directly related to Transpower's IMs, we note Vector has submitted that it *"believes that the Commission needs to align the regulatory focus attributed to Transpower to EDBs."*
35. Transpower has a different regulatory regime from those electricity distribution businesses on a default price path. We are on an individual price path, the setting of which is much more akin to a customised price path. This process requires Transpower to submit a proposal to the Commission every five years. With specific and detailed

requirements around independent verification and the Commission's scrutiny across our plans.

36. EDBs can apply for a customised price path, this would allow the Commission to apply a similar level of regulatory focus to EDBs as it applies to Transpower. New Zealand consumers may benefit from independent verification and more Commission scrutiny of EDBs' investment and operating plans.

Concluding remarks

37. We have sympathy for the challenges the Commission faces in reviewing the IMs and ensuring they are fit-for-purpose in an ever-changing and uncertain environment.

38. We share the sentiment expressed by Electra about the challenges the Commission faces:

Realising New Zealand's Carbon Zero goals by 2050 will require EDBs to existentially flex. Our decarbonisation journey cannot be taken by doing more of the same. ...

...

We do not envy the Commission's task of setting the Part 4 framework. Certainty has been a driving force since the IMs were introduced in 2010. This is the third review conducted by the Commission and has come at a precipitous of change. Like us, the Commission is uncertain about what enduring changes will be driven by decarbonisation or the timing. Setting a framework ensuring EDBs operate at the least cost is difficult.

Letting go of some certainty to introduce flexibility is the way forward.

Please contact me at [REDACTED]

Kind regards,

Joel Cook
Head of Regulation