

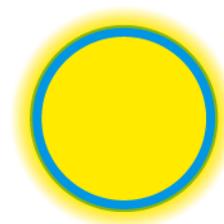
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POWERCO



Dear Sir/Madam

Re: Scope and process for fast track amendments to the CPP input methodology requirements

Attached is Powerco's submission on the appropriate scope and process for the Commission's fast track amendments to the CPP Input Methodology requirements.

Powerco appreciates the Commission committing the necessary resources to facilitate a fast track IM review process. Experience to date with using the CPP process has highlighted aspects of the regime that increase costs, cause delays, or create perverse incentives. These are important problems to be resolved, as a workable and efficient CPP mechanism is an important part of the Part 4 DPP / CPP regime.

Our submission is in two parts. In Part 1, we highlight a material issue (and solution) which has already been identified by the Commission and we ask the Commission to put this on the agenda for the fast track process.

The issue in summary is that the current requirement that a CPP applicant includes the Commission's most current estimate of WACC, creates perverse incentives for a potential applicant to apply or defer applying when this would not be in the interests of consumers. We explain in Part 1 the materiality of this issue and why we believe it needs to be addressed this year.

In our view the CPP process was always intended to focus principally on investment requirements and quality standards specific to the supplier's business, rather than offering an opportunity to revisit other elements of the regulatory building blocks that are not specific to the supplier's business (for example, WACC).

The solution to this issue has been identified by the Commission, namely that the WACC for a CPP should align with the prevailing DPP WACC. An applicant should be required to include in its application the WACC used to set the current DPP and when the DPP WACC changes the CPP determination should provide that the CPP WACC changes also.

In Part 1, we explain how the solution addresses all of the issues facing potential CPP applicants. We also explain why this solution is appropriate for the fast track process.

In summary, this is because the proposal is:

- necessary to facilitate CPP applications during this DPP period
- advances the purposes of Part 4 and the interests of consumers
- is severable from the general review of IMs This “fast track” solution addresses which WACC should apply to a CPP not how the WACC itself should be specified). Any changes to the WACC methodology can be left to the general review of IMs (and any change would flow straight through to a CPP during the next default Regulatory Control Period)
- can be implemented in the timeframe. We have sought advice from Jeff Balchin of Incenta Consulting, and he advises that the changes necessary are modest and mechanical.

In Part 2 of this submission we set out our recommendations as to how the CPP IM information and process requirements can be simplified.

The Orion CPP process identified a number of areas where the CPP IM information and process requirements create unnecessary cost or delay. Our own experience to date with preparing for a CPP application has confirmed these issues. We therefore support the Commission’s efforts to ‘streamline’ the CPP submission process and address these issues.

Starting from the objective of what the CPP process is aiming to achieve we have structured our suggested areas for “streamlining” on those aspects of the current CPP IM that should be either:

- clarified, amended or deleted; or
- made subject to a proposed exemption mechanism that allows for tailoring to suit the features of the applicant and available information.

With reference to the above, in Part 2 we provide some specific examples for consideration during the fast track review..

We would be happy to discuss the CPP fast track process with the Commission. Once the Commission has received submissions and has a better understanding of the topics to be reviewed we suggest that the process steps / timings could be refined. For example it may be that:

- it would be useful to have time allocated at the July Forum to discuss some of the more material fast track issues (taking advantage of the opportunity while all stakeholders are present)
- the draft decision on fast track issues could be released after the Commission has had the opportunity to consider the Forum discussion
- the timeframe for making a final “fast track” decision could be more flexible and extended to later than October 2015 in order to accommodate the DPP / CPP WACC alignment issue. .

We look forward to discussing these issues further with you.

Yours sincerely



Richard Fletcher
General Manager Regulation and Government Affairs

PART 1: DPP/CPP INTERACTION

- 1 The Commission in its Problem Definition paper, under the heading ‘Topic 3: Interactions between the DPP and CPP’, has identified a number of problems that suppliers need to consider when deciding whether or not to apply for a CPP. Powerco submits that the issues raised under this heading should be included in the Commission’s fast-track review to facilitate supplier decision-making leading into the 2016 CPP application windows.
- 2 This Part explains Powerco’s concerns regarding the interaction between the DPP and CPP, outlines in summary form Powerco’s proposed solution (which we anticipate developing further with the Commission through the consultation process), and explains why the Commission should include this issue in the fast-track review process.

Problem definition

- 3 The purpose of the CPP process is to allow a supplier to seek a price path that better suits the specific needs of that business and its consumers. While the DPP offers a relatively low-cost form of regulation, it may be that the differing requirements of a given supplier – for example the need to invest more in its network than is provided for in the DPP, or to address operating requirements that are unique to its business – warrants a tailored approach that provides for recovery of those specific expenditures.
- 4 Moreover, the CPP process aims to align the interests of suppliers and consumers, by permitting a departure from the default model in circumstances where meeting consumer demand requires investment not provided for in the DPP.
- 5 The CPP process is therefore intended to focus principally on capex and opex requirements and quality standards specific to the supplier’s business, rather than offering an opportunity to revisit other elements of the regulatory building blocks that are not specific to the supplier’s business (for example, WACC). However, as the IMs are presently drafted, when a supplier applies for a CPP a number of other regulatory parameters – not specific to the supplier’s business – are also updated, including WACC.
- 6 As the Commission has noted in its Problem Definition paper,¹ changes in WACC parameter values (e.g. the risk free rate) since the start of the DPP regulatory period mean that the DPP WACC may differ materially from the CPP WACC. Accordingly, applying for a CPP may significantly affect the supplier’s allowable revenue for this reason alone. This has a dampening effect on the supplier’s incentives to apply for a CPP.
- 7 Importantly, these incentives are unrelated to the expenditure forecasts and quality matters which are intended to inform the decision whether or not to apply for a CPP. Rather than focusing solely on the extent to which their capex and opex requirements differ from those assumed in the DPP, suppliers are also required to consider how the choice of continuing with the DPP WACC or transferring onto a (materially different) CPP WACC will affect, either positively or negatively, their allowable revenue.
- 8 As the Commission has noted, this misalignment of the DPP WACC and CPP WACC results in a corresponding misalignment of the supplier’s and consumers’ long term interests, contrary to the purpose of the CPP process:²

¹ Paragraphs 183 et seq.

² Paragraph 190.

- 8.1 if the CPP WACC is lower than the DPP WACC, then suppliers may be deterred from applying for a CPP even where it is in the long term interests of consumers to customise the supplier's expenditure assumptions and/or quality standards; or
- 8.2 if the CPP WACC is higher than the DPP WACC, then suppliers have an incentive to apply for a CPP in order to capture that enhanced return on capital, even where the expenditure assumptions and quality standards in the DPP remain appropriate for that supplier.
- 9 As the Commission knows, Powerco is presently deciding whether or not to apply for a CPP in the May 2016 window. Powerco has identified a need for investment in its network that exceeds the Commission's default forecast that underpins the DPP if it is to continue to efficiently serve its customers. Accordingly, Powerco considers it is in the long term interests of its customers for Powerco to apply for a CPP in 2016 in order to finance that investment.
- 10 However, since the date of the reference observation used to set the risk free rate for the 2015 DPP (August 2014), interest rates on Government bonds used by the Commission as a proxy for the risk-free rate have declined from 4.09% to (currently) 3.09%. If current interest rates remain constant, Powerco's WACC under a CPP would decline from the allowed DPP rate of 7.19% to 6.35%. Assuming a regulated asset base of \$1,449.8m that implies a reduction in return on capital of \$12.1m p.a. In reality, Powerco is exposed to the risk of further reductions in WACC because the risk-free rate that would apply to a CPP application made in 2016 is observed by the Commission in August of this year.
- 11 The reduction in WACC is exacerbated by knock-on effects to Powerco's hedging costs. Hedging is an expected part of the regime as suppliers manage their exposure to interest rate risk on their actual debt.³ Powerco has entered into hedges to align its actual cost of debt with the cost of debt assumed in the DPP cost model. To maintain this corporate policy, Powerco would have to enter into further hedging arrangements. Entering into new hedging arrangements to reflect a reset cost of debt as of the start of the CPP regulatory period will involve significant additional costs (over \$10 million), which Powerco has to factor into its decision-making.
- 12 Powerco is therefore facing exactly the problem the Commission has identified in paragraph 190.1 of its Problem Definition paper. Because of the misalignment of the DPP and CPP WACCs under the rules as they presently stand, Powerco and other suppliers are strongly disincentivised from applying for a CPP in 2016. When we factor in the way rates have moved since August 2014, the cash flow implications and projected reduction in return on capital that would result from applying for a CPP in 2016 (as well as associated hedging costs), are material. If the Commission determines that the issue cannot be resolved prior to the 2016 CPP application windows, it is likely that a CPP application in 2016 would be ill-advised and imprudent.
- 13 This is not to imply that safety or other essential investments would in any way be compromised. However the incentives created by the current DPP / CPP interaction leave suppliers little choice but to defer any CPP application and take a short term, suboptimal approach to managing the network, which is likely to result in higher than optimal long term costs. This goes against the long-term life-cycle approach to network management that the DPP / CPP framework should be encouraging, and in our view would not be in the long-term interests of consumers.

³ See, for example, *Wellington International Airport Limited v Commission* [2013] NZHC 3289, at paragraph [1116](b).

- 14 Powerco therefore welcomes the Commission's identification of this issue as warranting examination in the IMs review. In our view, the perverse incentives created by the misalignment of the DPP WACC and CPP WACC were not intended, but are simply an unforeseen consequence of the decision to reset the WACC as part of the CPP process. It is now clear to both suppliers and the Commission that the result of changing the WACC when a supplier moves from a DPP to a CPP may create incentives that do not serve the purpose of Part 4 of the Act and significantly undermine the DPP / CPP regime.

Powerco's proposed solution

- 15 We note that the Commission has suggested in paragraphs 197 to 200 of its Problem Definition paper the following options for addressing this problem:
- 15.1 carrying over the prevailing DPP WACC into the CPP (paragraph 200). When the DPP WACC changes, it changes for the CPP also. This is the solution proposed by Powerco;
 - 15.2 indexing prices to changes in the cost of debt (paragraph 197); and
 - 15.3 substituting a long-run average risk-free rate (with or without annual updating) for the current spot rate observation (paragraph 198).
- 16 The first option addresses the divergence between the DPP and CPP WACCs by amending the CPP IMs to provide for the prevailing DPP WACC to be carried over. When the DPP WACC changes, it would change for the CPP also. The CPP IMs currently require the WACC to be the Commission's most recent annual re-estimate at the date of application. It would be a straightforward amendment to provide for the CPP applicant to specify the DPP WACC in their application, and for the CPP IM to specify that the WACC updates when the DPP WACC is updated.
- 17 The second and third options both involve amending the DPP IMs to adjust the way in which the cost of debt is accounted for in the DPP WACC. Were either of these options adopted they would not influence CPPs until after the general IM review was completed in December 2016, and would not address the incentive problem and align the CPP and DPP until the next EDB DPP determination in 2020.
- 18 The Commission has expressed these options as potential alternative solutions that would address the misalignment between the DPP and CPP WACCs. However, only the first of those options – carrying over the prevailing DPP WACC into the CPP – is a comprehensive solution to the identified problem. Powerco supports that option. The remaining two options:
- 18.1 only serve to mitigate to some degree the potential for divergence between the DPP and CPP WACCs (as the Commission notes, they can only 'reduce' the divergence between the DPP and CPP WACCs); and
 - 18.2 preserve the current scheme of incentives, which the Commission acknowledges does not serve the purpose of Part 4 of the Act and the CPP regime.
- 19 Carrying over the prevailing DPP WACC into the CPP is also the only timely solution that will assist suppliers (like Powerco) considering a CPP application during the current DPP regulatory period. The options set out in paragraphs 197 and 198 involve amending the DPP IMs so that the cost of debt in the DPP roughly tracks changes in market rates, which would in theory reduce the magnitude of the difference between

the DPP WACC and the CPP WACC at the point at which a supplier chooses to apply for a CPP.

- 20 However, given that the current DPP determination will run to March 2020, changing the DPP IMs will not address the misalignment between the DPP and CPP until a fresh DPP determination is made in 2020. These options will not assist suppliers that are proposing to apply for a CPP during the course of the current DPP regulatory period. Only carrying over the prevailing DPP WACC into the CPP will create the right framework of incentives for suppliers between now and 2020.
- 21 The differences here also illustrate the distinction between the fact track and general IM review processes. The solution proposed by Powerco is suitable for the fast track as it changes only the information requirement for a CPP application – the question of which annual Commission WACC estimate should be used – and not the WACC methodology. Changes to the WACC methodology (for example those options discussed by the Commission in paragraphs 197 and 198 of its Problem Definition paper) are obviously more suited to the general IM review process. Further, if the general IM review results in changes to the methodology used to set the DPP WACC, the result will flow straight through to any CPP.
- 22 Accordingly, Powerco supports the option set out in paragraph 200 because:
 - 22.1 by carrying over the prevailing DPP WACC into the CPP the Commission can eliminate the perverse incentives that currently deter suppliers from applying for CPPs, and that create a disconnect between the commercial case for a CPP and the interests of consumers;
 - 22.2 carrying over the prevailing DPP WACC into the CPP is consistent with the rationale of the CPP process, which is to allow suppliers to customise their price-quality path to better reflect their specific investment needs and service profile, rather than to take advantage of changes in WACC parameters that are not specific to their business; and
 - 22.3 given the current DPP regulatory period will run until 2020, it is the only solution that will be immediately effective.
- 23 Carrying over the prevailing DPP WACC into the CPP does not exclude either of the Commission's other two options, which might independently be viewed as having merit. However, there is no immediate time pressure to determine whether either of those remaining two options should be adopted, as neither will be implemented before the next round of DPPs. We propose, therefore, that the Commission move to consider implementing the option in paragraph 200 as part of its fast-track review, and separately consider the options in paragraph 197 and 198 in the course of its general IMs review.

Suitability for consideration in the fast-track review

- 24 The Commission has recognised the importance of resolving outstanding questions relating to the CPP process before the CPP application windows in 2016. The Commission is therefore proposing to fast-track its consideration of the rules and processes for CPP applications. Powerco's submission is that, for essentially the same reasons, the Commission should also include in its fast-track review consideration of Powerco's proposal to carry over the prevailing DPP WACC into the CPP.
- 25 The Commission has in its Notice of Intention referred to several criteria for assessing whether or not an issue should be fast-tracked:

- 25.1 Will fast-tracking make suppliers' preparation of their applications, and the Commission's evaluation of those applications, clearer and more cost-effective to benefit both suppliers and consumers?⁴
- 25.2 Does the issue clearly need to be addressed for suppliers of electricity distribution services intending to submit a CPP application in 2016?⁵
- 25.3 Is delivery achievable within the fast-track timetable?⁶
- 26 In addition to those criteria, the Commission should also consider:
- 26.1 whether fast-tracking consideration of the issue would better serve the purpose of Part 4; and
- 26.2 whether the issue is severable from other issues to be considered in the general review (such that the Commission can be confident that its decision on the fast-tracked issue will not rely on its conclusions in relation to issues in the general review). Conversely, the Commission should consider whether the issue is closely linked to topics that the Commission is proposing to fast-track, such that they would be most efficiently considered together.

Fast-tracking will make the preparation and evaluation of applications clearer and more cost-effective

- 27 All suppliers considering applying for a CPP currently face considerable uncertainty in the preparation of their applications and their commercial decision-making because of their exposure to movements in the risk-free rate and the consequent effect on their return on capital under a CPP.
- 28 The point at which suppliers will have clarity as to the WACC that will apply for a CPP submitted in 2016 and commencing 1 April 2017, is September 2015, when the Commission publishes its updated estimate of WACC. By that point, Powerco will have incurred considerable cost – both direct and in terms of distraction of key business personnel – in the preparation of a CPP application which may, at that point, be confirmed as commercially infeasible due to the effect of the WACC re-estimate.

The issue clearly needs to be addressed for suppliers intending to submit a CPP application in 2016

- 29 The Commission has recognised that there is a pressing need to implement changes to the CPP application processes and rules in advance of the 2016 application windows. We agree and appreciate the Commission putting additional resources into identifying and resolving the necessary issues on a fast track process. We note here that the same pressing need warrants consideration of carrying over the prevailing DPP WACC into the CPP during the fast-track process.
- 30 As outlined above, clarity on this question will be determinative of Powerco's decision whether or not to apply for a CPP. The way interest rates have moved means the financial implications of applying for a CPP in May 2016 under the current IMs are too significant. We imagine that other suppliers considering applying for a CPP are in the same position.

⁴ Cover letter to the Notice of Intention, page 8, paragraph 3.

⁵ Ibid at paragraph 5.

⁶ Ibid.

- 31 Accordingly, there is little practical value in fast-tracking other changes to the CPP application process, aimed at streamlining general information requirements and processes (matters which, while important, are less likely to be determinative of any supplier's decision to apply) unless the resolution of these perverse incentives facing CPP applicants is not also fast tracked.
- 32 We note that considering this issue in the course of the general IMs review is not a practical substitute for fast-tracking this issue. Given the financial implications of the current IMs, Powerco cannot make an application for a CPP (which is irrevocable) if there is no certainty about the rules under which that application will be assessed. While variations to the IMs can be agreed with the Commission once an application is made, this is more suitable for implementation issues. The commercial materiality of the DPP / CPP alignment issue means it is reasonable for suppliers to need certainty upfront.

Delivery of the solution is achievable within the fast-track timetable

- 33 The effect of carrying over the WACC from the DPP into the CPP would involve two steps, which are:
- 33.1 First, the WACC from the prevailing DPP would be applied for the preparation and assessment of the CPP. Where a CPP is to extend beyond the current DPP (and therefore beyond the term of the existing forecast of the WACC) a proxy for the WACC for the additional period is required. It is suggested that the prevailing DPP WACC for the current DPP period would be assumed to continue into the next DPP period.
- 33.2 Secondly, in the case discussed above where the CPP is to extend past a resetting of the DPPs, the MAR under the CPP would be revised from the year corresponding to the first year of the new DPPs to apply the new DPP WACC for the remainder of the CPP term. This would unwind any error involved in using the proxy values described above.
- 34 Powerco also considers that it would be appropriate for both the WACC together with the relevant forecasts of inflation from the DPP to be applied to the CPP, and also for the MAR to apply the new DPP WACC to also apply the new forecast of inflation that was derived in the DPP calculations. Applying the DPP WACC together with the associated forecasts of inflation would leave intact the natural hedge for inflation that the Commission has observed is present in the current arrangements (para 125).⁷
- 35 In terms of implementing revision to the MAR during the course of the CPP to apply the new DPP WACC (and forecast of inflation, as discussed above), it is proposed that this would simply require the financial model that was used to determine the initial MAR

⁷ The new CPP will take effect part way through the first of the DPP periods. In this context, there are two options to create consistency between the treatment of inflation applied in the CPP calculations and the DPP WACC (and thereby to preserve the implicit inflation hedge). The first option is to calculate the required price change under the CPP using an opening RAB value and prices that have both been updated for actual inflation over the DPP period to date, and then to apply the DPP inflation forecasts from that point forward. The second option is to calculate the required price change under the CPP using an opening RAB value and prices that have both been adjusted to be consistent with the forecasts of inflation used in the DPP (with the calculated price change then to be applied to the actual prices in the year prior to the CPP commencing). The two options will deliver outcomes that are approximately the same, with the options being approximately the same (rather than identical) because of the slightly different indexation conventions applying to prices and the RAB (i.e., the former uses the change in the annual average of price indices over a lagged period, whereas the latter uses the change in the CPI between the start and end of the each year and without any lag). Powerco submits that the IMs could be amended to set out the objective to be achieved (i.e., the use of an inflation assumption in revenue and the RAB that is consistent with the DPP WACC, so that the implicit inflation hedge is preserved) and to defer the question of its detailed implementation to the CPP determination.

values for the CPP to be re-run, with the new WACC and inflation forecasts simply inserted into the model. The full detail of how this calculation is to be specified need not be addressed in the IMs – this detail could be deferred to the determination in relation to the specific CPP. Rather, the IMs could reference the objective of the revision calculation. It is suggested that this would be to:

- 35.1 derive the MAR for the remaining years of the CPP period that would have been calculated when forming and assessing the CPP if the DPP WACC (and inflation forecasts) for the full term of the CPP had been known at that time, holding fixed all forecasts except the WACC (and inflation forecasts) and holding fixed the MAR determined for the period prior to the revision of the CPP.
- 36 However, in order to give flesh to the issue, our view at this stage as to how such an adjustment would work is as follows:
- 36.1 At the time of the determining the CPP, a MAR for the full period would be determined, based upon the current DPP WACC and inflation (including appropriate proxies for beyond the current DPP period) and forecasts of expenditure and demand. The model would include the capacity for a change to the MAR from the first year of the new DPP period, but that change would initially be set to zero. The model would also allow the WACC to be different across the different DPP periods, but with a proxy used initially for the second DPP period (it was suggested above this should be the DPP WACC from the current period).
 - 36.2 As part of specifying this model, the full interrelationship between the inflation forecast and the price would be determined. The “natural hedge” for inflation referred to above is achieved by the inflation forecast feeding in to the forecast of RAB revaluations as well as the forecast escalation in the MAR. However, a mechanistic link could also be specified between the nominal-dollar forecast of expenditure and inflation, in which case changes to the forecast of inflation would also flow through to changes in the forecast of expenditure.
 - 36.3 Once the DPP WACC and inflation forecasts for the second DPP period are determined, these would be inserted into the financial model and the MAR adjustment referred to above would be determined. Importantly, all forecasts apart from WACC and inflation would remain unchanged, and the MAR for the period under the first DPP WACC would also be held fixed at the initially determined values.
- 37 The adjustment described above would be entirely mechanical given the new WACC and inflation forecasts.
- 38 In addition, if the DPP WACC is applied to the CPP as described above, the NPV=0 principle as applied by the Commission will be achieved. The quote from the Commission in paragraph 195 of the current consultation paper summarises the Commission’s NPV=0 objective well, which is to align the term of the risk free rate with the horizon over which those rates apply. If the DPP WACC is to be applied to CPPs as proposed above, then the relevant risk free rate will always apply for the duration of the DPP – the horizon over which the risk free rate is to apply will become independent of the duration of the CPP. Accordingly, the DPP WACC will now satisfy the NPV=0 objective. While the act of approving a CPP will mean that prices will be changed to account for firm-specific expenditure or demand forecasts, this is not relevant to the question of the term of the risk free rate satisfies the NPV=0 objective.
- 39 Finally, the outcome described above is simple to draft and affects only the CPP part of the IMs. Much of the detail that the Commission will need to address – such as the

mechanics of the mid-period price alteration – do not need to be written into the IMs and are appropriately matters for the CPP determination. The changes that we think are required are:

- 39.1 amend the definition of cost of capital in clause 5.3.2 to refer to the cost of capital applicable for the corresponding DPP period, or a reasonably proxy for that value (i.e., for the period where the CPP will extend past the current DPP period);
 - 39.2 Change the definition of “forecast CPI” as it applies to Part 5 to refer to the use of values for inflation that are consistent with the forecasts of inflation that were adopted in the DPP (and so consistent with the DPP WACC);
 - 39.3 amend clause 5.3.6 to allow for a step change in the MAR at the changeover between one DPP and the next; and
 - 39.4 insert a new clause to enable the MAR to be revised at the changeover between one DPP and the next to adjust for the difference between the proxy for the WACC (and inflation forecasts) that was adopted in the original calculation of the MAR and the WACC (and forecasts of inflation) that apply for the new DPP period.
- 40 We do not see any reason to change the IM principles as they apply to the RAB (except to change the definition of “forecast CPI”, which therefore will have a flow on effect to the RAB values) or the WACC, except in relation to the latter that there will no longer be a reason for the Commission to calculate WACCs corresponding to different terms.

Fast-tracking would better serve the purpose of Part 4

- 41 The misalignment of the DPP and CPP WACCs both permit, and indeed incentivise, suppliers to apply for a CPP in circumstances where it is not in the interests of consumers to do so, and to refrain from applying for a CPP in circumstances where it would be interests of consumers to apply.
- 42 Not only does this undermine the rationale and effectiveness of the CPP process, more problematically it suggests that the CPP IMs as presently drafted conflict with the purpose of Part 4 of the Act, as articulated in section 52A. Relevantly, that section states that the purpose of Part 4 is to promote the long-term benefit of consumers by, amongst other things, ensuring that suppliers “have incentives to innovate and to invest, including replacement, upgraded, and new assets” and “have incentives to improve efficiency and provide services at a quality that reflects consumer demands”.
- 43 The CPP process is intended to achieve this purpose by allowing suppliers to substitute their own specific expenditure requirements and service profiles for those in the default price path, which in turn is intended to align their regulatory quality standards and allowable revenue with their intended investments. Applied properly, this should serve the interests of consumers by ensuring that efficient investments are both undertaken by the business, and recovered in the regulated revenue stream.
- 44 However, as the Commission has identified, where, as here, changes in the parameter values of the WACC estimate would lead to a divergence between the DPP WACC and the CPP WACC, suppliers may be deterred from applying for a CPP and consequently from undertaking investments that would be in the interests of consumers. Conversely, suppliers may be incentivised to undertake additional investment in order to justify a CPP application, where in fact the principal commercial motivation is to capture a

higher return on capital than that which applies under the DPP. In both situations, the interests of consumers, as expressed in section 52A of the Act, are not best served.

- 45 For that reason, we welcome the Commission's recognition of this issue and stated intention to address it. However:
- 45.1 if the Commission intends to address this issue only in the context of the general IMs review, reporting in December 2016, then it is likely that Powerco and other similarly positioned suppliers will defer plans to apply for CPPs in the 2016 application windows, with consequences for their investment plans and in turn for consumer welfare; and
- 45.2 if the Commission intends to address this issue by amending the process for estimating the WACC in the DPP IMs, rather than amending the CPP IMs to carry over the DPP WACC, then the framework for CPP applications will continue to conflict with the purpose of Part 4 until fresh EDB DPP determinations are made in 2020.
- 46 Accordingly, it is only by considering carrying over the DPP WACC into the CPP in the course of the fast-track process that the Commission can ensure that the CPP regime is brought back into line with the purpose of Part 4.

Carrying over the DPP WACC into the CPP is closely related to the CPP rules and processes, and conversely is severable from other issues in the general review

- 47 The Commission has already signalled its intention to consider changes to the CPP IMs (specifically the rules and application process) as part of its fast-tracked review. As outlined above, the change we are proposing – that set out in the Commission's paragraph 200 – also involves amending only the CPP IMs, and in a straightforward manner that the Commission will be able to deliver within the fast-track timetable. Given the Commission is already proposing to re-examine the CPP IMs on a fast-track, there is an obvious efficiency in including Powerco's proposal in that process.
- 48 Moreover, the issue of realigning the DPP and CPP WACCs is closely linked to the question of the CPP application process in the minds of those suppliers currently considering whether or not to apply for CPP in 2016. These two issues are the principal stumbling blocks to making an application for a CPP in 2016, and therefore it would be sensible to consider them together.
- 49 Conversely, as we have outlined above, the question of carrying over the DPP WACC into the CPP can be consulted on – and the solution implemented – independently of other proposed reforms to the IMs. Carrying over the DPP WACC into the CPP does not pre-empt or exclude other amendments that the Commission might wish to consider in relation to the methodology for estimating WACC (e.g. the options the Commission has identified in paragraphs 197 and 198), nor does it give rise to knock-on implications for other building blocks that will be consulted on in the general IMs review timetable.

Conclusion

- 50 Powerco is facing the problem the Commission has identified in paragraph 190.1 of its Problem Definition paper. Because of the misalignment of the DPP and CPP WACCs under the rules as they presently stand, Powerco and other suppliers are strongly disincentivised from applying for a CPP in 2016.
- 51 When we factor in the way rates have moved since August 2014 the projected reduction in return on capital, and associated transaction costs, that would result from

applying for a CPP is insurmountable. If the Commission is not able to resolve the misalignment of the DPP and CPP WACCs prior to the 2016 CPP application windows, we currently cannot see how we can be in a position to apply.

52 In response to this problem we propose addressing the divergence between the DPP and CPP WACCs by amending the CPP IMs to provide for the prevailing DPP WACC to be carried over. Under this approach, when the DPP WACC changes it changes for the CPP also. This would be a straightforward amendment providing for the CPP applicant to specify the DPP WACC in their application, and for the CPP IM to specify that the WACC updates when the DPP WACC is updated.

53 In our submission this solution is appropriate for the fast track process applying the criteria identified by the Commission. This is because:

53.1 resolution of this issue will resolve a key source of uncertainty for suppliers, which will assist them in their decision-making and preparation of their 2016 CPP applications;

53.2 it is essential that the misalignment of the DPP and CPP WACCs is addressed before the 2016 CPP application windows open otherwise Powerco – and we expect other similarly positioned suppliers – will likely not be in a position to apply for a CPP in 2016. Indeed, there is little point in fast-tracking consideration of the CPP application process and rules if the question of the misalignment of the DPP and CPP WACCs is not also put on the agenda;

53.3 carrying over the DPP WACC into the CPP is a self-contained issue that requires relatively straightforward drafting and has minimal implications for other elements of the model. Accordingly, the Commission can be confident that it will be able to adequately consult on, and deliver, this solution on the fast-track timetable;

53.4 the Commission has recognised that the status quo does not meet the purpose of Part 4 and should be remedied in order to align the incentives of suppliers with the interests of consumers. We agree, but note further that only fast-tracking consideration of carrying over the DPP WACC into the CPP brings the IMs into line with the Part 4 purpose in a timely manner; and

53.5 carrying over the DPP WACC into the CPP is closely related to those other CPP IM issues that the Commission is already proposing to fast-track. Conversely, those issues are easily severable from other issues that the Commission could better address in the context of the general IM review timetable.

54 Finally, we make two observations in relation to the fast-track process:

54.1 While we understand that the July forum is principally focused on the general IM review, we think this would also be a useful opportunity to discuss the issues arising on the fast-track. Powerco would be happy to lead a discussion on these issues at the forum.

54.2 The Commission may want to consider whether the proposed October end-date for the fast-track review is an unnecessarily aggressive timetable, even for suppliers targeting the 2016 CPP application windows. Powerco would be happy to discuss an adjustment to this end-date if that means the Commission would feel better able to fully consider and address the issues we have outlined in this submission.

PART 2: STREAMLINING CPP INFORMATION AND PROCESS REQUIREMENTS

Proposed Fast Track Process

- 55 This part of our submission comments on the areas of the CPP IM which we believe could be improved to reduce complexity, ambiguity and cost, including in relation to information requirements and pre and post CPP application processes. Powerco considers that potential improvements in these areas will have long term benefits for consumers because they will reduce the costs of applying for and assessing a CPP application. Importantly this will assist suppliers to make CPP applications which may be of long term benefit to consumers.
- 56 Given the complexity and breadth of the current CPP IM requirements a complete review of all aspects of the CPP IMs will be impractical within the timeframe of the fast track review. Powerco considers that the scope of the review should be prioritised to focus on matters of greatest materiality.
- 57 We recommend that when the initial scope of the fast track review has been decided, an industry working group is established to help identify and prioritise areas of the CPP IMs that should be examined in more detail with a view to amendment.
- 58 The areas that should be accorded the highest priority are those that the group identifies as provisions that must be amended to enable an EDB / GPB to develop an efficient CPP proposal in 2016. Other, less critical improvements could be put on a slower track, such that two phases of CPP amendments could be progressed – with Phase 1 amendments to be made by December 2015 and Phase 2 amendments to be made by December 2016.

Options for modifying the CPP IM

- 59 We recommend that amendments to the IMs take one of the following forms, depending on the problem being addressed:
- 59.1 Deletion of a requirement from the IMs;
- 59.2 “Hard coded” amendments” to the IMs, and associated schedules;
- 59.3 Exemptions agreed by the Commission, on a base by case basis, via a new exemption provision incorporated into the CPP IM.
- 60 The table below provides examples of when the different approaches would be best used.

Amendment approach	Example
Delete requirement	<ul style="list-style-type: none"> A requirement fails a high level cost-benefit test. Information that the Commission will not use to inform its decisions.
“Hard coded” amendment	<ul style="list-style-type: none"> Changes to ensure that information specified by the CPP IM aligns with other Part 4 requirements. information for example IDD. CPP IM process and information requirements align to the extent practical with the most recent DPP determination Ambiguous requirements / Drafting errors. Process refinements for example clarifying the role of the Verifier
Exemption provision (see below)	<ul style="list-style-type: none"> An EDB uses a different approach to formatting data that it would be expensive to modify but which if applied to the CPP IM would meet the Commission’s assessment requirements An EDB’s systems are not able to supply particular information.

Information Exemption Provision

- 61 As noted in the table above, certain information specified in the CPP IM, particularly in Schedules D and E, may not be available to a particular applicant or may not be useful to the Commission in deciding the CPP application in question
- 62 As part of the fast track review, the Commission could introduce a 'pre-submission' process into the CPP Input Methodologies to tailor certain requirements to each specific application.
- 63 A pre-submission process could take a number of forms:
 - 63.1 The Commission could include a provision preserving discretion to determine whether information is relevant to an individual proposal in the circumstances;
 - 63.2 Alternatively, the Commission could prescribe in more detail a pre-submission process, with steps and timeframes for when a potential applicant approaches the Commission and the process for considering refinements to Schedules D and E. This would reduce uncertainty for regulated suppliers and interested parties. The requirements of Schedules D and E would be the backstop.

Areas of high priority

- 64 The following tables provide more detail of specific CPP IM amendments that Powerco believe should be fast-tracked as a priority.

INFORMATION NO LONGER ALIGNED WITH OTHER ASPECTS OF THE FRAMEWORK

Type of Issue	Guiding Principle	Issue to be Addressed	IM Reference	Recommendation
<p>IM requirement is no longer consistent with other aspects of the regulatory regime</p>	<p>Where particular CPP IMs refer to or otherwise relate to the DPP and the DPP has subsequently been updated (such as has occurred with the quality path provisions in the DPP) the relevant CPP IMs (such as the CPP IMs that specify the information to be provided on a proposed quality standard variation) should be updated to reflect the changes to the DPP.</p>	<p>The 2015-2020 DPP reset adopted a new approach to setting quality standards that does not specifically use μSAIDI, μSAIFI, σSAIDI or σSAIFI. An amendment should be developed that clarifies what data would be required by the Commission to reset quality measures for a CPP, and this should include the following as a minimum:</p> <ul style="list-style-type: none"> - whether and, if so, how the target, cap and collar specified in the DPP may be varied - what additional data, if any, are required to update the reference dataset - specifics on the methodology that will be used to set the quality standards - whether or not the incentive rate can be varied 	<p>5.4.5 Information on proposed quality standard variation Where a CPP applicant seeks a quality standard variation, the CPP proposal must contain the following information:</p> <p>(a) different values of either or both of–</p> <ul style="list-style-type: none"> (i) μSAIDI and μSAIFI; and (ii) σSAIDI and σSAIFI, <p>to those which would be determined in accordance with the methodology for calculating reliability limits specified in the DPP determination;</p>	<p>The Commission prioritise amendments to IM 5.4.5 that clarify how quality standards will be set under the new DPP methodology, including specifying which parameters an applicant can propose to alter and the inputs the applicant must provide.</p>

INFORMATION INCONSISTENTLY DEFINED

Type of Issue	Guiding Principle	Issue to be Addressed	IM Reference	Recommendation
<p>Information is inconsistently defined</p>	<p>The information disclosure requirements in the CPP IMs should be aligned with those in the Electricity Distribution Information Disclosure Determination (“IDD”) wherever possible (and, hence, inconsistencies between the two should be eliminated) in order to minimise the need for EDBs to rework information or establish duplicate reporting frameworks</p>	<p>Capex categories are defined in Commerce Commission decision number NZCC22: Electricity Distribution Information Disclosure Determination 2012 and reported annually in ID schedules 6a and 11a. Internal reporting systems have been developed to produce information in this format. Rework is required to recategorise expenditure consistent with the CPP requirements including historical comparisons.</p> <p>Opex categories are defined in Commerce Commission decision number NZCC22: Electricity Distribution Information Disclosure Determination 2012 and reported annually in ID schedule 6b. Internal reporting systems have been developed to produce information in this format. Rework is required to recategorise expenditure consistent with CPP requirements including historical comparisons.</p> <p>Asset categories are defined in Commerce Commission decision number NZCC22: Electricity Distribution Information Disclosure Determination 2012 and reported annually in ID schedule 6b. Internal reporting systems have been developed to produce information in this format. Rework is required to recategorise expenditure consistent with CPP requirements including historical comparisons.</p>	<p>Capex categories as defined in Schedule D compared to the capex categories required in information disclosure are summarised in the following table:</p> <p>Opex categories as defined in Schedule D compared to the capex categories required in information disclosure are summarised in the following table:</p> <p>Asset categories as defined in Schedule D compared to the asset categories required in information disclosure are summarised in the following table:</p>	<p>A change should be implemented to allow Capex categories in the CPP to reflect ID categories and definitions.</p> <p>The Commission undertake a full review of asset and expenditure category definitions to ensure consistency with the ID definitions.</p> <p>Opex categories in CPP should be permitted to reflect ID categories and definitions. The Commission should undertake a full review of asset and expenditure category definitions to ensure consistency with ID definitions.</p> <p>Asset categories in the CPP should be permitted to reflect ID categories and definitions. The Commission should undertake a full review of asset and expenditure category definitions to ensure consistency with ID definitions.</p>

EXAMPLES OF AREAS WHERE INFORMATION IS INCONSISTENTLY DEFINED BETWEEN THE CPP IM AND THE INFORMATION DISCLOSURE DETERMINATION

Capex categories as defined in Schedule D compared to capex categories required in information disclosure

CPP – CAPEX CATEGORIES	INFORMATION DISCLOSURE – CAPEX CATEGORIES
a Customer Connection Capex	6a (iii) Consumer Connection
b System Growth Capex	6a (vi) Quality of Supply
c Reliability, Safety and Environment Capex	6a (vii) Legislative and Regulatory
d Asset Replacement and Renewal Capex	6a (viii) Other Reliability, Safety and Environment
e Asset Relocations Capex	6a (iv) System Growth and Asset Replacement and Renewal
f Non-System Fixed Assets	6a (v) Asset Relocations
	6a (ix) Non Network Assets

Opex categories as defined in Schedule D compared to opex categories required in information disclosure

CPP – OPEX CATEGORIES (Schedule D1)	INFORMATION DISCLOSURE – OPEX CATEGORIES (Schedule 6b)
a General Management, Administration and Overheads Opex	Business Support
b System Management and Operations	System Operations and Network
c Routine and Preventative Maintenance	Routine and Correction Maintenance Vegetation Management
d Refurbishment and Renewal Maintenance	Asset Replacement and Renewal
e Fault and Emergency Maintenance Opex	Service Interruptions and Emergencies
f Other Capex	

Asset categories as defined in Schedule D compared to asset categories required in information disclosure

CPP – ASSET CATEGORIES (Schedule D1)	INFORMATION DISCLOSURE – ASSET CATEGORIES
b Sub-transmission network including power transformers	Sub-transmission Lines / Sub-transmission Cables
c Distribution network including distribution transformers	Distribution and LV Lines / Cables / Substations and Transformers
d Switchgear	Distribution Switchgear
e Low Voltage Distribution Network	-----
f Supporting or Secondary Systems	Other Network Assets
g Other	Zone Substations

NECESSITY OF INFORMATION

Type of Issue	Guiding Principle	Issue to be Addressed	IM Reference	Recommendation
Necessity of Information including format type / disaggregation	The Commission should consider the costs and benefits of an existing information requirement with the goal of eliminating those requirements that are unlikely to provide a positive net benefit (which include requirements to provide information which the Commission will not use or which will not inform the Commission's decisions);	Schedule D4 . Powerco does not use a Service Category to manage its business nor is Service Category reporting required in ID, so this requirement creates a further cost to produce no apparent benefits.	Section D: definitions, D4. Schedule E: Table 2 Capex Summary, Tables 3(a), 3(b) and 3(c) Opex, Table 4 Capex Project Programme and Table 5 Opex Project Programme	Grant companies with appropriate exemptions from having to provide certain Service Category information.
		The IMs require disaggregation of Regulatory tax asset value (RTAV) information by asset category. This would not provide any further useful information but represents a significant increase in cost.	5.4.26(2),(4),(5) and (8)	Where no net benefit would accrue from Service Category reporting, the Commission should delete the requirement for Service Category reporting including the references in Schedule E. Hard code changes to 5.4.26 to remove the requirements to disaggregate information by asset category.
		IM requirements refer to the need to provide "all" information at a highly disaggregated level. The use of the term "all" significantly increases the work needed to reproduce spreadsheets to contain supporting material that is not materially relevant to the application process and has no other value to the business. Additionally, some requirements introduce the need to disaggregate information by asset category which appears to produce no additional benefits but imposes additional costs. The blanket approach to information supporting capex requirements adds significant work that could be avoided by focusing on areas that have a material impact on expenditure.	5.4.7(2), 5.4.7(2)(b), 5.4.7(2)(c), 5.4.7(4), 5.4.7(5), 5.4.12(3)(e), 5.4.14(2)(a)	1. Amend these clauses to require only 'material' or 'relevant' information to be provided. 2. Introduce a threshold such that the level of information specified would only be required when it relates to a material increase in expenditure.

ROLE AND SCOPE OF THE VERIFER

Type of Issue	Guiding Principle	Issue to be Addressed	IM Reference	Recommendation
Scope and Focus of Verifier and overlap with requirement for Independent Engineer	Costs and benefits of an existing information requirement should be considered with the goal of eliminating those requirements that are unlikely to provide a positive net benefit (which include overlapping requirements and / or the requirement to provide information which the Commission will not use or which will not inform the Commission's decisions).	There is currently an overlap between the role of the Verifier and that of the Independent Engineer.	Subpart 4	To improve efficiency the requirement to appoint an Independent Engineer to review quality should be removed and the Verifier's role should be extended to include an integrated review of both expenditure and quality plans
		There is currently an overlap between the role of the Verifier pre-submission and the role of consultants engaged by the Commission during the post submission assessment stage.	Subpart 4	The Verifier should be retained to advise the Commission during the pre-submission stage and the post submission assessment stage – this is consistent with the tripartite deed arrangement specified in the IMs.
		Requirement for a Verifier to select 10 projects is too prescriptive. Powerco is grouping projects at higher levels and 10 may therefore pick up projects that are not material.	Schedule G3(1), G10, 5.5.2(3)(a)(ii)	Allow flexibility for the Verifier to determine a representative sample of projects based on the supplier circumstances.
		IM 5.5.2(3)(a)(ii) sets a requirement that exceeds the intended scope of the Verifier	5.5.2(3)(a)(ii)	Delete / amend the current requirement