Aurora Energy's submission

Commerce Commission Part 4 Input Methodologies Review 2023 – Draft Decision

19 July 2023

Table of Contents

1. Introduction

1. Aurora Energy Limited (Aurora) welcomes the opportunity to submit its views on the Commerce Commission's (the Commission's) Part 4 Input Methodologies Review 2023.
2. Section 2 of this document provides a summary of the key aspects of our feedback, with more detail on each of the three topic papers provided in sections 3 to 5.
3. No part of our submission is confidential.

2. Executive Summary

4. The electricity distribution industry is a key enabler of the energy transition required to meet New Zealand's goal of reaching net zero carbon emissions by 2050. The pace and scale of electricity distribution investment required to facilitate the energy transition is uncertain, especially over the next decade as uptake of new technologies such as electric vehicles and distributed energy resources accelerates. It is crucial that the regulatory framework responds to these uncertainty challenges by providing more flexible investment reopeners and ensuring that incentive mechanisms do not create barriers to efficient investment.
5. We appreciate that the Commission has made some steps in the right direction in its draft Input Methodologies decision by introducing small improvements to the reopener mechanisms. However, we note that the changes to the Input Methodologies in themselves do little to address the inherent forecast uncertainty during this increased period of electrification. Therefore it is critical that the DPP4 reset process appropriately provides for the expected increases in costs and investments associated with increased electrification.
6. Sections 3 to 5 of our submission provide the supporting rationale for Aurora's position. In summary, there are six key areas which we would like the Commission to consider before finalising their decision:

Cost of Capital

7. As a member of the 'Big Six' electricity distribution businesses (EDBs), Aurora support the cost of capital report submitted by Oxera. In particular, we disagree with the Commission's rationale for reducing the WACC percentile from the 67th to the 65th percentile and we have concerns about the Commission's exclusion of beta estimates during the Covid 19 period.

Reopener process

8. Generally speaking, we support the changes to align the Part 4 reopener process to the reopener process in the Fibre IMs. However, we are disappointed that the Commission has not provided more prescription about the information required to support a reopener process, or commit to evaluation timeframes. The lack of clarity and certainty about the process may result in additional resource costs for applicants and delays to projects to the detriment of consumers.

Ideally the reopener process would provide electricity distributors with enough confidence to make investments ahead of the formality of the process.

IRIS incentive mechanisms

9. Fundamentally we do not believe the IRIS incentive mechanisms are achieving their purpose of incentivising efficient expenditure, rather they have become a mechanism that largely reflects forecast variances which are outside the control of distributors. For the IRIS incentive mechanism to be effective it needs to be based on a reliable forecast of expenditures. It is our view that determining a reliable forecast basis will not be possible in the next regulatory period due to the uncertainty arising from increased electrification. Without a reliable basis to forecast future costs our view is that the IRIS incentive mechanisms in their current form are inappropriate and should be paused during this period of transition.

Large Connection Contracts

10. Aurora support the intention of the Large Connection Contract (LCC) mechanism, but we have some questions about how this mechanism would work in practice and how the contractual LCC risk will be managed. Furthermore, we feel the 10MW threshold will unnecessarily limit the application of this mechanism.

New connection volume wash-up mechanism for EDBs on a CPP

11. We support the Commission's intentions around the new connections volume wash-up mechanism for EDBs on a CPP, however we have some questions about how this mechanism would work alongside EDBs Capital Contribution policies. We have also suggested some alternatives to a simple volume calculation that we believe will improve the accuracy of the mechanism.

Revenue smoothing mechanism

12. We fundamentally disagree with smoothing mechanisms because they can create unsustainable cashflow issues for distributors. We especially disagree with the Commission using revenue as a proxy for customer price shock. Our submission includes a suggested improvement to the proposed revenue smoothing mechanism which takes into account connection growth to better align the smoothing mechanism with its intent of mitigating customer price shock.

3. Cost of capital

13. As a member of the 'Big Six' electricity distribution businesses (EDBs), Aurora support the cost of capital report submitted by Oxera.

14. In particular we disagree with the Commission's rationale for reducing the WACC percentile from the 67th to 65th percentile. We are concerned that insufficient investment incentives during the energy transition period may result in New Zealand not realising its carbon emissions target. The social impacts of underinvesting are significant and we believe there is not sufficient evidence to support a reduction in the WACC percentile.

15. Aurora support a principled and objective measuring of inputs into the WACC calculation. As outlined in Oxera's report we are concerned that the Commission's exclusion of beta estimates during the Covid 19 period has introduced an element of subjectivity to the WACC calculation methodology. The selective use of sample data leads to an asset beta input which does not fully reflect real world market volatility.

16. Cost of Capital is a complex topic and often has material impacts for electricity distributors. The relatively short consultation period is insufficient for electricity distributors to fully analyse and provide detailed feedback on the draft decision. In future we would like the Commission to consult separately on this topic and allow more time for submissions.

4. Financing and incentivising efficient expenditure during the energy transition

4.1. New connections volume wash-up mechanism for EDBs on a CPP

17. Aurora supports the Commission's intent to streamline and add certainty to the process for addressing connection growth uncertainty, however we have concerns about how the process will be applied in practice.

18. The mechanism relies on determining a fixed unit cost for each 'standard' new connection. In practice, it will be difficult to define a 'standard' new connection. The cost of new connections can vary significantly depending on connection type (capacity, location, density of subdivisions etc). Using a single fixed unit cost as the basis for calculating a wash-up could lead to a significant under, or over-recovery of costs if the mix of new connections during the regulatory period is different to the mix of new connections during the assessment period.

19. We would like the Commission to clarify their expectations of how the proposed wash-up mechanism would work alongside EDB's Capital Contribution policies. In order to mitigate the risk of being underfunded for excess connection growth, we anticipate that some electricity

distributors may choose to amend their Capital Contribution policies to reflect the Commission's fixed unit cost.

20. As an alternative to a simple unit cost x quantity wash-up mechanism, we suggest a better approach may be to base the wash-up mechanism on the dollar value of new connection capex where the distributor can demonstrate they have applied their Capital Contributions policy consistently during the CPP period.

4.2. IRIS INCENTIVE MECHANISMS

21. The Commission's 2010 Input Methodologies (Electricity Distribution and Gas Pipeline Services) - Reasons Paper outlined the foundational elements required for an appropriate IRIS mechanism as follows:

    > 8.5.6 A rolling incentive scheme is contingent on having reliable cost forecasts for the regulatory period. This is required to make it possible for the regulator to assess and reward the extent of any unforecast efficiency gains achieved by suppliers.
    >
    > 8.5.7 An appropriate IRIS is one that:
    >
    > • only rewards genuine efficiency gains;
    >
    > • takes into account both efficiency gains and losses; and
    >
    > • results in efficiencies being shared with consumers in a reasonable time-frame, while providing suppliers sufficient incentives to pursue efficiencies.

22. The Commission's Context and summary of draft decisions paper acknowledges the widely held belief that increased electrification is leading to significant uncertainty as to the extent, timing, and location of increased electricity demand.

23. It is Aurora's view that, in the context of increasing electrification, it is unrealistic to determine a reliable cost forecast upon which to base an appropriate IRIS mechanism. The timing of the DPP reset process, combined with the length of the current DPP period effectively mean that cost forecasts are being made up to six-years in the future against a backdrop of significant uncertainty.

24. While the suite of in-period adjustments offer some mitigation for significant cost increases, they do not adequately address cumulative cost increases that fall below the reopener thresholds. Furthermore the reopeners do not adequately provide for other cost increases relating to the changing business environment such as climate change related costs and additional cybersecurity costs.

25. Without a reliable cost forecast the basis for an appropriate IRIS mechanism does not exist. Therefore, we encourage the Commission to pause the application of the IRIS mechanism during this period of transition.

26. We note that Aurora's current CPP allowances were significantly scrutinised by independent verifiers, yet the resulting forecasts have still been significantly different to observed actual

costs. It is unlikely that the lighter touch DPP reset process will produce the level of forecast accuracy needed for an effective IRIS mechanism.

27. Whilst uncertainty can result in increased or decreased costs, we believe that the uncertainty is weighted toward cost increases rather than cost decreases. Therefore, we request the Commission demonstrate how the current IRIS mechanism will produce the intended symmetrical results if applied during this period. An asymmetric approach that either reduces the weighting of spend in excess of forecasted allowances, or applies a margin above the expenditure allowance before IRIS takes affect would be a more appropriate method during this period of increased uncertainty.

28. Furthermore, the cost of the energy transition is placing cashflow pressure on many EDBs. This cashflow pressure creates a natural incentive for EDBs to increase their expenditure efficiency as they prioritise operational costs with investment priorities to support decarbonisation.

4.3. Improvements to the revenue path

29. Aurora support the change to remove pass-through costs from the limit to revenue increases, and the subsequent reclassification of transmission recoverable costs to pass-through costs. We would like the Commission to consider expanding the definition of transmission costs to include all reasonable and prudent Transpower costs. The expanded definition could allow for investigation studies into GXP upgrades which are currently not provided for.

30. Whilst we share the Commission's concerns about consumer affordability, We fundamentally disagree with smoothing mechanisms because they can create unsustainable cashflow issues for distributors. We especially disagree with the Commission using revenue as a proxy for customer price shock.

31. Price is a function of revenue divided by billable quantities. A mechanism focussed on revenue ignores the impact that connection growth has on reducing customer price and has the effect of disadvantaging electricity distributors operating higher growth networks.

32. The proposed secondary "revenue smoothing limit" could achieve its purpose more effectively by including an adjustment mechanism based on the forecast change in connections determined during the annual price-setting process as demonstrated in the following example:

Annual Price-Setting Statement Example Extract

Table 1: Annual change in connections

Annual change in connections = (Forecast ICPs (end of period) / Forecast ICPs (beginning of period)) - 1	
Number of ICPs forecast at beginning of regulatory period	100,000
Number of ICPs forecast at end of regulatory period	101,000
Annual change in connections	**1%**

Table 2: Adjustment of the provisional limit on annual percentage increase in forecast revenue from prices

Adjustment of the limit on annual percentage increase in forecast revenue from prices	
Provisional limit on percentage increase in forecast revenue from prices	10%
Annual change in connections	1%
Adjusted limit on annual percentage increase in forecast revenue from prices	**11%**

5. CPP AND IN-PERIOD ADJUSTMENT MECHANISMS

5.1. DPP REOPENERS

5.1.1. Reopener process

33. Aurora support the alignment of the Part 4 price-quality part reopener processes with the reopener process in the Fibre IMs.

34. We are disappointed that the Commission has not improved the reopener process to provide timeframes for the Commission to evaluate reopener applications. Delays in approving reopener applications may result in projects or investments being deferred to the detriment of consumers.

35. We are also disappointed that the Commission has not provided more prescription about the types of information required in reopener applications. Significant uncertainty still remains for EDBs seeking to use the reopener process. This uncertainty may result in EDBs either providing too much, or too little information to support an application resulting in rework. Providing more certainty will allow EDBs to use resources more efficiently when applying for a reopener. Ideally the reopener process would provide electricity distributors with enough confidence to make investments ahead of the formality of the process.

5.2. LARGE CONNECTION CONTRACT MECHANISM

36. Aurora support the Commission's general intentions to provide certainty to electricity distributors and look for solutions that avoid the need for reopeners.

37. We have some clarification questions about how the LCC is expected to work in practice and some general comments as outlined below:

A.1.1. Is the LCC mechanism optional?

38. We request the Commission clarifies that entering into a Large Connection Contract (LCC) is optional. For example, we would expect that any commercial contract meeting the criteria for a LCC would specifically reference this criteria within the body of the contract. Furthermore it would be helpful for the Commission to clarify whose role it is to determine whether the LCC qualification criteria has been met. Is the expectation that the Commission would have to approve that the criteria had been met, or is determination up to the electricity distributor and connected customer to agree?

39. In instances where the criteria for a LCC are met, is the EDB required to opt into the LCC criteria, or can the contract be treated in the traditional manner with the assets being recorded in the RAB and revenue and costs included in the allowances?

A.1.2. How are stranded assets treated in the case of default?

40. It should be noted that the risk profile of Transpower's New Investment Contracts (NICs) with EDBS are likely to be different to the risk profile of LCCs that EDBs negotiate with commercial customers. Generally speaking, there is a very low risk of financial default, or stranded assets involved when Transpower enter into agreements with EDBs. This will not necessarily be the case with electricity distributor customers whose operations may be less certain.

41. If a customer default resulted in a stranded asset risk for the EDB is the expectation this stranded asset value would then be included in the RAB? Or is the expectation that the risk of a stranded asset is a business risk for the EDB to absorb, with a commensurate risk premium built into the commercial return of the contract?

A.1.3. 10MW Threshold

42. We see the introduction of an LCC as a positive step towards simplifying the reopener process and providing freedom for commercial solutions where market conditions exist. However, the 10MW threshold is prohibitively high and will likely preclude connections that would otherwise qualify as LCCs. The LCC is a positive initiative and it would be a shame to limit its uptake due to an unreasonably high and seemingly arbitrary threshold.

43. We understand the Commission's concerns that EDBs could utilise their bargaining power to extract excessive profits, however the size of the connection is not necessarily representative of the relative bargaining power of the connecting customer. We believe there should be scope to

enter into LCCs for connections less than 10MW, if the EDB can demonstrate that the contract meets the criteria for workable or effective competition.

A.1.4. How are payments for shared asset use treated?

It is likely that new large connections will use and benefit from some network assets that are shared with other customers. Typically a contract of this nature will include a charge for these assets that are included in the RAB. We would like the Commission to clarify whether these payments for shared assets are to be treated as regulated income as they are currently? For example, is it anticipated that a new LCC would have two components to the charges; one component qualifying as regulated income, and the other component being exempt from regulated income?.