
The Lines Company Limited views:

Issues paper: 15 November 2018

**Default price-quality paths for electricity
distribution businesses from 1 April 2020**



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Introduction

The Lines Company Limited (TLC) thanks for the Commerce Commission (the Commission) for the opportunity to provide our views on the matters raised in the paper, and on any other matters relevant to the DPP3 reset.

In our submission, we have taken extracts from the paper's executive summary, for context, and provided feedback in boxes thereafter.

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Purpose of this paper

X1 This paper:

X1.1 explains our framework for considering changes when resetting the default price-quality path (DPP) for electricity distribution businesses (EDBs) for the third regulatory period beginning 1 April 2020 (DPP3); and

X1.2 consults on potential issues we have identified in advance of the DPP3 draft decision.

X2 Submissions on this paper are due 20 December 2018, and cross-submissions are due 31 January 2019.

Decision making framework

X6 In making decisions about DPP3, we propose applying a decision making framework that focuses on retaining approaches from the current DPP (DPP2), unless changes would:

X6.1 better promote the purpose of Part 4;¹

X6.2 better promote the purpose of default/customised price-quality path regulation;²

X6.3 better promote incentives for EDBs to invest in energy efficiency and demand-side management, and to reduce energy losses (or better avoid disincentives for the same);³ or

X6.4 reduce unnecessary complexity and compliance costs.

Our approach to DPP3

X7 The core components of a DPP that we need to make decisions about remain largely unchanged from DPP2. These components are:

X7.1 forecasts of operating expenditure;

X7.2 forecasts of capital expenditure;

X7.3 quality standards and incentives;

X7.4 incentives to improve efficiency; and

X7.5 incentives for energy efficiency, demand-side management, and reduction of energy losses.

X8 Additionally, there are two components of the DPP which have changed significantly as a result of amendments we made to the input methodologies (IMs) in 2016. These are:

X8.1 the move from a price cap to a revenue cap;⁴ and

X8.2 changes to the treatment of depreciation which allow EDBs to apply for a discretionary shortening of asset lives (accelerated depreciation).

Forecasts of operating expenditure

X9 Our emerging view is that we should retain the general approach used to forecast operating expenditure from the 2015 DPP reset. This involves:

X9.1 taking a base level of operating expenditure;

X9.2 carrying this forward by certain trend factors; and

X9.3 applying any known step changes (this is commonly referred to as a 'step and trend' approach).

TLC agrees with the approach suggested and comments that there needs to be effective mechanisms for the "steps" for individual EDB's to be communicated to the Commission.

X10 Within this step and trend approach we are proposing, at a high level, to:

X10.1 use actual operating expenditure for the 2019 disclosure year as the base level of operating expenditure;

X10.2 retain the general econometric approach to forecasting operating expenditure growth due to network scale growth;

X10.3 explore further disaggregation of the operating expenditure forecast from network and non-network to the operating expenditure categories disclosed in information disclosure, and we will consider what the drivers for each category might be;

X10.4 use an operating expenditure partial productivity factor of 0% (however, we are seeking any reasons and evidence for deviating from this assumption); and

X10.5 retain a weighted average of the all-industries labour cost and producer price indices to calculate nominal operating expenditure over DPP3.

We agree that the use of a weighted average of labour and producer indexes as appropriate base but note also that these indices should be chosen to reflect the relevant underlying costs i.e. these indices need to specifically reflect the sector.

X11 We are also seeking reasons and evidence for any likely step changes applicable to the electricity distribution industry between 2019 and 2025.

- Health and safety costs (particularly with regard to labour) e.g. additional training, contractor compliance, equipment decisions, compliance reporting and overhead
- Availability of skilled staff (qualified line mechanics on the Immigration New Zealand Long Term Skills Shortage list), high calibre project management resource is in high demand across the whole electricity sector

- Contracting/Labour Market impact of Powerco's planned investment following approval of their CPP
- Fire services levies on Insurance
- Electricity Authority Pricing Methodology change recommendations

Forecasts of capital expenditure

X12 We consider that the approach we took in DPP2, where we used EDB Asset Management Plans (AMPs) as the starting point for our forecasts, remains appropriate. Consistent with this, we are considering using:

X12.1 the 2018 AMP as the basis of the draft decision and the 2019 AMP update as the basis of the updated draft and final decision; and

X12.2 breaking capital expenditure down into network and non-network capital expenditure.

X13 However, we do not consider it appropriate to use EDB AMPs without some form of limit or scrutiny. This is in part due to the incentives EDBs face to over-forecast capital expenditure needs.

X14 The options for scrutiny we are considering fall into four broad categories. From least to most scrutiny, these options are:

X14.1 capping forecasts based on historical expenditure levels;

X14.2 assessing AMP capital expenditure forecasts against other material disclosed in the AMPs;

X14.3 assessing AMP capital expenditure forecasts against independently derived, external drivers; and

X14.4 qualitative analysis of AMPs and other information where expenditure exceeds reasonable limits.

X15 We are interested in views about which of these options is most appropriate considering the long-term benefit of consumers and the relatively low-cost framework of DPPs.

With regard to scrutiny of capex forecasts, we agree that some form of scrutiny is useful.

- We do not agree with X14.1 (capping forecast based on historical levels). Capping forecasts at historical levels does not allow for any large one-off projects or for increased expenditure that may be planned to respond to reliability, demand profiles and/or risk profiles.
- We agree with X14.2, this appears to be consistent with using the AMP's as a base for forecasting and allows for large one-off projects.
- With regard to X14.3, it is difficult to comment without the detail but in principle we agree but note the impact of large one-off capex.

- X14.4 seems a reasonable approach but further detail is needed before detailed comment can be made.

Any methodology needs a mechanism to manage the impact of customer driven work that might not be obvious at the commencement of the DPP period.

Other considerations

X16 We are also seeking views on other aspects of how we forecast capital expenditure. These include:

X16.1 How any of the metrics we use when assessing AMP forecasts could be used to provide accountability during the regulatory period as part of a 'delivery report'.

X16.2 Ways in which other independent forecasts or methods of scrutinising EDB capital expenditure could be incorporated into the DPP3 reset process.

We believe a review by EDBs of their capital expenditure at the end of a DPP period against what was proposed at the commencement could provide a means of assessing capital expenditure delivery. It is important to note that for a range of reasons planned work may move across years or are reprioritised.

It is our view that EDBs themselves best understand their asset base, the condition, risk and criticality that drives their investment decisions. We believe that independent forecasts or review of planned expenditure would introduce a burden to the planning process that would outweigh any perceived benefit.

Cost escalators for capex

X17 We would assess AMP forecasts of apply capital expenditure caps on a constant-price basis. However, the financial model depends on forecasts set on a nominal basis. Therefore, we need to determine a cost escalator to do this.

X18 The options we are considering are:

X18.1 retaining the use of the all-industries capital good price index (CGPI) forecasts, either from NZIER or another provider;

X18.2 using an industry- or region-specific index; or X18.3 using the consumer price index (CPI).

We agree that a cost escalator is required and believe that this should reflect underlying cost drivers. Our preference(s), in order, are for an industry specific index, followed by capital good index – focusing on underlying drivers. We do not believe that CPI is an appropriate base as CPI is a broad measure it does not reflect underlying cost base well.

Quality standards and incentives

X19 We are considering whether to retain both the DPP2 reliability standards and incentive scheme for DPP3. Within this, we are considering whether to amend certain aspects of:

- X19.1 setting the reliability standard(s);
- X19.2 setting the reliability incentive scheme;
- X19.3 normalising SAIDI and SAIFI; and
- X19.4 including additional reliability metrics.

Quality standards relating to reliability

X20 We invite views as to whether planned interruptions should be assigned a lower weighting or be treated as a separate quality standard.

We believe that planned outages should be treated as a separate quality standard, their underlying drivers are different to unplanned and the current methodology can drive counter intuitive behaviour with regard to long term reliability (i.e. planned outages are deferred in an attempt to remain within the quality limits).

X21 We are considering whether the buffer between the SAIDI and SAIFI limits and the SAIDI and SAIFI historical average should change.

X22 We are considering the appropriateness of updating the reference period to the most recent 10 years, and we are open to suggestions as to the best means of doing this. We are also considering removing the most extreme years from the reference dataset.

X23 We are considering alternative approaches to determining a quality standard contravention.

X24 We are considering additional reporting requirements for DPP3 when an EDB contravenes its quality standard. This would assist our understanding of the reasons for the contravention, the state of its network, and the responses it has taken to address the worsening reliability performance.

Agree that this is appropriate.

Quality Incentive scheme

X25 We consider that a cost-quality trade-off between distributors and consumers is still relevant. However, we are seeking views on the value of the revenue-linked incentive scheme for SAIDI and SAIFI.

X26 We are seeking views on raising the total revenue at risk from 1% to up to 5%.

TLC is supportive of a quality incentive continuing but has concerns at quality incentive levels above 2% of regulated revenue.

Our concerns are:

- if the quality incentives result in additional revenue of 2-5%, then customers would see price shocks at this level;
- if the quality incentives result in a decrease in revenue of 2-5%, then this would be sufficient to adversely affect an EDB's cash flow to a level that additional expenditure required to address underlying issues (e.g. additional maintenance, additional capital expenditure) may be compromised:
 - this is particularly, given that the expected reduction in WACC will result in reduction in underlying profitability (and cash flow);
 - given the potential lag between some major capital investment commencing and material changes in quality, an increase to 5% could result in a 'self-fulfilling prophecy' where network performance decreases, cash is constrained to address the issues so quality further decreases.

X27 We are seeking views on widening the SAIDI and SAIFI cap and collar band from one standard deviation to up to two standard deviations from the historical average. We also consider that the caps applicable to the incentive scheme should be consistent with the limits applicable to the quality standard.

On the basis of the SAIDI/SAIFI caps being moved to 2 standard deviation (i.e. twice the current levels) we consider that twice the current quality incentives (i.e. up to 2% of regulated revenue) would appropriately reflect this.

X28 We are considering the option of explicitly setting the incentive rate, for example, with reference to the value of lost load (VoLL).

In principle, we agree that linking the incentive rate to VoLL provides a more transparent methodology, however further detail on this would need to be provided noting our comments on revenue at risk in X26.

X29 We are considering whether to include notifications of planned interruptions and new connection measures within the quality incentive scheme.

We would support the disclosure of planned interruption notification and new connection measures rather than as part of the quality incentive scheme at this stage. This will allow the establishment of good baseline data for future inclusion in the quality incentive scheme.

Careful consideration needs to be given to any measures put in place for new connections given the wide range of field work that may be required to complete this (i.e. anything from connecting to an existing fuse to a substation build depending on location).

Normalisation

X30 We are considering whether to continue using the 23rd highest daily unplanned SAIDI

and SAIFI, assuming a 10-year reference period, for the boundary values.

- X31 If feasible, we will consider identifying an unplanned major event day based on a rolling 24-hour period. We will also consider the practicality of aggregating multi-day events attributable to extreme weather events and disasters.

We support the rolling 24 hour approach to MEDs, and the aggregation of multi day events.

- X32 We invite views on what actions should be taken when a major event day is triggered. Our starting point is that we should retain the replacement of any major SAIDI or SAIFI event day with the applicable boundary value. This ensures there is a limit on how much risk an EDB is exposed to during a major event without removing it completely.

Other measures of quality beyond reliability

- X33 In addition to revisiting our approach to reliability, we are also assessing whether there are other measures of quality which might better reflect customer demands. This could encompass matters such as:

X33.1 providing high quality power supply;

We note that the quality of supply is defined in the Electricity (Safety) Regulations 2010, which we are required to comply with. The ability to monitor and report on this accurately would require significant investment (both capital and operationally) and we do not feel this warranted given the relatively low number of customer complaints we currently receive on this issue.

X33.2 the time it takes to respond to a power cut;

We support this at a disclosure level rather than as part of an incentive scheme. Consideration would need to be given to detailed measures (e.g. time from receipt of notification to attendance on site).

X33.3 the time taken to answer the telephone;

We do not believe this would provide material additional customer benefit.

X33.4 providing information on reasons for and the likely duration and extent of a power cut;

We support the provision of this information to customers, however note that there would be relatively high overhead in monitoring and reporting on targets across the reporting period.

X33.5 processing applications for new connections; and

We support providing this information as part of information disclosure per our comments in X29.

X33.6 providing sufficient notice of shutdowns.

We support providing this information as part of information disclosure per our comments in X29.

X34 As part of this work, we are considering the material produced by the Electricity Networks Association Quality of Service Working Group, which we have published alongside this decision.

Incentives to improve efficiency

X35 We are proposing to continue using retention factors for operating expenditure and capital expenditure in order to provide EDBs with incentives to seek efficiency gains over the regulatory period, with the strength of incentives remaining constant over the regulatory period.

Operating expenditure incentive

X36 Our intended approach for DPP3 is to use the incremental rolling incentive scheme (IRIS) mechanism using the DPP3 weighted average cost of capital (WACC) value, so that the EDBs have certainty around the retention factor applied to operating expenditure efficiencies achieved throughout the regulatory period.

Capital expenditure incentive

X37 We are considering whether the reasons for setting the capital expenditure retention factor at 15% in DPP2 remain valid for DPP3. If the reasons are no longer valid, we remain of the view that the retention factors for capital expenditure and operating expenditure should be broadly similar (or there should be a smaller disparity between these incentive rates).

We agree that any incentive/retention factor should be similar between operating and capital expenditure. This will support delivery of efficiency incentive without favouring opex or capex.

Smoothing operating expenditure incentive amounts

X38 It is possible that 'operating expenditure incentive amounts' could be large enough to cause price shocks to consumers, so we are considering smoothing the annual operating expenditure incentive amounts during the regulatory period to reduce the likelihood of price shocks from individual amounts.

X39 The smoothed amounts would apply for each of the last four years of the regulatory period with a nil amount for the first year. The present value of the smoothed amounts would be set equal to the present value of the operating expenditure incentive amount'. The smoothing mechanism could be similar to the smoothing

mechanism used for the capital expenditure incentive in the IMs.

- X40 We welcome submissions on smoothing the operating expenditure incentive amounts in order to avoid price shocks to consumers and revenue shocks for EDBs.

In general we support smoothing to avoid customer price shocks and EDB revenue shocks.

Incentives for energy efficiency, demand-side management, and reduction of energy losses

- X41 In the sections below, we identify a number of issues relating to incentives for energy efficiency, demand-side management, and reduction in energy losses. We are interested in views on these issues.

Energy efficiency and demand-side management

- X42 Under a revenue cap regime such as that which will apply during EDB DPP3, the energy efficiency and demand-side management incentive scheme that we introduced for the current EDB DPP is not required. In our 2016 IM review, we gave effect to this by removing the energy efficiency and demand-side management incentive allowance as a recoverable cost. In our IM review reasons paper, we noted that submissions supported the removal of the scheme if we moved to a revenue cap.⁵
- X43 Although the move to a revenue cap form of control will remove the disincentive for EDBs to undertake energy efficiency and demand-side management initiatives, we are still required to positively promote such initiatives.
- X44 One area where we are considering strengthening incentives for demand-side management is the retention factors that apply to capital expenditure and operating expenditure. As discussed in Attachment E, we are proposing to revisit the capital expenditure retention factor to see whether it should be increased towards the operating expenditure retention factor.

The issue for retention factors is whether a demand-side initiative results in a positive or negative cash flow for the EDB. If it is a negative cash flow for an EDB, then higher retentions will work against the intended incentive; if it is a positive cash flow, then the incentives are reinforced by a higher retention factor.

- X45 As we noted in 2014, the retention factors for operating expenditure and capital expenditure can influence decisions by EDBs on energy efficiency and demand-side management activities.
- X46 We note that demand-side management incentive schemes have been introduced internationally in similar regulatory regimes, although they are still at an early stage. For example, the Australian Energy Regulator (AER) introduced a demand management incentive scheme in December 2017. The effectiveness of these schemes is not yet known. This may support taking an incremental approach for EDB DPP3, based on our review of the retention factors that will apply during DPP3.

- X47 We are interested in views on whether the incentives for EDBs to promote energy efficiency and demand-side management initiatives should be further strengthened beyond our reconsideration of retention factors.

We agree to strengthening of incentives for energy and demand side management. The issue for retention factors is whether a demand-side initiative results in positive or negative cash flow for the EDB. If it is a negative cash flow for an EDB then higher retentions will work against the intended incentive, if it is a positive cash flow then the incentives are reinforced by a higher retention factor.

Reduction of energy losses

- X48 Although it is not possible to eliminate line losses, we are interested in exploring options for incentivising the EDBs to reduce distribution line losses.
- X49 One option might be to consider moving towards a ‘cap and collar’ type of mechanism to incentivise EDBs to factor energy losses into their decisions. Under such a mechanism, an EDB is rewarded for reducing line losses below a target level and penalised where line losses increase above the target. However, if such a mechanism were to be considered, we would have to be satisfied that this is consistent with section 52A of the Act, in particular having regard to whether consumers are willing to pay for reduced line losses.
- X50 Under an incentive scheme, consumers would pay a financial ‘reward’ to EDBs who reduce line losses below the target level (in the form of a revenue uplift). Consumers would also pay for EDB investments in loss reduction activities as the assets associated with those activities enter the regulatory asset base. These costs to consumers would have to be weighed against the consumer benefits of lower losses.
- X51 We are interested in views on whether an explicit mechanism to promote investment in line loss reduction should be considered as part of EDB DPP3, or whether we should instead progress this through summary and analysis of information disclosed by the EDBs (such as through the 2018 AMP review) and targeted new disclosure requirements.

We consider regulation in this area unnecessary. As part of commercial and prudent operation of a network life cycle cost (including line losses) is factored into investment decisions.

Additional information: Workshops we would find helpful:

1. Revenue Path X8.1

TLC agree with the move to a revenue path but have a number of questions.

- TLC would need to understand how over recovered revenue will be treated
 - A wash up between years?
 - Reduction of DPP4 opening revenue?
- Volume risk is also prevalent particularly when a single significant new customer occurs
 - If the process for considering a “re-opener” is simple enough this may provide adequate flexibility to handle this
- There is similar volume risk to areas with significant growth – although it is acknowledged that the AMP should anticipate this growth to a certain extent.
- Confirmation of “rules” around inflation
- How the potential “wash-up” will work – or options to consider
 - Understanding of IRIS incentives (both Capital and Opex) and how practically these will work.

2. Quality Incentives – revenue discussion (i.e. 1-5%) X26

3. Quality incentives – additional items to be included and/or measurement commenced X27 to X34