Mercury

Compliance
Electricity Authority
via email
compliance@ea.govt.nz

8 July 2024

Dear compliance team,

Part 6A exemption and dispensation application from WEL Networks Ltd

Thank you for the opportunity to provide feedback on the application made by WEL Networks Ltd (WEL) for an exemption under part 6A of the Electricity Industry Participation Code 2010 to develop solar farms and battery with a total generation capacity exceeding the 50MW threshold (Application).

Mercury does not oppose the Application. However, in the interests of promoting economic efficiency and transparency we seek confirmation the Authority is satisfied that:

1. cross subsidisation is not occurring between WEL Networks regulated network business (regulated under Part 4 of the Commerce Act) and the non-regulated solar generation and BESS assets. To prevent cross-subsidisation from occurring the Authority should provide guidance to WEL to ensure fair and reasonable allocation of common costs. Any required adjustments should then be reflected in WEL's Default Price Path (DPP) maximum allowable revenue;
2. WEL is charging itself the same price to connect its generation assets to its network as it would charge a third party's generation assets – i.e. that the risk of WEL foreclosing on price is minimal; and
3. WEL has justified its claim that it would cost more to develop the generation assets in compliance with the arms-length rules or a subset of the arms-length rules than it would if the exemption were granted.

On a general note, the Top Energy Ngāwhā exemption and the current Application indicate a potential relaxation of the Authority's approach to distributor involvement in contestable services. We urge the Authority to address any wider policy issues such as this through consultation and regulatory change rather than allowing a part 6A exemption application to become a back door opportunity for lines companies to invest in generation. The Authority must ensure appropriate safeguards are in place to protect competition in the relevant markets where there is a risk of harm through distributor ownership of generation assets.

Yours sincerely

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Risks to competition outweigh potential benefits from exemption

Genesis Energy Limited **(Genesis)** welcomes the opportunity to provide feedback on the Part 6A exemption and dispensation application from WEL Networks Limited**.**

WEL's exemption application is an important test of the applicability of the arm's-length rules under Part 6A and occurs at a crucial point in time in Aotearoa New Zealand's energy transition. The Authority has previously emphasised the crucial role flexibility services will play in New Zealand's transition, with Sapere analysis completed for the Authority estimating potential net benefits from flexibility services enabled by DER at nearly $7 billion. Both MDAG and the BCG report also highlighted the need for significant investment in flexibility services between now and 2050. Electricity industry participants, including Genesis, are actively considering investments into flexibility markets, including BESS. For New Zealand to realise the potential benefits of the nascent market for flexibility services in our electricity system, it will be critical to encourage investment and avoid unnecessarily crowding out of potential sources of capital by ensuring a level playing field.

As noted in WEL's application, the difference in competition between the Factual and Counterfactual One (the only likely counterfactual) is 'negligible'. When one considers the broader risks to competition that may result from perceptions that the nascent market for flexibility is not a level playing field, we submit that any potential benefits from WEL's ownership and operation of its New Generation Assets (the Factual) are not sufficient to justify the Authority granting an exemption to Part 6A of the Code.

Response to WEL's exemption application

Impact on competition of WEL's ownership and operation of NGA

WEL's application contends that the primary purpose of the 'New Generation Assets' (solar and BESS) will be to participate in the wholesale and ancillary services markets, and with network support services an unlikely secondary purpose. The exemption application states that WEL's New Generation Assets (NGA) could '…in theory, provide network support services to WEL's distribution network (but not in practice, as discussed below)', but that this would be secondary to the primary purposes noted (para.'s 3.4-3.5). The reason given is that WEL has 'no incentive to fulfil its requirements for network support services from the BESS to the extent there are lower cost alternative providers available', and '…given that WEL would receive a higher return from the BESS in the wholesale and ancillary services markets in this situation'.

However, WEL nonetheless acknowledges that '…it cannot be ruled out that, on occasion, it [BESS] would be used for the purpose of self-supplying network support services to WEL's distribution network' (para. 6.19). Given the exemption term sought is 25-30 years, even if only used 'rarely' as indicated by WEL, it appears there is a real and genuine risk the NGA will be used for network support services at some point during their lifetime. This is particularly so given the fact that, while it may true WEL can presently earn a higher return from participation in wholesale or ancillary markets, this is by no means guaranteed to remain true over the full lifetime of the asset. Hence, we think there is a reasonable risk the NGA are used for both network support services and participation in competitive wholesale and ancillary markets, and that the potential to use its NGA for network support services creates an incentive to prefer self-supply over a third-party and thereby diminishes competition.

WEL contends that, as the NGA will be connected to a high capacity 33kV line, there will be no physical constraint on an alternative provider competing to provide local network support services. While this may be true, it does not render the arm's-length rules unnecessary or adequately mitigate the risk to competition. Indeed, the arm's-length rules are clearly designed to mitigate risks to competition precisely in situations where the absence of any physical constraints nonetheless leaves open the possibility for preferential treatment by a parent business (network owner) in favour of an associated business. For example, rules 3, 4 & 6 (3C, 3D and 3F) prevent preferential treatment or discrimination.

We have noted the importance of maintaining a level playing field to ensure investor confidence is not harmed, particularly during the nascent stage of flexibility market development. There is a risk perceptions of foreclosure become self-fulfilling. This objection can also be raised regarding the points made by WEL regarding the non-materiality of the size of the NGA relative to the wholesale market, and the claim that matching solar and BESS improves market rivalry. WEL's interpretation of 'competition' is too narrow. That is, while it may be true that matching solar and BESS improves the competitiveness of WEL's project and could be therefore said to increase competition, and that WEL may not have an incentive or opportunity to 'use its monopoly distribution business to inhibit competition or cross-subsidise', its application does not consider the impact WEL ownership and operation of the NGA will have on wider market dynamics, including investor confidence and perceptions of a fair and level playing field.

We also question the implications of WEL's argument that matching solar assets with BESS improves the competitive rivalry of its NGA in the wholesale electricity market and therefore improves competition generally. The implication of this argument is that an exemption from Part 6A under section 11 of the Code is justified where an applicant can demonstrate the result will be to increase the competitiveness of the applicant's generation or DER project. We question whether the arm's-length regime is intended to work this way. In all cases application of the arm's-length rules in Part 6A may risk reducing the competitiveness (and indeed efficiency) of a given applicant's project, and this is an entirely predictable outcome of their application. The rationale of Part 6A assumes that competition is nonetheless best served by promoting a level playing field.

The rationale of the arm's-length rules in Part 6A is that there is an inherent risk to consumers from allowing a natural monopoly company to also operate in competitive markets, in particular the risk EDBs can socialise the costs of investing in an asset used to participate in competitive markets via its regulated lines charges, with the result consumers may end up paying more than they otherwise would. This risk of cross-subsidisation is exacerbated by the broad definition of distribution services under Part 4 of the Commerce Act which can include any form of asset used in the provision of distribution services (e.g., a network or load management function), including technology, human, or any other form of capital (e.g., offices, IT equipment etc.). If an exemption is granted, this significantly increases the onus on the Authority to work with the Commerce Commission to ensure disclosure mechanisms under the Commerce Act

provide the market with sufficient transparency about cost allocation between shared, dual-use assets such as BESS and distributed generation (see further comment on this issue below).

With regards to both Counterfactuals One and Two, WEL assumes other participants (whether an existing generator or new entrant) would not be able to realise comparable benefits from arbitrage in wholesale markets or, in the case of Counterfactual Two, provision of ancillary or network support services using BESS. These assertions are, however, based on untested assumptions about the asset ownership and operational profile of any other participants.

WEL's exemption application argues competition will not be harmed. However, as conceded in WEL's application, the obverse is also true: the difference in competition between the Factual and main Counterfactual (Counterfactual One) is 'negligible', as its solar farm at Te Ohaaki would only operate in the wholesale market and its loss does not prevent WEL from engaging in arbitrage or providing ancillary or network support services; indeed, as the application notes (para. 6.8), '…the difference in competition in the national wholesale market between Counterfactual 1 and the Factual is negligible'. Given, as WEL notes, counterfactual one is the only likely counterfactual, this suggests that any negative impacts on competition likely to result if the proposed exemption is not granted are negligible. This would suggest that the competition benefits from granting an exemption are not sufficient to overturn a presumption in favour of the application of the arm's-length rules.

Distinction from Top Energy decision

The exemption application cites the Authority's December 2023 Top Energy Part 6A exemption decision to support its arguments. However, there are crucial differences between Top Energy's application and the present application:

- Non-contestable nature of Top's application: in Top Energy's case, other competitors were highly unlikely to be able to enter with comparable or substitute projects. Not only did this mean competition was less likely to be weakened, it also increased the benefits that would result from exempting Top Energy from Part 6A, particularly the regional reliability or resilience benefits. In WEL's application, it is materially more likely that other participants would be able to deliver the types of wholesale, ancillary and network support services WEL's NGA can provide.
- Hedge market participation: participation in the hedge market was the primary revenue stream for Top Energy's application. Arguably, and as stated in the Authority's decision, increasing the availability of OTC hedge products could be seen to increase competition. However, in contrast, WEL's application identifies wholesale and ancillary market participation as targeted sources of revenue, reflecting the intermittent nature of solar-BESS assets. The market for flexibility services is nascent and highly competitive, meaning granting an exemption now could harm rather than help competition.
- TEL was only awarded a partial and conditional exemption from rules 9 and 10 from Part 6A. In the present application, WEL seeks a blanket exemption from all arm's-length rules.

Increased scrutiny needed on multi-use, 'shared assets'

The Authority will be aware that risks associated with investing in nascent markets, such as BESS in New Zealand's flexibility services market, are materially higher than when investing in established markets with guaranteed revenues, such as regulated electricity distribution services. Ensuring confidence and a level playing field is crucial to encourage participants to enter the market. Transparency around how regulated monopolies allocate costs is vital to

supporting competition, as it provides other participants with confidence regulated EDBs are not able to socialise costs from participating in competitive markets among their regulated services, and thereby gain an unfair advantage.

As noted, the fact that distributed energy resources such as solar generation and BESS can be used for both regulated network services and be used to participate in competitive markets poses challenges for both the Authority and the Commerce Commission. We urge the Authority to continue working closely with the Commission to ensure they both fully utilise the tools available to adequately scrutinise cost allocation by regulated EDBs, particularly where EDBs have ownership of shared assets, such as BESS, that can be used for both regulated and competitive services. For example, the Commission could commit to auditing cost allocation and use of assets. This need for increased transparency will only be increased should the Authority decide to grant WEL's exemption from Part 6A, as the disclosure mechanisms under the Commerce Act will effectively be the only mechanisms for ensuring WEL's New Generation Assets are used in a manner that is consistent with its exemption application, and thereby providing confidence to the market that there is a level playing field.

Potential misalignment between the section 11 exemption test and the purpose of Part 6A

Finally, we make an observation regarding the section 11 exemption test. The stated purpose of Part 6A is to '…promote competition in the electricity industry by restricting relationships between a distributor and a generator or a retailer, where those relationships may not otherwise be at arm's length'. Previously, the exemption test for Part 6A was section 90 of the Code, which allows the Authority to grant an exemption if satisfied the exemption will either 'promote, or not inhibit, competition in the electricity industry' and the exemption will not '…permit an involvement in a distributor and a generator that may create incentives and opportunities to inhibit competition in the electricity industry'.

However, the Authority's Top Energy Decision found that when the arm's-length rules were moved into the Code, the exemption test switched to section 11(2), which allows an exemption if Part 6A is not necessary for meeting the Authority's statutory objectives under section 15, including reliability and efficiency. Hence, it appears an unintended consequence of moving the arm's-length rules into the Code has been to broaden (and therefore, arguably, weaken) the exemption test, by allowing applicants to argue exemption from the arm's length rules can be justified if broadly consistent with the Authority's overarching objectives, including by reference to apparent reliability or efficiency benefits. This may not be consistent with the purpose of Part 6A, which is clearly to promote competition; nor does it appear consistent with Parliament's intention when enacting the Electricity Industry Amendment Bill 2021 the aim of which was limited to improving the Authority's ability to adapt regulations to meet technology changes.

Yours sincerely,

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