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POWERCO – CROSS-SUBMISSION ON ELECTRICITY DPP RESET DRAFT DECISION

Powerco Limited (Powerco) welcomes the opportunity to provide feedback on the views submitted in relation to the Commerce Commission's Draft Decision *Default price-quality paths for electricity distribution businesses from 1 April 2020.*

Attachment 1 has a summary of our feedback and Attachment 2 has more detailed comments. If you have any questions on this submission, please contact Nathan Hill (Nathan.Hill@powerco.co.nz).

Yours sincerely

Stuart Marshall
General Manager – Regulation and Commercial

Attachment 1: Summary of Powerco's feedback

Topic	Powerco response
Innovation allowance	• We disagree with the submissions of ERANZ and Meridian that suggest the proposed innovation allowance should be removed o We can appreciate ERANZ and Meridian's concerns about the innovation allowance. However, we think inclusion of an innovation allowance is prudent and in the best interests of consumers. Why? It recognises the increasing importance of innovation in the way distributors invest in and operate their networks
Gap in the regulatory framework between a default price-quality path (DPP) and a customised price-quality path (CPP)	• We agree with Vector and Wellington that there is a gap in the current regulatory framework, between a DPP and CPP, that may be constraining prudent and efficient expenditure that is in the best interests of consumers o Our preferred solution, that would address concerns about barriers to applying for a CPP, is to move all large distributors on to an individualised price-quality path regime

Attachment 2: Commentary on submission points

1. Innovation allowance

The electricity industry is changing – driven by interrelated changes in customers' attitudes, use of networks, policy around a low carbon economy, and emerging technology opportunities. These changes have the potential to have a profound impact on the nature and operation of electricity distribution networks and should over time translate into improved cost efficiency and customer service outcomes.

However, without specific regulatory innovation incentives or allowances, we are concerned distributors' innovation expenditure may not appropriately reflect the scale and scope of the investment needed to prepare for future electrification needs. We think there is a genuine risk that under-investment in innovation in DPP3 will increase the likelihood that the full benefits of new technologies aren't realised by New Zealand electricity consumers.

Given this concern, Powerco welcomes the Commission's introduction of an innovation allowance that recognises the increasing importance of innovation in the way distributors invest in and operate their networks.

We disagree with the submissions of ERANZ and Meridian that suggest the proposed innovation allowance should be removed.

ERANZ and Meridian's arguments against the innovation allowance are:

- because it lowers innovation investment risk it would not result in outcomes consistent with those produced in competitive markets
- the allowance could hinder competition and harm consumers by creating an uneven playing field
- unsuccessful projects will result in higher costs for consumers without any long-term benefit to consumers
- the IRIS incentive scheme already provides the necessary incentives for innovation investment by distributors

Whilst we agree these are genuine concerns, we have outlined below why we think these concerns can be alleviated.

Consistency with outcomes produced in competitive markets

We agree with ERANZ and Meridian that an innovation allowance for distributors can create some mis-alignment with the innovation investment risks faced by competitive businesses. However, we do not think the Commission should be concerned by this. This is because:

1. As noted by the Commission in its DPP3 draft decision reasons paper, alignment with competitive outcomes must be weighed against the relative risks to the long-term benefit of consumers. For example, the risk of under-investment by distributors[1]
2. The purpose of section 52A of the Commerce Act does not specify parity of investment risk between monopoly and competitive markets as an outcome that must be sought

[1] Commerce Commission, EDB DPP3 Draft Decision Reasons Paper, 29 May 2019, Paragraph 3.9

3. The innovation allowance promotes outcomes that are consistent with the outcomes produced in competitive markets. These outcomes are about incentives to innovate, invest and improve efficiency – and are specifically referred to in the section 52A purpose
4. While the allowance will reduce distributors' innovation investment risks, expenditure on the accepted innovation project is certainly not risk free. The innovation recoverable cost requires an equal or greater amount to be simultaneously spent by the distributor that is not covered by the recoverable cost.

Level playing field

We can appreciate ERANZ and Meridian's concerns about the innovation allowance potentially creating an uneven playing field that could hinder competition and harm consumers - Powerco supports the principles of open access and a level playing field. We consider that an innovation allowance will not bias the playing field because:

- The innovation allowance will support the development of open access networks that will enable maximum flexibility and uptake of new technologies by end-users. This will enable competitive markets for new technologies and non-wires alternatives to grow and consequently promote competition and increased options that will benefit consumers
- The value of the allowance is very low and shouldn't skew the playing field – even at the 0.5% of revenue level proposed by the ENA and supported by Powerco

Unsuccessful projects

We share ERANZ and Meridian concerns about the cost of unsuccessful projects being passed onto consumers. However, we think the ENA's proposed pooled incentive fund approach can provide a solution. This is because under the ENA pooled approach distributors will share the learning inherent to 'unsuccessful' projects. This should result in significant cost savings to consumers because it should prevent unsuccessful innovation projects being repeated by distributors across the country.

IRIS Incentives

The evidence suggests that the IRIS incentive scheme isn't incentivising innovation expenditure.[2] Despite the availability of IRIS incentive benefits, current levels of innovation by distributors are low and insufficient to realise the potential available benefits.

As a mechanism to promote innovation, the IRIS scheme is a weak tool – as it is primarily designed to reward improving efficiency that lowers costs to customers. Innovation may not reduce expenditures, but instead lift benefits to customers for the same amount spent – however as most innovation comes with risk of failure [and therefore potential for overspend] the IRIS scheme instead discourages many areas of innovation.

In addition to commenting on the concerns of ERANZ and Meridian, we have outlined below other reasons, why inclusion of an innovation allowance is prudent and in the best interests of consumers.

[2] For the 2018 regulatory year, distributors reported a total of less than $10m expenditure on research and development (compared to total lines charges of around $2.5b); Commerce Commission, DPP draft decision reason paper, paragraph 4.54.3

- **The risk of under-investment is high (and likely highly asymmetric when compared with the low level of investment involved)**
    - Should distributors use conventional means to address the network stability issues potentially caused by material uptake of variable, distributed generation or energy-intensive customer devices, the overall cost to consumers will be significantly higher than adopting innovative solutions. As innovative solutions take time to develop, understand and embed, even delaying this investment will almost inevitably mean that consumers will suffer much higher costs than the proposed quantum of investment proposed under the innovation scheme
    - There is a strong international trend towards open access distribution networks. This is seen as essential if customers are to be allowed unfettered access to networks, in order to trade energy, connect new types of edge devices or adopt solutions that materially alter electricity use patterns. Innovative solutions – technology, commercially and behaviorally driven – will be a critical part of enabling the open access network
- **Distributors have a major, ongoing role to play**
    - Ensuring safe, reliable and efficient networks and customer supplies remains primarily the responsibility of distributors. Distributors can in the large majority of instances provide this service at the lowest cost to customers
    - Distributors can also generally provide the lowest cost solutions to meet customers emerging requirements and changing energy consumption patterns
- **The ENA's proposed pooling of the incentive fund is the most cost-effective manner of coordinating research and development across 29 distributors and ensuring the benefits from this work is shared with all NZ electricity consumers.[3]**
    - Pooling of the innovation incentive fund is consistent with the Government's view that more collaboration among distributors could increase their efficiency and their collective capability to use emerging technologies for the benefit of consumers.

[3] New Zealand Government, Transitioning to a low-emissions future, August 2019, recommendation 13.7, p19

2. Gap in the current regulatory framework between a DPP and CPP

Vector and Wellington's submissions echoed our concerns that there is a gap in the current regulatory framework, between a DPP and CPP, that may be constraining prudent and efficient expenditure that is in the best interests of consumers.[4]

The only option currently available to distributors to materially increase expenditure above their DPP allowances is to apply for a CPP. We agree with Vector and Wellington that this option doesn't necessarily promote consumer interests. This is because expenditure above the regulatory allowance may be in the best interests of consumers, but its quantum may not justify a high cost and time consuming CPP application.

We think a solution to this situation needs to be found because the cost of under-investment is high.

Future electrification needs and the general aging of asset fleets across New Zealand's distributors is creating a need for levels of investment above DPP allowances - having a high cost CPP as the only approval option is a barrier to this essential investment. If distributors are unable to undertake higher levels of investment, we are concerned this may significantly increase the risk consumers suffer higher costs or degraded quality in the long-term because of under-investment in the near-term.

The outcome we are seeking is flexibility for the regulatory framework to apply a higher degree of scrutiny that is proportional to the level of additional investment needed so that distributors can continue delivering the safe, reliable and efficient service customers expect.

Our preferred solution is to move all large distributors on to an individualised price-quality path regime.

We think this would address concerns about barriers to applying for a customised price path and allow a proportional and higher degree of scrutiny of network business that have the highest levels of expenditure and serve the most consumers. It would also allow the default price-quality path to be tailored for the needs of smaller distributors.

Other solutions

We consider that there is merit in Wellington's suggestion to allow one-off projects by applying additional scrutiny. We also support Aurora and Vector's suggestion of a 'first pass, second pass' capex forecasting approach that makes better use of AMPs - both suggestions would remove barriers to essential investment. Our key concern with these solutions is that they would need to remain proportional to the low-cost nature of the DPP.

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[4] Powerco submission on the Electricity Price Review First Report, 23 October 2018, p12