Mercury

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

Process and Issues/Draft Framework submission

Mercury welcomes the opportunity to provide feedback to the Commerce Commission on its Process and Issues paper and Draft Framework paper.

The focus of the Consultation Papers at this stage of the Input Methodology (IM) Review is to identify the key topics, issues, risks and opportunities the review process should address. Mercury looks forward to continuing to engage on the review.

Mercury agrees with the Commission's assessment that the further development of the process and sequence for the IM Review will be influenced by the number, size and interdependencies of the issues to be addressed and therefore a comprehensive understanding of topic areas and specific issues is important. We have reviewed both papers and agree the list of topics, issues, risks and opportunities identified is comprehensive and sets an appropriate platform for forward engagement.

The energy sector faces significant challenges and opportunities in the coming decade and beyond to support New Zealand's decarbonisation transition. The transition requires maintenance of existing supply infrastructure, as well as delivering new sources of grid and distributed scale generation, storage and integrating known and emerging innovative technologies.

The industry is responding to this challenge with significant capital currently being deployed. Mercury recognises that electricity and gas distributors face particular challenges managing and investing in existing assets to ensure reliability in the face of physical climate change impacts as well as the transition to a low carbon and climate resilient economy.

Mercury agrees with the Commission that it will be important to ensure that the IMs enhance the incentives to invest and innovate to maintain reliable services, while responding to changing consumer preferences, technology and other environmental factors, including climate change, consistent with outcomes in competitive markets.

Focus on best-practice asset management of natural monopolies is appropriate

Mercury welcomes the review addressing whether the IM process remains fit for purpose given the government's climate change objectives. We agree that it is important that regulatory bodies achieve alignment on decarbonisation issues where appropriate. It can be challenging to introduce new objectives for regulators to balance such as climate change.

Mercury considers that it is appropriate the Commerce Act regime continues to focus largely on effective price quality outcomes for consumers, improving reporting and information to enforce robust, best-practice asset management of natural monopolies. Improved information sharing and greater transparency over network investments may provide the impetus for developments in the flexibility services market, reducing the need for deep regulatory intervention. This would be a desirable outcome both in terms of cost and efficiency. The Commission has scope to take into account government climate change objectives pursuant to section 5ZN of the Climate Change Response Act 2002.

In Mercury's feedback to the Commission's open letter on ensuring our energy regulation is fit for purpose, 28 May 2021, we stated that ensuring regulatory frameworks remain open and flexible for new technologies will be

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essential to support the transition. We gave as an example the declining costs of battery storage which we believe has implications for distribution services both as potential alternative investments to conventional 'poles and wires' and in terms of transport electrification. Distributed storage in the form of electric vehicles will create new challenges for distributors who will need to work collaboratively across the supply chain to understand how best to manage and integrate this new technology to ensure the future reliability of their networks.

Regulatory regime should not act as a barrier to distributors purchasing information from MEPs

Mercury has long supported open, transparent and competitive markets to deliver greater flexibility into distribution systems from new technologies in a least cost manner for consumers. The Electricity Authority's (EA) IPAG process has established clear data sharing arrangements via bilateral agreements with distributors and through the EA's Default Distribution Agreement process.

However, retailers do not contract for or hold all forms of data that distributors may find valuable to ensure reliability of their networks, such as voltage or real-time outage information, which distributors must contract directly with Metering Equipment Providers (MEPs) to obtain.

Mercury supports the IM process allowing for the recovery of distributor's reasonable costs of acquiring network performance data from MEPs for the LV network given this will have positive consumer outcomes. We understand that the capex focused regulatory regime may act as a barrier to distributors purchasing this information from MEPs. To the extent this is the case, we consider addressing this is an important issue that should be evaluated in this Review.

Net benefit test could be applied more widely

Mercury submits that the Commission should consider whether sufficiently large network investments should be subject to net benefit test requirements akin to Transpower's $20m "major CAPEX" threshold and as seen in other jurisdictions such as Australia.

This would provide confidence and transparency that network investment decisions are taken in a consistent manner that deliver the highest expected net electricity market benefits under credible scenarios and sensitivities, whether Distributed Energy Resources (DER) are involved or otherwise.

Supporting markets for flexibility

Mercury supports the following measures to ensure a competitive market for flexibility services emerges over time:

1. Better access to information (e.g., of network needs/constraints and indicative costing/pricing for solutions) would encourage market participation and ensure the highest value allocation of DER alternatives against conventional network solutions; and
2. Requirements for:
    a. arm's length procurement for flexibility;
    b. competitive tenders for flexibility (akin to Transpower's processes for procuring non-transmission solutions to address grid investment needs and the System Operator's annual procurement plan for ancillary services); and
    c. ringfencing (if a distributor proceeds with in-house investment for flexibility services).

Treatment of inflation in IMs based on consistent application of economic principles

Mercury requests that the Commission review the treatment of inflation particularly across the EDB and Transpower's IMs to ensure that:

- Current differences in approach between EDB and Transpower's IMs are reasonable and based on sound economic principles, are reconcilable, and taking both sets of networks together as a whole do not expose the energy sector to risk; and

- They are fit for purpose given an expectation that the rate of inflation may continue to remain well above forecast over the medium term.

Mercury notes that forecast inflation affects the determination of key variables in the IMs such as the RAB indexation and the revaluations subtracted from the revenue path. The nominal WACC also implicitly includes a market-based expectation of the inflation rate.

As the Commission states in paragraph 5.206 of the Process and Issues paper;

> ... *recent domestic and global macroeconomic events have led to high and rising inflation, up to levels not seen for decades in New Zealand and other developed economies. Recent outturn inflation has been well above forecast levels, and this could continue into the medium term.*

This statement suggests that actual inflation could continue to be well above the forecast levels incorporated in the IMs, which is anchored in the medium term by the Reserve Bank of New Zealand (RBNZ) inflation target.

Mercury's concern is that the above statement implies that the EDB IM's methodology for forecasting inflation over the regulatory period, which is used for the EDB IM, RAB indexation and revaluations, is no longer fit for purpose. The EDB IM's inflation forecast starts with the RBNZ forecast for the first two years of the regulatory period and then trends to the RBNZ's inflation target at the end of the regulatory period. If outturn inflation is expected to continue to be greater than the RBNZ inflation target into the medium term then EDB IM forecast methodology would not reasonably align with the Commission's own expectations.

Mercury also notes that Transpower's IM uses a different methodology compared with the EDB IM, as it does not include an inflation forecast. This raises a concern that the energy sector may be exposed to risk by this divergence, particularly as inflation is likely to remain high.

Task Force on Climate-Related Financial Disclosures

Mercury supports the Commission using the Task Force on Climate-Related Financial Disclosures (TCFD) framework as the basis for the initial review of climate change-related risks and opportunities. We note the Commission intends to adopt TCFD terminology of risk themes and impacts to help identify and categorise these climate-change related risks and opportunities.

If you have any questions, please contact nick.wilson@mercury.co.nz.

Yours sincerely

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