



19 July 2023

## Submission to the Commerce Commission's Part 4 Input Methodologies Review 2023 – Draft Decision

### Introduction

Electra Limited (Electra) welcomes the opportunity to submit to the Commerce Commission's Part 4 Input Methodologies Review 2023 – Draft decision. Nothing in this submission is confidential.

Electra owns and operates the electricity lines and assets in the Kapiti and Horowhenua districts. We are locally owned through the Electra Trust and have over 45,700 beneficiaries who are consumers connected to our network. We are an exempt electricity distribution business (EDB) under s.54G(2) of the Commerce Act 1986 (the Act).

Most of the Commission's proposed input methodologies (IMs) changes will not directly impact us as they are aspects of price-quality regulation, and we are exempt. Accordingly, we have not expressed any views on those proposed IM changes that impact price-quality regulation in this submission. Our views on these substantive matters are conveyed in the industry feedback provided by the Electricity Networks Aotearoa (ENA).

Being an exempt EDB does not mean we are not interested in the IMs review, as the IMs underpin the Part 4 regulatory framework, which is wider than just price-quality regulation. Part 4 wraps around our operations and directs and steers how we deliver electricity distribution services, making this review important to all EDBs, non-exempt and exempt alike. On that basis, our submission focuses on the issue of incentivising innovation, an area that we believe the Commission's review has not adequately considered and needs to do so before finalising this review.

### Proposed changes to the IMs are a tweak to the status quo

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 must innovate at an unprecedented rate. A regulatory framework that incentivises innovation is essential.

Innovation cannot thrive under a regulatory framework that, by its very design, prevents variation and error. The IMs are heavily prescriptive and designed for certainty, built on the precepts of dynamic efficiency (i.e., efficiency-orientated regulation). What got us here will not get us there; decarbonisation requires flexibility to become characteristic of the regulatory framework. And flexibility is the enemy of certainty.

The Commission's review of the IMs has brought no surprises; the proposed changes firm up the existing framework creating a level of predictability and certainty for the default price-quality reset in 2024. Such an outcome would be appropriate if the environment in which we operate were business-as-usual, were not expecting much to change and operated in an environment with a high level of certainty; however, this is not the case; decarbonisation is a disruptor.

New Zealanders have a reasonable expectation that EDBs will be an enabler of decarbonisation. We must be positioned to meet the expectations of our government (local and national), communities, and customers. Decarbonisation is an evolving platform which means we do not have certainty and are unlikely to have sufficient clarity until we are well into this journey.

In this environment of uncertainty and change, we must be able to innovate to be an enabler. The IMs are the platform on which we will do this. Currently, the IMs are not designed to support innovation, and from what we can see from this review, the Commission is not proposing to evolve the IMs to become so. The proposed changes to the IMs are a simple tweak to the status quo. EDBs need more than a tweak; we need bold regulatory change that supports the delivery of New Zealand's decarbonised future.

## Flexibility supports innovation, and EDBs must be innovative

EDBs are often described as 'conservative and slow to change', a criticism not without foundation. Natural monopolies are capital-intensive, resulting in high economies of scale relative to market size and little or no competition. The absence of workable competition means the pressures to innovate are less (or completely absent) than those in competitive markets. The Oxford Institute for Energy studies described innovation in electricity networks as a 'relatively sluggish'—

'While the economics of low carbon generation technologies is fast improving due to a mix of policy and market-driven incentives, innovation in electricity networks has been relatively sluggish. This slow adoption of electricity networks is challenging as they are key to the energy transition.'<sup>1</sup>

While understandably frustrating for competitive market participants, having 'relatively sluggish' EDBs have served consumers well with realised cost efficiencies, keeping prices low and service standards high compared to other OECD countries<sup>2</sup>. The efficiency-oriented regulatory framework has justifiably incentivised investment in the least-cost proven technology, organisational structures, operations, and disincentivised risk-taking.

Decarbonisation, however, is a game changer that requires EDBs to be less conservative than would be the case in a business-as-usual environment. The Institute goes on to say—

'Further electrification of the economy requires significant investment and innovation in the grid segment of the electricity supply chain. Traditional regulatory models of natural monopoly network utilities are designed to incentivise cost efficiency, with the assumption that network business is costly, and the task of regulation is to encourage cost reduction subject to the firm achieving a certain level of reliability. A feature of innovation activities is that they are riskier in comparison with the business-as-usual activities of network firms.'<sup>3</sup>

Decarbonisation requires EDB to innovate; innovation demands risk-taking; risk-taking is uncertain, and uncertainty by its very nature is inefficient as it introduces a level of avoidable costs. The IMs, by design, is an efficiency-orientated regulatory framework written in a period of little change and high levels of certainty. Incentivising EDBs to continue using tried and true

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<sup>1</sup> The Oxford Institute for Energy Studies, Electricity Networks: Technology, Future Role and Economic Incentives for Innovation, December 2017, Abstract, page ii.

<sup>2</sup> [https://www.globalpetrolprices.com/electricity\\_prices/#hl167](https://www.globalpetrolprices.com/electricity_prices/#hl167)

<sup>3</sup> Supra n2.

approaches with a high probability of success and avoid approaches with uncertain outcomes and a low probability of failure.

Risk-taking introduces avoidable costs, as not all risks will result in a successful outcome. Most innovations will never get off the ground, will be abandoned part way through, or not result in a tangible outcome, but costs will be incurred. That is, unless the risk is not taken in the first place, this reality makes risk-taking an avoidable cost. The IMs reward cost avoidance and punish risk-taking by only allowing EDBs to recover unavoidable costs (i.e., efficient costs).

For EDBs, risk-taking is an existential flex, the polar opposite of the foundations of cautious and conservative directives that EDBs have operated under for decades. Conservative and cautious thinking must evolve into innovative and creative thinking, and EDBs cannot undergo this evolution without authorisation from the regulations to take risks. If the costs risk-taking is deemed inefficient, expenditure remains unrecoverable innovation in electricity networks will continue to be relatively sluggish.

### An innovation-orientated framework could support decarbonisation

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. We are not suggesting that EDBs be given carte blanche freedom to spend unchecked in the name of decarbonisation. No matter how well intended, such a mandate would result in perverse outcomes. We suggest that the Commission evolve the IMs to include innovation-orientated mechanisms that allow EDBs to appropriately recover the costs of risk-taking by fairly sharing the risk of innovation efforts between stakeholders (i.e., EDBs, shareholders, and consumers).

The trade-off of certainty and flexibility need not be absolute; a balance can be struck. There are mechanisms used in other jurisdictions that the Commission can leverage to develop the Part 4 framework to give EDBs the platforms to innovate and simultaneously meet the purpose of Part 4.

- Ofgem Strategic Innovation Fund (SIF) — designed to drive innovation in gas and electricity networks for a low-carbon future—  
“to find and fund ambitious, innovative projects which can help shape the future of the energy networks and accelerate the transition to net zero, at lowest cost to consumers.”<sup>4</sup>
- Australian Energy Regulator (AER) Energy Innovation Toolkit — framework facilitates trials of innovative projects by giving the AER the power to temporarily exempts an innovator from having to comply with specific rules acting as regulatory barriers to enabling a trial to proceed.
- Italian Regulatory Authority for Energy, Networks and Environment (ARERA) revenue incentives — which allows an increase of 2% on the WACC for 12 years on capital invested in smart grid projects (including investment in storage)

We are not suggesting that these mechanisms should not be mechanically inserted into the Part 4 framework. Rather, we ask that the Commission consider what might be gained from the intent of these mechanisms and introduce a right-sized approach for New Zealand as part of this IMs review.

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<sup>4</sup> <https://www.ofgem.gov.uk/strategic-innovation-fund-sif>

## Closing comments

The IMs will be reviewed in another seven years (by December 2030); it will be too late if the Commission waits for more certainty around New Zealand's decarbonisation journey until 2030 before adding innovation mechanisms to the IMs. EDBs must now innovate, accept an uncertain environment and embark on an unproven path. The IMs reward for a successful outcome (i.e., processes and procedures that create little or no variability or error) and punish for unsuccessful outcomes (i.e., variability and errors are deemed inefficient expenditure). Innovation cannot happen under an efficiency-orientated framework as such a framework only supports successful outcomes and not risk-taking.

The Commission can incentivise innovation by adopting the precepts of innovation-orientated frameworks. Ofgem, the AER and ARERA have introduced such mechanisms to support mitigated risk-taking. Under these mechanisms, the risks must be justifiable (effective and appropriate), and the results shared (successes and failures). The costs of risk-taking are fairly shared across stakeholders, with consumers benefiting in the long term from lower prices despite the short-run costs incurred from exploring alternatives to the current conservative approach of poles and wires.

We hope the Commission find our submission helpful in completing its IMs Review 2023. Should the Commission want to discuss our views further or have any questions, please contact me at [REDACTED].

Yours sincerely



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