

20 November 2020

Sue Begg
Deputy Chair
Commerce Commission
44 The Terrace
WELLINGTON

By email only: sue.begg@comcom.govt.nz
cc. John Crawford, Derek Johnston, Elizabeth Welson

Dear Sue

AURORA ENERGY'S CPP PROPOSAL

I am writing to you to request an urgent meeting with Commissioners to discuss the Commission's draft decisions in relation to Aurora's CPP proposal. Having reviewed the draft decisions, I am deeply concerned that the Commission does not appreciate the practical implications of its proposals for the success of Aurora's CPP programme of work, the financeability of the business over the next five years, and by extension the interests of Aurora's consumers.

We are in the process of preparing our submissions in response to the draft, which will address these matters in detail. But given the critical importance of these issues to the future of the company, it is my responsibility as Board Chair to ensure that you understand clearly the risks of the Commission's proposed approach. Having reviewed the Commission's draft decisions, I have little confidence that the Commission appreciates the real-world consequences of its draft decisions.

I have two principal concerns with the Commission's draft decisions.

Reduction in non-network opex

First, the Commission's proposed reduction in Aurora's non-network opex will significantly compromise our ability to deliver our re-investment programme.

The Commission's draft decision largely endorses our proposed capital expenditure and – more importantly – acknowledges the importance of the CPP for the long-term safety and reliability of the network. But the Commission's ~25% reduction in non-network opex puts delivery of the CPP programme at risk. As you know, the CPP continues a substantial re-investment programme that commenced in regulatory year 2017 with the fast-track pole programme, which required network investment at level significantly higher than that allowed for under the regulatory price path in place at the time. Delivering this work has been very challenging, and it is a challenge the company, under its new board and management, has risen to meet. The CPP represents a continuation of that challenge. The opex forecasts in our proposal reflected a realistic assessment of the resources we need to deliver the CPP. They were informed by Aurora's specific circumstances and requirements, including the need to develop Aurora's capacity and resources following the 2017 split from Delta. Our forecasts were then reviewed in detail by the independent verifier, who had the benefit of comprehensive access to the business over an extended period (over 12 months).

In addition to compromising delivery, the reduction of non-network opex will prevent Aurora from making the asset management improvements that the Commission has indicated – through the quality breach process and the WSP review – it expects Aurora to achieve.

The Commission's reduction in our opex allowance means that Aurora's opex allowance under the CPP is lower than it would be if we continued under the DPP. I recognise that the Commerce Act provides for that possibility, but it cannot be appropriate in this instance given the obvious case for a step change in our operating costs relative to the DPP methodology.

I suspect your immediate response will be that the Commission's draft decision represents its best estimate of the non-network opex that Aurora requires over the next five years. The Commission's draft decision is obviously strongly influenced by Strata's 'desktop' analysis, which diverges substantially from the verifier's report.

I do not regard Strata's analysis as a persuasive reason to depart from the conclusions of the verifier. Strata's analysis appears to be a top-down, desktop review that relies heavily on questionable assumptions and benchmarks and involved no engagement with Aurora. This is in contrast to the extended and rigorous on-the-ground evaluation undertaken by the verifier. I am also concerned that, despite repeated requests, the Commission is unable to provide us with a copy of Strata's report, on which the Commission purports to rely. I have now been advised that the reason the Commission cannot provide the report is that, as of the date of this letter, no report exists. It is still in the process of being written. I understand that the draft decision was instead based on "notes" provided by Strata, supported by conversations. If there was in fact no report provided to commissioners, then I would like to understand exactly what information was made available to commissioners and on which your draft decisions were based. I would also like to know what weight we should attach to the report that is now being prepared, given that it evidently did not form part of the evidence base for the draft decisions.

In any event, this does not inspire confidence in the Commission's process, and puts us in the untenable position of having to address – in a constrained timeframe – evidence that has not been made available to us.

It is also important that the Commission bears in mind the asymmetric nature of the risk to consumers from under-estimating versus over-estimating Aurora's non-network opex requirements. The risks to consumers – in terms of network safety and reliability – from further deferral of necessary capital expenditure significantly outweigh the costs to consumers from potentially over-estimating Aurora's non-network opex requirements. Given that asymmetric risk to consumers, the Commission should require compelling evidence before departing from the verifier's view. Strata's analysis does not provide that.

10% limit on annual price increases

Second, the Commission has failed to appreciate the impact of its somewhat arbitrary 10% limit on annual price increases on the financial position of the company over the next five years.

Aurora has been engaged in its current programme of network re-investment since regulatory year 2017. Over that time, expenditure has been significantly more than the DPP2 allowance which has only been possible through reliance on our shareholder for funding support lines. You will know that this has placed considerable strain on the company's balance sheet which will only be exacerbated under the terms of the draft decision. We have discussed with you the financing challenges we face over the next five years, which we were assured the Commission understood. The timing of cashflows is therefore critically important to the company's ability to finance and deliver the CPP programme of work. The Commission has concluded that its proposed revenue smoothing (Scenario 1) delivers sufficient cashflow in the first CPP period to ensure Aurora can deliver the CPP. It is not clear to me how the Commission has reached this conclusion and I disagree. It does not reflect my assessment of the financing challenge the company faces. On a standalone basis, our financial position would be unsustainable. It is only because of shareholder support that the company has been able to raise the debt necessary to pursue the necessary network renewal in DPP2. But we are at the point where we must demonstrate a pathway back to sustainable levels of debt. The cashflow profile in the first CPP regulatory period is critical to achieving that.

Again, the issue here is ultimately one of asymmetric risk to consumers. In its attempt to moderate price increases, the Commission has erred too far on the side of under-compensating Aurora in this CPP period. This risks compromising delivery of the CPP, which will further defer the necessary re-investment in the network and ultimately hurt consumers in the long run.

As the Commission has noted, historically low investment delivered correspondingly low lines charges to Aurora's consumers, but at the cost of long-term safety and reliability. The priority of this board has been to address the consequences of that trade-off. The need is urgent. We recognise the consequences for household bills. We have been transparent with our community about the need for this CPP and have engaged extensively with stakeholders. In preparing the CPP proposal we were very aware of the impact on our consumers, and so our preparation included extensive challenge to the level of forecast expenditure to ensure it was genuinely necessary. The verifier agreed with our assessment.

Request for meeting

The success of our CPP programme will secure the long-term safety and reliability of the network for the benefit of all consumers. Conversely, failure to deliver the CPP will kick the can further down the road, with adverse consequences for consumers in the meantime. Delivery of the CPP will be challenging and we have worked very hard to put the company in a position to meet that challenge. But the Commission's proposed approach to non-network opex and annual price changes undermines Aurora's ability to deliver.

It is also appropriate that the Commission recognise that our CPP proposal is the latest step in the sustained programme of improvement that Aurora has been pursuing since 2017 under its new board and management, in close collaboration with the Commission. We have approached our engagement with the Commission constructively and in good faith. The current board and management are not responsible for the situation Aurora found itself in in 2016, but we are committed to fixing it and have diligently applied ourselves to that task. Against that background it is deeply disappointing that the Commission, with limited evidence and reasoning, has proposed to reduce our expenditure and apply an arbitrary limit to annual price increases that undermines our efforts to put the network on secure long-term footing.

Given the Commission's decisions now will set the company's course for the next ten years, it is important that you fully appreciate the real-world consequences of the Commission's draft decisions. In light of that, I think it is appropriate that we meet to discuss these matters directly and I request that opportunity as a matter of urgency.

I look forward to your response.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Steve Thompson', followed by a period.

Steve Thompson
Chairperson, Aurora Energy Board of Directors