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Dear Mr Gunnell

Part 4 Input Methodologies Review 2023 – Process and Issues paper and Draft Framework cross submission

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to make a cross submission in response to the Commerce Commission's (**Commission**) "*Part 4 Input Methodologies Review 2023 – Draft Framework*" and "*Part 4 Input Methodologies Review 2023 – Process and Issues paper*" published on 20 May 2023. This cross submission refers to the papers as the "**Draft Framework**" and "**Process and Issues Paper**" respectively.

Stakeholder submissions were substantively aligned about what key issues should be addressed in the IM review. This is a reflection of the Commission's process to date which started with the early identification of what future regulatory settings should look like in last year's consultation and follow-up workshop. We thought the Commissions did a good job of identifying where the IMs may need to change in response to changing external factors.

Submissions provided several new topics we believe should be addressed in the IM review and included new aspects to our own submissions points that we think are important to highlight. Submissions also suggested topics which we believe have already been extensively debated in previous IM reviews which do not need readdressing again. Submissions agreed that the Emissions Reductions Programme (**ERP**) will drive a step change in investment and the regulatory framework will need to change to support this investment – it will be important to focus the Commission's and industry resources on these changes, and not to be distracted by topics which have already been settled.

2. Draft Framework

It was pleasing to see stakeholders supported continuing to using the review framework in its current format – this will provide a well understood and robust basis for assessing any potential changes. We also note that all submissions recognised the impact the ERP will have on the industry and many submissions favoured making consideration of the 5ZN of the Climate Change Response Act 2002 (CCRA) mandatory and not an optional consideration.

Chorus and Powerco provided a sensible reminder of the importance of predictability and stability in the regulatory settings and that changes should only be made that are necessary and will make a material difference. Regulatory certainty is important for maintaining investor confidence and for attracting the additional investment needed going forward.

Vector provided an additional example to our submission point of including a financeability test to the FCM principle[1]. Vector highlighted that RAB indexation maybe creating large differences between the regulatory allowances and cashflows, potentially impacting solvency and a networks ability to invest. For this example, we support Vectors view that an EDB should be given a choice whether to index their RAB, providing another tool to manage EDB cashflows.

We also support Vector's submission points relating to incentivising efficiency – that the past focus has been on 'static' efficiency to reduce costs and prices. Networks will now need to make new investments to deliver a step change in demand, using a mix of traditional wire solutions and new non-wire solutions. Future distribution prices should be a product of networks making efficient long-term investment- '*investing in the right things at the right times'*. This may mean higher short-term prices from investing now, to enable lower long-term prices. We agree with Vector that '*failure to appropriately promote dynamic efficiency will significantly undermine the long-term benefit of consumers*'.

We agree with First Gas and Unison that the pace of change in the industry means that it's unlikely that this IM review will make all of the changes needed to support price path resets and applications up until the next review in 2030. We believe that the Commission should consider more frequent reviews, potentially every five years inline with the DPP resets.

3. Process

We agree with Unison, Vector, First Gas and Aurora, that some of the key topics are complex and the process going forward should be expanded to include workshops addressing specific issues, using topic experts. The issues identified could lead to substantive changes and we agree with these submissions that detailed discussion using industry experts will be needed to develop and recommend options for the Issues Paper and Draft Decision.

We though Aurora's suggestion of developing a framework of future demand and service scenarios that networks would need to accommodate, could be a useful tool to test what regulatory changes might be needed. We have used a similar approach with our own long term network modelling (we presented a selection of this work in the case studies provided in our submission). An industry wide scenario framework would capture the range of network specific demand and investment profiles.

[1] While a regulatory mechanism may maintain ex-ante real financial capital maintenance from an economic viewpoint, the timing of the resulting revenue and cashflows may not allow a network to maintain its financial solvency. A financeability test would ensure an EDB has the cashflows to remain solvent and make necessary investment.

Applying the current regulatory framework to the scenarios would highlight any limitations and could be used to prioritise the issues that need addressing.

Aurora's scenario framework could also be a good tool for assessing the materiality of any changes proposed. Applying a materiality threshold could be used to help maintain the balance between regulatory certainty and ensuring the regulatory framework remains fit for purpose.

4. Issues to address in the IM review

Submissions were generally aligned with what the key issues are and what aspects of the IMs should be reviewed. We do disagree with some submissions that suggested the calculation methodologies for some WACC inputs need reviewing. The WACC calculation methodologies have been extensively debated and reviewed as part of previous IM reviews. We believe the methodologies should only be reviewed again if changes in economic and industry conditions now mean the methodologies are no longer fit for purpose.

4.1. Efficiency and innovation and significant expenditure increases to date

Submissions from Electricity Distribution Businesses (EDB's) were generally aligned in their concerns around the productivity analysis provided in the Process and Issues Paper – for multiple reasons, the simple productivity analysis and metrics used do not provide an accurate measure of productivity.

Unison's submission provided an important additional point that simple productivity measures, like absolute expenditure levels, do not take into account the infrastructure life cycle. Using the Commissions productivity metrics, declining expenditure will show improved productivity, where in reliability it could indicate an under investment in the network. Unison used the under investment in the water sector as an example of this.

4.2. Efficiency and innovation and the transition to increased electrification

Submissions for most stakeholder groups recognised the need for the IMs to support more innovation. We note stakeholders representing customers or those that are customer facing (Amazon Web Services, Consumer Advocacy Council, Cortexo/Our Energy and Meridian) also supported the need for more innovation, specifically noting the need to develop flexibility services. Those submissions recognised the significant long-term customer benefits flexibility services could provide and the level of research and development needed to develop them.

4.3. Incentive mechanisms to improve expenditure efficiency for EDBs and Transpower

The IRIS is the central mechanism for promoting efficient expenditure, a core objective of Part 4 regulation. Submissions from EDBs were aligned in their concerns about the operation of the IRIS in its current form. The importance of the IRIS in promoting Part 4 and the issues highlighted in the submissions, confirm our view that a review of the IRIS should form a central part of the IM review. The complexity of the IRIS and its interaction with the wider regulatory framework also make the IRIS a good topic for more detailed workshops using subject experts, as suggested in our feedback about the IM review process.

4.4. Form of control (short-term demand risk)

The revenue cap for distribution services was supported by stakeholders, with submissions focusing on refining the 10% cap on the washup amount allowed each regulatory year. We believe the IMs should focus on the suggested refinements to the revenue cap. The form of the treatment of short-term demand risk for distribution services does not have to be re-addressed.

4.5. Long term demand risk

We submitted that the risk of stranded assets due to declining volumes on the Wellington network is low and that more of the long-term demand risk should not be shifted to suppliers as customers would then pay a premium for a risk that seems unlikely to eventuate.

Unisons submission highlighted the risk of stranded assets due to sea-level rise – a risk we had not included in our submission response. We agree with Unisons observation that the best approach is to leave the assets in the RAB so that they can be fully depreciated over time. We also agree with Unison that thought will have to be given to how the quality standards are treated for those assets. Customers may prefer to bear a lower level of quality than to pay more to replace or move the assets. The current quality reopener could provide a useful tool to make these types of quality adjustments.

4.6. RAB indexation and inflation forecasting

EDB submissions were consistent in their concerns about the impact of inflation forecast errors on a networks ability to earn real FCM. We agree with Unison's submission point that inflation and the possible solutions of indexing part or all of the RAB should be a key review topic.

We also note and agree with Chorus' submission point that the regulatory framework should ensure the first year of the regulatory period is adjusted for CPI. Under the current IMs, networks or customers will be exposed to differences between actual costs and allowances for the first year of the regulatory period.

4.7. Issues relating to the cost of capital

We believe many of the cost of capital issues have been debated in detail and the underlying calculation methodologies have been settled. Given the complexity of some of the other issues that need resolving, the Commission and industry resources should only focus on cost of capital issues where the current calculation methodologies are no longer fit for purpose. We do not believe that there have been economic or industry changes that have now require the following aspects of the WACC calculation to be re-examined:

- alternative mechanisms to the WACC percentile as suggested by MEUG.
- Splitting the WACC percentile – we agree with Transpower that the Commission's reasonings, from the 14/15 IM review, for maintaining a single WACC still hold.
- Calculating separate WACC for gas and electricity – we agree with Transpower that we will still face the same sample size issues when this issue was discussed in the 14/15 IM review.

Submissions did highlight aspects of the WACC calculation methodologies that could have been impacted by changes in the economic/industry conditions, and would be worth reviewing to ensure the calculation methods are still fit for purpose:

- The increasing reliance on electricity as New Zealand's primary energy source is increasing the impact of underinvesting. This suggests a higher WACC percentile might be appropriate.
- We agree with Unison and the ENA that WACC inputs should have a sensibility check to ensure volatile market conditions are not resulting in a WACC that doesn't reflect a fair market return that is consistent with comparable investments. Chorus suggested considering a total market return approach for estimating TAMRP, like that used by UK regulators. This might provide a cross check to the current approach of determining TAMRP.
- It is likely that more networks will need to apply for a CPP as ERP related investment programmes increase. The current approach of applying a WACC which aligns with the DPP regulatory period means that a CPP usually has to be re-set at some stage during the regulatory period to reflect the updated WACC (this is because the DPP and CPP periods may not align). We agree with Transpower's suggestion of calculating a WACC to align with each CPP period. This would allow an EDB to match their funding with a discrete CPP investment period. It would also avoid the complexity and uncertainty caused by resetting WACC mid regulatory period.
- Changing economic conditions and changes to banking rules has meant that the cost of raising debt has increased. We support Unison's comments that the current approach of using a historic debt premium (which can be up to 10 years old by the end of a regulatory period) means that the debt allowances may not align with actual debt costs.
- We also agree with Unison's submission point that the increasing investment programmes (driven by the ERP) will mean that networks are likely to have to raise additional equity as they approach their debt lending limits. Currently the allowances do not provide funding for raising equity.

4.8. CPPs and in-period adjustments to price-quality paths

Submissions supported our view that changes are needed to the overall regulatory framework that allows investment profiles to flex and adjust to changes in the underlying investment drivers. This could mean a different approach to the current DPP/CPP model of discrete, ring-fenced price paths based on five-year regulatory periods. We believe that the size of the ERP related investments and the inherent uncertainty of those investments makes this a priority issue for the IMs.

Various EDB's, Gas networks and Transpower recognised the impact of the ERP on energy demand and investment profiles. Submissions also supported developing new regulatory mechanisms that could flex in response to the underlying uncertainty of the demand forecasts. Submissions suggested several additional (additional to our original submission) regulatory mechanisms that we think could be worth considering:

- Vector suggested applying reopeners, like those used in Ofgems RIIO-ED2 draft determination, for expenditure that is too uncertain to include in a price path. The reopeners were for decarbonation related investment, digitisation, cyber resilience and DSO – all topics that EDB submissions have highlighted as new areas of investment that EDBs will need to make.

- Transpower discussed a ‘dynamic uncertainty mechanism’ that would allow the price path to be adjusted automatically based on triggers set in their IPP. This type of trigger or contingent event could be useful for uncertain distribution investment programmes.
- Orion suggested uncertainty mechanisms used by Ofwat which uses a core price path which has the ability to be adapted over time.
- Mercury suggested using the Transpower “Major Capex’ net benefit test for large network investments. This could be a useful tool for streamlining a single issue CPP’s application or a large project reopener.

Different uncertainty mechanism would best suit specific types of investments. The complexity of this subject and the wide range of possible solutions would make this a good workshop topic using subject experts.

4.9. Other topics – support for the development of flexibility services

We note submissions from non-lines companies had a strong theme of regulatory support for the development of flexibility services. While submission points did not always relate directly to an IM change, we think the overarching message is important to keep in mind when reviewing the regulatory mechanisms – that there is significant customer value in using flexibility services and that development and investment is needed to make those services available as a non-wire solution:

- Mercury submitted that rules should be made to ensure non-wire solutions are considered as an investment alternative and that procurement is at arm’s length.
- Mercury supported the IMs providing allowances for purchasing performance data from meter providers – an essential input into better visibility of the low voltage network and for using flexibility services.
- SmartCo also commented on providing EDBs with access to meter data.
- Cortexo/Our Energy suggested changes to incentivise the development of flexibility services.
- The Consumer Advocacy Council also promoted the development of non-wire alternatives and supported more transparent disclosures around network constraints.

These submissions also highlight the importance of the Electricity Authority and the Commission working closely together. Many of the regulatory changes needed to accommodate smart DER and to facilitate the provision of flexibility services, are the accountability of the Electricity Authority but will need funding support via the Commission. Our submission provided details of the new costs that will be needed to support the development and provision of flexibility services.

Other topics – intergeneration risk sharing and insurance

As demonstrated in the case studies provided to support our submission, WELL has experienced a significant increase in insurance costs. We have had to find savings to fund the cost increase, and we have been considering reducing our insurance cover so that the insurance premiums better match the allowances provided. The current regulatory allowance calculations, which are based on historic cost data, are incentivising insurance coverage decisions to be made on the availability of allowances, rather than on what is the best natural disaster risk mitigation for customers (i.e. the right balance between insurance and customers funding network repairs post event)..

Unison's submission expanded on the issue of the regulatory framework not incentivising the most appropriate risk mitigation for customers. Unison commented that as insurance markets tighten and the likelihood of natural disasters become more likely, networks will need more flexibility to:

'*establish better risk transfer mechanisms to more effectively spread the costs of disasters more equitably over consumers over time'*.

We agree with the need to review how the risk of a natural disaster is treated and how mitigations (including insurance) are funded. The discussion should also be expanded to also include Increasing costs of climate change related damage - i.e. damage from increasingly severe storm events that do not reach the level of an natural disaster.

5. Closing

WELL appreciates the opportunity to provide a cross-submission on the Commissions Draft Framework and Process and Issues Papers. These consultations and last years '*Open letter—ensuring our energy and airports regulation is fit for purpose'* provide an important step in defining what the priority issues are – the key issues that need to be resolved to allow EDBs to continue to provide secure and reliable distribution services, at a price customer are willing to pay.

If you have any questions or there are aspects you would like to discuss, please don't hesitate to contact Scott Scrimgeour, Commercial and Regulatory Manager, at scott.scrimgeour@welectricity.co.nz .

Yours sincerely,

Greg Skelton

Chief Executive Officer