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Dear Mr Gunnell

Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision cross-submission

1. Introduction

Wellington Electricity Lines Limited (WELL) welcomes the opportunity to make a cross-submission in response to submissions made to the Commerce Commission's (Commission) draft decision paper on the "Default price-quality paths for electricity distribution businesses from 1 April 2020" published on 29 May 2019. This cross submission refers to this paper as the "Draft Decision". The cross-submission will also reference the "Default price-quality paths for electricity distribution businesses from 1 April 2020 Issues Paper" published on 15 November 2018 which is referred to in this paper as the "Issues Paper".

WELL thanks the Commission for the opportunity to provide input into the DPP3 price-quality path reset process. With the exception of a few topics where retailer's views differed from other submissions, WELL thought feedback was well aligned. Those who submitted on the specific mechanisms for setting allowances and managing quality were also generally aligned on the suggested changes to the draft decision as follows:

- Not all operating costs are being capture by the traditional network growth cost drivers. A partial productivity factor should be included to ensure EDBs are recovering costs to adequately fund the lines function services required to deliver the expected level of quality.
- A higher level of scrutiny is suggested to assess AMP capex forecasts. The proposed tests should be refined using new information collected over the DPP3 period. While this is being done, the allowances should be based on the AMP until the suggested tests are refined.
- The proposed unplanned reliability breach assessment will increase the number of breaches simply because of a tighter target – not because of a deterioration of supply or because customers have agreed to pay more for the higher reliability inferred from the proposed targets. Revert back to the two out of three rule which is a better measure to trigger further review of performance.
- The introduction of the separate planned quality and incentive targets will result in some EDBs choosing between paying penalties or deferring planned work, rather than incentivising continuous improvement with an equivalent reward. Both planned quality

targets and reference periods should be adjusted to reflect work practice changes since the last reset period.

2. Flexibility in the regulatory model

A leading theme of the Commissions Draft Decision and in submissions for many of the Electricity Distribution Businesses (EDB), The Independent Electricity Generators Association, First Gas, emhTrade and Lord Consulting, is that services in the electricity industry sector are changing and the demand placed on the network may increase as de-carbonation programmes are implemented. The Independent Electricity Generators Association provided examples of how EDB networks could support new distributed energy resources (DER) that could contribute to the local or national energy pool. Orion highlighted the Interim Climate Change Commission's report that is planning for increasing electrification of process heat and transport fleets by 2035.

WELL agrees with Vector's view that to meet these changing demands and uncertainty, the regulatory model must have more flexibility. The current mechanisms will not enable EDBs to test, develop and implement the new technology needed to support customer DER or meet the increase in energy demanded from these new devises. As voiced by Vector "The Commission's incremental changes to the DPP setting process and preference for 'one-size-fits-all' approaches unnecessarily restrict much needed regulatory innovation, ignoring the fact that EDBs with different contexts will evolve at different speeds".

WELL commends Orion for testing with its customers whether they agree with this sentiment. 79% of Orion's residential customers surveyed think it is important or very important for Orion to be a leader of technology, anticipate customer needs, innovate, and proactively prepare for new technologies. WELL's own Electric Vehicle (EV) trial with 100 EV owners found that its customers who own EV's also supported the development of new services like management of EV charging. The trial found that around 70% of customers were comfortable with someone (supplier or distributor) managing EV charging to help smooth network congestion.

WELL supports the intent of the Commission's proposed new mechanisms designed to support the development of new technology and capture unexpected demand increases from de-carbonisation. WELL also agrees with the Commission plans to develop a better understanding of the potential impact new technology might have on EDB services and changing consumer requirements within the DPP3 period. However, as highlighted by Orion and Vector in particular, the draft DPP3 mechanisms are still too restrictive and the incremental approach to change could mean that new technology and new services demanded by customers will outpace the regulatory model and negatively impact outcomes for service quality.

WELL supports Vector's submission which highlights specific areas of investment needed to support the introduction of customer DER. WELL agrees that EDBs need to consider efficient investment to enable visibility of the low voltage (LV) network within the DPP3 regulatory period. Visibility of the LV network is needed to manage the improved voltage quality and increased capacity needed for the introduction of customer DER.

Submissions provided good ideas on how to add more flexibility into the regulatory model to meet changing customer demand, while maintaining a low cost regulatory model. The changes that WELL considers most important follow.

2.1. Adding flexibility into the new unforeseen connection re-opener

Submissions supported the new unforeseen connection re-opener but suggested flexibility needs to be added to capture a wider range of de-carbonation initiatives. WELL supports this view - the proposed reopener criteria needs to be flexible enough to capture all of the potential changes the New Zealand Government are proposing in their climate change and accelerated electrification initiatives. WELL especially agrees with Alpine's view that the re-opener should not ignore aggregated unforeseen growth. The revenue cap is designed for current levels of demand and on its own is not suited for non-traditional growth that will come from new customer DER services or government climate change initiatives. This growth will not come from new connections, but from existing consumer connection choices for demand or generation added to their existing connections.

Removing the restriction of a single new connection and allowing it to also be applied to existing connections is a low risk adjustment for the Commission that would provide EDBs with much of the flexibility needed to meet changing customer demand and government policy requirements. WELL also supports Powerco's suggestion of adding flexibility to the expenditure threshold to ensure the re-opener is applied consistently to investments across New Zealand's networks.

2.2. Allow for one-off projects within the DPP3 framework

Alpine, Vector, Unison and Centralines submitted that the capex 120% cap should be relaxed. Submissions suggested this would better reflect the lumpy nature of capital programmes and allow large one-off programmes to be included in the low cost DPP regulatory model. The one-off capital programmes should be supported with a higher level of scrutiny, avoiding the need of an expensive CPP application.

WELL supports this idea as it would also provide the DPP with the flexibility to support network investment needed to introduce new services and too support de-carbonisation initiatives.

3. Innovation

All EDB submissions, the submissions from similar infrastructure businesses and those from entities interested in introducing new DER services supported an innovation allowance. Sapere's review of other jurisdictions showed that innovation funds had been applied to support network flexibility and de-carbonisation. Sapere's research also showed that the proposed Draft Decision fund was small in comparison to other jurisdictions. Most submissions supporting the innovation fund said that the fund is too small to be effective. WELL agrees the fund should be larger and administered by a similar model as that used in the UK which provides a higher level of application scrutiny which is in-line with larger funds. WELL also supports Sapere's observation that there is no robust way of calculating an optimal level of funding and that its's more important to provide flexibility to allow the funding level to be set with the need. The UK funding model provides for this flexibility.

MEUG expressed concerns that the evidence of underinvesting is not strong enough to be confident of the need for the fund. MEUG suggested a benchmarking study would provide useful evidence.

WELL believes that waiting until DPP4 will be too late as EDBs need to start developing the tools for incorporating customer DERs onto their networks now. The Sapere submission also provides useful benchmarking information that should provide MEUG with some comfort as to the need for the fund. A business case driven process like that used in the UK will also provide additional scrutiny and confidence that any innovation funding would be effective and that all EDBs will benefit from shared intellectual property.

Contrary to other foreign regulatory jurisdictions and the Commission's own analysis that suggests the industry is under investing in innovation, retailers (with the exception of MEUG) don't support an innovation fund. Retailers appear to have two concerns which are discussed further below.

3.1. Not consistent with a competitive market

Meridian suggested treating innovation as a recoverable cost would not result in outcomes consistent with a competitive market. In competitive markets innovation is high risk and emerging technologies may succeed or fail and be quickly abandoned, generally at the expense of investors rather than consumers.

WELL disagrees. Regulated providers don't have the same rewards and incentives that competitive businesses do. There is an asymmetry in regulated markets where risk is limited for consumer's who also benefit from the full upside gains, while the opposite is true for regulated parties who therefore may not consider to invest due to this disincentive.. While the IRIS provides rewards for productivity improvements through innovation, there is no reward or incentive to provide new or improved customer services using non-wire solutions. There is also no way of recovering operating costs needed to research, trial or develop new technology. Without funding and incentives to support the introduction of customer DER services and the on-going management of their increased energy demands, DER devices will be installed on networks at the expense of network quality and reliability or EDBs will simply not allow their inclusion and curtail their connection due to quality or constraint risks. Note, this assumes that EDBs are notified of all DER installations (including EVs).

If the innovation does lead to IRIS savings, customers will benefit as any savings are shared through price reductions.

3.2. The fund would provide regulated businesses with an unfair 'leg up'

At the heart of retailer concerns seems to be that the innovation fund could be used to develop new services that will then be sold in a competitive market – that EDBs will use their position of market power to develop an unfair competitive advantage. Meridian's submission highlighted this when it said "… outcomes produced would not only be inconsistent with outcomes in competitive markets but would also be so much of a leg up over other participants in competitive markets (who do not enjoy regulated allowances or incentives for innovation) that innovation in those markets would be stifled". ERANZ said that the fund would promote investment in new technology that should be a competitive market.

WELL disagrees but perhaps not for the reasons expected. WELL agrees that EDBs shouldn't be using their position of market power to create an unfair advantage for competitive services. WELL believes that EDBs will require markets to assist with the coordination of DER services to manage congestion,

constraints and quality to ensure all consumers receive an equitable energy supply system. WELL is indifferent to who owns DER. However, it is essential that EDBs have oversight of the network operational limits and where and how DER will operate to provide a stable supply system, similar to what already occurs at the transmission level where demand and generation require real time coordination.

The ability to purchase new, non-traditional, non-wire services to assist in managing congestion and delivering new DER services, does assume that the regulatory model provides the funding required to enable this change in investment. In its current form it does not. This challenge was discussed in WELLs original submission.

To facilitate the introduction of new customer DER services, EDBs need to manage the impact the new services will have on the network. The innovation fund will be essential to allow EDBs to develop the tools to manage and co-ordinate DER devises to maintain network security and reliability. Rather than reducing competition by using the fund to develop competitive services, the innovation fund will promote competition by creating the platform on which the new services will become visible for other businesses to consider future market services.

4. Customer prices

Contact Energy and ERANZ both commented that prices in the retail and generation sector have decreased while distribution costs have increased. WELL refers to its cross-submission to the Issues Paper which provided price change analysis showing distributors price changes were less than energy/retailers. This issue was further addressed at the Governments Electricity Price Review Advisory Committee, the outcomes of which are yet to be released by the Minister.

As outlined in our Issues Paper cross submission, there may be periods of modest increases as EDBs reinvest at the end of asset lives to maintain services or invest in new capability. Prices should be viewed over the long term to capture the long replacement lifecycles assets require. EDBs will also have to invest in new capacity or in improving the efficiency of the existing capacity to meet the expected exponential increased in electricity usage from new technology like electric vehicles. WELL notes that ERANZ does recognise these latter points.

4.1. EDBs have failed to provide productivity improvements

Related to comments on overall distribution prices was ERANZ and Pat Duignan's comments on the lack of productivity improvements shown by EDBs during the DPP2 period. As stated by ERANZ and Mr Duignan, this was in despite of a 34% incentive for EDBs not to overspend.

These observations highlight a larger issue. A 34% reward for saving operating costs is a strong incentive that would motivate EDBs to save costs if they could do so. As detailed by the ENA's submission and supported by the NERA study, the DPP2 mechanisms did not capture all of the operating cost EDBs incurred to operate their networks. Any potential productivity saving has been offset by costs not allowed for in the DPP2 allowances.

Meridian suggests that the Commission carry out and publish a systematic analysis of the way IRIS has operated and the effect of IRIS on various EDBs investments and revenues. Meridian suggests that if it's shown that the IRIS hasn't incentivised cost savings, then EDBs should not be allowed

access to the innovation fund. As highlighted above, IRIS incentives will only be effective if EDBs have the allowance to cover the cost of operating its network. WELL also does not understand the link between the IRIS and the innovation fund and why success in the IRIS should be a criteria for access to the fund. As illustrated in the various submissions including WELLs own, the innovation fund will be used primarily to test and develop new services to support the introduction of DERs while maintaining network security and reliability. The benefits to the customer of facilitating DER network connection will come from the deferral of short term network reinforcement – using DER resources to assist EDBs to smooth congestion which would avoid early investment in providing greater network capacity.

5. Operating costs

ERANZ submitted that a positive productivity factor should be applied to promote cost efficiencies. Productivity should improve in a competitive market. ERANZ suggested setting a factor in-line with foreign jurisdictions. A positive productivity factor is not appropriate because:

EDBs allowances do not cover all of the costs they incur when operating their networks. As explained in the ENA's, Unison's and Vector's submissions, EDBs are not able to fully cover their operating costs with the allowances available. EDBs returns for the DPP2 period are below WACC. Reducing the level of available funding further by applying a positive productivity factor will make this worse, potentially resulting in a corresponding reduction in service quality (due to the dichotomy of price-quality recognised in Part 4 regulation).

1. The partial productivity factor rates used in overseas jurisdictions are not reflected in the New Zealand operating environment.

WELL supports using the partial productivity factor to capture costs missed by the other regulatory mechanisms. The ENA's submission discusses this in depth.

6. WACC

Contact Energy and ERANZ suggest reducing WACC to drive innovation and competition across regulated businesses. It is important to consider this suggestion in the context of the distribution sector:

- EDBs are already performing below WACC due to the regulatory model not capturing cost increases – EDBs are currently not receiving the regulated return they expected for investing in the network.
- Part 4 recognises that the impact to customers of underinvesting is disproportionately larger than incentivising slightly higher investment levels to ensure consumers receive the expected level of reliability and security of supply.
- As highlighted in Vectors submission to the DPP3 IM changes, the negative real risk free rate is resulting in a cost of equity that is significantly lower than what investors can receive for comparable investments.
- Investing in New Zealand distribution network is potentially less attractive than investing in other infrastructure investments at a time when investment is needed to support de-carbonisation initiatives.

WELL believes that care must be taken to not further reduce an EDB's ability to invest in the network for our customers. WELL encourages the Commission to investigate the challenges outlined by Vector in their DPP3 IM submissions and to consider their recommended changes which includes implementing corrections that have already been applied in the regulatory regimes of other countries. If New Zealand is to become carbon neutral, more investment will be needed in distribution networks. Investors will need to feel confident they will receive a fair market return, if they increased their investment into the network.

7. Growth capex test

Submissions on the new capex tests focused on the proposed growth capex scrutiny. Vector's submission suggested including sub-transmission expenditure and capacity in the system growth test. WELL disagrees with this suggestion as sub-transmission expenditure doesn't always result in an increase in MVA but may be for security or resilience purposes. This highlights the challenges of designing a test for systems growth with the data available. Unison, Orion and Network Tasman all expressed concerns around the effectiveness of this test.

8. Quality performance

ERANZ commented that DPP2 quality incentives did not appear to lead to quality improvements and that reliability appeared to deteriorate. ERANZ suggested the Commission investigate whether Part 4 requirements were being met and to establish why incentives are not improving performance.

As outlined in our response to the Issues Paper and in our draft decision submission, WELL believes that the quality regime is operating well and incentivising businesses to adapt or to face further investigation into performance levels. Investigations are formal processes to consider if there are natural quality variations occurring due to climate changes or changes to EDB work practices or asset performance changes. WELL does not believe that network asset reliability is deteriorating. The Commission have attempted to better expose asset deterioration through changes to normalisation methods. However, the nature of long life distribution assets means that deterioration may occur gradually over time and is difficult to separate from outages caused by the natural variation in uncontrollable outages from external causes.

WELL believes that the current incentive levels do encourage EDBs to invest in reliability improvements. An example of this being EDBs using generation to help ensure the power stays on for customers normally exposed to outages from planned work. Under the draft decision, these incentives would be reduced to the point there would be no incentives to improve quality apart from penalties for exceedances.

To ERANZ's underlying concern around asset deterioration, WELL is concerned that quality could deteriorate under the DPP3 due to changes to the targets being measured. The proposed changes to the quality targets are pressuring EDBs to now improve quality despite customers being comfortable with maintaining current levels of reliability while also increasing the likelihood of EDBs breaching. This is at a time when allowances are under pressure from greater business-as-usual costs.

The increasing difficulty of balancing price and quality was expressed by many EDBs including Centralines, Unison, The Lines Company and Vector. Unison expressed this well when it described

Vector's quality breach outcomes which suggested there was a requirement on Vector to address the impact of foreseeable changes (such as increasing traffic congestion) on its operational performance. This is a change to the level of quality and requires additional allowances which the current regulatory model does not provide. Importantly, this finding deviates from the quality test of 'no material deterioration'.

8.1. Limiting inter-period quality adjustments

Submissions that commented on the proposed 5% limitation of inter-period movements in quality targets all agreed that EDB's poor performance should not be 'rewarded' with relaxed standards. Most EDBs either agreed with the 5% cap or argued for a higher percentage.

WELL also agrees that EDB's poor performance should not be 'rewarded' with relaxed standards. However, WELL disagrees with using a cap based on a percentage movement in quality targets. As outlined in WELLs submission, a 5% cap on a more reliable network represents a small absolute movement in quality, and hence has a much smaller impact on customers than a 5% move on a less reliable network. WELL recommends setting the inter-period movement cap to be within the current DPP2 one standard deviation range. WELL does not understand why changes beyond the control of an EDB are limited to a 5%, a restriction that doesn't have empirical support and deviates from the IEEE standard.

9. Closing

WELL appreciates the opportunity to provide a cross-submission in response to submissions to the Commerce Commission's Draft Decision "Default price-quality paths for electricity distribution businesses from 1 April 2020".

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

Yours sincerely

Greg Skelton

Chief Executive Officer