21 December 2021

Dear Andy Burgess (he/him)

Head of Energy, Airports and Dairy Regulation
Commerce Commission / Te Kamihana Tauhokohoko
44 The Terrace / PO ox 2351 / Wellington 6140 / New Zealand

Dear Andy

Further views on ensuring our energy and airports regulation is fit for purpose

We welcome the opportunity to provide further views on ensuring that the energy and airports regulation is fit for purpose following the *Workshop on the impact of decarbonisation on Electricity Lines Services*, held virtually on Tuesday, 7 December 2021. We found the workshop useful and congratulate the Commerce Commission for taking the step to engage on the emerging issues for regulated services early and in a flexible manner.

Nothing in this letter is confidential or commercially sensitive.

Recap of the issues raised by us

In our letter *Feedback on fit for purpose regulation*, 28 May 2021, we raised two topics on the emerging issues for electricity networks, gas networks, and airports related to New Zealand's decarbonisation journey, energy transition, and the impacts Covid-19.

(i) Reopeners are ineffective in supporting decarbonisation; accordingly, the Commission must consider other mechanisms to support the necessary investment.

(ii) We encourage the Commission to bring the reset process forward so that all stakeholders can engage as soon as is reasonably practicable to ensure comprehensive engagement, particularly on the issues arising from decarbonisation.

What is the problem with the reopener mechanism?

While well-intended, we are concerned that the Commission's use of reopeners as a mechanism for supporting investment in New Zealand's decarbonisation future is neither effective nor appropriate in the long term. Reopeners are a common feature of a revenue cap form of control. It is a mechanism whereby the regulator can vary a service provider's revenue cap allowance within a regulatory period in response to 'exogenous events. We do not view decarbonisation as an exogenous event as the investment is driven by the government's 2050 target of net-zero emissions and therefore is predicted.

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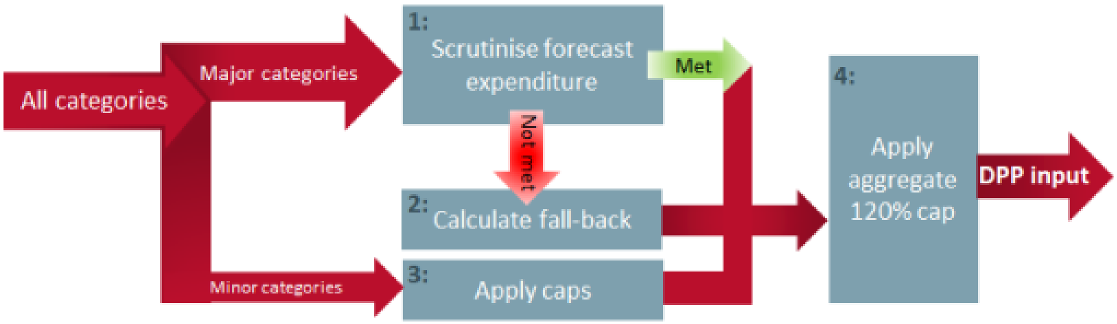
Ideally, reopeners should be the exception and not the rule. Investment driven by decarbonisation has seen its first non-exempt electricity distribution business (EDB) apply for a reopener in DPP3[1], i.e., Unison, in June 2021[2], the second year of DPP3. We expect the Commission to receive several more reopener applications before the end of DPP3. Should the Commission apply the same approach to capex forecasting in DPP4[3] as in DPP3, most non-exempt EDBs will need to apply for a reopener at least once during DPP4.

The issues arise around the investment needed to deliver New Zealand's decarbonised future. At the workshop, there was general agreement that the investment needed is a 'step change'. There was also a general view that the Commission's current approach to setting the expenditure allowances under the price-path does not support the investment needed in the long term.

While we are starting to get a clearer picture of New Zealand's decarbonised future, there remains a high degree of uncertainty around the timing of the investment. The Commission's approach to capex forecasting relies on a high degree of certainty. Deviations away from that certain future by EDBs are treated as inefficiency rather than a variation.

Figure B1[4] below illustrates the four steps[5] that the Commission took when setting the capex allowances for DPP3.

Figure B1 Flow diagram of approach to capex forecasting for DPP3



Step 1 – scrutinise forecast expenditure: utilising the expenditure categories in the AMP associated with:

- growth–consumer connection and system growth; and
- used to renew or improve existing capabilities–asset replacement and renewals and reliability, safety, and environment.

The Commission identifies the cost drivers for each expenditure category and assesses whether the expenditure appears consistent with those cost drivers within a tolerance.

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[1] Regulatory period 1 April 2020 to 31 March 2025.

[2] More information about the Unison reopener application can be found on the Commission's website at https://comcom.govt.nz

[3] Regulatory period 1 April 2025 to 31 March 2030.

[4] Commerce Commission, Default price-quality paths for electricity distribution businesses from 1 April 2020—Final decision, Reasons paper, 27 November 2019 (the Reasons Paper), paragraph B17, on page 199.

[5] The Reasons Paper, paragraph B18, on page 200.

Step 2 – calculate fall-back expenditure where necessary: where the Commission finds that AMP forecasts do not reflect cost drivers, it calculates an expenditure allowance for that category more consistent with those costs' drivers.

Step 3 – cap 'other' expenditure: for the remaining minor categories of expenditure, i.e., asset relocations and non-network, apply the same' sliding scale' applied to non-network assets in DPP2[6].

Step 4 – apply an aggregate cap: to each EDB of 120% of its historical average expenditure to reflect the point at which the cost impact on consumers justifies further scrutiny of expenditure (i.e., signal the option for an EDB to apply for a CPP).

The Commission's approach to capex forecasting for DPP3 operates under the premise that EDBs are delivering under conditions whereby:

- the past is a good predictor of the future;
- costs are certain; and
- recovery after the fact drives dynamic efficiencies.

However, decarbonisation is a disruptor that means the conditions we will deliver in the future are uncertain, and none of the above assumptions holds true. Our view is that investment driven by decarbonisation requires the Commission to rethink its traditional approach to capex forecasting for DPP4.

What other mechanisms might better support New Zealand's decarbonised future?

The rigorous discussion heartened us at the workshop and the many ideas presented. Following the workshop, we have put some time into considering what other mechanisms might better support New Zealand's decarbonised future and at the same time meet the purpose of Part 4 of the Commerce Act 1986 (the Act).

Create a new expenses category and allowances for decarbonisation expenditure

The uncertainty around the cost and timing of investment associated with decarbonisation is currently high. One idea is to have expenditure categories and allowances specific to decarbonisation. A decarbonisation expenditure category could be determined, assessed, applied, and recovered, and allowances could also be set, monitored, and incentivised using approaches specific to decarbonisation expenditure.

Create a decarbonisation reopener

As discussed above, we believe that the reopener provisions are not appropriate for the step-change in expenditure needed to support decarbonisation. The reopeners provisions have been constrained and set using a BAU base. The Commission could determine a decarbonisation-specific reopener. The decarbonisation reopener could take account of the unusual nature of the investments including, the size of the investment required, the timing of rolling the investment into the regulatory asset base (i.e., expensed vs. commissioned), avoiding first-mover disadvantage, and variability of the investment (i.e., alternatives to traditional poles and wires solutions).

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[6] For DPP2 (i.e., 1 April 2015 to 31 March 2020) the Commission set for non-network capital expenditure, the limit equivalent to 200% of the distributor's historic average, unless non-network capital expenditure represents more than 5% of capital expenditure. For those distributors who are forecasting non-network capital expenditure to be more than 5% of total capital expenditure, it adopted a sliding scale approach to calculating the limit.

The idea of targeted reopeners is not new. In December 2020, Ofgem[7] issued its final determinations for RIIO-2[8] that included mechanisms to address the uncertainty around the development of the British Government net-zero targets during the price control period. The Net Zero and Re-opener Development Fund use it or lose it allowance (NZARD UIOLI)[9] was developed to allow Network Licensees (electricity transmission, gas distribution, and gas transmission) to bring forward projects that may be low in materiality but high in consumer value through reopeners.

Network Licensees	Net Zero Reopener
Gas Transmission Gas Distribution	Net Zero Pre-construction and Small Projects Reopener (NZASP)
Gas Distribution	Heat Policy re-opener, and New Large Reopener (if Net Zero related)
Electricity Transmission	Medium Sized Investment Projects (MSIP) Reopener

The allowances can be spent at any time over the price control period (i.e., over the five years). The Network Licensee manages the spending profile so that it does not need to spend to its total allowance equally over each year of the control period.
While NZARD UIOLI does not currently apply to electricity distribution, Ofgem will soon start the RIIO-ED2 reset for the five years 2023-2028. It is expected that re-openers specific to electricity distribution will be developed along the same lines as the net-zero reopeners applicable to Network Licensees.

Strip out investments attributable to decarbonisation

Decarbonisation is currently a disruptor with significant unknowns. However, investment in decarbonisation will inevitably become part of the norm and BAU for EDBs. An option available to the Commission is to keep the mechanisms in place but exclude investment in decarbonisation expenditure from those for DPP4.

One of the ideas raised during the workshop was the exclusion of customer capex from the Capex IRIS[10], raised by Nathan Strong, Unison. We believe that this idea has merit. The investment to meet decarbonisation goals is likely to see EDBs invest well over the capex allowances and incur a material penalty under the incremental rolling incentive scheme (IRIS).

Bold Transformational changes

In addition, we support Vector's challenge to the Commission that it is time to make bold transformational decisions. In the context of moving away from historical regulatory mechanisms to set forward regulation, we encourage, as Vector has, that the Commission

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[7] Ofgem, the energy regulator for Great Britain. More information about Ofgem can be found on their website at https://www.ofgem.gov.uk

[8] More information on the network price controls and performance 2021-2028 can be found on the Ofgem website at https://www.ofgem.gov.uk/energy-policy-and-regulation/policy-and-regulatory-programmes/network-price-controls-2021-2028-riio-2

[9] More information about the net zero reopener can be found in the Net Zero and Re-opener UIOLI Allowance Governance Document, available on the Ofgem website at https://www.ofgem.gov.uk/publications/net-zero-and-re-opener-development-fund-governance-document

[10] Incremental rolling incentive scheme.

looks at broader regulatory mechanisms that will align more appropriately with New Zealand's net-zero carbon future.

More workshops, please

When we asked the Commission to bring the reset process forward to June 2022, or earlier our concern was that the 'traditional' methods employed by the Commission at prior resets would not give adequate time to engage stakeholders appropriately. Decarbonisation is a complex issue that is constantly evolving. In contrast, the regulatory setting process tends to be a prolonged inflexible process.

The workshop was a great start to the Commission's engagement. We encourage the Commission to keep engaging along these lines. In doing so, we would consider our concerns addressed.

The discussion at the workshop was invaluable. We encourage the Commission to hold more workshops like it as we work through each issue before us.

The format, in this instance, a Zoom call supported participation by a diversity of stakeholders that may not have been the case had the workshop been held in person in Wellington. We encourage the Commission to continue considering the flexible methods that it can use to encourage participation by stakeholders.

Concluding comments

We do not profess that our ideas outlined in this letter are the only ideas available to the Commission or good ideas or even ideas with true merit; they are just ideas. Through engagement and the presentation of ideas, followed by discussion, debate, and diversity of perspective, we believe the Commission will develop the regulatory framework and ensure that our energy and airports regulation is fit for purpose.

Yours sincerely

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Alpine Energy