

# Have your say on Aurora Energy's proposal to change its prices and quality standards to fund major network investment

## Regulatory framework and how we will assess the proposal

**Date of publication:** 30 July 2020



## Why we have written this paper

On 12 June 2020, Aurora Energy (Aurora) applied to the Commission to charge its customers more to fund a \$383 million three-year investment plan to make its electricity lines network safer and stabilise the reliability of its network to prevent further deterioration.

This paper is one of six available documents that the Commission has published as part of its initial round of consultation on Aurora's proposal:

1. Have your say on Aurora Energy's investment plan Consumer Summary Key Issues paper – a 10-page document (20-minute read) which is an executive summary/overview of the next five documents below
2. Have your say on Aurora Energy's investment plan Consumer Feedback Form with key questions for consumers (4-page document, 10 minute read)
3. Our assessment of Aurora Energy's investment plan factsheet (4-page document, 10-minute read) which explains our role, process and approach to setting Aurora's customised price-quality path (CPP)
4. Have your say on Aurora Energy's investment Proposal Factsheet which is a 2-page document (5-minute read) that summarises Aurora's proposal
5. Discussion of key issues and questions for consumers and stakeholders (40-page document, 70-minute read)
6. Regulatory framework and how we will assess the proposal (this paper, 11-page document, 15-minute read) which describes the high-level-framework that we will apply in setting Aurora's CPP and explains how we will assess the proposal.

These documents, along with more information on the project including Aurora's full proposal, can be downloaded from [www.comcom.govt.nz/aurora](http://www.comcom.govt.nz/aurora)

Feedback can also be submitted in writing to [feedbackauroraplan@comcom.govt.nz](mailto:feedbackauroraplan@comcom.govt.nz)

Consultation on this paper closes on **20 August 2020**.

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## Attachment A Regulatory framework for setting the CPP

### Purpose of this attachment

A1 The purpose of this attachment is to describe the high-level framework that we will apply in setting a CPP for Aurora.

### What we are required to do under the Commerce Act 1986

A2 The Act provides us with our purpose in making our decisions, and directs us to set out processes and rules up front that we will use to provide certainty on what CPP applicants must do to apply and how we should go about making our CPP decisions.

A3 Our starting point for our decisions on Aurora's CPP is the purpose of Part 4 of the Act – to promote the long-term benefit of consumers.

<b>The purpose of Part 4 of the Commerce Act</b>	
<b>52A purpose of Part 4</b>	
(1)	The purpose of Part 4 is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
(a)	have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
(b)	have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
(c)	share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
(d)	are limited in their ability to extract excessive profits.

The Act requires us to set rules and processes for CPPs (Input Methodologies or IMs). These establish the key rules, requirements and processes that must be met by the applicant for information, verification, audit and consumer consultation, as well as the criteria that we must use to evaluate a CPP proposal.<sup>1, 2</sup>

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<sup>1</sup> An explanation of the verification requirements, the factors we intend considering in assessing the independent verifier's recommendations and a description of how we will apply this in practice is set out in Attachment B.

<sup>2</sup> We will be consulting on any variations to IMs as part of our draft decision as they apply to Aurora (with their agreement).

## Assessing Aurora's CPP proposal

A1 We must apply the following evaluation criteria to assess Aurora's CPP proposal:

**Evaluation criteria for customised price-quality path proposals**

The Commission will use the following evaluation criteria to assess each CPP proposal:

- a) whether the proposal is consistent with the input methodologies;
- b) the extent to which the proposal promotes the purpose of Part 4 of the Act;
- c) whether data, analysis, and assumptions underpinning the proposal are fit for the purpose of determining a CPP;
- d) whether the proposed capital and operating expenditure meet the expenditure objective;
- e) the extent to which any proposed changes to quality standards reflect what the applicant can realistically achieve taking into account statistical analysis of past SAIDI and SAIFI performance; and/or (ii) the level of investment provided for in proposed; and
- f) the extent to which the CPP applicant has consulted with consumers on its CPP proposal; and the proposal is supported by consumers, where relevant.

We expand on each of these below.

### *Whether the CPP proposal is consistent with the input methodologies*

A2 Our evaluation of Aurora's CPP proposal will assess whether it is consistent with the IMs. Prior to accepting the CPP proposal, we will assess whether the proposal meets the CPP process requirements, as well as whether it meets the substantive IMs for determining a CPP.

### *The extent to which the proposal promotes the purpose of Part 4 of the Act*

A3 We will assess whether the proposal promotes the long-term benefit of consumers and reflects key areas of supplier performance that we would expect in markets that have workable competition.

### *Whether the data, analysis, and assumptions underpinning the proposal are fit for determining a CPP*

A4 We will assess whether the information in a proposal is sufficient in detail and quality to allow us to undertake our assessment, and whether the assumptions used are sufficiently robust. Where further information is required to establish that information in the CPP proposal is fit for purpose, we may request this from Aurora, from the independent verifier or from other experts. Where we do not accept the robustness of an assumption, we may seek further explanation for the assumption, or we may apply a different assumption.

*Whether the proposed capital expenditure and operating expenditure meet the expenditure objective evaluation criteria in the IMs*

- A5 The IM expenditure objective requires us to assess Aurora's proposed capital expenditure and operating expenditure on the basis that it reflects the efficient costs that a prudent supplier subject to price-quality regulation would require to:
- A5.1 meet or manage the expected demand for electricity distribution services, at appropriate service standards, during the CPP period and over the longer term; and
  - A5.2 comply with applicable regulatory obligations associated with those services.
- A6 The assessment of forecast expenditure is not a mechanistic process. It necessarily involves the exercise of our judgement, supported by the verification report and possibly supported by further expert advice.

*The extent to which proposed quality standard variations are realistically achievable*

- A7 The evaluation criteria in the IMs require us to assess the extent to which any proposed quality standard variation in the CPP proposal better reflects the realistically achievable performance of Aurora over the CPP period than the quality standards under the DPP.
- A8 This will be done through statistical analysis of Aurora's historical reliability performance and/or by considering the level of investment provided for in the CPP period.

*The extent to which Aurora has consulted with its customers on its CPP proposal, and the degree of support from its customers*

- A9 Aurora is required to consult with its customers in advance of submitting its CPP proposal. This has the benefit of gauging what its customers value, such as the trade-offs they are prepared to make between the price they will pay and the quality of services they will receive from Aurora.
- A10 In making our decisions on the CPP, we will consider the extent to which Aurora has consulted with its customers and the extent to which those customers support the CPP proposal. We will also take into account feedback we receive on the issues we expect to raise in our own consultation with customers and other stakeholders.

## **Attachment B    How we will assess the proposal**

### **Purpose of this attachment**

- B1     The purpose of this attachment is to summarise the purpose and scope of the verification of Aurora's CPP proposal, explain the factors we will consider when assessing the independent verifier's recommendations, and explain how we will assess the proposal.

### **Purpose and benefits of verification of CPP proposals**

- B2     Verification involves a review of the CPP proposal by an independent expert and presents an opportunity to increase the effectiveness and efficiency of the CPP decision-making process.
- B3     The verification process is intended to add value to the quality of CPP proposals and to our decision-making by testing, in advance of submission, the assumptions that underpin forecast information on capital and operating expenditure, and proposed quality settings.
- B4     The key demonstrated benefits of verification are that it:
- B4.1    tests the policies, planning standards and assumptions used in the development of expenditure forecasts;
  - B4.2    enables us to better focus our review of Aurora's proposal on areas where forecast expenditures and/or associated quality settings are less likely to meet the expenditure outcome, consistent with the proportionate scrutiny principle;
  - B4.3    provides useful independent insights to Aurora of potential operational improvements it could make;
  - B4.4    helps to mitigate the risk of any potential incentive on Aurora to provide overly generous estimates of forecast expenditures; and
  - B4.5    results in better scrutiny of Aurora's investment proposals prior to them being submitted to us, which may result in a more appropriate level of forecast expenditure in the proposal.

## How we will review the proposed expenditure

- B5 The verification process requires the verifier to test the business based on the framework we set out in our IMs. In summary it is a top-down bottom-up testing process where the business practices, policies and planning standards are tested for their suitability and maturity from a top-down perspective, then projects and programmes are tested from the bottom-up to see if the business practices, policies and planning standards are implemented in practice. This forms the basis of verification.
- B6 We use the verifier's report as a key input into our approach to testing a CPP proposal. We also hold a workshop with the verifier to go through those findings and to make sure we will focus our review in the right areas, and to clarify any technical questions we may have.
- B7 Our approach to assessing the proposed expenditure in a CPP includes the following steps:
- B7.1 We review the CPP proposal, and in this case, the WSP report on the state of Aurora's network and the verification report to identify key issues for us to consider, including issues highlighted for our attention by the Verifier.
  - B7.2 We assess the extent to which we can rely on the Verifier's analysis and conclusions. We have already conducted a workshop with the Verifier to test its approach, conclusions, and to discuss issues identified by the Verifier and by us.
  - B7.3 We are publishing this Issues Paper to provide an opportunity for interested people to express views on Aurora's proposed capital expenditure and operating expenditure, proposed quality standards, and the Verifier's conclusions.
- B8 Following the CPP application to us, we raise questions with Aurora, and where necessary, the Verifier, to seek further clarifying information. We may also seek further analysis from Aurora.
- B9 We perform our additional analysis where necessary to form our own views and may seek expert external advice regarding key aspects of the proposal to assist us in our deliberations.
- B10 Following our assessment of the CPP proposal we will make recommendations to accept or decline levels of expenditure and quality of service proposed by Aurora. These inputs feed into the final step of setting the price-quality path.

### **We will use a range of tools in assessing Aurora's expenditure forecasts**

- B11 The verification process provides us with an advance review of Aurora's CPP proposal. We consider that an independent verifier adds significant value to our CPP decision-making processes.
- B12 In using the verification report and in assessing the Verifier's findings, we will consider several factors when we assess Aurora's expenditure forecasts, including:
- B12.1 whether the Verifier's assessment is consistent with the requirements of Schedule G of our Electricity Distribution Business Input Methodologies;
  - B12.2 whether the Verifier has sufficiently explained the reasons for its conclusions; and
  - B12.3 whether there are any limitations in the Verifier's expertise.
- B13 Where appropriate, we will perform an in-depth qualitative and quantitative assessment of selected aspects of Aurora's CPP expenditure forecasts (after considering the expenditure materiality):
- B13.1 by capital expenditure programme, or project level, or category level; and
  - B13.2 by operating expenditure programme, or category level.

### **How we will apply proportionate scrutiny to Aurora's proposal**

- B14 In defining scope of our review of a CPP proposal, we are guided by the principle of proportionate scrutiny.
- B15 In broad terms, proportionate scrutiny means that we will apply a higher level of scrutiny for issues with a greater price impact on consumers and the quality of service they may receive. We will examine these higher impact issues more closely. Issues that we consider will have a lesser impact may not need to be examined in as much detail.
- B16 In exercising proportionate scrutiny, we will be supported by the outcome of verification process which will assist us in defining the scope of our own review. The verification report will assist us to define:
- B16.1 the breadth of our review, by highlighting forecast expenditures that are likely to meet the expenditure objective, but also by pointing us to forecast expenditures the independent verifier considers fail to do so. Our review will focus on the latter. We will only perform significant further scrutiny on those forecast expenditures the independent verifier considers are likely to meet the expenditure objective where we are not satisfied with the independent verifier's conclusions; and

- B16.2 the depth of our review, by identifying forecast expenditures that need to be investigated at greater depth. For example, this may refer to:
    - B16.2.1 areas where Aurora did not provide sufficient information to the independent verifier for it to assess those against the expenditure objective,
    - B16.2.2 areas where sufficient information was provided, but the independent verifier was still unable to come to a conclusion; and/or
    - B16.2.3 areas where we are not satisfied with the independent verifier's conclusions.
  - B16.3 Our review will focus on the areas outlined above as opposed to areas the independent verifier (and we) consider have been subject to sufficient in-depth scrutiny.
- B17 Having established the breadth and depth of our review based on the verification report, we will overlay it with our own considerations of the Aurora CPP proposal material, in order to decide what we intend to cover in our review.

## **Attachment C     Duration of CPP**

- C1     Aurora has sought a CPP with a duration of three years, instead of five, so we have set out how we will approach the question of the CPP's duration.
  
- C2     The default term for a CPP is five years. However, we may set a CPP of a shorter duration (to a minimum of three years) if we consider that the shorter duration will better meet the purpose of Part 4 of the Act (as set out in A3, above).
  
- C3     It is our decision whether to depart from a five-year duration or not, and we can consider whether this better meets the purpose of Part 4 at our own initiative or if it is sought by a CPP applicant.
  
- C4     If a CPP applicant seeks to have us depart from the five-year period, the CPP proposal must contain an explanation of why the shorter duration better meets the purpose of Part 4 of the Act than five years.
  
- C5     Aurora has sought a three-year CPP and provided reasons why it says that duration better meets the purpose of Part 4 of the Act. Our role is now to consider whether the three-year duration would better meet the purpose of Part 4 of the Act than five years.
  
- C6     In making our decision we will also have regard to Aurora's indication that it is likely to seek a successive CPP. Aurora is not permitted to apply for a further CPP during the present DPP regulatory period, and therefore would not be able to apply for a successive CPP to follow a three-year CPP.