

1 June 2020

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Dear Dane

## **AURORA ENERGY CPP PROPOSAL – APPLICATION FOR IM VARIATIONS**

### **Background to this application**

1. As the Commerce Commission is aware, Aurora proposes to submit an application under section 53Q of the Commerce Act 1986 for a customised price-quality path (CPP) on or around 12 June 2020.
2. On 27 March 2020, Aurora requested modifications and exemptions to certain requirements of the Electricity Distribution Services Input Methodologies Determination 2012 (IMs). As indicated in the Commission's draft response to Aurora's 27 March 2020 application,<sup>1</sup> two of the requests included in Aurora's 27 March 2020 application should have been framed as IM variations under section 53V(2)(c) of the Commerce Act 1986 rather than modifications under clause 5.1.6 of the IMs.<sup>2</sup> We have set out further information about these two requests below.
3. In addition, we request a variation to the cost allocation method used to determine the CPP opex forecast to reflect Aurora's expected change to opex sharing arrangements during the CPP period.

### **Summary**

4. There are three requirements of the IMs for which Aurora considers IM variations are warranted. The following table outlines the IM variations requested.

<sup>1</sup> Commerce Commission Response to Aurora Energy's application for modifications and exemptions 27 March 2020, 12 May 2020.

<sup>2</sup> Under clause 5.1.6 of the IMs, the Commission is only able to approve modifications to, or exemptions from, requirements set out in subparts 1, 4 or 5 of Part 5 of the IMs. Clauses 3.1.3 and 3.3.2 fall under Part 3 of the IMs, so the Commission is not able to approve a modification to those clauses.

<b>Issue</b>	<b>IM clause</b>	<b>Variation</b>
Urgent Project Allowance	Clause 3.1.3	A variation to permit Aurora to recover the prudently incurred costs of its network remediation programme in disclosure year 2021 that are above the DPP allowance.
Operating expenditure incentives	Clause 3.3.2	A modification to permit Aurora to spread the impact of the opex IRIS incentive over two regulatory periods.
CPP opex forecast	Clause 5.3.5(1)	A variation to the cost allocation method used to determine the CPP opex forecast to reflect Aurora's expected change to opex sharing arrangements during the CPP period

5. We provide further detail on these proposed variations below.

#### **Power to grant IM variations**

6. Section 53V(2)(c) of the Commerce Act 1986 (the Act) permits the Commerce Commission to vary an input methodology with the agreement of the supplier.

#### **PROPOSED VARIATIONS**

##### **Enable recovery of pre-CPP costs associated with Aurora's network remediation programme**

Aurora requests a modification to clause 3.1.3 of the IMs to allow Aurora to recover the prudently incurred costs of its network remediation programme in disclosure year 2021 that are above the DPP allowance.

Aurora proposes to modify clause 3.1.3, as it applies to Aurora's CPP proposal, as follows:

###### **3.1.3 Recoverable costs**

(1) A recoverable cost is a cost that is-

...

(u) an urgent project allowance, as determined by the **Commission** under subclause (11);

...

(11) 'Urgent project allowance' means the allowance determined by the **Commission** in a **CPP determination** in respect of additional net costs where these costs-

(a) exceed those already provided for in a **DPP determination** or **CPP determination**;

(b) will not otherwise be recovered by the **EDB**; and

(c) will be prudently incurred by the **EDB** in the last disclosure year before commencement of the resulting **CPP regulatory period** in responding to an urgent **project** or **programme** that relates to the **EDB's rationale for seeking a CPP occurred in the time between the submission of a CPP proposal and determination of the resulting CPP determination by the Commission**.

#### **The Issue**

7. As the Commission is aware, Aurora has been undertaking a substantial remedial investment programme since late 2016. This was principally driven by Aurora's actions to remedy historic under-investment in the network, improve its asset management and operational maturity and implement the separation from Delta.

8. This investment programme has resulted in a material step-up in both opex and capex from historical levels. As a result, Aurora's expenditure in the later years of DPP2 was significantly in excess of the Commission's expenditure allowances. Expenditure allowances under DPP3 are also set to be exceeded until Aurora's CPP is determined and comes into effect and have the effect of incurring ongoing negative IRIS incentives.
9. This over-spend in DPP2 was prudent in light of the issues identified by the Commission and WSP in relation to the state of Aurora's network and Aurora's asset management maturity. However, the resulting IRIS adjustments will continue to put considerable pressure on the company's financial position.
10. Aurora's CPP application relates to this ongoing programme of work that commenced in DPP2 and will continue through DPP3. Aurora is therefore already incurring costs to which the CPP application relates. Accordingly, Aurora seeks an extension to the concept of an urgent project allowance to reflect the fact that Aurora is already incurring these costs.

**Aurora's proposal**

11. Section 53V(2)(b) of the Act allows the Commission to set prices under the CPP that allow Aurora to recover (or "claw-back") some or all of any shortfall in its revenues that occurred under the prices previously charged by Aurora through the DPP<sup>3</sup>.
12. The IMs already recognise that it will be appropriate in some circumstances for suppliers to recover pre-CPP costs through the CPP regulatory period. In the 2015/16 IMs review the Commission introduced the concept of an "urgent project allowance" in clause 3.13, which allows a supplier to recover additional net costs that<sup>4</sup>:
  - 12.1. exceed those already provided for in a DPP determination or CPP determination;
  - 12.2. will not otherwise be recovered by the EDB; and
  - 12.3. will be prudently incurred by the EDB before commencement of the resulting CPP regulatory period in responding to an urgent project that occurred in the time between the submission of a CPP proposal and determination of the resulting CPP determination by the Commission.
13. To give effect to the claw-back mechanism under section 53V(2)(b), we propose to extend clause 3.1.3(11) to:
  - 13.1. enable recovery of costs incurred in the last disclosure year before the CPP regulatory period, as opposed to only after the submission of the CPP proposal; and
  - 13.2. broaden the category of expenditure that can be recovered to include all prudently incurred expenditure that relates to projects or programmes that are connected to the CPP.
14. We note that our proposed drafting differs from our original request on 27 March 2020 to fix a typo so that recovery is not limited to the period after the submission of the application.
15. The proposed extension would recognise that there is an unavoidable lead-in time for a CPP proposal (including a stand-down period in the year immediately preceding a DPP reset), but that Aurora has been prudently incurring costs to which the CPP application relates during this period.
16. We consider that this proposal to amend clause 3.1.3 is consistent with the Part 4 purpose statement. The Commission has in the past recognised that regulatory processes or settings should not operate to dis-incentivise suppliers from undertaking prudent investments in the

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<sup>3</sup> Commerce Act 1986, ss 53V(2)(b), 52D.

<sup>4</sup> Electricity Distribution Services Input Methodologies Determination 2012, cl 3.1.3(11).

- interests of consumers.<sup>5</sup> Preparing for and submitting a CPP application is a significant undertaking with an unavoidable lead-in time of several years. To the extent possible, the process requirements of the CPP should not dis-incentivise suppliers from commencing necessary CPP-related investment if that is in the interests of consumers. The proposed variation is a modest extension of the concept of the urgent project allowance that would allow Aurora to recover a small amount of expenditure prudently incurred in the current disclosure year.
17. Furthermore, given the extensive unrecovered costs incurred by Aurora since early 2017, including substantial negative IRIS incentives (penalties), an inability to recover any part of this expenditure would diminish incentives to invest in network assets, or encourage deferral of expenditure, contrary to section 52A(1)(a) of the Act. As the Commission has recognised in its various decisions on WACC percentile, underinvestment represents an asymmetric risk to consumers, which should prompt the Commission to resolve forecast or estimation uncertainty in favour of compensating the supplier.

### **Operating expenditure incentives**

Aurora requests a modification to clause 3.3.2 of the IMs to allow Aurora to spread the IRIS opex incentive amount across two regulatory periods.

Aurora proposes to modify clause 3.3.2, as it applies to Aurora's CPP proposal, as follows:

#### 3.3.2 How to calculate opex incentive amounts

- (1) An **opex incentive amount** must be calculated for each **disclosure year** of a **regulatory period**, subject to subclause (3).
- (2) The 'opex incentive amount' for a **disclosure year** is an amount equal to the sum of–
  - (a) all **amounts carried forward** into that **disclosure year** from a **disclosure year** in a preceding **regulatory period**; and
  - (b) where an **adjustment to the opex incentive** is applicable under clause 3.3.4(1), and the **starting price year** applicable under clause 3.3.4(1) is the **2022 disclosure year**–
    - (i) the amount calculated in accordance with the following formula for a **disclosure year** in the **regulatory period** and in the **five disclosure years** immediately following the **regulatory period**–

$$\left( \frac{\text{Adjustment to the opex incentive}}{I-1} \right) \times (1+r)^{y-1}$$

where

- I is eight ~~the number of disclosure years in the regulatory period~~;
- r is the **cost of debt** applying to the **DPP** or **CPP** in question; and
- y is the number of **disclosure years** between preceding the **disclosure year** in question and the **2022 disclosure year** ~~in the regulatory period~~ plus one; and
- (c) where an **adjustment to the opex incentive** is applicable under clause 3.3.4(1), and the **starting price year** applicable under clause 3.3.4(1) is the **2025 disclosure year** –
  - (i) the amount calculated in accordance with the following formula for a **disclosure year** in the **regulatory period**–

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<sup>5</sup> For example, the Commission's IRIS mechanism is intended to neutralise the incentive that suppliers would otherwise face to pursue efficiency-enhancing investments only in the early years of a regulatory period. The Commission also, in 2016, amended the IMs to provide that the DPP WACC carries over into the CPP regulatory period in order to avoid dis-incentivising suppliers from applying for a CPP.

$$\left( \frac{\text{Adjustment to the opex incentive}}{I-1} \right) \times (1+r)^{Y-1}$$

where—

- $I$  is the number of **disclosure years** in the **regulatory period**;
- $r$  is the **cost of debt** applying to the **DPP** or **CPP** in question; and
- $Y$  is the number of **disclosure years** preceding the **disclosure year** in question in the **regulatory period**.

- (3) An opex incentive amount shall not be calculated:
  - (a) by Orion New Zealand Limited, for any **disclosure year** in a **regulatory period** commencing on, or prior to, 1 April 2020; and
  - (b) by any other **EDB**, for any **disclosure year** commencing prior to 1 April 2020, unless the **EDB** becomes subject to a **CPP**.

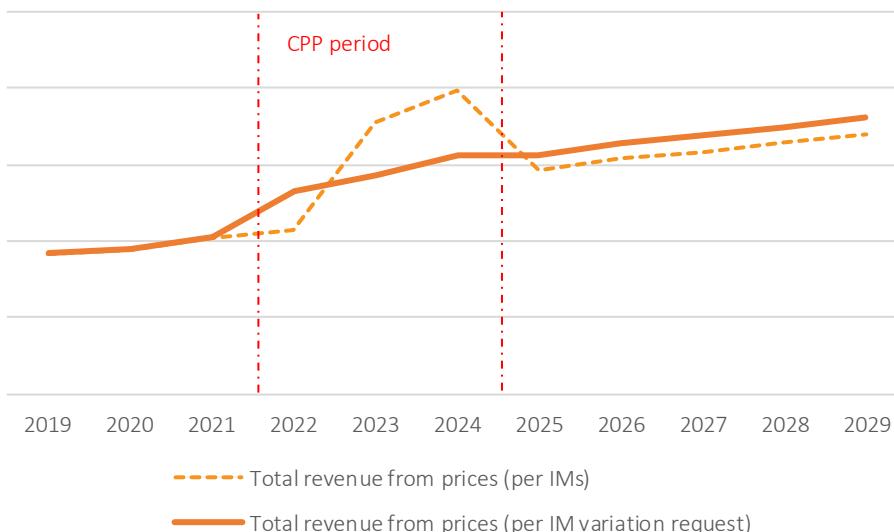
#### The issue

18. Clause 3.3.2 requires an opex incentive adjustment to be calculated in the second year of a regulatory period and spread over that year and the remaining years of the regulatory period. This opex incentive amount is a recoverable cost component of allowable revenue.
19. Aurora Energy intends to apply for a three-year CPP, and the opex incentive adjustment at that time is forecast to be significant. Under the current IMs this amount is to be recovered over two years giving rise to a question of affordability for consumers.

#### Aurora's proposal

20. We propose to amend clause 3.3.2 to allow the IRIS opex incentive to be spread across two regulatory periods, being the 3-year CPP spanning 2022 to 2024 that Aurora is preparing a proposal for, and a further 5-year CPP that Aurora has signalled that it will propose for the period 2025 to 2029.
21. Figure 1, below illustrates how the proposed IM variation is expected to change Aurora's annual revenue profile (i.e. the maximum allowable revenue) over the proposed 3-year CPP period and over a 5-year CPP compared to the revenue if the proposed IM variation did not apply.

Figure 1: Illustrative impact of IM variation request (clause 3.3.2)



22. We consider that this proposal to amend clause 3.3.2 will assist in managing the scale of revenue uplift and potential rate shock. To this extent, we consider that approval of the proposal is in the long-term interest of consumers and consistent with the Part 4 purpose statement.

#### **CPP opex forecast**

Aurora requests a variation to clause 5.3.5(1) to the cost allocation method used to determine the CPP opex forecast, to reflect Aurora's expected change to opex sharing arrangements during the CPP period. Aurora proposes to modify clause 5.3.5(1), as it applies to Aurora's CPP proposal, as follows:

- (1) *Operating costs forecast in disclosure year of the next period must be calculated in accordance with clause 2.1.1, using forecast values of cost allocators, in the case of an operating cost for which disclosure pursuant to an ID determination has*
- (a) *been made for the last disclosure year of the current period, be consistent with the operating costs allocated to electricity distribution services in that disclosure; and*
- (b) *not been so made, be consistent with an allocation of operating costs to electricity distribution services carried out in respect of the most recent disclosure made for the current period in accordance with clause 2.1.1.*

#### **The issue**

23. Clause 5.3.5(1) requires the historical cost sharing position to be maintained throughout the CPP regulatory period. However, Aurora anticipates making changes to its opex sharing arrangements during the CPP period.

#### **Aurora's proposal**

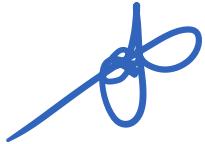
24. We request a variation to clause 5.3.5(1) of the IMs to reflect Aurora's expected change to opex sharing arrangements during the CPP period. Using forecast values of cost allocators will better reflect the transition to Aurora's new operating model than the current wording which requires the historical cost sharing position to be maintained throughout the CPP regulatory period.
25. It is not apparent that requiring the historical cost sharing position to be maintained throughout the CPP regulatory period would assist with the evaluation of Aurora's CPP proposal.
26. In addition, as set out at paragraphs 10 to 16 in our second application for modifications and exemptions dated 30 April 2020, we propose additional information is added to the cost allocation information required to be included in the Schedule B tables to demonstrate the application of the proposed cost allocation methodology. Accordingly, under our proposed modification to clause 5.4.9(4)(e) the Commission will be provided with additional information in relation to Aurora's cost allocation and expected change to opex sharing arrangements during the CPP period.
27. We consider that this proposal to amend clause 5.3.5(1) will mean that the cost allocation method used to determine the CPP opex forecast will be more accurate and will better reflect the changes that will be made to Aurora's opex sharing arrangements during the CPP period. To this extent, we consider that approval of the proposal is in the long-term interest of consumers and consistent with the Part 4 purpose statement.

#### **Approach in the CPP Application**

28. In order to comply with the process and content requirements of the IMs, Aurora's CPP Financial Model will set out operating costs using both forecast values of cost allocators and also using cost allocators consistent with Aurora's historical cost sharing position.
- 28.1. Disclose this variation request in our application;
- 28.2. Indicate in our application that we have relied on the variation (consistent with the approach for requesting IM modifications and exemptions)

28.3. Present the application consistent with the variation (we will provide instructions alongside our application that will describe how both the variation approach and the IM compliant approach can be viewed in the financial model)

Yours sincerely

A handwritten signature in blue ink, appearing to read "Alec Findlater".

**Alec Findlater**

General Manager, Regulatory and Commercial