Cross-submission to Part 4 IM Review 2023 Draft Decision

9 August 2023

Contents

Submission and contact details

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Release of information

This cross-submission contains no confidential information and can be publicly disclosed.

1 Introduction

All submissions relating to the electricity sector highlighted the need for EDBs and Transpower to invest in new capacity in response to New Zealand decarbonation. The sector is aligned in its intent and commitment to electrifying transportation, process heat and (potentially) fossil gas use. The Boston Consulting 'Future is Electric' provided a common roadmap for EDBs, retailers, flexibility providers and regulators to frame the regulatory changes that are needed to support New Zealand electrification[1].

A common theme from many submissions was the Draft IM Decision provided some of the changes needed to support the step change in investment, but further changes are needed to allow networks to flex their investment programmes in response to changing customer requirements. BusinessNZ Energy Council said that "*We welcome the Commission's review. However, despite the Commission acknowledging the changing circumstances in the sector, the draft decision largely retains the current IM. This may not be prudent in the medium to long-term considering the evolving needs of electrification. Notwithstanding several welcomed changes proposed in the draft decision, we are concerned that necessary adjustments to promote the long-term interests of consumers and adapt to the changing energy landscape is missing*".

Submissions also highlighted the importance of carrying the intent of IM changes through to the price reset, recognising that any IM change is meaningless without the corresponding price-quality path decisions. The FlexForum said (in relation to innovation allowances) "*The FlexForum suggests the Commission clarify how the allowance will work in practice ahead of the 2025 DPP determination and is happy to engage with the Commission to support this*".

1 https://web-assets.bcg.com/b3/79/19665b7f40c8ba52d5b372cf7e6c/the-future-is-electric-full-report-october-2022.pdf

2 Financing and incentivising efficient expenditure

2.1 Cash flows and financeability

Many networks are concerned about the impact that a step change in investment will have on their operating cash flows and the impact that the widening between cash inflows and outflows could have on funding costs[2][3][4][5].

Conversely, retailers are concerned about customer price shocks and support revenue smoothing. Contact Energy, for example, believes that 'revenue smoothing limits' need to be firmly applied over all line charges to ensure that the price change risk will sit with the party best placed to manage it[6].

The regulatory framework requires the Commission to consider both the impact of regulatory changes on customer prices and the impact on supplier cash flows. Specifically, Part 4 of the Commerce Act requires that:

> **s52R -** The purpose of input methodologies is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part.
>
> **s53P(8) -** The Commission may set alternative rates of change for a particular supplier—
>
> (a) as an alternative, in whole or in part, to the starting prices set under subsection (3)(b) if, in the Commission's opinion, this is necessary or desirable to minimise any undue financial hardship to the supplier or to minimise price shock to consumers; or
>
> (b) as an incentive (under section 53M(2)) for the supplier to improve its quality of supply.

We agree with PWC's report[7] which explains that the Commission's decision not to include a financeability test in the IMs is not compelling when the s52R purpose of the IMs is to promote regulatory certainty. PWC also states that:

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2 Page 12 and 15, https://comcom.govt.nz/__data/assets/pdf_file/0018/323811/Unison-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

3 Pages 29 to 31, https://comcom.govt.nz/__data/assets/pdf_file/0020/323174/Vector-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

4 Page 11, https://comcom.govt.nz/__data/assets/pdf_file/0018/323154/Orion-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

5 Page 7, https://comcom.govt.nz/__data/assets/pdf_file/0013/323104/Aurora-Energy-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

6 Section 30, https://comcom.govt.nz/__data/assets/pdf_file/0015/323115/Contact-Energy-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

> "The IMs therefore currently do not address the second component of s53P(8)(a) which is to minimise any undue financial hardship for suppliers. Including a financeability test in the IMs would address this omission and would better give effect to s53P(8)(a) by ensuring that both the price shock and financial hardship criteria are addressed in the IMs"

The Draft IM decision considers the impact on customer prices by applying regulatory price smoothing mechanisms like indexing the RAB and applying a revenue cap. However, the draft decision does not test the impact of applying these mechanisms on supplier cash flows. Introducing a financeability test would allow the Commission to meet its Part 4 obligations, helping to ensure suppliers continue to be incentivised to invest.

We also disagree with Contact's approach of passing all price volatility onto EDBs. Retailers also have a role to play in New Zealand electrification. We agree that EDB's should manage some of the price volatility, but this needs to be carefully managed to ensure regulatory allowances cover funding costs and net cashflows remain at levels where an EDB is still incentivised to invest. Electrification and decarbonisation benefit all New Zealanders and we believe it is fair to expect retailers and customers to share in managing price volatility.

2.2 Non-networks solutions and quality of supply

Contacts submission discussed EDBs offering new connecting customers different levels of quality for different prices. Specifically, Contact suggested EDBs could offer newly connecting customers spare capacity that may not be at the standard N-1 level of quality for a reduced price. The connecting customers could provide their own backup supply through generation or batteries to achieve an equivalent N-1 service[8].

We support considering this type of hybrid approach to providing electricity services and we can envisage that there will be some situations where this could provide a more cost-efficient service. In addition to the commercial scenario provided by Contact, we think there could be benefits for residential customers investing in household generation or batteries (including EV batteries) as a backup to the general electricity supply. In rural settings or in urban radial networks, this could provide a cost-effective way of providing an additional level of redundancy and improved resilience.

8 Section 24, https://comcom.govt.nz/__data/assets/pdf_file/0015/323115/Contact-Energy-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

Regulatory changes would be needed to support these types of solutions:

- The quality path would need to recognise customer-provided redundancy so as not to penalise EDBs for offering a lower network level of security.
- Customers would need to be more active in their price/quality choices. These types of solutions would pass part of the responsibility of providing a secure supply to the end consumer.
- The regulatory model would need to be able to purchase flexibility services as an outage response. This also assumes that flexibility services have been developed to the scale needed to provide an alternative to traditional network reinforcement and that the technology exists to provide a viable alternative to traditional network reinforcement.

These regulatory changes would be significant. We recommend that the Commission continues to explore and develop this regulatory capability post the final IM decision.

2.3 Debt washup

The ENA has Commissioned further work with PWC on the debt washup provision. The PWC study highlighted the cashflow volatility created by this mechanism. We also note that alternative methods suggested CEG and Frontier also remove inflation forecasts error, but without introducing cashflow volatility. We note that it may be too late in the process to consider these alternative options. We reiterate our Draft IM Decision suggestion of a post-IM workstream in parallel to the DPP4 reset to consider the alternative options which we believe could be better.

2.4 Innovation

Innovation to support the development of LV management tools

The Drive Electric submission highlighted the need for EDBs to invest more in research and development, specifically the development of low-voltage management tools[9]. They highlight the importance of EDBs having detailed visibility of the capacity and performance of their LV networks to support large new connections like public EV chargers. EDBs also need visibility of their LV networks to support flexibility services.

9 Section 37, https://comcom.govt.nz/__data/assets/pdf_file/0018/323118/Drive-Electric-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

This new capability requires specialised software, access to external data (including the location and size of new customer devices and consumption and quality data), strong internal spatial data (including cleaning and correcting historic data) and the development of processes and expertise to manage LV operations. The development of this capability is not trivial. WELL's sister company in South Australia (South Australia Power Network) has invested $37m ($4m p.a. in operating costs) and took five years to implement the 900,000 connections they service. They have now reached the point they can host flexibility services.

Ensuring the innovation mechanisms is workable

We agree with Chorus that it will be important to ensure that the innovation mechanisms must be workable to use, i.e. "low cost, predictable, and broadly accommodating[10]". We liked their ideas on how to make the application for innovation allowance for efficient and agree that the suggested changes would encourage suppliers to innovate more. We also think these ideas provide good examples of how the intent of the IM Draft decision changes (to reflect the step change in innovation needed to support decarbonisation) can be carried through to the price/quality setting process.

We note Contact's concerns around ensuring rigour around funding innovation, specifically to ensure that 'business as usual' costs aren't captured in innovation allowances. We think this risk is low and that EDBs could provide a description of innovation projects (in line with Chorus's suggested supporting documentation) that could be used to test that projects fit the innovation definition. Reiterating Chorus' submission points, care must be taken to ensure that any innovation mechanism is workable. The consequence to customers of networks not developing the capability to use non-wire solutions (our initial estimate is that it will save $200-$300m in avoided investment) will outweigh the potential of networks over investing in innovation.

A leg up in the development of non-regulatory services

We note Contact's concerns about the allowance being used by EDBs to develop non-regulatory competitive services. We agree that the Electricity Authority will need to decide to what extent that EDBs can participate in non-network services like the supply of flexibility services (i.e. potentially restricting EDBs to purchasing flexibility). Clear participation rules should be developed as a priority. We believe this will help promote the development of flexibility services by clearly defining what components of the flexibility supply chain each party will be responsible for and what new capability

10 Section 4, https://comcom.govt.nz/__data/assets/pdf_file/0012/323112/Chorus-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

needs developing. We note the Electricity Authority does have this issue included in their upcoming "Regulatory Setting for Distribution Networks" works programme.

Funding third parties

We also note Contact's recommendation that the allowances should not be used to fund third-party participation in innovation trials and projects to avoid 'competitive distortions'. We strongly disagree with this recommendation as it will slow the development of flexibility services.

While established retailers will be able to afford to fund their own research and development and participation in EDB innovation projects, small startups may have to rely on EDBs providing seed funding to the development of their part in providing flexibility. For example, our Resi-Flex trial with Orion has been designing commercial and operating models for flexibility products that consumers will want to participate in. The next step in the trial is to partner with flexibility suppliers to test these products with consumers. We are considering whether to test the commercial viability of these products by paying a flexibility provider for the service like we would in practice. Payment for the services would both test the commercial viability of the products and ensure that the flexibility suppliers are able to provide customers participating in the trial realistic incentives. Excluding the ability to pay suppliers could exclude small start-ups from participating in trials and ultimately limit long-term competition.

Importantly, we will also be sharing the results of the trial publicly so any advantages or learning gained from participating in the trial will be shared publicly, including with any potential future competing flexibility suppliers. This would limit any competitive advantage from direct participation in the trial.

3 Cost of Capital

We agree with Airport submissions, Vector and Transpower that some of the Commission cost of capital Draft IM Decisions do not maintain a principled and independent approach. Specifically, the decision to reduce the WACC percentile to the 65th and to exclude samples from the asset beta sample introduce subjective judgments to what was a well-established approach.

3.1.1 Asset beta sample set

We agree with the Airports general view that the Commission's decision to treat the Covid-19 pandemic observations differently is a change in approach and adds subjectivity[11]. The Draft IM Decision excludes pandemic observations and replaces them with a manually created forward-looking view of pandemic risk.

As also highlighted in the Oxera report[12] the approach comes with a high level of subjectivity. Beta estimates affected by the Covid-19 pandemic provide valuable information about the companies' risks, as any other event causing volatility would. The Oxera report continues to argue that the Commission's approach potentially introduces "non-justified non-replicable methodological steps and by this, reduces the stability and predictability of the regulatory regime". The assumptions around the length and frequency of pandemic-like events are not well-explained, as well as the choice of representative pandemic and non-pandemic periods, which leads to a large degree of subjectivity and introduces regulatory risk.

This view is echoed in Auckland International Airport submission which adds that making ad hoc adjustments "requires arbitrary judgement calls over time regarding which shocks should be adjusted, which should be ignored and how new shocks on top of old shocks should be accounted for. This adds unpredictable complexity and heightened uncertainty to the regulatory regime[13]."

Dr Martin Lally also expressed his concern about the approach stating that "the merits of applying such treatment to selected events are contentious, especially when the probability of a recurrence of the event is so hard to estimate and any such recurrences may be materially more or less severe[14]".

We support advice from both Oxera and Competition Economics Group (CEG) that Covid-19 pandemic observations should be treated in the same way as all observations, just like other outlier events such as the Global Financial Crisis and other major economic shocks have been in the past.

11 Page 2, https://comcom.govt.nz/__data/assets/pdf_file/0012/323103/Auckland-International-Airport-Limited-AIAL-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

12 https://comcom.govt.nz/__data/assets/pdf_file/0016/323107/27Big-627-EDBs-Oxera_-Response-to-Commission27s-draft-decision-for-IM-Review-2023-on-the-cost-of-capital-Submission-on-IM-Review-2023-19-July-2023.pdf

13 Page 3, https://comcom.govt.nz/__data/assets/pdf_file/0012/323103/Auckland-International-Airport-Limited-AIAL-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

14 Section 1, https://comcom.govt.nz/__data/assets/pdf_file/0017/323117/Dr-Martin-Lally-The-impact-of-future-COVID-19-scenarios-on-beta-Submission-on-IM-Review-draft-decisions-22-June-2023.pdf

3.1.2 Tax adjusted market risk premium (TAMRP)

Our submission highlighted the weakness of the Draft IMs Decision of relying heavily on the Siegel I model[15]. Chorus also recognises the weakness of the Draft IM Decisions approach to calculating a market risk premium and suggested moving to a Total Market Return (TMR) approach for estimating equity costs in the Cost of Capital IMs. It states that deriving the TAMRP as a residual from a stable TMR is better than the current 'averaging' method because it will increase the stability and accuracy of the cost of equity estimate. This is supported up by an expert report from Incenta[16] (https://comcom.govt.nz/__data/assets/pdf_file/0042/287988/Chorus-Measures-to-improve-the-stability-in-WACC-estimates-11-July-2022.pdf) and is also the standard approach by all UK regulators.

There is little reason provided by the Commission for why retaining its existing 'averaged' method of estimating the TAMRP better meets the purpose of the IMs or Part 4 than the TMR approach suggested by Incenta. We recommend that the Commission considers alternative models which put more weight on the more reliable Siegel II model.

3.1.3 65th Percentile

We support Transpower's view that the decision to apply a 65th WACC percentile has been made without compelling evidence and that the decision departs from the well-understood and predictable methodology used in past resets. We also agree with First Gas who said "when considering proposed IM changes, we must therefore be mindful of the importance of predictability, which plays a role in providing suppliers with incentives to invest in accordance with section 52A(1)(a)". We believe that it is essential that the Commission maintains investor confidence in the regulatory model at a time when customers will be asking investors to choose to increase their investment in distribution networks. The 67th percentile was already at the lower end of the optimal range. Insufficient investment incentives might risk delaying the energy transition, which would have significant asymmetric effects in terms of social outcomes that are additional to those captured in the loss analysis framework.

We also disagree with MEUG's submission to reduce the WACC to the 65th percentile. MEUG provided no evidence to support the reduction in the context of the New Zealand regulatory environment. Other countries have different regulatory frameworks and mechanisms that reduce the impact of

15 Page 31, https://comcom.govt.nz/__data/assets/pdf_file/0021/323175/Wellington-Electricity-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf
16 Page 28, https://comcom.govt.nz/__data/assets/pdf_file/0042/287988/Chorus-Measures-to-improve-the-stability-in-WACC-estimates-11-July-2022.pdf

estimation errors and a comparison of WACC percentiles can't be made without considering the whole regulatory framework.

4 CPP and in-period adjustments

We noted the general support across most electricity-related submissions for more regulatory flexibility so networks can make their Emissions Reduction Plan related investment. We thought PowerNet's submission highlighted the differences in connecting customers under price-quality regulation and under the light touch Information Disclosure regulation[17]. Their submission highlights the barriers the regulatory framework creates for customers connecting. It is important for the regulatory framework to support customers decarbonation related investments, rather than to create additional implementation steps.

4.1 Timeframes

We note MEUG's submission highlighting the importance of having reopener timeframes, "…it is important that reopeners are considered in a timely manner, reflecting the importance and impact that the proposed change will have on the consumers in that region[18]". MEUG represents the types of customers who could be connecting to distribution networks using a reopener. This view reflects the feedback we have received from customers on the Wellington network wanting to connect using a reopener. They have expressed their frustration about the difficulty in incorporating the reopener process into their own project planning[19].

4.2 Reopeners for general growth

We have similar concerns as many networks and the ENA about restricting reopeners for general growth to foreseen reopeners. We agree with Horizon Network that there could be scenarios (like an accelerated gas transition) that could mean new network growth investment is needed and that investment isn't captured in the 10-year AMP planning window i.e. the investment is technically unforeseen and therefore an EDB can't apply for a reopener to fund the investment.

17 Section 25, https://comcom.govt.nz/__data/assets/pdf_file/0020/323156/PowerNet-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

18 Section 15b, https://comcom.govt.nz/__data/assets/pdf_file/0021/323139/Major-Electricity-Users-Group-MEUG-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

19 Page 42, https://comcom.govt.nz/__data/assets/pdf_file/0021/323175/Wellington-Electricity-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf

In response, an EDB could be conservative and include different growth scenarios in its 10-year capex planning window, however, this would provide a conservative and inflated capex forecast.

Alternatively, an EDB could provide different growth scenarios separate to the capex schedule, for possible, but not probably growth profiles. This would allow an EDB to base their AMP capex schedules on what they consider the most likely investment profile while also informing customers and the Commission of the possibility of different investment profiles in response to changes in the growth drivers. This would require the IM's definition of a foreseen investment to capture investments provided in scenario analysis separate to the capex provided in the AMP schedule. We think that relying on alternative forecast scenarios could make the assessment of what is 'foreseeable' subjective.

Our preferred approach is to remove the complexity of providing separate 'foreseeable' and 'unforeseeable' definitions and to make reopeners available for all general growth scenarios.

4.3 CPP applications and customer consultation support

We note Meridian's suggestion that the Commission and/or lines companies should be more active in explaining price increases to consumers. While we think retailers should retain the primary relationship with the end user, we do think that the communication channel through to consumers for distribution services will need to be strengthened. As highlighted in our Asset Management Plan[20] EDBs need to understand the changing cost-quality trade-offs that their customers are prepared to make and promote customer participation in the flexibility services that will be critical for managing the rapid increase in demand. We will need customer feedback on more than just price increases – a change in approach to how we communicate with consumers is needed.

We recommend:

- The Commission provides guidelines about customer consultation expectations when making a CPP application (as per our submission to the Draft IM Decision).
- Note that EDBs are likely to have to make a step change in their customer communication capability for the next price rest. While not an IM decision, this will be a new capability that networks will need to include in the DPP4 price path.

20 Section 4.2.4, https://www.welectricity.co.nz/disclosures/asset-management-plan/document/318

- That the ENA continues to work with ERANZ to support retailers in developing key messages for price and service level changes. A good example of how this has worked well was the transition away from the Low fixed pricing restrictions.

4.4 large connection contract mechanism

We note MEUG[21] and several retailer's[22][23][24] concerns about the assumption that large customers will not have sufficient bargaining power when negotiating the large customer contract mechanism.

Meridian suggested a solution of providing customers with the choice of whether to negotiate terms outside of the regulatory model or to remain within the regulatory framework, which aligns with our own thinking and addresses the bargaining power concerns. We believe that the large connection contract mechanism should be available for all connections where an EDB and a customer to agree to negotiate terms outside of the regulator model and there shouldn't be a maximum connection size limitation of using the mechanism. If a customer has concerns about their ability to negotiate equitable terms, they can revert back to the regulatory model.

In reality, we believe networks would use commercial terms that align with the regulatory model to provide customers with the comfort of an equitable commercial model while providing the benefits outlined in the Draft IM decision.

21 Section 17, https://comcom.govt.nz/__data/assets/pdf_file/0021/323139/Major-Electricity-Users-Group-MEUG-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf
22 Section 10, https://comcom.govt.nz/__data/assets/pdf_file/0015/323115/Contact-Energy-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf
23 Page 2, https://comcom.govt.nz/__data/assets/pdf_file/0017/323144/Meridian-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf
24 Page 3, https://comcom.govt.nz/__data/assets/pdf_file/0016/323143/Mercury-Submission-on-IM-Review-2023-Draft-Decisions-19-July-2023.pdf