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Andy Burgess
GM – Infrastructure Regulation Branch
Commerce Commission
Wellington 6011
By email: im.review@comcom.govt.nz

Dear Andy

Vector submission on IM review 2023: Draft Framework Paper

1. This is Vector's submission on the Commerce Commission's (Commission) *Part 4 Input Methodologies (IM) Review 2023: Draft Framework Paper*.

2. This IM review comes at a crucial time in the context of New Zealand's transition to a net zero economy. The right regulatory settings must be in place to enable regulated businesses to deliver the pathway set out in the Emission's Reduction Plan (ERP). This is a transition that was not contemplated at the time the IMs were first set, reviewed on appeal, or even when last reviewed in 2016.

3. The energy sector is also transforming more broadly as new and innovative technologies become integrated into the network, in particular digitalisation and greater use of data will allow networks to become smarter, more flexible, and more resilient at lower long-term cost to consumers. The right regulatory settings will be fundamental to enable the transformation of the energy sector to support the long term benefit of consumers. Getting this wrong, or even delaying some of the changes that are needed to unlock and support this transformation, will cause harm to consumers, as well as to 'NZ Inc.'

4. We are concerned the ordinary IM review process set out in the consultation paper is not sufficient to canvas the challenges the sector faces and truly explore the degree to which regulation either supports or hinders the necessary change. Formal written engagement will only go so far. Significantly more conversation and engagement between the Commission and stakeholders is needed, not only to explore the issues and define the challenges, but also to identify workable solutions that achieve better outcomes for consumers over the long term. Our submission on the *Process and Issues Paper* provides more substantive feedback on this. Our core concern is that unless the engagement process is fit for purpose then the work on substantive topics by all parties may be lacking, however well intentioned.

Part 4 and the Climate Change Reduction Act

5. The Draft Framework Paper acknowledges that the Commission can take the net zero target and ERP into account but that when it will do so is a matter for its expert judgment.

6. We are pleased to see the Commission has stated it will take into account s5ZN in its decision making. However, the Commission states it will take this into account "*where we consider it relevant.*" This does not provide sufficient clarity as to when the Commission will take s5ZN into account.

7. A key issue for this IM review is to ensure the regulatory settings are fit for purpose to ensure regulated businesses can fulfil their roles in the pathway to net zero. Accordingly, s5ZN considerations will be highly relevant to every decision made in this IM review and are relevant considerations in promoting the Part 4 purpose. That is, they should always be considered in terms of the factual matrix considered in promoting s52A.

8. The Draft Framework Paper states the Commission will only propose IM changes that meet the overarching objectives of the IM review, being to:

   - Promote the Part 4 purpose (s52A) more effectively;
   - Promote the IM purpose (s52R) more effectively without detrimentally affecting the Part 4 purpose; and
   - Significantly reduce compliance costs, other regulatory costs, or complexity without detrimentally affecting the Part 4 purpose.

9. In the current context, we would suggest that the IM review requires an additional overarching objective: to promote the ERP Pathway and the net zero target more effectively.

10. The ERP has set out the pathway needed to reduce emissions to enable New Zealand to meet its target of net zero emissions by 2050. The Commission has a crucial enabling role for regulated businesses to transform as necessary to meet this target. Regulated businesses must have the right regulatory settings to be able to fulfil their roles in the transition to net zero and deliver to customer expectations and long-term interests. The criticality of the electricity distribution layer to the wider energy system is increasingly recognised as fundamental to enabling consumer choice, electrifying transport, and ensuring resilience of electricity supply in the face of climate change impacts and necessary adaptation investment.

11. Accordingly, 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.

12. Given the significance of decarbonisation to regulated businesses and to the long-term benefit of consumers, we would be surprised if there was no reference to decarbonisation in the IMs by the end of this review.

S54Q of the Commerce Act

13. 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.

14. We note this is a mandatory, rather than permissive, consideration for the Commission in making regulation. It is also directly relevant to key issues for this IM review both in enabling network transformation and in the transition to net zero.

Use of TCFD Framework

15. We support the use of a Task Force on Climate-related Financial Disclosures (TCFD) Framework in principle. We were pleased to see this indication that the Commission will assess climate change related risks, issues, and opportunities.

16. Vector has experience with the TCFD framework, having published a TCFD report in 2021.[1] We intend to publish our second TCFD report in the coming months.

17. As discussed above, the impact of the ERP and net zero target must be a routine consideration for every IM the Commission considers. A TCDF-type framework appears an appropriate method to consider these aspects of the review.

18. We are not clear, however, what this means in practice so cannot provide any substantive comments. We would welcome more information on how the Commission will apply the TCFD framework.

National adaptation plan

19. Along with expenditure in line with the ERP to deliver the net zero target, regulated businesses will also need to manage and adapt their networks to deal with the impact of climate change, such as sea level rise and increased severe weather events.

20. The Government has recently consulted on its draft National Adaptation Plan with the final expected in August 2022.

21. As New Zealand electrifies, the cost of outages will grow significantly. At the same time, extreme weather and other climate change related impacts will challenge network resiliency. If left unaddressed this will cause significant harm to consumers.

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[1] Available: https://blob-static.vector.co.nz/blob/vector/media/vector2021/vector_tcfd_2021.pdf

22. Accordingly, the Commission should also keep in mind the need to support adaptation and the requirements set out in the National Adaptation Plan. To support the long-term benefit of consumers it is vital regulated businesses are able to invest to support resiliency in the face of climate change.

Efficiency

23. In considering its statutory purpose to incentivise efficiency, the Commission's focus in recent regulatory periods has been on static efficiency (i.e. on reducing costs). In the current environment, dynamic efficiency is of paramount importance.

24. EDBs have significant upcoming investment needs to facilitate increased electrification for the transition to net zero. This will include investment beyond traditional poles and wires, as non-network investment in digital platforms and data become increasingly important.

25. In the long run, the prices consumers pay for their electricity will be determined to a large extent by the efficiency of those investments and the cumulative effect on the capital stock of the industry. There could be significant negative consequences if EDBs fail to invest in the right things at the right times. Furthermore, the benefits to consumers from new investments (i.e. dynamic efficiency) can significantly outweigh the benefits obtainable by marginally reducing prices (i.e. static efficiency).

26. If businesses are not investing in the right new things at the right times, the consequences are potentially far worse than if consumers are paying too much for existing services. In technical economic terms:

    - If a business invests in a new or innovative service that consumers want to buy, then the 'net benefit' is represented by the entire area under the demand curve; whereas
    - If a business reduces its prices for existing services, the net benefit is the reduction in deadweight loss, which is only a fraction of the area under the demand curve.

27. It is axiomatic that suppliers must be appropriately incentivised to make the right investments at the right times, and adequately compensated for doing so. If they are not, then they may choose not to invest, to invest too late, or to invest in the wrong things. It is beyond dispute that this will significantly harm both consumer and producer welfare.

28. 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. Given historical expenditure patterns no longer provide a reliable predictor of future outlays, the potential adverse consequences of maintaining the status quo are profound.

29. Failure to appropriately promote dynamic efficiency will significantly undermine the long-term benefit of consumers.

Can the Commission determine a new IM not covered by the existing determination?

30. We are not convinced by the Commission's statement in the *Draft Framework Paper* that it cannot make additional IMs.

31. Most importantly, we urge the Commission to ensure it fully explores all levers available to it to ensure the regulatory framework can support the energy transition. For example, the Commission should be willing to consider issues related to the Default Price-Quality Path (DPP), given they are intertwined with the IMs. Expenditure forecasting is a significant issue for the transition to net zero. While this is typically dealt through the DPP reset process it is strongly linked with the IMs (for example, due to outcomes under the IRIS incentive).

32. This IM reset process is also an opportunity to ensure the next DPP resets are successful and can be approached with confidence by regulated suppliers, knowing that the regulatory settings are evolving in line with industry best practice and consumer demands as the sector undergoes transformation to support electrification.

Key economic principles

33. The Draft Framework Paper describes the Commission's key economic principles and states that, "*if a principle ceases to be consistent with the section 52A purpose of Part 4, we will not continue to apply that principle*."

34. The Commission's key economic principles underpin the design of the Part 4 regime. In particular, the principle of real ex ante financial capital maintenance (FCM) is the cornerstone of the Part 4 regime. The High Court stated that the concept of FCM was, "*Central to the Commission's approach to Part 4 regulation and to regulatory control of natural monopolies more generally.*"[2]

35. We do not consider there could be justifiable reason for the Commission to depart from this principle. This statement appears to have introduced considerable uncertainty into the Commission's approach to regulation which, in a regime designed to promote certainty, is difficult to reconcile. We encourage the Commission at the earliest opportunity to clarify precisely what it meant in making such a statement.

Whole of system costs

36. Achieving an efficient energy transition at least cost to consumers requires consideration of costs across the whole supply chain. A narrow focus on the cost impact on only one part

[2] Wellington International Airport Ltd & Ors v Commerce Commission NZHC 3289 [11 December 2013] at 256

of the supply chain (e.g. just distribution or just transmission) will not provide the true picture of the costs and benefits of a particular investment.

37. We recognise the Commission's statutory role is focussed on consumers in the relevant market (e.g. distribution customers). However, there still needs to be there needs to be acknowledgement by the Commission of the broader overall impact. Work commissioned by Vector and authored by Frontier Economics in London discusses how the UK Government, including OFGEM, is now considering its regulatory regime in light of the need to target better whole-of-energy-system costs for consumers.[3]

38. It is also important to bear in mind that the benefits of electrification extend beyond benefits to consumers in their capacity as consumers of the regulated service. For example, while investment to support the uptake of EVs will likely increase network costs in the short-term it will also allow consumers to significantly lower their petrol costs.

39. Accordingly, we encourage the Commission to remain cognisant of costs across the energy system. Otherwise there is a risk the real impact that potential IM changes (and resulting investment behaviour) would have on consumers in practice is not taken into account.

Yours sincerely

Richard Sharp

GM Economic Regulation and Pricing

[3] Frontier Economics, *Whole Electricity System Costs: A report for Vector* (March 2021), Available: https://blob-static.vector.co.nz/blob/vector/media/vector-regulatory-disclosures/annex-3-whole-system-costs-in-nz.pdf