Submission

Powerco's proposal to customise its prices and quality standards: Draft decision

15 December 2017

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1 Introduction

Aurora Energy welcomes this opportunity to comment on the Commerce Commission's draft decision on "*Powerco's proposal to customise its prices and quality standards*", dated16 November 2017.

No part of our submission is confidential and we are happy for it to be publicly released.

If the Commission has any queries regarding our submission, please do not hesitate to contact:

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2 An uplift is justified

We are disappointed that ERANZ has expressed the view that *"Powerco has not sufficiently demonstrated that the additional levels of investment will result in the security levels required"*[1] particularly given the open and helpful way Powerco has engaged with affected stakeholders.

ERANZ's stance seems to be based on (1) a view that a new quantified cost-benefit analysis (CBA) requirement should be developed and retrospectively applied to the CPP process, and (2) a desire on the part of retailers to limit EDBs' ability to engage in new technology initiatives. Neither of these are relevant considerations.

Our assessment supports the Commission's conclusion that *"Powerco has satisfied us that an uplift in expenditure is required to provide a safe, reliable network for its consumers, and allowing for the uplift now is prudent to manage network reliability in both the short and long term"*[2].

It appears that the iterative approach to reaching a CPP determination has, for the most part, worked well.

The process from development of the CPP proposal, through to independent verification and the Commission's draft decision has resulted in shifts in position, with Powerco making adjustments to its proposal and the Commission moving closer to Powerco's position than the Verifier. For example, the draft decision accepts 96% of Powerco's proposed expenditure compared to the 91% that the Verifier was able to verify.

While it is pleasing that the Commission has confidence in the rigour of Farrier Swier's verification report, the iterative process has meant that Powerco has been able to provide the Commission with additional and new information that the Verifier did not have available when it was compiling its report.

The lesson we take from this, is that it is important that the CPP applicant has multiple opportunities to respond to questions about aspects of its proposal, and is able to provide additional evidence and information in justification.

3 Precedent

The precedent that the Powerco CPP determination will set is important for 'reasonable investor expectations', maintaining a viable and proportionate alternative to the relatively low-cost default price-quality path (DPP) setting, and promoting regulatory certainty:

[1] ERANZ. (2017). ERANZ Submission on Powerco's Customised Price-Quality Path Proposal. 22 September 2017, paragraph 2.4.1, p1.

[2] Commerce Commission. (2017). Powerco's proposal to customise its prices and quality standards. 16 November 2017, paragraph X18, p8.

- Providing regulated suppliers' with confidence that 'reasonable investor expectations' will be satisfied. This, in turn, directly flows into aspects of the Part 4 purpose; particularly incentives to invest, including in replacement, upgraded, and new assets (s 52A(1)(a)), and ensuring regulated suppliers provide services at a quality that reflects consumer demands (s 52A(1)(b);
- Making sure that there remains a viable alternative to the relatively low-cost DPP that better suits individual circumstances. The Commission's application of the 'proportionate scrutiny principle' is, in our opinion, a vital aspect of maintaining viability; and
- Promoting certainty for suppliers and consumers. While the Commerce Act only explicitly links the regulatory certainty purpose to the Input Methodologies (IMs) we consider regulatory certainty to be important for all aspects of the operation of Part 4.

The Commission's process, so far, is helping to provide greater clarity about what is expected from CPP applications; particularly around asset management practices, and what could be expected as an outcome of the process. There have clearly been learnings from the first CPP determination process that have helped with the process.

4 Retailer views on network evolution should be dismissed

One question we have is whether retailer submissions have had any influence on the Commission's draft decision not to provide an allowance for network evolution capex?

This is not clear either way from the draft decision.

We raise this because we consider the retailer submissions (Contact Energy, ERANZ & TDB Advisory) to be flawed and materially self-serving. The retailer submissions do not provide any relevant or helpful basis for making a decision on whether to approve Powerco's network evolution capex proposal.

The Commission correctly noted that *"Some submitters in [the IMs review] process (retailers in particular) sought to constrain EDBs from fully using (ie, owning and operating) new technologies, in particular by restricting the inclusion of certain assets classes into the regulated asset base (RAB). We did not accept that approach …"*[3]

The debate over what EDBs should and should not be allowed to do was then re-litigated in the Electricity Authority's Mass Participation consultation and now, regrettably, is being re-litigated yet again in the Powerco CPP determination process.

This can be seen vividly, for example, in TDB Advisory's submission on behalf of ERANZ: *"one underlying issue is what activities should be treated as falling within the regulated service. Absent a specific determination by the Commission, it is not obvious how Powerco is constrained in the extent to which it seeks to include capital expenditure that relates to network evolution in the RAB"*[4].

TDB Advisory continues to re-litigate the emerging technology debate with the claim that *"it would be prudent to ensure that network-evolution capex that is included in the RAB is confined to areas that do not encroach on services that could be supplied by competitive markets, as otherwise more competitive suppliers may be squeezed out of the market"*[5]. For statements like this to be in any way helpful, TDB Advisory would, at least, need to explain how the conditions under which price squeezes can occur would be met if Powerco's network-evolution capex was approved. We consider that TDB Advisory should take heed of the High Court's view on required standards of evidence, that *"Where a proposition is simply asserted by economic experts, we give it little or no weight"*[6].

Contact Energy is quite transparent, at least, that their view on whether Powerco's network evolution capex proposal should be authorised is based on its view that EDBs should be required to rely on third-party provisioning, and be prohibited from owning assets that could be supplied competitively. This issue has already been dealt with by the Commission, and does not belong in CPP determination processes.

[3] Commerce Commission. (2017). Powerco's proposal to customise its prices and quality standards. 16 November 2017, paragraph 301, p76.
[4] TDB Advisory. (2017). Submission on Powerco's CPP Proposal. 22 September 2017, paragraph 6.5, p16.
[5] TDB Advisory. (2017). Submission on Powerco's CPP Proposal. 22 September 2017, paragraph 6.6, p16.
[6] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC, paragraph [1745].

We would urge the Commission to reconsider its position on network evolution expenditure. Our view is that Powerco's proposal for modest network evolution expenditure provides a relatively low risk (for consumers and Powerco) opportunity to test and develop new network technologies and to evaluate how consumers' use of emerging technology will affect and influence the provision of network services into the future.

5 Quantified CBA would require further review of the IMs

We consider that the Commission was correct to reject ERANZ (TDB Advisory), MEUG and TrustPower's view that a quantified CBA should be required to justify the CPP proposal.

The appropriate channel for advocating such requirements is, as the Commission notes, the IMs review process. For whatever reasons, ERANZ, MEUG and TrustPower choose not to advocate that the CPP IM be amended to require quantified CBA. We note that the main component of the TDB Advisory submission, prepared for ERANZ, was advocacy of the application of CBA to the CPP determination and service quality standards.

What ERANZ (TDB Advisory), MEUG and TrustPower have advocated for, is that the Commission be open to a 'mid-play' changing of the 'rules of the game'; that is, change the criteria for determining a CPP, after a CPP application has been made. This is contrary to the regulatory certainty principle underpinning the IMs.

Quantified CBA can play an important role in decision-making. Given CPP applications cannot be withdrawn after they have been made, the addition of a new CBA requirement would create considerable, and unnecessary, additional risk and uncertainty for regulated suppliers contemplating or making a CPP application. We do not see how this would help promote any of the Part 4 (or subpart) purposes.

It is disappointing that the CBA provided by NZIER was of such a poor quality, and excluded substantive categories of benefits. Aurora Energy agrees with the Commission that, regardless of whether quantified CBA should be part of the relevant criteria for a CPP, the NZIER CBA is not fit-for-purpose and, if it is corrected for the most obvious and egregious errors, the NZIER CBA can actually provide support for Powerco's CPP proposal.

6 Service quality requirements

We have sympathy for the Commission's desire to retain some level of service quality requirement for planned outages, but also for Powerco's concerns that the planned outages service quality requirements could cause it problems during the CPP period.

It would not be in the best interests of consumers if approved CPP expenditure was delayed in order to avoid a technical breach of the planned service quality requirements. Powerco has noted the service quality standards for planned outages could result in a perverse outcome where it is incentivised to reduce planned work *"If this incentive remains, it may perversely compromise the delivery of the CPP programme, should we have to reduce shutdowns in order to avoid exceeding regulatory quality caps, or to pursue a revenue bonus"*[7].

A service quality breach could arise simply because the forecast timing of CPP expenditure cannot be 100% accurate. Powerco has noted: *"There is a significant range of uncertainty around the forecasts ..."*[8].

In our previous submission, we suggested there could be middle-ground options that deal with both the Commission and Powerco's concerns. Two options we suggested the Commission consider were:

- **An average service quality requirement:** Measuring service quality performance over the entirety of the CPP period (rather than year on year); and/or

[7] Powerco. (2017). Customised price-quality path (CPP); Main Proposal. 12 June 2017, section 17, p208.
[8] Powerco. (2017). Customised price-quality path (CPP); Main Proposal. 12 June 2017, section 17.2.2, p216.

- **A service quality floor:** Basing the minimum service quality requirement on Powerco's highest level of projected planned outages for the CPP period.

The Commission did not respond to these suggestions in the draft decision, so we reiterate them for the Commission's consideration.

With regard to the Commission's required SAIDI (10%) and SAIFI (5%) improvements by the end of the CPP period, we have been unable to determine exactly how the Commission arrived at these improvements as the 'right' answer. The link between investment and reliability is not necessarily strong, and the Commission noted, in its recent open letter, that "*there can be a significant lag between assets deteriorating and quality reducing*"[9]. While agreeing with that view, we consider that the reverse is also likely, and that the reliability benefit that accrues from Powerco's investments could take longer than the CPP period to emerge and become stable.

We consider that the approach the Commission proposes has a fundamental bearing on future CPPs and potentially shapes the future of quality regulation more generally. Accordingly, we recommend that the Commission publish the 'improvement models' used to inform its proposed quality standard for unplanned outages. We would be disappointed if the improvements were arrived at arbitrarily.

7 Other matters

We note the following additional views:

- Aurora Energy supports removal of the service quality-revenue link for the Powerco CPP. Whether the service quality-revenue link should be retained or removed is likely to be case-specific and vary from CPP to CPP. We would not expect, for example, the link to be removed as part of the Wellington Electricity CPP.
- The draft decision floats the idea of linking CPP delivery to Powerco's ability to increase prices. This included limiting Powerco's ability to increase future prices and/or clawing back price increases where the proposed investment did not in fact occur. Regardless of the merit of this idea, we agree that the Commission should not pursue it as part of the Powerco CPP determination. The appropriate vehicle for considering such options is as part of the review of the IMs.
- We are generally supportive of the proposed annual delivery report, in order to provide an assurance to stakeholders that Powerco's CPP is delivered to plan. However, the fact that Powerco will operate under a CPP does not undermine the utility of existing information disclosure requirements, including the annual publication of its asset management plan. We question whether some of the proposed information requirements go too far, being of little benefit or interest to stakeholders, and imposing a disproportionate burden on Powerco to compile.
- Our previous submission noted that we support deviating from the WACC IM to reflect expected changes to interest rates and WACC when the EDB DPPs are reset for 2020.
- We note that the approach to WACC that Powerco has advocated will result in a lower price increase for consumers at the start of the CPP determination. Given this, we are somewhat puzzled by Contact Energy's view that the Commission needs to adopt a prescriptive approach "*to ensure a fair outcome for consumers*"[11]? It would have been easier for Powerco to simply accept the existing WACC IM requirements.

  Contact Energy's submission highlights the disadvantage of applying a rate-of-the-day (ROTD) WACC rather than a trailling average cost of debt (TACD) WACC. A ROTD WACC can result in windfalls to the regulated supplier when interest rates are declining (and vice versa). It is surprising that Contact Energy would make such arguments given they opposed adopting a TACD WACC during the IMs review. A TACD WACC would have addressed the issues Contact Energy is raising now.

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[9] Commerce Commission. (2017). Our priorities for the electricity distribution sector for 2017/18 and beyond. 9 November 2017, paragraph 12, p3.

[11] Contact Energy. (2017). Re: Invitation to have your say on Powerco's proposal to change its prices and its quality standards: issues to explore and consider. 22 September 2017, section 9, p13.

8 Concluding remarks

The Powerco CPP determination will set important precedents for *"reasonable investor expectations"*, maintaining a viable and proportionate alternative to the relatively low-cost default price-quality path (DPP) setting , and regulatory certainty.

Aurora Energy is comfortable with the way the Powerco CPP determination process appears to be preceding. We are particularly encouraged by the interactive approach being adopted, and that Powerco has multiple opportunities to respond and provide new information and evidence.

The targeted approach that the Commission has taken, following the independent verification report, has meant the the Commission's review avoids simply repeating the work the Verifier has already done, without simply being a 'rubber-stamping exercise'. It appears that the Commission has achieved the right balance in applying the 'proportionate scrutiny principle'.

We are supportive of the Commission's draft decisions that:

- The vast majority of Powerco's proposed expenditure is justified, and that there should be an uplift compared to the DPP;
- The service quality-revenue link should not be applied to the Powerco CPP;
- Powerco's forecast of the 2020 WACC should be adopted, to help smooth the price-path (and reduce the initial uplift), with wash-up to reflect any variation between Powerco's forecast and the actual 2020 DPP WACC;
- A requirement for a quantified CBA should not retrospectively be applied to the CPP determination process; and
- A link between CPP delivery and Powerco's ability to increase prices should not be imposed.

We have proposed potential middle-ground options for the planned outage service quality requirements that should be considered.

Given the importance of the CPP decision to the successful operation of the Part 4 regime and, more specifically, for consumer outcomes over the long-term, we were disappointed that some of the submissions diverted into issues such as: (i) re-litigating issues about what EDBs should and should not be allowed to do in relation to new technology; and (ii) revisiting issues about how WACC is determined under the IMs while also contradicting previously held positions on the matter (Contact Energy Energy). TrustPower attacking gas pipeline businesses over their AMPs represents a regrettable nadir for engagement over CPP determination processes.