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POWERCO – SUBMISSION ON DPP RESET ISSUES PAPER

This is Powerco Limited's submission on the Commerce Commission's consultation paper *Default price-quality paths for electricity distribution businesses from 1 April 2020: Issues paper*. Our high-level views on expenditure forecasts and incentives are:

Expenditure forecasts

- Potential increased and new operating expenditure needs to be factored to forecasts for the next regulatory period
- Asset Management Plan forecasts are the correct starting point for setting capital expenditure allowances

Incentives to improve efficiency

- Adjusting capital expenditure retention rates may have negative impacts for consumers in the long-term
- Promoting efficient network innovation expenditure needs to be incorporated into the regulatory framework

On reliability standards and quality of service we support the ENA's submission. Attachment 1 has a summary of our views and Attachment 2 has more detailed comments about the topic areas in the issues paper. We look forward to the next steps in consultation process. If you have any questions on this submission, please contact Nathan Hill (Nathan.Hill@powerco.co.nz).

Yours sincerely

A handwritten signature in blue ink, appearing to read "Stuart Marshall".

Stuart Marshall
General Manager – Regulation and Commercial

Attachment 1: Summary of Powerco’s views

Topic	Commission’s proposed approach and key issues	Powerco view
Forecasting operating expenditure	<ul style="list-style-type: none"> The Commerce Commission (Commission) intends to use the same forecasting approach as that used for the DPP2 reset The Commission is seeking reasons and evidence for any likely step changes applicable to the electricity distribution industry between 2019 and 2025 	<ul style="list-style-type: none"> There are several potential step changes that will affect EDB operating expenditure (opex), and therefore will need to be considered in the development of DPP3 opex forecasts The gap between default price-quality paths (DPPs) and customised price-quality paths (CPPs) may be constraining prudent and efficient expenditure that is in the best interests of consumers or penalising EDBs for actions outside of their control. We think it is sensible to consider this issue in the DPP3 reset decision because improvements to the opex forecasting approach may help mitigate this issue.
Forecasting capital expenditure	<ul style="list-style-type: none"> The Commission consider that Asset Management Plans (AMPs) are the best starting point for setting EDB capital expenditure (capex) forecasts – with some form of scrutiny or limits applied The need for the DPP to remain relatively low-cost, and the availability of a CPP to suppliers whose future capex needs depart significantly from their past needs means there are limits to the level of scrutiny applied in a DPP 	<ul style="list-style-type: none"> We agree EDB AMPs are the best starting point for setting DPP capital expenditure forecasts We agree that scrutiny of AMP forecasts is necessary to mitigate the risk of EDBs over-forecasting their capex requirements Our key concern regarding capex forecasting is that the scrutiny applied remains proportional to the low-cost nature of the DPP Using a stepped approval approach like that used in the 2017- 2022 gas DPP reset may be useful for minimising costs The final capex forecasts will need to account for the impact of the final DPP decision.

Topic	Commission’s proposed approach and key issues	Powerco view
Reliability standards and incentives	<ul style="list-style-type: none"> • The Commission is considering several changes to the reliability standards, this includes: <ul style="list-style-type: none"> ○ whether planned interruptions should be assigned a lower weighting or be treated as a separate quality standard ○ the buffer between the SAIDI and SAIFI limits and the SAIDI and SAIFI historical average ○ updating the reference period ○ removing the most extreme years from the reference dataset ○ including additional reporting requirements for DPP3 when an EDB contravenes its quality standards ○ disaggregating quality standards by location or customer type ○ if the current ‘non-material deterioration’ standard used to set reliability measures remains appropriate ○ raising the total revenue at risk under the quality incentive scheme 	<ul style="list-style-type: none"> • Powerco has contributed to and supports the Electricity Network Association (ENA) submission points on ‘Reliability standards and incentives’. To avoid duplication, we have not included comments on reliability standards in this submission • Note - we have commented on the percentage of revenue at risk under the quality incentive scheme in this submission in our comments on incentives to improve efficiency.
Other measures of quality of service	<ul style="list-style-type: none"> • The Commission is considering whether there are other measures of quality which might better reflect customer’s demands. This could include matters such as: <ul style="list-style-type: none"> ○ providing high quality power supply ○ the time it takes to respond to a power cut ○ the time taken to answer the telephone ○ providing information on reasons for and the likely duration and extent of a power cut ○ processing applications for new connections • providing sufficient notice of shutdowns. 	<ul style="list-style-type: none"> • Powerco has contributed to and supports the ENA submission points on ‘Other measures of quality of service’. To avoid duplication, we have not included or repeated those comments in our submission.

Topic	Commission’s proposed approach and key issues	Powerco view
Incentives to improve efficiency	<ul style="list-style-type: none"> • The Commission is considering increasing the capex incremental rolling incentive scheme (IRIS) retention rate • The Commission considers that the opex and capex incentive rates should be aligned, except where there are good reasons 	<ul style="list-style-type: none"> • The Commission’s decision on the capex IRIS retention rate will need to mitigate the risk of underinvestment • An increase to the capex IRIS retention rate is inappropriate because: <ul style="list-style-type: none"> ○ There is no evidence that the current settings aren’t achieving the intended purpose of the incentive scheme ○ We anticipate that increasing the capex retention rate may incentivise EDBs to defer network investment at a time when it is needed. This may significantly increase the risk consumers suffer higher costs or degraded quality in the future because of underinvestment now ○ EDBs may defer unanticipated expenditure that would otherwise be prudent and efficient • Some EDB capex spend is driven by external factors eg customer connections. Including this capex in IRIS calculations means EDBs are exposed to IRIS incentives despite the costs being driven by 3rd parties. Increasing the retention rate would exacerbate this issue.
Network innovation allowances and incentives	<ul style="list-style-type: none"> • There is no mention of network innovation allowances and incentives in the DPP reset issues paper 	<ul style="list-style-type: none"> • We think it is important that the DPP appropriately incentivises EDBs to pursue network innovation research and development (R&D) • Without specific regulatory incentives or allowances, we are concerned consumers might suffer higher costs in the future because of underinvestment in innovation by EDBs now • We consider that it is appropriate to explore options for R&D efficiency gains as part the DPP reset consultation.

Attachment 2: Commentary on key topics

1. Forecasting operating expenditure

Potential increased and new opex needs to be factored into DPP3 forecasts

Historical expenditure is unlikely to reflect EDB DPP3 opex needs

We anticipate EDBs will have new opex needs in DPP3 that aren't reflected in historical expenditure. The need for increased opex could be driven by numerous influences such as technology growth, consumer demands and regulatory change.

The Commission's proposed opex forecasting approach can accommodate known and predictable operating expenditure changes (up & down) common to the industry that are not already captured in the base level via a step change mechanism.

Potential opex step changes that should be considered for DPP3 include:

- Increasing opex due to changes to the Fire and Emergency levy¹
- Increasing opex due to changes to the Electricity (Hazards from Trees) regulations²
- New opex associated with low-voltage network monitoring
- New opex to prepare for the future state/function of networks
- Increasing cloud-based information technology solutions may result in expenditure switching from capex to opex

Is there a gap in the regulatory framework around significant and unforecastable opex?

Step changes currently only apply to significant, known and predictable opex changes that are applicable to most, if not all, distributors. Where expenditure needs arise that don't meet the conditions of a 'step change' or a 'DPP re-opener' request, a customised price-quality path application can be made.

However, an expenditure increase above the regulatory allowance may not justify a high cost CPP application – this doesn't mean the additional expenditure isn't material or that it should be deferred. Where opex is greater than the allowance it will be uncompensated until the next regulatory reset. EDBs will also face opex IRIS penalties.

This outcome highlights a gap in the current regulatory framework that may be constraining prudent and efficient expenditure that is in the best interests of consumers or penalising EDBs for actions outside of their control. This gap was one of the reasons Powerco proposed the idea of

¹ This increase in expenditure may need to be assessed via a 'change event' DPP re-opener if the legislative change occurs after the DPP3 reset.

² This increase in expenditure may need to be assessed via a 'change event' DPP re-opener if the legislative change occurs after the DPP3 reset.

moving large distributors on to an individual price-quality path (IPP) regime in our submission on the Electricity Price Review.³

We acknowledge this gap is probably a consideration for the wider regulatory framework and therefore best dealt with as part of an IM review. In the interim, it is sensible to consider this issue in the DPP3 reset decision because improvements to the opex forecasting approach may help mitigate this issue.

³ Powerco submission on the Electricity Price Review First Report, 23 October 2018

2. Forecasting capital expenditure

Powerco agrees EDB AMP forecasts are the correct starting point for setting capex allowances.

Given the relatively low-cost nature of the DPP regime and EDB knowledge of their own networks the Commission considers that AMPs are the best starting point for setting DPP capital expenditure forecasts.⁴ We agree. It also aligns with the Commission's increasing focus on EDB asset management practices and plans.

Scrutiny options

We agree with the Commission's view that the risk of EDBs over-forecasting their capex requirements creates a need to scrutinise an EDB's AMP forecasts.

Our key concern is that it remains proportional to the low-cost nature of the DPP. This is a concern the Commission shares and informed our suggestion for an IPP for large EDBs in our submission on the Electricity Price Review. The feedback and experience gained by the Commission in the 2017-2022 gas DPP reset should help in this regard. Although the differences between the electricity and gas industries will obviously need to be considered eg 17 EDBs compared to only 4 GDBs.

Using a stepped approval approach like that used in the Gas DPP reset may be useful for minimising costs. The approach involves:

- A cap on historical expenditure is a pragmatic and low-cost first acceptance step
- further scrutiny of AMPs applied when the cap is exceeded

This type of approach has the benefit of being flexible enough to accept expenditure above historical caps if suppliers' AMPs demonstrate the additional investment is prudent and efficient.

Capex driven by regulatory change

The DPP reset final decision may create a need for expenditure that isn't included in an EDB's AMP forecasts. An example could be the Commission's decision regarding EDB low-voltage monitoring and reporting. EDBs won't know if they need to undertake expenditure to facilitate low-voltage reporting in DPP3 until after the final reset decision is made. To accommodate this type of additional expenditure the Commission will need to take the expenditure implications of the final DPP reset decision into consideration when setting an EDB's capex forecasts.

⁴ Commerce Commission, issues paper on Default price-quality paths for electricity distribution businesses from 1 April 2020 (15 November 2018), p76

3. Incentives to improve efficiency

The Commission's decision on the capex IRIS retention rate will need to mitigate the risk consumers might suffer higher costs or degraded quality in the future because of underinvestment

The Commission has indicated it is considering changing the capex IRIS retention rate used for DPP3.

There are two reasons in the issues paper for this: These are:

- A. the reasons for setting the DPP2 capex retention factor lower than the opex retention factor may no longer be valid; and
- B. changing the capex incentive rate may remove a preference or bias towards the type of expenditure that is subject to the lower incentive rate. In this instance a bias towards capex.

We comment on each of these below.

A: Are the reasons for a lower capex retention rate in DPP2 still valid?

Is there evidence from DPP2 of biased forecasts?

We have no evidence to suggest DPP2 forecasts were systematically biased.

Will increased scrutiny of EDB DPP3 capex forecasts mitigate the risk that EDBs could systematically bias their forecast upwards to increase their capital expenditure allowance?

We agree that increased scrutiny of EDB forecasts will mitigate the risk of inflated forecasts to some extent.

The amount of risk mitigation realised will ultimately depend on the level of scrutiny applied. The Commission rightly acknowledges that even with increased scrutiny, due to information asymmetries and the need for the DPP to be relatively low-cost, there remains a risk that the expenditure forecasts they approve will include some upward bias.⁵

Will a higher retention rate result in the incentive to inefficiently defer or reduce capital expenditure being stronger than the incentives to maintain quality?

We agree with the Commission's concern that a higher retention rate may place a stronger incentive on EDBs to avoid IRIS penalties, than on investing to maintain quality.

The Commission has suggested that it may be able to mitigate this risk by increasing the revenue at risk under the quality incentive scheme. This approach needs further thought: all investment is captured by IRIS, but the impact on quality will vary eg investment in systems to deliver pricing reform will not directly impact quality. As a principle, the IRIS mechanism ought to be independently workable.

Additionally, we consider it is inappropriate to raise the revenue at risk under the quality incentive scheme because:

⁵ Commerce Commission, issues paper on Default price-quality paths for electricity distribution businesses from 1 April 2020 (15 November 2018), p127

- the penalty/bonus is to a large degree dictated by the weather patterns in a year and hence not directly controllable by EDBs
- a material amount of an EDB's annual revenue would be at risk each year, especially when factoring in other incentives like IRIS. This could influence incentives to invest
- having such a high proportion of revenue at risk could drive outcomes that are against customers' best interests:
 - it would encourage attention to shift even more to the dense part of networks (with the highest SAIFI/SAIDI impact)
 - a stronger incentive to invest to improve quality may not necessarily reflect customers' price/quality trade-off preferences

B: Capex bias

We agree with the Commission's concern that misalignment of the opex and capex IRIS retention rates may create a preference or bias towards the type of expenditure that is subject to the lower retention rate. In this instance a bias towards capex.

In principle, Powerco supports the need for neutral policy settings, including any incentives that distributors face around operational and capital expenditure. This is important in ensuring the most efficient/ lowest cost investment option is chosen regardless of expenditure type. However, we question whether a higher retention rate is appropriate in DPP3.

We think an increase in the capex retention rate is not appropriate

1. There is no evidence that the current settings aren't working

Given the immaturity of IRIS in the New Zealand context, there is not yet enough evidence to demonstrate that the incentive scheme with its current settings is achieving the intended purpose.

The Input Methodologies (IM) review exercise in 2016 was excellent because it was based off experience. We think it is prudent for the Commission to use this evidence based decision-making approach again in its decision on the capex IRIS retention rate. This approach would suggest that any changes should be delayed until evidence of a problem emerges.

2. Risk of underinvestment

The general aging of asset fleets across New Zealand's EDBs is resulting in declining network performance and reliability. This is generating a need for increasing levels of network investment to ensure EDBs continue delivering the safe, reliable and efficient service customers expect. The Powerco CPP is a leading example of addressing this need.

We anticipate that increasing the capex retention rate may incentivise EDBs to defer network investment at a time when it is needed. This may significantly increase the risk consumers suffer higher costs or degraded quality in the long-term because of underinvestment in the near-term.

The risk of under investment was a major concern of the Commission's that lead it to set a Weighted Average Cost of Capital (WACC) uplift in the 2014 WACC percentile decision. We think that the Commission's decision on the capex IRIS retention rate will similarly need to mitigate this risk.

3. *Unpredictable capex needs*

As a principle we consider that EDBs shouldn't be incentivised to 'game' actual expenditure because of externalities that impact forecasts.

There are numerous reasons why an EDB's expenditure needs may vary from forecasts. The drivers for these variances are often unpredictable and can be internal or external to the actions of the business eg customer connections. The unpredictability can result in IRIS rewards and penalties for deviations from forecasts (as opposed to a forecast "error"). The choice of a higher retention rate will magnify the financial benefits/penalties of these deviations.

Faced with higher penalties for overspending, EDBs may defer unanticipated expenditure that would otherwise be prudent and efficient, and most importantly, meet customer needs. We think this outcome is undesirable and an issue to explore further.

An alternative solution: Reduce the opex IRIS retention rate

In our opinion the simplest solution that mitigates the risk of investment deferral and any expenditure bias is to align the opex and capex retention rates by lowering the opex IRIS retention rate. The opex retention rate is set through the IRIS mechanism, so this would require a reduction to the length of the opex IRIS retention period or some other inventive solution.

We acknowledge that this would require an IM change. We don't think the requirements of an IM change should be barrier to this option being considered.

Other expenditure incentive issues

NZ IFRS 16 lease accounting standard

The issues paper notes that the Commission will be undertaking a separate consultation process on the treatment of operating leases. We consider that any move away from a GAAP based approach would add unnecessary complexity and burden to EDBs. The simplest approach would be for regulatory treatment to continue to follow generally accepted accounting practices (GAAP). This would result in a movement in costs from opex to capex.

We look forward to discussing this issue further with the Commission during its consultation process in 2019.

4. Network innovation allowances and incentives

The DPP framework should promote appropriate levels of efficient network innovation expenditure to mitigate the risks of under-investment

The current regulatory framework provides too little incentive for distribution businesses to undertake research and development, or reward for successful innovation.

Without specific regulatory incentives or allowances, we are concerned consumers might suffer higher costs in the future because of underinvestment in innovation by EDBs now.

Increasing network innovation expenditure is prudent

The electricity industry is changing – driven by interrelated changes in customers' attitudes, use of networks, policy around a low carbon economy, and emerging technology opportunities. These changes have the potential to have a profound impact on the nature and operation of electricity distribution networks and should overtime translate into improved cost efficiency and customer service outcomes.

We consider that the current regulatory framework has the potential to result in under investment by EDBs. We are concerned that setting generic expenditure allowances, based largely off historical expenditure, may not appropriately reflect the scale and scope of investment needed to prepare for future electrification needs. Without specific network innovation incentives or allowances there is a genuine risk that under investment in DPP3 will enhance the likelihood the full benefits of new technologies aren't realised by New Zealand electricity consumers.

The risks of underinvestment in network innovation are high.

Under investment will create risks that:

- the adoption of lower cost new technologies is delayed
- a reactive response materially increases costs
- asset management processes and capabilities aren't maximised
- EDBs are unable to perform the functions demanded by consumers when required
- the electricity distribution industry doesn't maximise it's potential to help New Zealand reach its low carbon economy goals

To mitigate these risks, we think it is important that the DPP appropriately incentivises EDBs to pursue network innovation R&D now.

Efficiency is important

In addition to ensuring EDBs undertake appropriate levels of network innovation expenditure, we recognise that it is equally important that this expenditure is efficient.

We consider that the status quo maybe resulting in inefficiencies as it limits the scope of collaboration between EDBs and third parties. This is because suppliers will naturally focus on R&D that addresses their specific network issues.

We think it is appropriate to explore options for R&D efficiency gains as part the DPP reset consultation.