Orion

9 August 2023

IM Review

Commerce Commission

Wellington

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

Feedback on the Cross Submissions of the Input Methodology Draft Decision

Introduction

1. Orion appreciates the opportunity to provide feedback on the submissions to the Commission's Draft Decision on the Input Methodology (IM) Review published on 26 July 2023.
2. We have reviewed the submissions which were published from the various industry participants and note that cross submissions close on 9 August 2023 according to point 1.26 in the draft decision[1].
3. The main points in this submission focus on:
   - Incentivising efficient investment (Cost of Capital)
     - *i.* WACC Percentile
     - *ii.* Debt premium and term credit spread difference (TCSD)
     - *iii.* Tax-adjusted Market Risk Premium (TAMRP)
   - Cashflows and Inflation
     - *i.* Financeability
     - *ii.* Effectiveness improvements to revenue path wash-up mechanism and revenue smoothing
   - Dealing with changing circumstances and uncertainty
     - *i.* Reopener for new connections
     - *ii.* Reopener timeframes

[1] https://comcom.govt.nz/__data/assets/pdf_file/0027/318627/Part-4-IM-Review-2023-Draft-decision-Report-on-the-Input-methodologies-review-2023-paper-14-June-2023.pdf

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iii. Network utilisation key to decarbonisation

iv. Large Customer Contracts

- Flexibility with the review of the IMs

Summary

4. This submission highlights support of the stakeholders' submissions on the IM Review from submitters focussed on the electricity industry.
5. Many EDBs faced challenges during DPP3 which we would expect to be fairly compensated for during DPP4. Regulated businesses were not able to adjust prices in period to pass on the significant rise in costs, particularly since 2020 (DPP3). The industry is also facing challenges leading up to 2030 (DPP4).
6. We also refer to section 52A of Part 4 of the Commerce Act which is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
   - have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
   - have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
   - share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
   - are limited in their ability to extract excessive profits.
7. We acknowledge that the Commerce Commission has a short turnaround time to complete both the ID and IM review. We feel that the short timeframes between submissions and cross submissions of 2 weeks does not afford submitters the time to give submissions the due consideration they deserve. There were 82 submission documents and excel models in total from regulated businesses and stakeholders on 19 July 2023[2].

[2] https://comcom.govt.nz/regulated-industries/input-methodologies/input-methodologies-for-electricity-gas-and-airports/input-methodologies-projects/2023-input-methodologies-review?target=documents

Cost of Capital

8. Referring to point 61 of Vector's submission[3] "*The Commission has proposed to keep its 'high-stakes lottery' approach to setting the risk-free rate, whereby businesses' returns are determined to a large degree by what transpires in a narrow 90-day window this is not regulatory best practice.* Point 64 goes on to state that, *"The methodology would therefore continue to needlessly expose businesses to risks they can neither avoid nor hedge against*".

   We agree with Vector that the approach of setting the risk-free rate (RFR) using a 90-day window is not best practice and should better reflect the period under review. The term of the government bonds used to estimate the RFR should consider longer tenors such as 5 to 20 years according to Oxera.

WACC (Weighted Average Cost of Capital) Percentile

9. Point 4.3 in Wellington Electricity's submission[4] stated that "*The Oxera report analyses the Commission's reasoning for reducing the WACC percentile for EDBs from the 67th to the 65th percentile and finds that the 67th percentile was already at the lower end of the optimal range."*

   We agree that Oxera's analysis is correct and that we have not had the opportunity to recover costs since 2020. Reducing the WACC to the 65th percentile further exacerbates the problem of compensation unlike a competitive business which was able to adjust prices when costs increased.

Debt Premium and Term Credit Spread Difference (TCSD)

10. Point 65b of Vector's submission[5] states "*The term credit spread difference: Oxera finds that the Commission's own evidence supports a higher TCSD at 10.2bps instead of 7.5bps if the Commission does not subjectively exclude the COVID-19 period from the estimation window, and if it avoids double-counting a category of the bonds within its sample. In addition, Oxera does not find the ten-year term cap to be well justified".* We did not initially submit on this, however after reviewing the submissions, Orion submits support for the higher TCSD on the grounds that the evidence supports a 10.2bps.

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[3] https://comcom.govt.nz/__data/assets/pdf_file/0020/323174/Vector-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

[4] https://comcom.govt.nz/__data/assets/pdf_file/0021/323175/Wellington-Electricity-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

[5] https://comcom.govt.nz/__data/assets/pdf_file/0020/323174/Vector-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

Tax-Adjusted Market Risk Premium (TAMRP)

11. PowerCo *supports "an appropriate method of calculation for the Tax-adjusted Market Risk Premium (TAMRP) that considers current data and using modelling that is not overly sensitive to input assumptions, to produce consistent results. This suggests 7.5% (not 7.0% as in the draft decision). Judgement is used in estimating this component and there is insufficient reasoning to reduce from 7.5% used in 2020 decision. We would like to draw attention to the following issue relating to Tax Adjusted Market Risk Premium (TAMRP) raised by Oxera in the EDB report:*

- *There are limitations of using the dividend growth model approach and collection of survey data, which is not used by the AER or Ofgem in their market return estimates.*

The updated estimates of TAMRP are closer to 7.50% than to 7.00% if the Commission's rounding approach is continued to be adopted." Orion supports PowerCo's submission for a 7.5% TAMRP given that the Commission's approach is not consistent with approaches used by other regulators in similar industries which has been verified by independent consultants, Oxera.

Financeability

12. Point 83 and 84 of Vector's submission[6], includes PWC's explanation "*that the Commission's decision not to include a financeability test in the IMs is not compelling. The s52R purpose of the IMs is to promote regulatory certainty. One of the largest sources of uncertainty at present is the ability of electricity distributors to fund the investments needed to facilitate the energy transition in Aotearoa New Zealand. PWC also believe that a financeability test will enhance the s52A purpose to incentivise investment at a time when there is significant amount of investment in electricity network infrastructure needed to meet increased demand and improve resiliency, as New Zealand becomes more reliant on electricity to meet its energy needs."* Orion agrees that the industry is facing significant uncertainty and investment need, and that financeability is highly likely to be an issue leading up to 2030. We believe the Commission has a role to ensure financeability from its decision making. We do not believe that appropriate testing is put in place to ensure certainty that EDBs will be able to fund the necessary investment during DPP4. We

[6] https://comcom.govt.nz/__data/assets/pdf_file/0020/323174/Vector-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

recommend that the Commission reconsider the financeability test in order to give both regulated businesses and stakeholders certainty.

13. Point 119 of Vector's submission[7] states "*As regards the various limbs of the purpose statement the Commission relies on:*

a. While protection from inflation maintains regulatory values in real terms, the Commission acknowledges that this does not necessarily incentivise investment in all circumstances because it also results in deferral of cashflows, which may disincentivise investment. The Commission's response is that it does not see strong evidence that financeability is a concern, and that there are other tools available to address financeability. We think a reasonable summary of the Commission's analysis is that indexation does not necessarily detract from investment incentives, but the argument that indexation incentivises investment (and therefore promotes s 52A(1)(a)) is, at the least, not straightforward as we discuss further below;"

Orion supports indexation as a measure to counteract inflationary challenges and to support in-period investment. This coupled with a one-year recovery lag would provide regulated businesses more certainty and ensure that they can recover the costs of financing during the 5-year period.

[7] https://comcom.govt.nz/__data/assets/pdf_file/0020/323174/Vector-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

14. *Wellington Electricity's submission*[8] *in point 3.1.4 (Topic 3f – Financeability test in the IMs) stated that " We disagree with the Commission's decision not to include a financeability test in the IMs. The Oxera report provides the detailed analysis and recommendations supporting this view. This submission summarises the findings of the report and supports the findings with examples from other supporting work. We ask that the Commission refer to the Oxera Report of the full analysis.*

We disagree that the Commission doesn't need to apply a formal financeability test in the IMs because they can already have regard to financeability if they judge it's needed. We believe an objective application of the financeability test is needed so as to ensure networks consistently and objectively can practically fund their investment requirements and the debt allowances needed to do this are adequate".

We support Wellington Electricity's view and believe that the Commission needs to do more work on modelling the effects of financing shortfalls, by fully considering the impacts on EDB's cashflows in the Commission's drat decision in respect of financing EDB's activities, before making a final decision that the proposed draft settings adequately compensate regulated businesses going forward.

Effectiveness improvements to revenue path wash-up mechanism and revenue smoothing

15. Wellington Electricity's submission[9] in point 3.1.4 states that;

   i. *"We do not support the proposal for the Commission to specify the pace of drawdown of a wash-up balance within a regulatory period. This is unnecessary given the compliance limit, the revenue smoothing limit and the cap on the accelerated wash-up. EDBs are best placed to manage cashflow.*

   ii. *We note the need for more clarification around the purpose of the base wash- up drawdown and what criteria the Commission will apply when determining the value of the drawdown for each EDB. The Draft IM Decision does not provide enough information to provide informed feedback. The ENA submission also outlines concerns that this mechanism could come into conflict with the intent of the accelerated wash-up drawdown*

[8] https://comcom.govt.nz/__data/assets/pdf_file/0021/323175/Wellington-Electricity-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

[9] https://comcom.govt.nz/__data/assets/pdf_file/0021/323175/Wellington-Electricity-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

mechanism."

Orion agrees that we are better placed to manage our cashflow requirements and therefore should be in control of the pace of the drawdown to support the business. We also agree that the Commission should have provided more information on the criteria that the Commission will apply in advance of the final decision if it intends to include this in the IMs.

16. Contact Energy stated in their submission[10] under point 38 that, "*A more consumer centric approach would be to retain the current obligations on EDBs but put greater obligations on Transpower to share some of the burden of smoothing prices for consumers. For example, it may be appropriate to set a 'revenue smoothing limit' on Transpower that applies at a regional level, and better accounts for the volatility from the yearly re-openers*". The Commission has changed Transpower's RAB to be unindexed which will curb any price fluctuations being passed through. We therefore believe that the Commission has taken due consideration of the revenue smoothing by regulated businesses and that Contact Energy has not taken this into consideration in the above statement. Furthermore, we have seen that when regulated businesses (i.e. EDBs and Transpower) revenues were constrained or reduced during DPP3, the reductions were not necessarily passed onto end-consumers but rather reduced retailers' input costs thereby increasing their profit margins.

Reopener for new connections

17. PowerCo's response to the Commission's proposal to introduce a new connections volume wash-up mechanism for an EDB CPP, but not a DPP stated, *"The proposed connections wash-up could go further. There is increasing uncertainty about the demand for new and upgraded connections to our electricity network, and for this reason we have previously supported excluding connection capex from IRIS. This has not been reflected in the draft decision. A connection capex wash-up has been introduced for CPPs but not for DPPs."* Orion agrees that this mechanism could go further and have also submitted on this previously to include this in DPPs. The Canterbury region has seen enduring exponential growth compared to some other regions following the Canterbury earthquake. We believe that a volume wash-up mechanism

[10] https://comcom.govt.nz/__data/assets/pdf_file/0015/323115/Contact-Energy-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

may better support areas of higher regional growth.

Reopener timeframe

18. In addition to Wellington Electricity, PowerCo also submitted[11] that "*The mechanism (timeframes, staging) could be implemented outside the IMs e.g., as a guideline. Having an IM requirement (commitment) to produce and follow the guideline would be advantageous. Either way, we encourage the Commission to set timeframes based on what a great customer outcome looks like. This could be as simple as defining a target date by which the applicant can expect to hear back from the Commission.*

    Release valve mechanisms can be built in to address circumstances when resources or other reasons mean achieving the target is not possible (like Part 6 of the Code)."

    Orion agrees that the Commission also forms part of the process in delivering great customer outcomes to consumers and that having Commission response timeframes to deliver solutions coupled with the uncertainty going forward will support the Commission's intent.

19. Wellington Electricity's submission[12] point 5.2.5 stated that "*We disagree with not having timeframes. New Zealand decarbonisation will be directly reliant on the speed at which EDBs can provide more capacity to support electrification. EDBs are expected to provide delivery timeframes that customers can then incorporate into their own delivery timetables. An application process reflects a significant proportion of a delivery timetable and will also have to be included in a work programme to allow customers to allocate their project resources to when they are needed.*"

    Orion also submitted on the timeframes; however we further support Wellington Electricity's position regarding setting timeframes. The Commission is part of the process when it comes to flexibility and assisting regulated businesses to respond in a timely manner to customers' needs. This was reinforced in FlexForum's submission to the draft decision.

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[11] https://comcom.govt.nz/__data/assets/pdf_file/0019/323155/PowerCo-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

[12] https://comcom.govt.nz/__data/assets/pdf_file/0021/323175/Wellington-Electricity-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

20. Horizon mentions in their submission[13], point 22 that *"Additionally, the process to apply for a reopener, level of information and timeframes for the Commerce Commission to consider a reopener application remain unclear. This uncertainty makes it difficult for EDBs to make informed decisions regarding how to handle necessary and efficient expenditure that has not been allowed for within a DPP".*

We therefore urge the Commission to consider providing more clarity on the level of information and provide timeframes for reopener applications.

Network utilisation key to decarbonisation

21. We refer to Counties Energy submission that raises one of the key issues which needs addressing during the energy transition and a well-known investment driver for EDBs. Once again, it also relates to demand growth (ICPs) which Canterbury has experienced over recent years. Counties stated that *"The IM Review should consider refining the investments category "Demand growth: investments to meet current and future consumer demand" to "Peak demand growth: investments to meet consumer demand that occurs during peak demand periods"*.

We consider that the Commission and its processes and rules, should be an enabler to ensure that there is adequate provision made for EDBs to respond when consumers need us to build extra capacity, this is not only for 10MW connections under the Large Connection Contract mechanism.

Large Customer Contracts (LCC)

22. Contact Energy[14] stated in their submission that LCC's should be abandoned on the basis that;

"11. The Commission justifies this on the basis that large customers have 'significant bargaining power'. There is no evidence to support this assertion. The reality is that it will give substantially more power to EDBs in an already lop-sided relationship."

Customers do have power in their relationship with EDBs. For instance, we have heard of a larger customer who clearly stated that they would bypass an EDB and connect directly to

[13] https://comcom.govt.nz/__data/assets/pdf_file/0018/323136/Horizon-Energy-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

[14] https://comcom.govt.nz/__data/assets/pdf_file/0015/323115/Contact-Energy-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

Transpower if the EDB were not able to connect them on appropriate terms. We therefore do not agree that LCCs will "unleash a fully unregulated monopoly", as they mention, and there is evidence to support the Commission's justification. Orion believes that the LCC's will provide flexibility and the Commission should proceed with the LCC's in the final decision.

23. We support point 16 of MEUG's submission which states:

"16. MEUG welcomes the introduction of the large connection contract mechanism for EDBs. We believe that this mechanism will be beneficial for both regulated EDBs and their consumers as:

a) It provides a timelier option and process for customers looking to enter into large contracts with EDBs, whether to support decarbonisation activity (fuel switching to electricity) or business growth / expansion. The timeframe is dictated by parties involved, not the regulator, therefore better meeting consumer needs.

b) It addresses the expenditure uncertainty that has been raised by numerous EDBs.

c) It is modelled off an existing mechanism – Transpower's new investment contract mechanism (NIC). This is a known mechanism and creates a more even playing field when large customers are considering where to connect into the electricity system (transmission or distribution network).

d) Ensures that costs attributable to a particular party are not recovered across the broader customer base in a EDB region."

We believe that the LCC will support flexibility to some extent and timeliness when large customers approach EDBs and EDBs have not been given advance notice to include such connections in their Asset Management Planning or forecasts ahead of DPP resets.

24. Meridian mentioned in their submission[15] that "*In our experience, even large consumers have little or no negotiating power in respect of new connections. The choice to connect to any given network is largely driven by the existing location of assets and supply chains. There is seldom a choice between competing networks and, if unrestrained, distributors have the ability to dictate pricing for a new or upgraded connection…. One option could be to make the large connection contract mechanism an option that the distributor and connecting customer could negotiate, while retaining the existing approach for new connections as a backup. This would ensure that if a consumer had no power to negotiate reasonable terms they could still ask for the connection assets to be included in the regulated asset base of the distributor, potentially requiring a reopener in some cases*".

    Orion cannot comment on Meridian's experience of customers not having negotiation power and there are instances where location plays a role in the provision of electricity regarding assets to supply a specific site. We see value in their comment to retain the existing approach to a new connection as a backup and if necessary, having a reopener if need be.

Flexibility with the review of the IMs

25. Electra stated in their submission[16] that "*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." In their closing comments they mention that "*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."*

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[15] https://comcom.govt.nz/__data/assets/pdf_file/0017/323144/Meridian-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf
[16] https://comcom.govt.nz/__data/assets/pdf_file/0019/323119/Electra-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

Orion agrees that monopolies need to make more of an effort to innovate than competitive businesses and that EDBs are capital intensive. Orion has put significant effort into innovation and exploring flexibility services which will be ongoing into DPP4. We believe that the Commission has taken a conservative approach to the review in general and to innovation in particular. Further consideration needs to be given to ensure a fit for purpose regime developed in the final decision to support New Zealand's decarbonisation journey.

26. Drive Electric[17] provided statistics on EV uptake in point 17, stating that "*EV uptake is accelerating beyond government expectations. In June 2020, 2.3% of light vehicles registered in New Zealand for the first time were plug-in vehicles. Just three years later, the average monthly market share of EVs is 12.6%.[6] The Climate Change Commission's analysis suggests that by 2030 67% of cars entering the New Zealand market will be EVs*."
A 67% penetration rate will impact electricity networks necessitating combinations of optimising the existing network (for instance through off-peak pricing and demand management) and investment. We need to ensure that we have the appropriate mechanisms in the IMs to address this, should this uncertainty eventuate.

27. *"The FlexForum[18] considers the IMs process will realise long-term benefits for consumers if it delivers these four outcomes:*

    1. *Improves the understanding of, and confidence in, the IMs by flexibility suppliers, owners of flexible resource, and anyone who isn't a network operator.*

    2. *Effective and accessible incentives for network operators to invest in innovation and non-traditional solutions (including flexibility) to support efficient electrification and decarbonisation, especially in the short-to-medium term as solutions are developed.*

    3. *Ensures network operators have effective incentives to make the appropriate investment decisions in the long term.*

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[17] https://comcom.govt.nz/__data/assets/pdf_file/0018/323118/Drive-Electric-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

[18] https://comcom.govt.nz/__data/assets/pdf_file/0020/323129/Flexforum-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

4. *Ensures the IMs enable agility so the Commission and network operators can respond to fast-evolving consumer needs."*

Orion appreciates the work which FlexForum is doing in bringing together industry participants to collaborate on innovation and stimulate flexibility across the energy sector. We support the above statement which is in the long-term benefit of consumers and believe that the IMs need to take into account the role which regulated businesses have to provide effective incentives to support fast-evolving consumer needs and the decarbonisation transition.

28. *Mercury stated in their submission*[19] *that "With respect to the regulatory framework required to enable this investment, BCG*[20] *also highlight:*

"Today's just-in-time approach to transmission and distribution network investment won't be suitable for the expected rapid electrification and renewable generation development. The existing regulatory system supports just-in-time investment decisions in a relatively stable environment, waiting as late as possible to achieve confidence before each increment of investment. However, with rapid electrification and renewable generation development on the horizon, a significant increase in network investment is needed under conditions of higher uncertainty, ahead of time. Late investment will stall low-cost renewable generation development and electrification, increasing emissions and net prices for consumers.

In other words, climate change, electrification, and government policy are resulting in changes across the energy sector that are more significant than an incremental growth in network capacity.

For instance, BCG's forecast growth of 30% in distribution network investment in the period 2026–2030 compared with 2021–2025 is not incremental. This investment, as highlighted above, is expected to be made under conditions of higher uncertainty and ahead of time – i.e. ahead of demand."

[19] https://comcom.govt.nz/__data/assets/pdf_file/0016/323143/Mercury-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

[20] https://web-assets.bcg.com/b3/79/19665b7f40c8ba52d5b372cf7e6c/the-future-is-electric-full-report-october-2022.pdf

Orion agrees that the sector will be facing increased investment for rapid electrification at the Low Voltage network level for in-fill housing and both LV and HV levels for replacement of other fuel types with electricity. We also see that government policy is driving a shift to electricity including through targeted incentives (GIDI fund), and compliance costs are increasing due to these policies. If the BCG is correct then the IMs, in conjunction with the next DPP reset need to be fit for purpose to support a 30% growth in EDB investment.

29. We appreciate that uncertainty in consumer demand has been a concern from the Commission. We therefore also recommend that the Commission review the supply side or generation pipeline of Transpower's (Connection Enquiry Dashboard)[21] to ensure that both grid and local networks have adequate capacity, to deliver the electricity generated to consumers of that electricity.

Conclusion

30. Thank you for the opportunity to provide this feedback and information. We do not consider that any part of this feedback is confidential. If you have any questions please do not hesitate to contact me.

Yours sincerely

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[21] https://www.transpower.co.nz/connect-grid/connection-enquiry-information