Electricity Networks Association
7th Floor, Wellington Chambers, 154 Featherston Street
PO Box 1017
Wellington, New Zealand 6140
Telephone: 64-4-471 1335 ***Fax:*** 64-4-496 5209

E-mail adj@electricity.org.nz

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Sue Begg
Deputy Chair
Commerce Commission
PO Box 2351
Wellington

Dear Sue

Update on Discussions of ENA Energy Efficiency Working Group

This letter provides an update on the matters being discussed at ENA's Energy Efficiency Incentives working group that we consider relevant to the Commerce Commission's decisions on regulatory incentives under Part 4 of the Commerce Act. Although the full report from our Energy Efficiency Incentives working group will not be available before Christmas, this letter briefly outlines some of the key points that the working group intends to include in its report to the ENA. We provide these key points now as we understand that there are long lead times to making changes to the input methodologies. We hope that early reporting may be helpful to the Commission as it consider changes to the DPP input methodologies to better address regulatory incentives.

As an initial point, the group considers that section 54Q of the Commerce Act gives strong support to these key points and recommendations that the group intends to include in relation to the implementation of Part 4. We interpret section 54Q as requiring the Commission to account for the energy efficiency and demand side impacts of each decision that it makes in relation to EDBs under Part 4. This means that regulatory approaches that promote energy efficiency should be favoured by the Commission, unless there are other factors that clearly show that such approaches would not be in the long term interests of consumers.

The working group has identified three issues that are directly relevant to the Commission's decisions on regulatory incentives:

- **Potential for energy efficiency to adversely affect EDB revenues.** Using a weighted average price cap to set price-quality paths for EDBs means that an EDB will earn less revenue within a regulatory period by carrying out energy efficiency measures that reduce total electricity volumes. The group has discussed possible short-term and longer-term solutions to this incentive problem. Short-term measures could include incorporating a mechanism into the price path to compensate EDBs for any revenue foregone from energy efficiency (known in Australia as the "D-factor"). Longer-term measures could include reconsidering the use of a weighted average price cap or changing the way the price cap is expressed (for example, from KWh to KW), and moving to a revenue cap or other approach to setting price-quality paths for EDBs.

- **Unequal incentives for opex and capex.** Energy efficiency initiatives may be considered to be operating expenditure (opex). For example, contracts with third parties to manage customer demand during network peaks will be recorded as an opex item by EDBs. EDBs face decisions on whether to incur such opex or invest in network capex that would achieve similar outcomes. The opex option will be in the long-term interests of consumers if it costs less in present value terms than any capital expenditure (capex) that EDBs would incur without the energy efficiency initiative. The group has identified that EDBs currently face different incentives for opex and capex, and the relative strength of those incentives changes throughout the regulatory period. This means that at times when capex incentives are stronger (such as towards the end of the regulatory period), EDBs may rationally substitute energy efficiency opex for a capex alternative. For energy efficiency initiatives that involve capex, EDBs may rationally defer investments that consumers would benefit from having carried out in earlier years to take place towards the end of the regulatory period. Measures to address these issues might include equalising the strength of incentives for opex and capex.

- **Uncertainty on the regulatory treatment of energy efficiency investments.** Section 54C of the Commerce Act defines electricity lines services as "the conveyance of electricity by line in New Zealand". Many energy efficiency initiatives directly impact on the cost of conveying electricity by line, but fall outside of what is traditionally regarded as network investment. For example, investments in efficient lighting or home insulation can have a material impact on an EDBs' costs of meeting peak demand. However, it is not universally accepted that such investments could be incorporated into an EDBs' Regulatory Asset Base (RAB).

  The working group considers that this issue has multiple layers and it would be good to have greater clarity on the regulatory treatment of energy efficiency investments that do not directly involve the conveyance of electricity by line (but relate to the cost or investment required to do so). In addition, if a service/asset has elements of both a regulated and unregulated service (depending on the definition of lines services), applying the cost allocation rules in the input methodologies will also become necessary. We would expect the regulatory settings to ensure that EDBs are indifferent between whether efficiency initiatives are undertaken by EDBs themselves or whether another party provides the service. However, this is not necessarily clear. A short term measure to address this may be for the Commission to clarify the regulatory treatment of energy efficiency initiatives that impact on the costs of conveying electricity by line that have regulated and unregulated elements. Longer-term measures might involve amending the input methodologies to ensure that these activities are promoted under Part 4.

While not directly within the Commission's control, the working group has also discussed the impact that EDB pricing methodologies can have on energy efficiency. The group recommends that the Commission works closely with the Electricity Authority and the Ministry for Business, Innovation and Employment to ensure that the regulation of distributor pricing facilitates efficient EDB investment and operational decisions.

Finally, I would like to convey the working group's appreciation of the Commission's recognition of the importance of this work by providing Nick Russ to observe the deliberations of the group. Please do not hesitate to contact me directly should you have any questions relating to this letter.

Best regards,

Alan Jenkins
Chief Executive