vector

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Andy Burgess
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Commerce Commission
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By email: im.review@comcom.govt.nz

Dear Andy

Incentives – Vector submission

1. This is Vector's submission following the Commerce Commission's (Commission) workshop *Forecasting and incentivising efficient expenditure for EDBs* held on 7 November 2022.

2. We found the workshop and associated staff papers helpful to understand the Commission's current thinking. We would welcome further opportunities for discussion on these topics.

3. We note our submission and our response to the guiding questions reflect our preliminary thinking on the topic as we need more time to fully engage with the material and issues canvassed. Accordingly, we have not answered all of the guiding questions provided by the Commission. However, we will continue to develop our thinking and intend to provide more substantive comments at a later time.

4. In terms of process, we would like confirmation whether the Commission is intending to also release an emerging views paper on the topic ahead of the issues paper.

Capex bias

5. As identified by the Commission at the workshop, decarbonising the economy is a top social priority and electrification is at the heart of decarbonisation. Electricity lines companies will be at the heart of the transition to electrification.

6. We consider the crux of the issue is ensuring the regime incentivises and allows the most efficient expenditure, regardless of whether this is opex or capex (or a combination of the two) and regardless of whether this is a network or non-network solution.

7. We would not characterise the key issue as 'capex bias' but the need for greater flexibility between opex and capex allowances. Investment plans can change within a DPP period so greater flexibility is necessary to ensure EDBs can implement the most efficient solutions with the most up to date information.

8. Many of our projects need only two-three years lead time so ensuring the regulatory framework allows the flexibility to adjust solutions between opex and capex is critical to deliver the best outcomes.

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Opex and capex IRIS

9. We appreciate the IRIS equivalence model and staff discussion paper published by the Commission.

10. We note it is not possible to draw solid conclusions from the model. The years analysed suggest from an NPV perspective that opex and capex spends are equivalent in terms of penalty for scenarios 1 and 2 and that capex overspends in scenario 3 are preferential for EDBs because a return can be earned on this capex.

11. Although these outcomes are true, they do not consider the following –

    - The capex and opex IRIS outcomes are dependent on the year in which overspend occurs. They have different escalation methodologies applied and make different penalty assumptions for different years.
    - The notion that capex overspend is better than opex overspend because of the WACC uplift is not a specific consideration for IRIS. The assumptions underpinning this appear to be inconsistent with the Commission's framework as set out in its 2014 Oxera Report.[1]
    - The Commission assumes the annuity rate for capex and opex equivalence to be 3.66% p.a. -$100 per year over 10 years with an NPV of $825. The Commission has not explained why it is using this rate as our understanding is lease rates for equipment are typically much higher than this.

12. We consider further investigation into the IRIS equivalence would be worthwhile.

Other IRIS considerations

[1] Oxera, Review of the '75th percentile' approach, June 2014.

13. We consider capex and opex are not substitutable in the IRIS regardless of the equalized incentive rates. This is because an EDBs actual spend on opex and capex in a particular year will have an impact. If an EDB is close to overspending its opex allowance and has more room in its capex allowance it will be incentivised to choose a capex solution to avoid an IRIS penalty.

14. As acknowledged in the staff paper, IRIS is unable to address incentives to make savings that materialise beyond the IRIS carry-forward period. However, the Commission considers it may be difficult to address this in the context of a DPP due to the less obvious link between spend and future savings.

15. We consider the Commission and stakeholders should still investigate how IRIS could be amended to reflect (and therefore better incentivise) savings beyond the carry-forward period. The impact of this issue may become greater overtime given opportunities presented by, for example, digitalisation to create significant future cost savings. It is critical that incentive mechanisms do not inadvertently discourage this kind of expenditure.

16. A further issue with the current IRIS mechanism is its potential to penalise EDBs for overspend, or reward EDBs for savings, related to factors entirely outside the control of the EDB. For example, the 2019 IFRS Interpretations Committee decision on SaaS resulted in Vector recategorizing SaaS expenditure from capex to opex. This could result in a penalty under the opex IRIS (or a reward under the capex IRIS) solely due to an accounting change. We note the Commission's recent decision on Powerco's transition back to a DPP included an adjustment for SaaS costs.

17. The current rising levels of inflation will also impact EDB performance under IRIS despite being outside the control of EDBs.

18. The IRIS could be improved by a mechanism (such as a re-opener or wash-up mechanism) designed to account for expenditure increases (or savings) that are clearly not in the control of the EDB.

Innovation

19. We consider the regime does not currently sufficiently incentivise innovation.

20. At the workshop the Commission discussed the potential to develop a regulatory sandbox to encourage innovation. We support the use of regulatory sandboxes in principle and agree this is something the Commission should consider further in the IM review.

21. The Commission described the Ofgem and AER regulatory sandbox approach as involving:
    - Providing advice and help without breaching regulatory rules;
    - Providing waivers from specific regulatory rules for a set time period; and
    - Allowing for testing of changes to existing regulatory rules.

22. We consider the Ofgem and AER approaches may be a starting point to develop a New Zealand regulatory sandbox, although the regulatory regimes have differences. We would need more information on how sandboxing would work in a Part 4 context before providing substantive comments.

23. A successful regulatory sandbox could provide the opportunities to identify and address regulatory barriers under both the Commission and Electricity Authority's jurisdiction. We recommend the regulatory sandbox considers costs and impacts at a whole system level.

24. While we support the use of regulatory sandboxes, we recommend the Commission also consider additional mechanisms to promote innovation such as "use it or lose it" allowances.

25. We recommend the Commission improve the Innovation Project Allowance which is currently too limited to promote innovation in the sector. The application requirements are onerous relative to the dollar value at stake. The ex post assessment and the requirement EDBs contribute 50% of the project limits the type of applications that EDBs could consider under the allowance (i.e. those that are 'safer').

26. A further issue is the regulatory framework does not provide a pathway to advance an innovation completed under the Innovation Project Allowance (i.e. if a pilot is successful under the Innovation Project Allowance the EDB may be unable to advance it further due other existing barriers). The Commission should consider how the IMs could better promote a pipeline for innovation projects to be advanced.

27. More broadly, innovation should not be considered solely in terms of specific innovation projects but, most critically, in terms of promoting dynamic efficiency in EDBs. Constrained cashflows arising from the regulatory settings (for example, due to the treatment of inflation

indexation) cannot be separated from the Commission's obligation to promote incentives to innovate and invest under Part 4.

28. Accordingly, ensuring EDBs have adequate cashflows to fund investment should be central to the Commission's approach to ensuring the regime promotes innovation.

Other outputs

29. Along with innovation, we consider the DPP regime could be improved by broadening incentive mechanisms to promote other outputs consumers value such as emissions reduction and customer service.

Yours sincerely

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