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21 December 2021

Dayle Paris
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565 Wairakei Road
Christchurch 8053

Dear Dayle

Re: Orion Innovation Allowance Application June 2021

Thank you for your letter response of 23 November 2021 to our letter of 15 November 2021.

We appreciate your endorsement of non-binding views from us on potential innovation allowance applications before an EDB submits a formal application or incurs substantial expenditure, particularly while the mechanism is new. We intend to publish the correspondence relating to this matter to further improve EDBs' understanding of the mechanism – unless you object due to commercial sensitivities.

We have considered your response to our non-binding view

We have considered your reasons for disagreeing with the non-binding view in our letter of 15 November, particularly on the matter of voluntary carbon offsetting falling outside the definition of 'electricity lines services' (**ELS**) under s 54C of the Commerce Act 1986 (**Act**). We note too the request in your feedback on our *Open letter – our regulatory priorities for energy networks and airports* for our view on the scope to include voluntary carbon offsets, like carbon credits and forestry, in the regulatory asset base.

Our view remains that voluntary carbon offsetting falls outside the s 54C definition of ELS. The reasons for this view are those outlined in our letter of 15 November – most important of which is that expenditure on voluntary carbon offsets is not expenditure on assets used, or costs incurred, in whole or in part, in supplying ELS.

Our non-binding view therefore remains that we would be unlikely to approve a drawdown amount for the offsets project under the innovation project mechanism of the *Electricity Distribution Business Default Price-Quality Path 2020*. It also means that the costs of the project should not be treated as regulated expenditure and should not be included in the regulated asset base if the project goes ahead without the innovation project mechanism.

We appreciate that Orion's proposed expenditure may bring decarbonisation and other benefits. Our non-binding view does not prevent Orion from continuing with that

expenditure. However, if that expenditure is not on assets used, or costs incurred, in supplying ELS, it cannot be recovered under the regulated price path.

Other areas of expenditure that fall outside the regulated electricity lines service

Your letter of 23 November listed other examples of expenditure that you consider we approve as regulated expenditure. We agree that, to the extent, for example, vegetation and traffic management relate to the supply of ELS, then their asset values and operating costs are regulated expenditure that can be allocated to ELS and recovered under the regulated price path.

However, like voluntary carbon offsetting, we consider that some of your other examples, such as corporate sponsorship and insulation funding for low income households, do not involve assets used or costs incurred in supplying ELS. Neither of these two examples involves assets used in the physical conveyance of electricity by line; nor do they amount to costs incurred in supplying ELS – such as office equipment and IT at an EDB's head office.

We have applied an established and tested approach to interpreting the definition of ELS

We extensively explored and tested with interested parties our interpretation of the s 54C definition of ELS in the *2015/16 Input methodologies review* (**IM review**). We considered submissions (including from Orion) on our pre-workshop paper covering this interpretation (*Topic 3 – the future impact of emerging technologies in the energy sector*). Our final decision in the IM review was to adopt the interpretation and approach we put forward in that pre-workshop paper.

In May 2018, we subsequently applied that interpretation in guidance we issued on the regulatory treatment of electric vehicle chargers' costs and revenue (see Attachment A of the *Open letter – Our intention to gather information relating to emerging technologies*). We sought submissions on our Open Letter, and, after considering them (including a submission from Orion), decided against revising our guidance.

The established interpretation and approach to the definition of ELS from the IM review and guidance on EV chargers underpins our non-binding view in this case.

We have issued further guidance, drawing on our established interpretation and guidance

We have provided further guidance on how to interpret the definition of ELS in an Attachment to this letter, which we will also publish separately on our website.

The guidance draws on our established interpretation of s 54C and previous guidance, focusing on the words of that provision and how they are given effect to via the cost allocation IMs. Expenditure on sponsorship or other community initiatives will generally fall outside ELS. Examples of such sponsorship or community initiatives could be sports teams and facilities, public swimming pools, home insulation programmes, community festivals, and art facilities.

In the future, we may consider taking a closer look at what expenditure regulated suppliers are treating as regulated expenditure. It is an essential part of our regime that costs outside the supply of the regulated service do not increase the price of the regulated service for consumers.

As noted above, we understand that some of these types of expenditure may be important and beneficial to the local community. Orion and its owner (and other regulated suppliers) are still able to support such community initiatives if they so choose, but they must not recover the costs from consumers through charges for ELS. This ensures that the ELS charges consumers pay reflect the cost of supplying ELS, and do not include costs that are solely attributable to unregulated goods or services.

Further engagement

We are happy to discuss our position with you further, as requested in your letter. We will contact you directly to arrange this.

Yours sincerely

Dane Gunnell
Acting Head of Energy, Airports and Dairy

Encl.

Guidance on s 54C definition of 'electricity lines services' under Part 4 of the Commerce Act

Attachment: Guidance on s 54C definition of 'electricity lines services' under Part 4 of the Commerce Act

1. Section 52 of the Commerce Act 1986 (**Act**) states that Part 4 of the Act "provides for the regulation of the price and quality of goods or services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition." Section 54E of the Act declares that "electricity lines services are regulated under [Part 4]".
2. Part 4 regulation therefore applies to electricity lines *services* (**ELS**); not to particular suppliers, or types of assets or activities. The boundaries of *what* we may regulate under Part 4 are therefore set by the definition of "electricity lines services" in s 54C.
3. This guidance discusses that definition and our established interpretation of it, and gives examples applying that interpretation. The guidance is drawn from materials we have already published separately, but which are brought together here for easy reference.

The definition of electricity lines services under s 54C

4. Section 54C defines 'electricity lines services', as follows:

> ... unless the context otherwise requires, electricity lines services –
>
> (a) means the conveyance of electricity by line in New Zealand
>
> (b) with respect to services performed by Transpower, includes services performed as a systems operator.

5. Subsection (2) then sets out several exclusions, which generally cover generation, services that are subject to actual direct competition, and services excluded based on their small scale.
6. Under s 54C(4) the reference to 'line' in subsection (1)(a) takes the definition of "lines" in the Electricity Act 1992, unless the context otherwise requires. 'Lines' is defined in the Electricity Act as "works…used for the conveyance of electricity by line" and 'works' is similarly defined as 'fittings', excluding any part of an 'electrical installation'.
7. The Electricity Act defines "electrical installation" mainly by reference to the location or use of particular assets that are beyond the point of supply or that are used for generation. The upshot is that ELS under s 54C of the Act is the conveyance of electricity by line, being any works or fittings that are not an electrical installation in whole or in part – ie, beyond the point of supply.
8. The above interpretation aligns with the industry separation of generation services, transmission and distribution services, and services beyond the point of supply. Under s 54C(1), Part 4 regulation applies to the service of the conveyance of electricity by line on the transmission or distribution networks and before the point of supply. This interpretation is further supported by the context and purpose of Part 4, and in particular s 52, which confirms the intention of Part 4 to provide for the regulation of services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition (such as distribution and transmission networks).

9. Notably, our view is that assets that fall within the definition of 'electrical installation' are *not* necessarily outside the scope of Part 4 regulation. So, a part or the whole of an asset used (or cost attributable to an activity) beyond the point of supply may fall within the scope of the regulated service, to the extent it is used or incurred by an EDB in supplying ELS.

10. Whether operating costs or asset values can be attributed in whole or in part to ELS is the focus of the cost allocation IM. The terms 'assets used' and 'costs attributed' are familiar to that IM, as well as the asset valuation IM.

11. Taking this together, whether assets or costs fall within the scope of regulation under Part 4 depends on whether:

    11.1. the assets are used or the costs are attributable (in whole or in part) to ELS – the conveyance of electricity by line in New Zealand before the point of supply; and

    11.2. any of the exceptions listed in s 54C(2) apply.

12. Importantly, the above test focusses on whether an asset is used in (or a cost is attributable to) supplying ELS; not whether the assets are themselves physically part of, or the costs are attributable to, the physical conveyance of electricity by line.

13. This means that the business costs of supplying ELS – such as the office equipment, local council rates, and employees' salaries in an EDB's head office – come within scope of the regulated service. To the extent the costs are not all directly attributable to the supply of ELS, then they must be allocated according to the cost allocation IM.

Our interpretation is established and tested

14. We extensively explored and tested in consultation with interested parties our interpretation of the s 54C definition of ELS in the *2015/16 Input methodologies review* (**2015/16 IM review**) – *Topic 3: The future impact of emerging technologies in the energy sector*. Our final decision in the 2015/16 IM review[1] was to adopt the interpretation and approach we put forward in our *Emerging technology pre-workshop paper* on this topic (**pre-workshop paper**).[2]

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1 Commission, *Input methodologies review decisions Topic paper 3: The future impact of emerging technologies in the energy sector*, 20 December 2016, at para 238, available at: https://comcom.govt.nz/__data/assets/pdf_file/0020/60536/Input-methodologies-review-decisions-Topic-paper-3-The-future-impact-of-emerging-technologies-in-the-energy-sector-20-December-2016.pdf.

2 Commission, *Input methodologies review – Emerging technology pre-workshop paper*, 30 November 2015, at paras 57-67, available at: https://comcom.govt.nz/__data/assets/pdf_file/0024/63096/IM-review-emerging-technology-pre-workshop-paper-30-November-2015.pdf.

15. In May 2018, we subsequently applied that interpretation in guidance we issued on the regulatory treatment of electric vehicle chargers' costs and revenue (**EV guidance**).[3] We invited submissions on that guidance, and, after considering them, decided against revising the guidance.

16. In the 2015/16 IM review, we unpacked the test in paragraph 11 into four key questions on the treatment of costs and revenues. We reaffirmed and reused these questions in the EV guidance, and we do so again here:

Box 1: Key questions

Within scope of the regulated service?

Is what the EDB doing part of the service of conveyance of electricity by line, and not excluded by any of the exceptions listed in s 54C(2)?

Treatment of capital costs

Is the asset used for the service of conveyance of electricity by line? If so, how are the capital costs associated with this investment treated?

Treatment of operating costs

Are the operating costs attributable to the service of conveyance of electricity by line? If so, how are the operating costs associated with this investment treated?

Treatment of revenues

Are the revenues attributable to the service of conveyance of electricity by line? If so, how are the revenues associated with this investment treated?

Examples applying our interpretation of ELS

17. The first examples analysed below – batteries, EV chargers, and load control relays – are drawn from existing guidance and analysis we have published. The later examples – corporate sponsorship and voluntary carbon offsetting – come from recent correspondence we have had with Orion Networks Limited who sought clarification from us.

[3] Commerce Commission, *Open letter – Our intention to gather information relating to emerging technologies*, 9 May 2018, at *Attachment: Regulatory treatment of EV chargers costs and revenue*, available at: https://comcom.govt.nz/__data/assets/pdf_file/0023/90581/Open-letter-Our-intention-to-gather-information-relating-to-emerging-technologies-9-May-2018.pdf.

Batteries

18. Our pre-workshop paper for the 2015/16 IM review set out a detailed case study of the regulatory treatment of EDB expenditure on batteries in the following three different investment scenarios, using the four key questions mentioned above:[4]

    18.1. EDB buys and installs battery in its network as an alternative to traditional network upgrades. Battery is metered;

    18.2. EDB buys and installs battery behind the meter as an alternative to traditional network upgrades; and

    18.3. Consumer buys battery from EDB and installs it behind the meter to reduce their power bill by optimising the time of sourcing electricity from the grid.

19. The analysis and outcomes of the case study are too detailed for this guidance, however, each scenario involved different uses (intended and unintended), ownership, control, costs, and revenues – some regulated and others unregulated.

EV chargers and load control relays

20. In our EV guidance, we observed that the main purpose of EV chargers is to charge cars, not to supply ELS. Our starting point was therefore that we would not expect the costs and revenues associated with EV chargers to be attributed to ELS.

21. We noted the following two exceptions to our general position above:

    21.1. where an EDB has active control over the EV charger, such that it can be controlled to manage network load (eg, for the purpose of deferring capital expenditure on the distribution network), and the control equipment is not separable from the EV charger; and

    21.2. where an EDB installs the EV charger to charge the EDB's own electric vehicles, so the EV charger is therefore a cost the EDB incurs to supply ELS.

22. The EV guidance further unpacked these two exceptions in the context of our generation position. In the case of the first exception, we noted that:

    22.1. if the control equipment was separable from the EV charger, then none of the charger capital costs should be recorded in the regulatory asset base (**RAB**) – just the cost of the control equipment. This is similar to load control relays attached to a hot water heater where the cost of the load control relay may be recorded in the RAB, but not the cost of the water heater itself; but

    22.2. if the control equipment was not separable from the EV charger, but was integrated within the EV charger, then the capital costs of the EV charger could be included in the unallocated RAB. However, the EDB should include in the allocated RAB value only the portion of the EV charger capital cost that is attributable to the control equipment. This reflects that the purpose of the EV charger itself was to charge cars, rather than supplying ELS.

[4] Pre-workshop paper, above n 2, at paras 68-121.

Corporate sponsorship

23. Corporate sponsorship, such as financial support for community initiatives and businesses in an EDB's local area, does not involve expenditure on assets used or costs incurred, in whole or in part, in supplying ELS. This does not prevent a regulated supplier from doing such corporate sponsorship, but they must not recover the costs from consumers through charges for ELS. This ensures that the ELS charges consumers pay reflect the cost of supplying ELS, and do not include costs that are solely attributable to unregulated goods or services.

Voluntary carbon offsetting

24. Our current position is that voluntary carbon offsetting—either through the purchase and cancellation of tradeable offsets or by the creation and cancellation of offsets (eg, through forestry)—does not involve assets used or costs attributable to supplying ELS.

25. By 'voluntary offsetting' we mean offsetting that is not required by law under the New Zealand Emissions Trading Scheme (**ETS**) or other regulations. This is distinct from expenditure on assets used or costs incurred from *mandatory* offsetting relating to the supply of ELS. For example, Schedule 3 of the Climate Change Response Act 2002 (**CCRA**) lists as an activity operating electrical switchgear that uses sulphur hexafluoride where the prescribed 1-tonne threshold is met (**SF6 activity**). A person that carries out a Schedule 3 activity must register as an ETS participant and open a holding account with the Environmental Protection Authority (**EPA**).[5] An ETS participant must:[6]

    25.1. collect and record specific information about the SF6 activity;

    25.2. use a prescribed method to calculate emissions from the SF6 activity; and

    25.3. submit an annual emissions return to the EPA in respect of emissions from the SF6 activity.

26. In the above circumstances, we would consider a regulated supplier's expenditure on the activities under paragraphs 25.1 to 25.3 as costs relating to the supply of ELS.

5 Section 56(1) of the CCRA.

6 Clauses 44B and 44C of the Climate Change (Stationary Energy and Industrial Processes) Regulations 2009 and s 65(1)(a) of the CCRA.