

Submission

18 July 2019

the **lines**
company

Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision

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connected**

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2 Summary

We thank the Commerce Commission (**the Commission**) for the opportunity for The Lines Company Limited (**TLC**), and other industry participants, to input into the process setting the default price-quality path that will apply to electricity distributors from 1 April 2020. We trust that our input is of value, and are happy to discuss with the Commission.

In this submission, we have focused on the Commission's assessment of TLC's forecast capital expenditure. We also comment on the recoverable cost for innovation expenditure.

It is important to TLC that the Commission recognises and allows TLC's forecast capital expenditure. The 2020-2025 default price-quality path (**DPP3**) expenditure is targeted towards improving the security, reliability, and risk associated with TLC's network. We consider that any reduction in forecast capital expenditure would compromise the reliability improvements that we can achieve over the coming years, which would limit our ability to comply with the Commission's quality standards.

In its draft decision, the Commission capped TLC's capital expenditure as it was not confident that TLC could deliver the increased expenditure forecast in its Asset Management Plan (**AMP**) (notwithstanding that the Commission considered that TLC's forecast level of expenditure, in some cases, was justified by information in TLC's AMP). It is our view that these concerns reflect our delivery performance before 2018. In particular, in the absence of the 2019 actual expenditure information, TLC failed the Commission's proposed forecasting accuracy test (Gate 1), which resulted in the Commission scaling TLC's forecast capital expenditure to 77% of that contained in its 2018 AMP. Including 2019 actual capital expenditure (as is intended in the final decision) results in TLC passing the Gate 1 test, and as a result, no scaling should be applied to TLC's capital expenditure.

Importantly, we have improved our expenditure delivery processes, and our recent delivery is greater than the average expenditure on assets forecast in our 2019 AMP over the DPP3 period. Based on our recent performance, the Commission should no longer have concerns about our ability to deliver the capital expenditure plan, and hence (and notwithstanding the favourable assessment that we believe will result in the final determination), we consider there is no reason for TLC's forecast capital expenditure to be reduced.

Finally, in respect of the innovation recoverable cost, we are supportive of the proposal in principle; however, we believe the size of the funding as currently proposed will be insufficient for small distribution businesses. We consider that the Commission's approach will be enhanced by applying a "floor" to the recoverable cost. In our opinion, setting a minimum level for TLC of \$200K or, approximately 0.5%, would properly incentivise innovation. Providing a "floor" to the innovation recoverable cost will enhance compliance with the purpose statement by ensuring *all* distributors *"have incentives to innovate..."*.

3 Introduction

3.1 This submission is focused on TLC's capex allowance

This submission is focused on the Commission's assessment of TLC's forecast capital expenditure. We believe that it is important that TLC is allowed its 2019 AMP forecast capital expenditure as our capital plans are focused on improving the security and reliability and risk associated with the network.

In our 2018 and 2019 AMP, we set out the basis for our capital expenditure plans^{1 2}. In our 2019 AMP, we quantified the improvement in reliability associated with each of the five focus areas for the AMP Update.³ Four of these focus areas require significant capital expenditure, and the targeted reliability improvement for these initiatives amount to a reduction in SAIDI of 53 minutes per customer.⁴

We believe that the Commission allowing TLC its 2019 AMP forecast capital expenditure is consistent with the purpose statement⁵, in particular, to "provide services at a quality that reflects consumer demands". That is, any reduction in our forecast capital expenditure would compromise the reliability improvements that we can achieve over the coming years. We believe that this would compromise our ability to provide services at an appropriate quality and would increase the risk that we would not comply with the Commission's quality standards.

3.2 We discuss the new recoverable cost for innovation expenditure

The Commission is proposing a new recoverable cost to incentivise expenditure on innovation. We are supportive of the proposal in principle; however, we believe the size of the fund will be insufficient as an incentive, particularly for smaller distributors. That is, for TLC, 0.1% of distribution revenue equates to circa \$35,000 per annum. This is insufficient when considered against the scale of investment required for the types of projects under consideration by distributors, and the "overhead" cost associated with the independent engineer's certification.

3.3 We endorse the Electricity Networks Association (ENA) submission

As a member of the ENA, we have contributed to and support the submission made by the ENA about the DPP3 draft decision. In this section, we have highlighted the areas and issues raised by the ENA that have a material impact on TLC. We also highlight one area in the ENA submission, where TLC is proposing a different solution.

The areas where we have the greatest concern are:

- The Commission is under forecasting opex allowances (for reasons set out in the ENA submission). For TLC, our actual opex for 2016-2018 has been 7% greater than the Commission's DPP2 allowance for the same period.
- The planned interruption reference period. In further support to the ENA submission, based on our experience, we consider that the 5-year dataset (2015 to 2019) is generally consistent with current work practices, the impact of the Health and Safety at Work Act, and more consistent with current and planned expenditure levels;
- A planned outage window of 4 hours is too short. For TLC 65% of planned outages in FY2019 had a duration of greater than 4 hours;

¹ The Lines Company Limited, "2018 Asset Management Plan", 31 March 2018, section 5.

² The Lines Company Limited, "2019 Asset Management Plan", 31 March 2019, section 3.

³ The Lines Company Limited, "2019 Asset Management Plan", 31 March 2019, section 3.1.4, 3.2.4, 3.3.4, 3.4.4, 3.5.4.

⁴ The Lines Company Limited, "2019 Asset Management Plan", 31 March 2019, section 3.1.4, 3.2.4, 3.3.4, 3.4.4.

⁵ Commerce Act 1986, section 52A.

- The proposal to change the compliance standard to a single year test is not consistent with a 'no material deterioration' standard.

As noted in this submission, we support the Commission's recognition of the increasing importance of innovation in the way distributors invest in and operate their network. However, we propose a different solution to the ENA's innovation proposal. We believe that having company-specific innovation incentives is the most appropriate approach with the inclusion of a minimum level of funding, as outlined in this submission.

4 The Context for the Lines Company

4.1 TLC implemented significant governance and management changes during 2017-18

TLC has been through a considerable transformation since 2017-18, with a change in Board composition, new structure and appointments to the Senior Leadership Team, including a new Chief Executive. During this time, we developed a new business strategy to position TLC as a sustainable company for the future in the face of significant change across the electricity industry.

As part of this change, TLC's 2018 AMP⁶ underwent a significant update. The re-write of the AMP reflected the commencement of our continuous improvement programme to increase the maturity of our asset management activities⁷.

4.2 TLC's asset management focus outlined in its 2018 AMP

The key focus of the 2018 AMP was on reducing safety and reliability risks. The key programmes to support this risk reduction were:

- Increasing the renewal of distribution assets that presented high public and personnel safety risks;
- Improving network security and reliability of key substations;
- Undertaking a comprehensive review of our line renewal programme;
- Improving the deliverability of our work programme.

Our commitment to these programmes led to a material increase in forecast expenditure on assets (as shown in Figure 1). Between the 2017 AMP and 2018 AMP, total forecast expenditure on assets increased by \$14.6m over the DPP3 period. The material changes applicable to the DPP3 period were:

- An increase in consumer connection expenditure of \$1.7m, which reflects a 23% increase in forecast consumer connections (predominately rural connections);⁸
- An increase in system growth expenditure of \$4.6m, which reflects a 10% increase in forecast system demand.⁹ The significant new projects included in the 2018 AMP were the Whakamaru zone substation upgrade, the Waitete zone substation upgrade, and an alternative supply for Ohakune.¹⁰
- An increase in asset replacement and renewal expenditure of \$6.1m. The significant new programmes include an increase in 11kV and 33kV line renewals from 2025, the renewal of 11kV cables on Mt Ruapehu, and an increase in 11kV switchgear renewal.¹¹
- An increase in reliability, safety and environment expenditure of \$2.1m due to the commencement of the ground mount transformer safety renewal programme.¹²

⁶ The Lines Company Limited, "2018 Asset Management Plan", 31 March 2018.

⁷ The Lines Company Limited, "2018 Asset Management Plan", 31 March 2018, section 9.1. Our average AMMAT score improvement from an average of 2.0 to 2.4 between 2017 and 2018.

⁸ The Lines Company Limited, Information Disclosure Schedule 12c(i) (comparison of the 2017 and 2018 disclosures).

⁹ The Lines Company Limited, Information Disclosure Schedule 12c(ii) (comparison of the 2017 and 2018 disclosures).

¹⁰ The Lines Company Limited, "2018 Asset Management Plan", 31 March 2018, section 5.3.3, Table 5.3.3.

¹¹ The Lines Company Limited, "2018 Asset Management Plan", 31 March 2018, sections 5.2.6 to 5.2.16 (33kV and 11kV lines), 5.2.30 to 5.2.33 (11kV cables), and 5.2.19 to 5.2.23 (11kV switchgear).

¹² The Lines Company Limited, "2018 Asset Management Plan", 31 March 2018, sections 5.2.27 and 5.2.28.

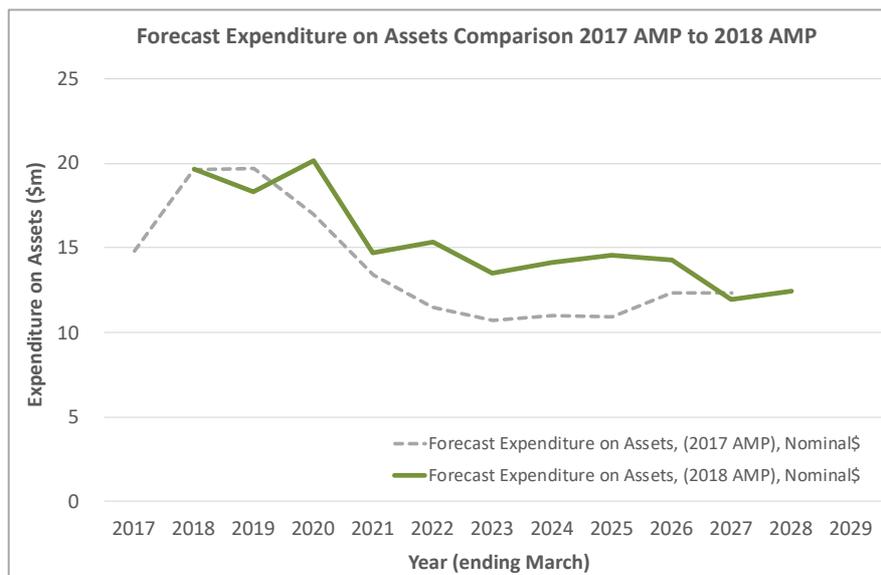


Figure 1: Forecast expenditure on asset comparison between 2017 AMP and 2018 AMP¹³

Improving the delivery of our works programme was also a focus of the 2018 AMP. The areas targeted for improvement included:

- Enhancing the delivery of work on the network assets through committing to quality, competency of teams, and efficient processes, as part of our Asset Management Policy;¹⁴
- Targeted improvement in work delivery processes;¹⁵
- Committing to employing four additional lines mechanic trainees;¹⁶
- Undertaking work using a mix of internal and outsourced service providers.¹⁷

4.3 TLC’s 2019 AMP Update included several changes to expenditure forecasts as a result of TLC’s continued focus on improving network security and reliability

In March 2019 we published a 2018 AMP Update that identified material changes to our 2018 AMP. The changes within the 2018 AMP Update related largely to the timing of projects and programmes within the 10-year planning period, with several projects and initiatives brought forward to ensure that the network achieves the required level of reliability, while other projects were delayed commensurate with risk (refer to Figure 3). The key changes to the 2018 AMP in relation to the DPP3 period included:

- An update to TLC’s security of supply standard that resulted in the reprioritisation of several security of supply projects that resulted in a \$5.6m increase in reliability, safety and environment expenditure. The key changes were the reinforcement of supply into the Turangi

¹³ Source: The Lines Company Schedule 11a for 2017 and 2018 (included with TLC’s published Asset Management Plans)

¹⁴ The Lines Company Limited, “2018 Asset Management Plan”, 31 March 2018, section 4.2 (item 8 of the Asset Management Policy).

¹⁵ The Lines Company Limited, “2018 Asset Management Plan”, 31 March 2018, section 1.6.1, 9.1.5 (Table 9.1.5 under Asset Management Team Development).

¹⁶ The Lines Company Limited, “2018 Asset Management Plan”, 31 March 2018, section 1.2.2.

¹⁷ The Lines Company Limited, “2018 Asset Management Plan”, 31 March 2018, section 5.9.

region, the purchase of new power transformers, and the expansion of the distribution automation programme;¹⁸

- An increase in system growth expenditure by \$3.2m. The material changes related to the timing of two major projects. The first was the capacity upgrade at Atiamuri and associated Whakamaru 33kV reconductoring with \$1.2m moving from 2020 to 2021. The second was the rescheduling of the 33kV reconductoring to Te Waireka from 2020 to 2021. These delays were a result of lower forecast load growth;¹⁹
- A reduction in asset replacement and renewal of \$4.2m over the DPP3 period as a result of optimising asset renewal based on our ongoing review of asset condition. The key changes were the increase in the replacement of cross-arm and insulators which was offset by a re-optimisation of pole renewal (the smoothing of the large increase in 11kV pole renewals that was to occur from 2024) and the delay in replacing the 11kV cables on Mt Ruapehu.²⁰

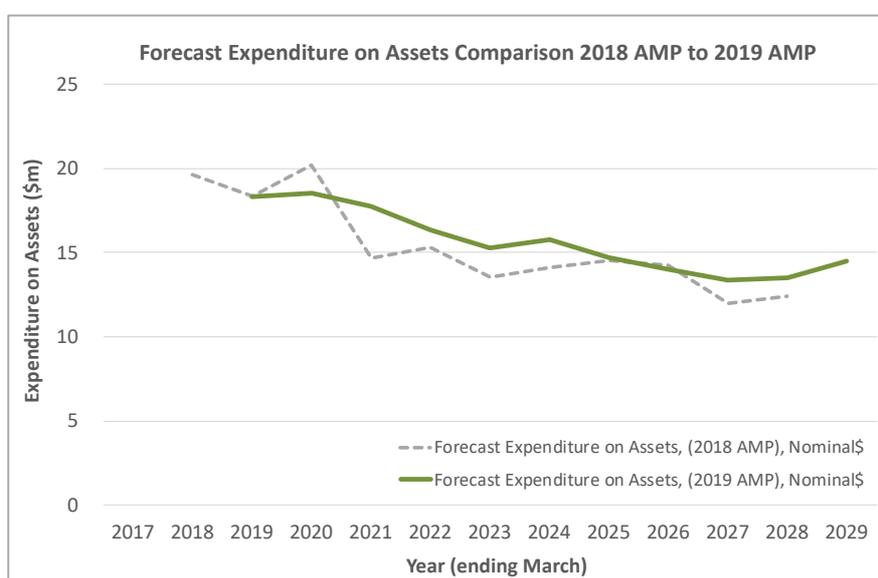


Figure 2: Forecast expenditure on assets comparison between 2018 AMP and 2019 AMP²¹

4.4 TLC’s expenditure on its assets increased significantly in 2018 and 2019

Following the implementation of the governance and management changes in 2017-18, we have been steadily improving the delivery of our works programme. Total expenditure on assets increased by 37% between 2017 and 2018 and increased by a further 61% between 2018 and 2019. The key reasons for the increase in delivery were:

- An increased focus on project management, contract management, and overall delivery programme governance through upskilling current staff and the use of specialist external Project Managers;

¹⁸ The Lines Company Limited, “2018 Asset Management Plan”, 31 March 2019, section 3.1, 3.2 and 3.3.

¹⁹ The Lines Company Limited, “2018 Asset Management Plan”, 31 March 2018, section 3.1.

²⁰ The Lines Company Limited, “2018 Asset Management Plan”, 31 March 2018, section 3.4.

²¹ Source: The Lines Company Schedule 11a for 2018 and 2019 (included with TLC’s published Asset Management Plans).

- The addition of four staff within the Asset Management Team allowing more accurate risk assessments, planning, design and project management of work to be delivered;
- The addition of six staff within the field service team to better match the predicted baseload of work with internal resourcing levels;
- An increase in the use of external service providers for specialist works and projects where project risk could be better managed by a third party. During 2019 approximately \$7.5m of work was completed by external service providers;
- The completion of an upgrade to TLC’s billing system (\$1.5m, non-network asset).

For 2020 we estimate that \$9.3m of work will be outsourced. To cater for the anticipated growth in external work, an additional service provider has been brought on to our preferred supplier panel.

We believe that our current level of work delivery is sufficient for TLC to achieve its forecast expenditure on assets included in its 2019 AMP. TLC’s recent average work delivered is 18% higher than the average annual expenditure on assets forecast in our 2019 AMP over the DPP3 period.²²

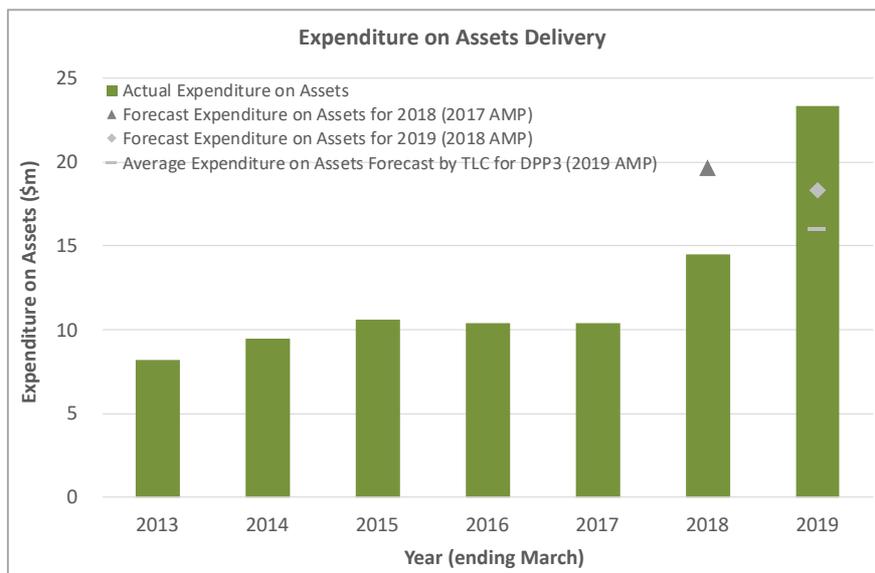


Figure 3: Expenditure on assets delivery²³

²² The average expenditure on assets delivered during 2018 and 2019 was \$18.9m, compared to the average forecast expenditure on assets during the DPP3 of \$16.0m (based on the 2019 AMP).

²³ Source: Information Disclosure for 2013 to 2018, Draft Information Disclosure for 2019.

5 Updating the Commission’s capex projections model with 2019 data

5.1 Summary of the draft decision in relation to TLC’s capital expenditure plans

In the Commission’s draft decision, TLC’s capex forecast acceptance rate was 77%.²⁴ The scaling of capex was primarily due to TLC’s failing to pass Gate 1 – forecast accuracy (refer table 1) as TLC’s average proportion of forecast to historic expenditure was 140%, against the proposed cap of 125% (refer table 2).

Failure of this test resulted in the scaling of TLC’s forecast expenditure to average historic levels across all capital expenditure categories (refer table 3). TLC’s capex category acceptance rates varied between 31% and 92%.²⁵

	Gate 1 - Forecast accuracy	Gate 2 - Consumer connections	Gate 3 - Consumer connection costs	Gate 4 - System growth	Gate 5 - Asset replacement and renewals	Sliding-scale cap for Asset relocation expenditure	Sliding-scale cap for non-network expenditure
Active EDB output	fail	pass	pass	pass	pass	200%	200%
Alpine Energy	pass	pass	pass	fail	pass	189%	200%
Aurora Energy	pass	pass	pass	fail	fail	200%	195%
Centralines	pass	pass	fail	pass	pass	200%	148%
EA Networks	pass	fail	pass	fail	pass	200%	195%
Eastland Network	fail	pass	pass	pass	pass	200%	200%
Electricity Invercargill	pass	fail	pass	pass	pass	200%	200%
Horizon Energy	pass	fail	pass	fail	pass	200%	200%
Nelson Electricity	pass	fail	fail	pass	pass	200%	200%
Network Tasman	fail	pass	pass	fail	pass	200%	200%
Orion NZ	pass	pass	pass	fail	pass	200%	200%
OtagoNet	pass	fail	pass	fail	pass	200%	200%
The Lines Company	fail	pass	pass	pass	pass	200%	200%
Top Energy	pass	pass	pass	fail	pass	200%	200%
Unison Networks	pass	fail	pass	pass	pass	200%	135%
Vector Lines	pass	fail	pass	fail	pass	200%	181%
Wellington Electricity	pass	pass	pass	fail	pass	200%	200%

Table 1: Gating output from DPP3 draft model

	Average proportion of forecast to historic expenditure
Active EDB output	140%
Alpine Energy	91%
Aurora Energy	99%
Centralines	122%
EA Networks	109%
Eastland Network	143%
Electricity Invercargill	94%
Horizon Energy	107%
Nelson Electricity	50%
Network Tasman	132%
Orion NZ	109%
OtagoNet	100%
The Lines Company	140%
Top Energy	91%
Unison Networks	101%
Vector Lines	111%
Wellington Electricity	110%

Table 2: Forecasting accuracy from DPP3 draft gating model

²⁴ Commerce Commission, “Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper”, 29 May 2019, Figure X7.

²⁵ Commerce Commission, “Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper”, 29 May 2019, Figure 5.10.

Distributor	Total capital expenditure acceptance rate (after 120% cap)	Asset replacement and renewals expenditure net of capital contributions	Consumer connection expenditure net of capital contributions	System growth expenditure net of capital contributions	Total reliability, safety and environment expenditure net of capital contributions	Other expenditure
Alpine Energy	100%	100%	100%	100%	100%	100%
Aurora Energy	41%	36%	100%	50%	100%	23%
Centralines	100%	100%	100%	100%	100%	99%
EA Networks	97%	100%	100%	91%	100%	100%
Eastland Network	81%	76%	100%	100%	96%	74%
Electricity Invercargill	92%	100%	38%	100%	100%	100%
Horizon Energy	98%	100%	100%	84%	100%	92%
Nelson Electricity	99%	100%	7%	100%	100%	100%
Network Tasman	35%	67%	100%	15%	100%	78%
Orion NZ	100%	100%	100%	100%	100%	100%
OtagoNet	91%	100%	61%	100%	100%	100%
The Lines Company	77%	81%	71%	31%	92%	97%
Top Energy	100%	100%	100%	100%	100%	100%
Unison Networks	100%	100%	100%	100%	100%	100%
Vector Lines	97%	100%	100%	85%	100%	100%
Wellington Electricity	91%	100%	100%	51%	100%	100%

Table 3: Capex acceptance rate from Commission's draft model

In its draft decision, the Commission noted that it capped TLC's capital expenditure as it considers that TLC's forecast level of expenditure, in some cases, was justified by information in TLC's AMP, but the Commission was not confident that TLC could deliver the increased expenditure.²⁶

The Commission stated that they were interested in any additional information distributors could provide to assure them about the deliverability of their investment plans.²⁷

5.2 Updates to the Commission's models to reflect 2019 actual expenditure and 2019 AMP forecast information

We have updated the Commission's capex projections models with our 2019 actual capital expenditure and 2019 AMP capital expenditure forecasts. The inclusion of this information materially alters the outcomes of the Commission's capex projection modelling.

We updated the Commission's draft decision capex projections models as follows:

- Overall and subcategory actual expenditure was updated with 2019 actual information;
- Forecast expenditure on assets and related subcategories was updated with the forecasts included in TLC's 2019 AMP.

These updates were consistent with the proposal by the Commission to:

- Forecast capex using distributor 2019 AMP forecasts for the final decision;²⁸
- Use 2013-2019 as the historical reference period for the capital expenditure assessment for the final decision.²⁹

²⁶ Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, Paragraph X49.

²⁷ Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, Paragraph X50.

²⁸ Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, DPP3 draft at a glance (Page 4) and Paragraph B63.

²⁹ Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, DPP3 draft at a glance (page 4) and Paragraph B92.

5.3 The change in the DPP capex model output after incorporating 2019 actual expenditure and 2019 AMP forecast information

TLC passes all the tests in the gating model

As a result of including the actual expenditure on assets for 2019 at 23,320 (\$000), TLC passes Gate 1 – forecast accuracy test, where TLC’s average proportion of forecast to historic expenditure is 120%, which is below the threshold of 125% (refer table 4). Actual expenditure on assets for 2019 was 61% more than the spend in 2018. The reasons for this increase in expenditure are discussed in section 4.4 above.

TLC’s acceptance rate for other expenditure subcategories is scaled to 98% as a result of TLC’s average proportion of forecast to historic expenditure for this category being greater than the 200% sliding-scale cap (refer tables 5 and 6). The level of expenditure capped is not material (c. \$36k in total over the DPP3 period) when considering TLC’s total capital forecasts.

	Gate 1 - Forecast accuracy	Gate 2 - Consumer connections	Gate 3 - Consumer connection costs	Gate 4 - System growth	Gate 5 - Asset replacement and renewals	Sliding-scale cap for Asset relocation expenditure	Sliding-scale cap for non-network expenditure
Active EDB output	pass	pass	pass	pass	pass	200%	200%
Alpine Energy	pass	pass	pass	pass	pass	189%	200%
Aurora Energy	pass	pass	pass	fail	fail	200%	195%
Centralines	fail	pass	fail	pass	pass	200%	148%
EA Networks	fail	pass	pass	fail	pass	200%	195%
Eastland Network	fail	pass	pass	pass	pass	200%	200%
Electricity Invercargill	pass	pass	pass	pass	pass	200%	200%
Horizon Energy	pass	fail	pass	fail	pass	200%	200%
Nelson Electricity	pass	pass	fail	pass	pass	200%	200%
Network Tasman	fail	pass	pass	fail	pass	200%	200%
Orion NZ	pass	pass	pass	fail	pass	200%	200%
OtagoNet	pass	fail	pass	fail	pass	200%	200%
The Lines Company	pass	pass	pass	pass	pass	200%	200%
Top Energy	pass	pass	pass	fail	pass	200%	200%
Unison Networks	pass	pass	pass	pass	pass	200%	135%
Vector Lines	fail	pass	pass	fail	pass	200%	181%
Wellington Electricity	fail	pass	pass	fail	pass	200%	200%

Table 4: Gating output from DPP3 draft gating model, following updating with 2019 actual and 2019 AMP data

	Average proportion of forecast to historic expenditure
Active EDB output	120%
Alpine Energy	97%
Aurora Energy	124%
Centralines	139%
EA Networks	127%
Eastland Network	152%
Electricity Invercargill	99%
Horizon Energy	119%
Nelson Electricity	54%
Network Tasman	155%
Orion NZ	115%
OtagoNet	121%
The Lines Company	120%
Top Energy	104%
Unison Networks	112%
Vector Lines	126%
Wellington Electricity	128%

Table 5: Forecasting accuracy from DPP3 draft gating model, following updating with 2019 actual and 2019 AMP data

Distributor	Total capital expenditure acceptance rate (after 120% cap)	Asset replacement and renewals expenditure net of capital contributions	Consumer connection expenditure net of capital contributions	System growth expenditure net of capital contributions	Total reliability, safety and environment expenditure net of capital contributions	Other expenditure
Alpine Energy	100%	100%	100%	100%	100%	100%
Aurora Energy	50%	43%	100%	58%	100%	56%
Centralines	99%	100%	100%	100%	100%	96%
EA Networks	97%	100%	100%	91%	100%	100%
Eastland Network	87%	83%	100%	100%	100%	92%
Electricity Invercargill	92%	100%	42%	100%	100%	100%
Horizon Energy	97%	100%	100%	79%	100%	96%
Nelson Electricity	100%	100%	100%	100%	100%	100%
Network Tasman	42%	69%	100%	24%	100%	79%
Orion NZ	100%	100%	100%	100%	100%	100%
OtagoNet	92%	100%	64%	100%	100%	100%
The Lines Company	100%	100%	100%	100%	100%	98%
Top Energy	100%	100%	100%	100%	100%	100%
Unison Networks	100%	100%	100%	100%	100%	100%
Vector Lines	98%	100%	100%	89%	100%	100%
Wellington Electricity	91%	100%	100%	52%	100%	100%

Table 6: Capex acceptance rate from DPP3 draft model, following updating with 2019 actual and 2019 AMP data

TLC passes the aggregate 120% cap

TLC passes the aggregate 120% cap test as its historic average capital expenditure is 12,896 (\$000) and its average forecast capital expenditure is 15,167 (\$000), resulting in a ratio of 118%, which is below the 120% cap.³⁰

³⁰ The Lines Company's own analysis.

6 Increasing the incentive to invest in innovation

6.1 The Commission is proposing a new recoverable cost for innovation expenditure

The Commission is proposing a new recoverable cost to incentivise expenditure on innovation. The Commission recognises that the benefits of distributors' investment in innovation may not always accrue to them, may be uncertain, or may eventuate in future regulatory periods.³¹

The Commission is seeking to promote further innovation in a relatively low-cost way and are proposing a new limited recoverable cost term as a change to the IMs:³²

- 4.75 The proposed new recoverable cost term will:
 - 4.75.1 target expenditure on innovative projects;
 - 4.75.2 require a 50% contribution from the distributor;
 - 4.75.3 be limited to 0.1% of revenue (excluding pass-through and recoverable costs), which equates to approximately \$5m across all non-exempt distributors over the next regulatory period, excluding those currently on CPPs;
 - 4.75.4 require a report from an independent engineer that the planned expenditure meets a simple list of criteria to show that the proposed project is expected to be innovative and potentially benefit consumers; and
 - 4.75.5 apply to DPPs and CPPs.

6.2 Innovation is important to TLC

As discussed in section 4.1, TLC has developed a new business strategy to position TLC as a sustainable company for the future in the face of significant change across the electricity industry.

We believe that investing in innovation will be important for TLC to adapt and respond to the changes across the electricity sector.³³ Given our low customer density and relatively high distribution prices, we believe that our network will be at the "frontier" for the potential change and disruption in the use of the network.³⁴

Over the next few years, we are contemplating trialling a range of innovations that could have the potential to minimise the need for significant capital investment (to cater for changing consumer use of the network as distributed energy resources (**DERs**) penetration increases). The trials will relate to the integration of DERs, how EVs will impact our network, and how we could use metering (or other technology) to manage network demand to minimise future investment. The cost of the trials for the first year would be approximately \$150K, increasing to \$500K if a wider trial is pursued.

We are also contemplating an innovation investment of \$250k in relation to single-wire earth return (**SWER**) and 3 phase battery system trial, where 3 phase supply is not economic for a farm. This type of technology could be better value for consumers than using diesel generation to provide an enhanced service and quality for consumers in remote areas (where investment in core network assets is not economic). In total this would see an investment in innovation projects of \$400k proposed for FY20.

³¹ Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, paragraph 4.70 and 4.72.

³² Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, paragraph 4.74, 4.75, 4.75.1 to 4.75.5

³³ The Lines Company Limited, "2018 Asset Management Plan", 31 March 2018, section 2.1.2 and 2.3.4.

³⁴ TLC ranks as the 4th lowest density distribution business, with the fourth highest gross line charge (\$/ICP).

6.3 Our view on how innovation could be better supported by the Commission

We are supportive of the innovation proposal in principle; however, we believe the size of the funding will be insufficient as an incentive, particularly for smaller distributors.

For TLC, 0.1% of distribution revenue equates to circa \$35K per annum, which we believe is insufficient when considered against the scale of investment required for the types of projects under consideration and the expected compliance costs. In our opinion, this level of funding will have a limited impact on incentivising innovation when our proposed innovative technology trials cost, for this coming year alone, range between \$150K to \$400K (as outlined in section 6.2).

We believe that an enhancement to the Commission's approach would be to set a "floor" on the recoverable cost. In our opinion setting a minimum level of \$200K (half of the \$400k we are proposing to spend in FY20) would be sufficient to properly incentivise innovation, particularly in relation to smaller distributors.

For TLC, a recoverable cost of \$200K equates to around 0.5%, which we do not consider is material when considered against the size of distribution revenues and the importance of investment in innovation given the potential changes and disruption to the electricity industry.

It may be appropriate for the Commission to consider setting a "sliding" floor by limiting the maximum recoverable cost at 0.5% of distribution revenue to ensure the recoverable costs stay within a reasonable level of materiality.

The Commission raised concerns in relation to the size of the funding and compliance costs.³⁵ We consider that applying a minimum innovation recoverable cost of \$200K would provide a meaningful incentive for all distribution businesses and will overcome the risk that compliance costs diminish the value of the proposal and hence reduce its uptake.

The Commission also raised concerns that the recoverable innovation cost does not directly facilitate collaboration between industry participants.³⁶ We agree with this view. However, we consider that more weight should be given to incentivising *greater* innovation over the need to collaborate to minimise the deadweight cost to the economy (due to duplication in innovative projects). Also, while other distributors may invest in similar innovative technology trails (to the ones being considered by TLC), we consider that it is unlikely that these projects will reflect the attributes of a highly rural network similar to TLC. Hence, a collaborative effort may not provide learning that is applicable to all participants.

An option that the Commission has would be to allow a sliding scale dependent upon the size of the distributor. For example, smaller distributors may be allowed a 0.5% allowance per annum, while larger distributors could be assigned a lower percentage on a per annum basis.

We note in the Callaghan Innovation, "Driving Clean, Smart Energy and Radical Services Integration" presentation, New Zealand's 2016 R&D spend as a percentage of GDP was 1.28%, the OECD is 2.40%, and Denmark has double the researchers and three times more investment than New Zealand.³⁷ TLC believes that the Commission should consider this information with a view of promoting R&D and innovation by having a higher allowance.

³⁵ Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, paragraph 4.76.2 and 4.76.3.

³⁶ Commerce Commission, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper", 29 May 2019, paragraph 4.76.4.

³⁷ Vic Crone, Callaghan Innovation "Driving Clean, Smart Energy and Radical Services Integration"—presentation at Downstream 2018 conference.

6.4 Increasing the size of the recoverable cost for innovation expenditure enhances compliance with the purpose statement

We consider that providing a “floor” to the innovation recoverable cost, as set out above, enhances compliance with the purpose statement³⁸. Ensuring *all* distribution businesses have access to an innovation incentive that is sufficient to incentivise investment means that all distribution business “*have incentives to innovate and to invest, including in replacement, upgraded, and new asset*”³⁹. We believe that the current innovation recoverable cost proposal fails to satisfy this aspect of the purpose statement for all distributors.

7 Conclusion

In its draft decision, the Commission raised concerns about TLC’s ability to deliver its capital expenditure plans. These concerns reflect TLC’s delivery performance before 2018, and in the absence of the 2019 actual capital expenditure information, TLC failed the Commission’s proposed forecasting accuracy test (Gate 1). This resulted in the Commission scaling TLC’s forecast capex to 77% (the capex acceptance rate).

Based on 2019 actual capital expenditure, TLC no longer fails Gate 1, and hence the final decision (based on the methodology applied in the draft decision) will result in no scaling of TLC’s capex (except for some minor asset relocation capex).

Importantly, during 2018 and 2019, we have improved our capex delivery processes, and recent capex delivery is now greater than the average forecast expenditure on assets outlined in our 2019 AMP for DPP3. Based on this recent performance, the Commission should no longer have concerns about TLC’s ability to deliver its capital expenditure plan, and hence, we consider there is no reason for TLC’s capital expenditure forecasts for DPP3 to be scaled.

In respect of the innovation recoverable cost, we are supportive of the proposal in principle; however, we believe the size of the funding as currently proposed will be insufficient for small distribution businesses. We consider that the Commission’s approach will be enhanced by applying a floor to the recoverable cost. In our opinion setting a minimum level of \$200K would be sufficient to properly incentivise innovation, particularly in relation to smaller distributors. Providing a floor to the innovation recoverable cost will enhance compliance with the purpose statement by ensuring *all* distribution businesses “*have incentives to innovate...*”.

This submission has been prepared The Lines Company Limited and is authorised by TLC’s Chief Executive, Sean Horgan. Please direct all inquiries to:

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³⁸ Commerce Act, section 52A.

³⁹ Commerce Act, section 52A, (1) (a).