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Keston Ruxton
Commerce Commission
Wellington

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

Dear Keston

Input Methodologies Review – Cross-submission on Problem Definition

1 This is Vector's cross-submission on the Commerce Commission's invitation to contribute to problem definition as part of the input methodologies review (IM Review). It may be publicly disclosed. Vector's contact for this submission is:

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2 We were pleased to see a number of other submitters share our view – and that of the Minister of Finance – that emerging technologies should be a key focus of the IM Review as their impacts are immediate, not future. As the Minister pointed out at the Competition Matters conference, lines companies risk becoming "relics of a bygone age" if they do not get ahead of the significant commercial risk facing them, and that policy-makers need to "reformulate what it means to regulate". This emphasises that there is a need for change now.

3 As outlined in our main submission, Vector is seeing a new competitive market that is driven by a new informed consumer. This consumer is experiencing increased, affordable access to innovative technology and energy services, which in turn is driving an unprecedented shift in the traditional boundaries between generation, grid operation, distribution and retail, as well as creating new boundaries as new entrants enter the market. At the same time, consumers will have an added incentive to invest in new technologies if their costs continue to increase through proposals such as the Electricity Authority's recent transmission pricing methodology.

4 In the context of this increasingly competitive and dynamic market, the challenge for the IM review will be to achieve a proper balance of risk between suppliers and consumers and ensure that balance is maintained as the market continues to change and customers continue to require high levels of reliability and security.

5 As Vector noted in its Annual Results announcement last week, the impact of market changes may necessitate the regulatory regime for energy networks, and in particular Auckland's networks, needing to evolve (possibly outside the scope of the Commission's review). Vector is seeing significant growth in its Auckland energy network, with a forecast \$1.8 billion of capital investment required. To

invest in our networks, Vector needs confidence that the regulatory environment will enable us to recover our capital and earn a fair return.

- 6 It is imperative that a robust examination of energy markets is undertaken so that input methodologies are responsive to rapidly changing market circumstances. The impact of changes in risk profile and risk allocation on the ability and incentives of regulated suppliers to invest should be a key issue for the IM Review. In particular, we believe focus needs to be directed to:
 - a. More flexible cost allocation methodologies will be needed as boundaries between competitive and monopolistic market segments blur and change over time, challenging current regulated capex and opex allocations. For example new technologies beyond the meter may deliver significant network benefits and flexibility is required to ensure the costs of those investments are allocated appropriately.
 - b. Changing standards for what can be included in the RAB, as flexibility will be needed to accommodate new types of investment. Also the rationale for indexation which pushes cash flows to the end of asset lives will need serious consideration as the ability to recover those cash flows over the medium to longer term will become more and more unlikely. Uncertainty of cash flow in turn leads to credit rating issues impacting supplier costs and also needs consideration in the review.
 - c. Changes to depreciation, as shorter economic asset lives may require bringing cost recovery forward to enable full recovery and to appropriately share costs with current consumers.
 - d. Incentives of when and how to invest need to incorporate a broader range of market risks and investment options. Incentives need to drive the right investment i.e. the investment that will benefit consumers in the long term and not the investment that is merely reflective of past practice.
 - e. The effect forecasting risk has on suppliers' revenue where actual volumes and outturn CPI are significantly lower than forecast.
- 7 Much attention in submissions has been placed on the potential alignment of cost of capital across a DPP and CPP determination (an issue the Commission intends to fast track). Vector is concerned that the DPP/ CPP WACC divergence issue may merely be a symptom of a more fundamental volatility issue with how cost of capital is currently calculated. Given the importance of the cost of capital IM to the regulatory regime and the emerging thinking of the Commission evident from the Chorus UBA process, we consider it critical that the Commission examine whether a problem exists around the volatility in cost of capital, whether such volatility is consistent with best practice regulation observed internationally, and ultimately whether the current cost of capital IM best promotes the objectives of Part 4, in particular in respect of promoting investment.
- 8 As the review process moves from its problem definition phase into consideration of options or alternatives, we think there is an onus on the Commission to actively consider options which can be demonstrated to adhere to core regulatory principles. For example, Vector has highlighted the increasing challenge of back-ending cash flows on long-life assets in face of growing uncertainty around full recovery. The ability to adjust cash flow profiles, while absolutely continuing to

deliver on the NPV=0 principle, appears to Vector as a relatively uncontroversial example of how IMs could be reconsidered in ways that mitigate some of the risk of long life assets in rapidly changing markets.

- 9 The spectrum of submissions received by the Commission demonstrates that there is no unified view across the industry about the importance of emerging technology in the current review, and it is unlikely that a unified view will emerge anytime soon. The lack of consensus over the timing and extent of the impact caused by emerging technologies reflects acute uncertainty, which itself is a matter that the IM review needs to take into account.
- 10 Some submissions suggest that the Commission should focus on incremental changes, as this may promote greater certainty for the sector. We strongly disagree with this approach and believe there is a strong case for the Commission to be bold. The changes facing the sector are significant. In the face of such dramatic changes incremental reform may simply not be appropriate. For the IMs to function effectively in the dynamic environment they will need to adapt, sometimes in potentially far-reaching ways. The Commission's function under s 52Y is to review and amend the IMs on the merits for proposed reform. We encourage the Commission not to forego needed reform on the basis of a predisposition towards incremental change.
- 11 In a similar vein, a "wait and see" strategy will often not be the most risk averse approach for the Commission to adopt. If a static approach to IMs prevents the development of dynamic efficiency gains that can be shared with consumers, then overall consumer and economic welfare is likely to be reduced. The Commission should recognise that a highly uncertain environment will prevail, which will require the Commission to look at how flexibility can be brought into the IMs.
- 12 We acknowledge that different suppliers will be affected in different ways due in part to their ownership, market conditions specific to each supplier and their different strategic responses. Vector is experiencing significant growth and change compared to other regions and believes an important consideration for the IM Review will be the appropriateness of a "one size fits all" regulatory framework in the context of an industry where growth and innovation are occurring at such widely varying rates. We do not see CPPs being a credible mechanism to deal with differing timings and impacts of the changing market on different suppliers.
- 13 Finally we note that some submissions went into detail about discrete matters submitters felt needed changing within the current IMs and posing solutions to those matters. We do not address any of those here – either in support or otherwise. We consider it important to clearly define problems at this stage as there will be time for detailed analysis of those identified problems later in the process.

Yours faithfully
For and on behalf of Vector



Richard Sharp
Head of Regulatory