

Aurora Energy's submission

**Default price-quality paths for electricity
distribution businesses from 1 April 2025:
Issues Paper**

19 December 2023

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1. INTRODUCTION

1. Aurora Energy Limited (Aurora Energy) welcomes the opportunity to submit its views on the Commerce Commission's (the Commission's) Default price-quality paths for electricity distribution businesses from 1 April 2025 – Issues Paper.
2. Section 2 of this document provides a summary of the key aspects of Aurora Energy's feedback, with our responses to the Commission's specific questions provided in section 3.
3. No part of our submission is confidential.

2. EXECUTIVE SUMMARY

4. We have summarised our feedback below into two sections:
 - General issues related to setting the Default Price-quality Path from 1 April 2025 (DPP4), and
 - Issues directly related to Aurora Energy's roll-off from its Customised Price-quality Path (CPP).

General DPP4 Reset Issues

5. The electricity distribution industry is a key enabler of the energy transition required to meet New Zealand's goal of reaching net zero carbon emissions by 2050. The DPP4 period covers a critical period in this energy transition, with the uptake of Electrical Vehicles (EVs) and Distributed Energy Resources (DER) expected to accelerate between 2025 and 2030. It is critical that distributors invest in appropriate infrastructure and continue to develop new skills and capability into the DPP4 period to enable a timely and low risk transition to a new energy future.
6. The pace and scale of change during the DPP4 regulatory period is uncertain. The Commission has an important role to play in managing this uncertainty; capex allowances need to be appropriate to support growth and opex allowances need to include sufficient step changes so distributors can meet the changing demands of consumers and stakeholders.
7. There will no doubt be further uncertainty during the DPP4 period, so the Commission needs to ensure it is able to respond to reopener requests in a timely manner, so consumers are not negatively impacted by future investments being delayed.

Forecasting capital expenditure (capex):

8. Electricity distributors need to invest in upgrading infrastructure ahead of the increases in demand. It is our view that the consequences of under investment, or investing too late, far outweigh the impacts of investing in network infrastructure too early. Distributors are best placed to understand the unique growth challenges on their own networks, and plan and articulate timely solutions in their Asset Management Plans (AMPs). We encourage the Commission to support the energy transition by removing arbitrary capex limits that have

traditionally been applied when assessing distributors capex allowances. This is particularly true at a portfolio level where one-off large projects can shift the percentage increase significantly. For example, our 2024 AMP forecast for system growth capex has tripled over the DPP4 period relative to our 2023 AMP, but more than one half of this increase is associated with a single subtransmission upgrade project in the upper Clutha.

Forecasting operating expenditure (opex):

9. Distributors opex expenditures have been increasing during the DPP3 period in response to growing consumer and stakeholder expectations, including responding to external pressures such as increasing costs of insurance, cyber-security, and Low Voltage (LV) network management. We expect this trend to continue through to the DPP4 period.
10. The Commission's criteria for assessing opex step changes during the DPP3 reset process resulted in genuine expenses such as cyber security, insurance uplifts, traffic management cost increases, and digitalisation being excluded from opex allowances. This has led to distributors incurring IRIS penalties when implementing critical and prudent opex projects which are in the long-term interests of consumers. This is not a sustainable approach to employ in DPP4, especially if the Commission considers applying productivity factors to future opex allowances.
11. Following application of the Commission's stringent criteria for assessing opex step changes, we believe there remains a compelling case to support material opex step changes in such areas as cyber security, LV monitoring, 'as a service' type software solutions, and insurance. We intend to provide further supporting evidence of these step changes in our 2024 AMP. We are concerned that if the Commission does not allow additional levels of expenditure in these areas, distributors will be encouraged to pursue traditional capex solutions which may not be in the best long-term interests of consumers.

Setting revenue allowances:

Revenue requirements are expected to increase significantly over the DPP4 regulatory period. It is important to recognise that these expected revenue increases are predominantly driven by external economic factors such as increases in the cost of capital and inflation. Limiting capital spend over the DPP4 period will not have a material impact to revenue paths because capital investment costs are recovered over multiple regulatory periods. We understand that the Commission is concerned with the consumer impacts that may arise from increases in revenue allowances, but limiting capital allowances or operating expenses could result in distributors being a constraint on New Zealand's energy transition.

12. The risk of consumer price shocks needs to be balanced against financeability concerns. It is our view that this balance can be adequately managed by making some pragmatic adjustments to the existing revenue cap mechanism to adjust for movements in inflation and volumes of electricity delivered.
13. Consumer prices are essentially a function of revenue divided by volumes. Therefore, any measure of consumer price impact needs to consider both changes in revenue, and changes in volume. This is particularly important during the DPP4 transition period where electricity

consumption is expected to grow as consumers transition from fossil fuels. The current revenue cap mechanism should include an annual adjustment for movements in volume to ensure that it is truly a measure of consumer price impact and does not disadvantage distributors who are experiencing high growth on their networks. Our submission includes a practical example of how this can be achieved during the annual price-setting process by including a measure of increased kWh delivered.

Aurora Energy CPP roll-off

14. We support the Commission's view that Aurora Energy should be included in the DPP4 reset process. It is important to have as much certainty as possible about the level of our capex and opex allowances under a DPP4 scenario. Greater certainty will:
 - enable us to undertake appropriate financial planning and plan for reopen applications where the regulatory allowances may not enable uncertain projects at this time, and
 - ensure we can transition from the CPP without compromising the delivery of network improvements or future growth enabling projects.
15. We understand that the Commission intend to set indicative allowances for Aurora Energy at the time of the DPP4 reset and then finalise the allowances during 2025. We invite the Commission to engage directly with Aurora Energy to clarify how this process will work. We are interested in understanding whether the finalisation process simply involves updating the financial model inputs for Aurora Energy's RY25 actual costs (RY25 being the penultimate year of Aurora Energy's CPP period), or whether there are other modelling adjustments being contemplated by the Commission. We would also like to know whether the Commission will use Aurora Energy's 2025 AMP to better inform expenditure assumptions for future growth projects that may be uncertain at the time of preparing the 2024 AMP.
16. Regarding the setting of quality standards, Aurora Energy supports the Commission's preferred approach to retain the standards and limits from the CPP period. We believe this is an appropriate reflection of the current state of the Aurora Energy network including modest forecast improvements through the DPP4 period and acknowledging that the CPP reliability targets are set slightly below current levels of performance.

3. CONSULTATION QUESTIONS

Context and challenges

- 1 We are interested in your views on whether we have properly understood the changing industry context as it relates to the DPP4 reset.

Have we properly understood and represented the changing industry context and are there other implications for the DPP4 you believe we should consider?

18. We agree with the Commission's assessment that the energy transition will require distributors to make significant new investments. However, our view is that the Commission has not adequately weighed the societal impacts of climate change and are overly concerned with the affordability impacts of distributors investing in infrastructure too early. The risk of distributors over-building during the DPP4 period is low, given the broadly accepted view of the level of infrastructure that will be required to achieve New Zealand's emissions goals. Now is not the time to be placing regulatory constraints on infrastructure spending.
19. The need for strong infrastructure investment in the DPP4 period has been exacerbated by low DPP3 allowances (low CPP period allowances in RY25 and RY26 for Aurora Energy) constraining current investment in an environment of strong growth and high levels of cost escalation. We estimate that recent cost escalation will lead to a 10 to 15% reduction in the work volumes able to be delivered within our RY25 and RY26 CPP allowances. This has the potential to cause additional work volumes to be carried forward into the DPP4 period.
20. The impact of the changing industry context is not confined to just increased infrastructure investment. Increased growth from electrification presents opportunities for distributors to invest in non-network solutions that are more efficient than capex alternatives. New LV visibility technology presents opportunities for distributors to make more targeted and efficient capex and opex investments in the future. Opex allowances need to be sufficient to ensure that distributors can spend in these areas that will ultimately benefit consumers.
21. We understand the concerns about consumer affordability, but we encourage the Commission to consider households total spend on energy, not just electricity. Naturally, as electrification accelerates consumers will spend more on electricity, but this will be offset by reductions in their spend on fossil fuels such as petrol and natural gas.

Forecasting capital expenditure

- 2 We are proposing to adapt our approach to capex for DPP4 based on feedback from EDBs, that past expenditure is not a good starting point for considering future spend.

Do you have any particular concerns or issues with our proposed approach? If so, how could these concerns or issues be resolved?

What alternative data and external sources should we use to support our consideration of capex forecasts, beyond the information in 2023 Asset Management Plans (AMPs), responses to section 53ZD notices and 2024 AMPs, and why should these be used?

22. We agree that historic capex spend is not a good basis for setting future allowances given the increased challenges the industry is facing. Our 2024 AMP forecasts incorporate the latest information we have in relation to customer connection and growth-related demand and provides the best available forecast of growth-related projects and expenditure.
23. Our 2024 AMP sets out a minimum viable forecast without provision for upside or contingency. Our expenditure forecasts have been prepared on the basis that we will rely on the Commission's 'reopener' mechanisms to secure additional allowances for projects that are currently 'uncertain' but do progress to detailed design and execution in the future. We do not consider it appropriate to apply a limit or top-down adjustment to forecasts that have been prepared based on minimum essential investment. Furthermore, we reiterate the impact that large, one-off projects can have on the forecast percentage uplifts. We strongly encourage the Commission to remove limits on capex and set allowances based on the capex plans included in distributors 2024 AMPs.
24. We believe there is a strong argument that the provisional limit of 10% currently applied to 'cap' EDB's forecast revenue increases, serves as a 'cash flow' penalty for EDB's that are investing prudently for the long-term benefit of consumers. Retaining the traditional approach of limiting capex allowances by reference to historical expenditure at a time when step changes to support electrification of the economy are required, carries the risk of disincentivising investment through the imposition of an additional penalty in the form of an IRIS calculation.
25. Individual distributors are best placed to understand the unique challenges of their networks and these challenges will be reflected in their 2024 AMPs. We believe that the independent review of distributors 2023 AMPs and the supplementary analysis of 53ZD responses provides sufficient evidence to support the adoption of the 2024 AMPs as the primary basis for setting capex allowances for the DPP4 period.
26. In the case of Aurora Energy, the transition to DPP4 in RY27 provides an opportunity for the Commission to consider the full 2024 AMP and possibly the 2025 AMP to inform a final decision.

3	<p>We are proposing to apply the capital goods price index to forecast capex allocations.</p> <p>Is there a more appropriate index which could be applied; and, if so, why?</p>
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27. We are not aware of any index that would be more appropriate.

4	<p>We have concerns about the challenges in delivering increased programmes of work given current labour market, supply chain and economic challenges in New Zealand.</p> <p>How should our capex forecast take into account potential sector-wide deliverability constraints?</p>
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28. There is no need for the Commission to specifically consider sector-wide deliverability constraints. Deliverability, including sector-wide factors, is already considered when distributors prepare their AMPs. Any sector-wide adjustment for deliverability would ignore the fact that each distributor has their own unique deliverability considerations and mitigations in place.

29. Furthermore, the concerns identified in the Issues Paper are a direct consequence of the pandemic and are reflective of a point in time. We have already seen labour market concerns reducing as the unemployment rate increases. Supply constraints are also easing as supply chains recover from the pandemic period. It would be inappropriate to factor concerns related to 2022/23 into the DPP4 period which commences in 2025.

30. In Aurora Energy's case, a large component of the higher levels of forecast capex in the DPP4 period are a combination of cost escalation and a small number of large projects. Throughout the CPP period we have successfully scaled up our internal and external works delivery capability and we do not see deliverability as a reason to deliberately constrain our forecasts and plans, which are linked to safety and consumer outcomes.

31. It should be noted that distributors prepare capital expenditure forecasts based on the level of expenditure required to maintain quality standards. We are concerned that if the Commission were to limit the amount of capex allowances there would be an impact on quality, therefore any adjustment to capex allowances must also be accompanied with a relaxation of quality standards.

5	<p>We will be using the s 53ZD notice to collect information about how EDBs have reflected resilience in their expenditure forecasts.</p> <p>What engagement have EDBs had with consumers about resilience expectations, especially as it relates to significant step changes in forecast expenditure?</p> <p>What other considerations should we factor into our analysis of the resilience expenditure information collected from the s 53ZD notice and/or what is unlikely to be visible in the forecasts that we should consider?</p>
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32. We consider that direct engagement with consumers is not the most efficient way to inform future resilience requirements. Instead, we meet regularly with local authorities to ensure that our infrastructure supports the resilience expectations of the communities they represent.
33. Direct consumer engagement can be costly and is not funded by opex allowances. Furthermore, consumers typically do not have sufficient knowledge or expertise to comment on electricity network resilience requirements.
34. Similar to reliability, investment in resilience is often integrated into network strategies, standards and guidelines as part of routine work. For example, subtransmission or zone substation renewals will be built to new network architectures and seismic standards and therefore resilience is integrated into our operations. For this reason, not all resilience expenditure will be transparent or separable from growth and renewals expenditure.
35. Other resilience expenditure including the provision of additional spares and storage facilities, back-up generation, a seismic retrofit programme, or improved operational management of High Impact Low Probability (HILP) events, may only be transparent at a concept level. Given the recency of a heightened focus on resilience improvement, a resiliency improvement programme is unlikely to be fully itemised at this stage with a provisional forecast only.

6 We would like to understand how potential changes in capital contributions policies could be accommodated in DPP4.

How could changes to capital contributions policies, either in advance of or within the regulatory period, be accommodated within our capex forecasts for DPP4?

36. We consider that distributors capital contribution policies including any recent changes will be reflected in the AMP forecasts. Further material changes to policies, including those arising from regulatory changes, should be accommodated through the reopener process.

7 We are interested to understand if EDBs are assessing investments driven by expected pace of change which may not be consistent with choices otherwise made under a least cost lifecycle basis.

Are there specific investment decisions being considered due to concerns on delivering increased scale of investment in limited time which are not consistent with a least cost lifecycle basis assessment; for example, areas where EDBs are intending to build well in advance of forecast need or for demand or generation that are only speculative?

On what basis are these investments being assessed?

37. As outlined in our response to question 1, we believe the Commission is overstating this issue. Delivering a least cost lifecycle basis involves making decisions with the best available information at the appropriate time. This does not mean that the timing of investment is always perfect, but it does mean that decisions are being made when they need to be made, taking account of uncertainty and the risks of deferred investment. The potential consumer impacts of

investing ‘too early’ are relatively minor when compared to the consequences of investing ‘too late’. This is especially true at a time of strong growth for N security capacity projects, and when cost escalation means the deferral benefits are small.

38. Furthermore, our AMP forecasts do not include speculative investments where different growth scenarios may lead to a need for stronger investment. We consider the ‘reopener mechanisms’ to be an appropriate solution to growth uncertainty. However, this does rely on the timely turnaround of reopener applications to ensure that customer service expectations can be met. For this approach to work, there must be high confidence in the reopener process with an appropriate DPP level of scrutiny.

Forecasting operating expenditure

8	<p>We are considering updating our approach to forecasting opex input price escalation to better reflect the mix of inputs EDBs face.</p> <p>Do you have a view on another index, or weighted mix of indices, which would improve the quality of opex forecasting compared to our current approach? (Using a 60/40 mix of percent changes in Labour Cost Index (LCI) all-industries and Producers Price Index (PPI) input indices.)</p> <p>If so, what evidence supports this view?</p>
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39. The current approach to opex forecasting has understated the actual level of inflation experienced by distributors over the DPP3 period to date. However, we are not aware of any other readily available indices that would more accurately reflect the cost increases experienced by distributors.

9	<p>We are considering revising our approach to scale growth trend factors, to better reflect EDBs increasing focus on investing to meet growth and renewal needs.</p> <p>Do you support our emerging view that including forecast capex as a driver of non-network opex could improve opex forecasts, and that this conclusion makes sense in terms of the way EDBs run their businesses?</p> <p>Are there alternative drivers that we should consider, and what evidence is there that they can meaningfully predict EDB scale growth?</p>
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40. We support the Commission’s proposed change to include forecast capex as a driver of non-network opex.

10 EDBs have identified that insurance costs have been increasing at a greater rate than other costs they face.

What evidence do you have about how these costs are likely to evolve overtime?

Is the option of trending insurance opex forward using a separate cost escalator workable? How could incentives on EDBs to make risk management decisions be maintained?

41. We support the inclusion of a separate escalator for insurance costs. Since RY21 we have observed a significant increase in insurance levies that are not accommodated within our CPP allowances. Insurance costs are expected to increase beyond the level of CPI throughout the DPP4 period. Applying a general CPI increase to insurance costs will not represent the actual cost increases impacting distributors.

11 Given the possibility of a greater need for step-changes in opex in a context of industry transition, we have clarified further how we are thinking of applying the step-change criteria and the supporting evidence we expect.

Do you consider the expanded descriptions of the step-change criteria provide sufficient clarity about the types of step-changes we consider meet the Part 4 purpose?

42. The Commission's criteria for assessing step changes are too stringent and do not provide for new expenditure categories that may emerge during a regulatory period. In particular, the criterion to 'be robustly verifiable' is overly onerous and not practically workable. This is evidenced by the Commission's decision to reject a step change for cyber security costs in the DPP3 reset due to a lack of information. In practice, for a spend category to meet the robustly verifiable criteria the need would have to arise at the exact time of the DPP reset. In the case of cyber security this need was foreseen at the time of the DPP3 reset, however the amount of the spend required only became clearer during the regulatory period – forcing distributors to either delay spend and risk the security of their networks, or sacrifice a fair shareholder return by incurring IRIS penalties.
43. The Commission needs to demonstrate that it is genuinely following a base-step-trend method for forecasting operating expenditure, rather than a base-trend method that relies on distributors essentially proving the validity of expenditure through their willingness to incur IRIS penalties to get the expenditure considered in their base spend.
44. In our view there is compelling evidence to support step changes for LV network monitoring plus additional cyber security and 'as a service' type technology solutions, alongside of insurance, as part of the DPP4 reset as outlined below.

LV monitoring

45. Currently we are experiencing growth on our network including residential developments such as subdivisions and in-fills on the LV network. Traditionally, LV networks have been passive

networks, constructed as ‘set and forget’ and therefore most distributors do not have a full view of demand and generation on their LV networks. However, the growth in uptake of electric vehicles and distributed energy resources will impact the LV networks at different times of the day and season with impacts related to thermal and voltage constraints. So, greater visibility and monitoring of LV networks is required to ensure distributors can manage their networks efficiently, maximise asset capability, and optimise future capex spend, by targeting the areas of the network that are experiencing the highest levels of growth. This is a new phenomenon and is affecting all distributors. LV monitoring comprises two core elements of opex spend that are not currently included in distributors opex allowances or base spend:

- LV visibility platform - We are currently in the early stages of procuring an LV visibility platform to enable our business to gain visibility of the LV network for different purposes including customer engagement, health and safety, operations, network performance, and asset investment decisions. Our initial market summary has identified that annual licence costs will be a significant percentage of our opex.
- LV monitoring data – The LV visibility platform requires high resolution data that must be procured from metering providers. We are in advanced discussions with a metering provider based on an annual charge per ICP.

Cyber security

46. As a lifeline utility, Aurora Energy has been and continues to be exposed to more and more varied threats and attacks by malicious actors, all of which could threaten our ability to conduct our core business operations and provide network services to our customers. To ensure our network is protected we have engaged a third-party supplier to monitor our ICT systems on a 24/7 basis. This has added significant costs to our opex that were not provided in the CPP allowances.

Technology ‘as a service’ solutions

47. The established global trend towards technology ‘as a service’ type solutions is continuing to drive an uplift in regular recurring opex. Software as a service licencing, cloud storage and compute costs will continue to increase as legacy ‘on premises’ systems are upgraded.

Quality Standards

12 Our initial view is to maintain the principle of no material deterioration and set quality standards on a basis consistent with that established in DPP3.

Do you agree with our proposed approach of maintaining the principle of no material deterioration and setting the quality standards on a basis consistent with DPP3? With regard to the quality standards, are the existing reporting obligations appropriate?

48. We support the Commission’s proposed approach of maintaining the principle of no material deterioration when setting the quality standards. In the case of Aurora Energy this requires

application of the CPP period quality standards which have proven to be appropriate after a period of declining performance pre CPP and stabilising performance during the CPP period.

49. The application of the 10-year historic DPP3 methodology to Aurora Energy would not correctly capture recent performance levels and would therefore lead to adverse regulatory outcomes with inappropriate breach limit risks and unrealistic targets for the incentive scheme.
50. We support a continuation of the Aurora CPP period limits and targets, noting that the target remains ambitious, but potentially achievable toward the end of the DPP4 period with a modest investment in reliability improvement as proposed in our 2024 AMP.
51. We have not had to comply with the additional reporting obligations that were introduced in DPP3 for a breach of a quality standard, and so we cannot comment on their appropriateness. In terms of the quality standard reporting included in the annual compliance statement, however, our view is that the reporting obligations for that content are appropriate.

13 Our initial view is to maintain the DPP3 settings of a 10-year reference period updated for the most relevant information and normalisation approach for major events.

Do you think that we should maintain a 10-year reference period updated for the most relevant information and normalise major events on the same basis as DPP3?

52. As noted above, the 10-year historic period of performance for Aurora Energy is not representative of the current level of Aurora's reliability performance which is better represented by the CPP reliability standards. We support a continuation of the Aurora CPP period limits and targets.

14 Our initial view is step changes in reliability, if appropriate, may be accommodated through setting of values or revisions to definitions.

Are there identifiable step changes to reliability parameters for quality standards to manage operational or situational changes outside the control of the distributor compared to historical periods?

What value and challenges do you see with different approaches to addressing inconsistencies in the recording of interruptions, the 'multi-count' issue, using either a proxy allocation basis or requiring a recast dataset? Are there alternative approaches which may appropriately address the issue?

53. Applying the CPP period limits and targets to Aurora Energy would prevent the need to address any historic step changes.

15 Our initial view is to not introduce new additional quality of service measures.

Are there any other quality of service measures beyond those currently required within DPP3 that we should consider introducing, and why?

54. We agree that no additional quality metrics are required to measure distributors performance.

Other issues

16 Aurora Energy is scheduled to rejoin the DPP from 1 April 2026.
Do you agree with how we propose to transition Aurora Energy to the DPP in 2026?

55. In principle we agree with the Commission's emerging view that Aurora Energy should be included in the DPP4 expenditure and revenue setting process. However, we would like more clarity about how Aurora Energy's allowances will be set to ensure a smooth transition from the CPP period and encourage the Commission to meet with Aurora Energy before setting allowances to confirm:

- How Aurora Energy's RY25 expenditure will be used to establish baseline opex spend, including whether any productivity factor will be applied.
- Confirm that the same DPP4 capex allowance methodology will be applied to Aurora Energy at the time of its CPP roll-off and the extent to which the Commission will use Aurora Energy's 2025 AMP to inform its decision.
- That the quality limits and targets from the CPP period will be retained.

17 Section 53M(5) allows us to reduce the regulatory period if this would better meet the purposes of Part 4 of the Act. We are considering whether we should reduce the regulatory period from five to four years.
What particular challenges do you perceive may arise from shortening the regulatory period?
What are the potential benefits to consumers from maintaining or shortening the length of the regulatory period?

56. We do not support a shortening of the regulatory period to four years. The DPP reset process requires significant resource from both distributors and the Commission to implement. It is not clear to us what additional benefits would be gained from shortening the regulatory period to justify the additional resource costs.

18 The DPP sets annual deadlines by which suppliers must make Customised Price-Quality Path (CPP) applications to enter into effect the following year.
Do you support retaining a similar approach to setting CPP application windows as was undertaken for DPP3?

57. We do not see any compelling reason to change the CPP application windows.

19 The current IMs provide for a discretionary shortening of asset lives.

Do you have views on the framework for assessing accelerated depreciation applications?

58. We support the principle of allowing distributors to apply for accelerated depreciation rates for shorter life assets.

Quality incentives

20 Our initial view for DPP4 is to retain revenue-linked quality incentives for both planned and unplanned SAIDI, with targets, caps, collars, incentive rate and revenue at risk set on a consistent basis with DPP3.

Are EDBs considering the quality incentive scheme (QIS) in their investment decisions?

Do you consider the proposed settings are appropriate for the QIS, including whether the incentive rate is driving appropriate outcomes with regards to consumer quality expectations?

59. We support the use of revenue-linked quality incentives, but the targets need to be realistically set to ensure that the mechanism is symmetric and not just a mechanism to reduce revenue. In practice if capex and opex allowances are insufficient to fund reliability driven investments, distributors are forced to effectively decide whether to incur a quality penalty, or future IRIS penalties.

60. As mentioned above, we have included a modest investment provision for reliability improvement in our 2024 AMP, which should enable the Aurora Energy network reliability performance to achieve the CPP period incentive target toward the later part of the DPP4 period. This assumes that our capex allowances are sufficient to accommodate the expenditure requirements forecast in our 2024 AMP.

21 Caution around treatment of non-performance of less proven solutions may create a reticence by EDBs to implement these types of solutions and result in a focus on more proven established technologies, typically, capex investments. Our intention is that the compliance with the quality standards and penalties under the QIS do not act as a potential impediment to innovation.

How should we account for non-performance of non-network solutions (regulatory sandboxing)?

61. We support any changes that will remove the barriers to innovation, especially if those innovations could lead to more efficient non-network solutions that will benefit customers in the longer-term. A new outage category for non-network solutions should be added and excluded from the calculation of quality incentives.

Innovation

22	<p>The regime's baseline incentives may be insufficient to support innovation, such that we consider it is appropriate to have an innovation (and/or non-traditional solutions) incentive scheme.</p> <p>Do you agree with our understanding of the regime's baseline incentives to support innovation, and the need for an innovation and/or non-traditional solutions scheme?</p> <p>Would you be interested in participating in a targeted workshop, and if so, are there any topics you consider should be covered?</p>
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62. We agree with the Commission's view that the current baseline incentives do not encourage distributors to innovate. Typically, the primary beneficiaries of innovation will be consumers, however the costs of innovation are usually borne by distributors in the form of IRIS penalties. This mechanism discourages distributors from pursuing non-network opex solutions and reinforces an inherent capex bias in the regulatory settings.

63. We welcome the opportunity to participate in a targeted workshop to discuss potential innovation mechanisms that provide appropriate incentives to distributors to pursue innovative solutions that will ultimately benefit consumers.

23	<p>We are interested in feedback on our initial thinking about how to design an incentive scheme to encourage innovation and/or non-traditional solutions in DPP4.</p> <p>What are your views on the key principles (see Attachment I)? Are they effective as the basis of an innovation and/or non-traditional solutions scheme? Are there others you think may be suitable?</p> <p>What are your views on the potential scheme design characteristics? Are they effective as the basis of an innovation and/or non-traditional solutions scheme? Are there others you think may be suitable?</p> <p>How could these principles and characteristics be best applied in designing a potential scheme? We would also welcome submissions with examples of overseas schemes/characteristics that you consider appropriate for a DPP.</p>
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64. We broadly support the Commission's approach to developing key principles.

65. We are interested in further discussions about the issue of risk allocation (and compensation). In practice, it seems likely that distributors would be best placed to manage the risk associated with innovation projects, however it is not clear how distributors would retain an appropriate reward for successful innovation – especially in circumstances where the benefits of innovation may endure across multiple regulatory periods.

24	<p>Our initial view is that a specific demand-side management and energy efficiency scheme is not required for DPP4.</p> <p>Is there a basis for strengthening the incentives for energy efficiency and demand-side management initiatives?</p>
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66. The evolution of flexibility services has somewhat superseded the demand-side management category, so we agree that there is no need for demand-side management and energy efficiency schemes in DPP4. We believe the Commission would be better served by concentrating on incentives to facilitate faster uptake of flexibility services.

25 We are not proposing to implement a QIS for line losses. We believe EDBs improved visibility of low voltage performance and improvements to the energy efficiency of distribution transformers should drive improvements in DPP4 without additional explicit incentives.

Do you agree with our approach to not introduce a specific QIS related to reducing energy losses?

67. We agree with the Commission's approach to not introduce QIS line loss related incentives.

Setting revenue allowances

26 We are proposing to retain our approach of setting a 'default' X-factor of 0% (before considering price shocks or supplier financial hardship).

We are interested in your views on whether this approach (where long-run changes in sector productivity are accounted for in our building blocks analysis) remains appropriate.

68. We agree with the approach of setting an x-factor of 0% for all distributors across the DPP4 period. The application of productivity targets during the transitional DPP4 period would introduce unnecessary delivery risks during a time of critical importance. Productivity is a topic best left until future regulatory periods when expenditure levels can be more accurately baselined and measured.
69. The New Zealand Productivity Commission published a report in July 2023 which identified New Zealand as having one of the worst rates of productivity in the OECD. The issue of productivity is complex and widespread across New Zealand, not just in the electricity sector as evidenced by the new Government's focus on removing regulation.
70. We also have concerns that the Commission's historic measures of productivity that focus on kWh and number of ICPs supplied are overly simplistic as they do not consider the growing service expectations of consumers, technology trends and the increased costs involved in maintaining a social 'license to operate'. Over the past decade distributors have seen numerous cost increases that are not reflected in historic measures of productivity, including:
- Increasing compliance costs related to health and safety legislation,
 - Traffic Management cost increases,
 - Web based consumer communications and outage notifications, including monitoring social media channels,

- Growing expectations from regulators to increase levels of consumer engagement and consultation,
- Increased consultation activity of regulators,
- Increases in the number of statutory holidays,
- Increased expectation of distributors to become more sustainable in their operations.,
- An established trend towards 'software as a service' type solutions which has driven an uplift in regular recurring opex versus the traditional model of periodic capex investments in software renewals/upgrades.

71. The Commission should also consider the role of the IRIS mechanism in incentivising productive spend. Due to the high threshold the Commission has chosen to apply for opex step changes, many distributors have been forced to incur IRIS penalties from spending opex on necessary areas such as cyber security and sustainability. Distributors have made the decision to forego a fair return in the short-term to make these necessary spends in the knowledge that the spend will be reflected in future baseline opex allowance calculations. To impose further productivity measures is unreasonable and would imply that the IRIS mechanism is not achieving its purpose.

27 Our emerging view is to assess price shocks for consumers using the real change in aggregate distribution revenue from year-to-year, with a particular focus on the change between regulatory periods.

Do you agree with this approach? If not, are there other alternatives we should consider?

When applying this (or any other) analysis, what factors should we consider in determining whether a price change amounts to a price shock?

72. To assess consumer price shock, any revenue smoothing mechanism must consider both movements in inflation and movements in consumption volumes. We encourage the Commission to apply the same inflationary adjustment mechanism that is specified in Aurora Energy's CPP Determination as well as adding an additional mechanism to take into account changes in volumes delivered.

73. Price is a function of revenue divided by billable quantities. A mechanism focussed on revenue ignores the impact that growth has on reducing customer price, and disadvantages electricity distributors operating higher growth networks.

74. A better approach is to allow an adjustment mechanism that adjusts the provisional revenue limit based on kWh of energy delivered at the time of price-setting. For the purposes of simplicity and transparency we favour using historic measures of kWh delivered from prior year's Information Disclosures rather than an unverified forecast of kWh to be delivered.

75. The following example demonstrates how this mechanism could work in practice:

Ry26 Annual Price-Setting Statement Example Extract

Table 1: Network growth factor

Network growth factor = ('kWh delivered as per Schedule 8 of Ry24' / 'kWh delivered as per Schedule 8 of Ry23') -1	
kWh delivered in Ry24	101,000
kWh delivered in Ry23	100,000
Network growth factor	1%

Table 2: Adjustment of the provisional limit on annual percentage increase in forecast revenue from prices

Adjustment of the limit on annual percentage increase in forecast revenue from prices	
Provisional limit on percentage increase in forecast revenue from prices	10%
Network growth factor	1%
Adjusted limit on annual percentage increase in forecast revenue from prices	11%

76. As an alternative to using historic measures of growth, the Commission could set provisional revenue limits based on forecast growth in the 2024 AMPs.

28 Our emerging view is that financial hardship will be 'undue' only where it is to such an extent that it is inconsistent with the long-term benefit of consumers.

Do you agree with this approach? If not, are there other alternatives we should consider?

When applying this (or any other) analysis, what factors should we consider in determining whether a supplier faces undue financial hardship?

77. The Commission needs to carefully consider the impact revenue deferrals will have on distributors cashflows. The Commission's view on undue financial hardship is only likely to apply in extreme scenarios and does not recognise that any deferral of revenue will have an impact on distributors cashflows and debt profiles. It is important that these impacts are reflected in the credit rating assumptions used in the calculation of the Weighted Average Cost of Capital (WACC).

Consumer bill impacts

29 Previously we have forecasted indicative consumer bill impacts from information disclosed by EDBs. We are interested in understanding what other information may help refine our approach.

What models or data inputs could be provided by EDBs which would improve our approach to modelling consumer bill impact?

78. The Commission needs to consider consumers energy spend as a whole, not just their spend on electricity. As the energy transition accelerates, we expect to see consumers spend more on electricity and less on fossil fuels. This 'energy wallet' effect needs to be measured to properly assess the impact on consumers.