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## **SUBMISSION ON PROPOSED QUALITY TARGETS AND INCENTIVES FOR DPPS**

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to provide a submission on the Commerce Commission's (**Commission**) "Proposed Quality Targets and Incentives for Default Price-Quality Paths from 1 April 2015" (the proposal) issued by the Commission in July 2014.
- 2 The Electricity Networks Association has also submitted on these matters. Orion endorses the ENA submission.

### **General comments**

- 3 In our view the scheme would promote reliability at better levels than the current set limit, and encourage distributors to seek improvements (particularly low cost improvements) that provide better levels of service.
- 4 We support the mechanism in principle, as an alternative to uncertain enforcement measures for small deviations above the current limit. However, we note the Commission still reserves its right to take the full scope of enforcement action in the "penalty" range (above the target) (para 2.19 and 2.20), so the uncertainty remains.

### **Capping prior year results**

- 5 We question the appropriateness of capping prior year results based on previous limits when calculating targets. The prior year results are actual results, and the Commission has had the opportunity to consider enforcement measures as a result of these breaches. Eliminating these actual results artificially lowers the target below the average, skewing the scheme asymmetrically against distributors, and creating a

wealth transfer from distributors to consumers, which we understand is not the intent of the scheme.

- 6 We are also concerned that benefits will be taken away as future reliability targets (and corresponding caps and collars) are adjusted to reflect improved reliability results. A short term gain (reward for enhanced reliability) could lead to a long term burden of providing enhanced reliability for no reward.

### **Revenue at risk and price volatility**

- 7 Orion agrees that 1% revenue at risk is an acceptable starting point, but notes that going from a full penalty year to a full reward year will result in a 2% price movement, on top of any other allowance under the price path. This could lead to unnecessarily large price movements, or conversely price reductions when costs are actually increasing, which is not an efficient pricing signal to send consumers. Spreading the penalty / reward over a number of years (say 3) would appropriately address this.

- 8 This alternative will address several issues:

- 8.1 The incentive range could be more readily increased in future,
- 8.2 The benefit can be increased to mitigate the improving reliability obligation when the scheme is rolled forward in future regulatory periods,
- 8.3 Price movements will be less volatile as rewards and penalties are spread and will tend to offset each other,
- 8.4 It will not increase the number of breaches caused by natural variation (see below).

### **Reliability assessments based on SAIDI and SAIFI**

- 9 We support using SAIDI and SAIFI as simple, well understood, robust measures of reliability with a good history of data. However, we note that these measures include a degree of natural variation, and the move away from a 2-out-of-3 assessment, and the removal of the one standard deviation buffer above the reference period average will increase the incidence of breaches.
- 10 Disclosure of breaches that result from natural variation (rather than any decline in underlying reliability) unnecessarily casts the performance of a distributor in poor light, which can be detrimental to the relationship between consumers and distributors.
- 11 Without adjusting the proposed quality incentive adjustment calculation (and its caps, collars and targets), Orion submits that the actual definition of a breach be reinstated in line with the approach in the current DPP (including the 2-out-of-3 assessment, and the one standard deviation buffer). With this approach the top of the penalty range in the incentive scheme will become the assessment point for a breach.

- 12 Importantly, this eliminates the overlap in the current draft where a result within the penalty range of the incentive scheme is also a breach, which brings about uncertainty in terms of the enforcement action that the Commerce Commission might take.

### **Delay in application of quality incentive**

- 13 Understandably for Orion, the application of the quality incentive must be delayed to allow it to be determined and included in the calculation of prices. We support this. However, it is unclear how the incentive will be carried over between regulatory periods, and the draft determination appears to require the incentive to be calculated and then applied in assessment periods which are not, by definition, assessment periods.
- 14 That is, schedule 5 paragraph 12 specifies that the quality incentive “must be recovered in the Assessment Period following that in which it was calculated”. “Assessment Period” is a defined term, and means a year ending 31 March during the Regulatory Period. “Regulatory Period” is also defined, and means the period specified in schedule 1, being 1 April 2015 to 31 March 2020. By definition, periods after 1 April 2020 are not assessment periods which fall within the regulatory period, leaving Schedule 5 paragraph 12 unworkable.
- 15 It would be better to specify the Quality Incentive Adjustment that is to be applied to each assessment period, rather than the specifying when the calculation should be carried out. Schedule 5 clause 12 could be replaced with:

*12. The Quality Incentive Adjustment for the Assessment Periods ending on 31 March 2016 and 31 March 2017 is nil. The Quality Incentive Adjustment for each subsequent Assessment Period is to be calculated based on SAIDI and SAIFI results for the year ending on 31 March two years prior to the end of each Assessment Period.*

- 16 The carry-over of the quality incentive to subsequent assessment periods could then simply be enacted within the subsequent DPP determination with:

*“The Quality Incentive Adjustment for each Assessment Period is to be calculated based on SAIDI and SAIFI results, caps, collars, targets and revenue at risk that applied for the year ending on 31 March two years prior to the end of each Assessment Period.”*

### **Relationship with cost-quality trade-offs**

- 17 The proposal (para 2.8.1) suggests the scheme will provide an incentive for distributors to understand the cost-quality trade-off on their network, which is not quite the case. The cost-quality trade-off is an attribute experienced by consumers and the scheme creates an artificial cost-quality trade-off which might be quite different to the actual cost-quality trade-offs on the network. Furthermore, the cost-quality trade-off is already explicit in network design and asset management planning, so we are not starting from a zero base.

### **Roll forward for Orion**

- 18 We acknowledge the proposed approach for Orion to effectively extend the CPP reliability assessment on for a further year, but provide for this under the framework of the DPP incentive scheme. However we do not believe the quality targets should be set in isolation from the determination of our prices for the 2019/20 year – or any year. As submitted elsewhere we want to progress discussions with the Commission on CPP / DPP transition as soon as possible.
- 19 In more detail, and looking further forward, we note the Commission's reference to the separation between planned and unplanned outages: we can separate these but note that both of these measures have been significantly affected by and following the earthquakes, so it would not achieve any useful purpose.

### **Major event days**

- 20 Orion does not support triggering Major Event Day Caps based only on SAIFI (see para 3.8). This would mean that long-duration interruptions affecting a relatively small number of customers would not trigger MEDs. This is not appropriate in situations where a network covers a dense urban area and a low density rural area – a wind or snow storm can have significant and long lasting impact on overhead rural networks (lasting weeks), yet it might not qualify as a major event day simply by virtue of the large number of unaffected urban customers (on underground network).
- 21 For Orion, in the 10 year period from 1 April 2004 to 31 March 2014 we have identified 25 SAIDI based major event days based on the standard 2.5 k-value formula in the current DPP, which includes earthquake impacts, and is only slightly above the target statistical expectation of 2.3 major event days per year.
- 22 Using a SAIFI trigger however, only 11 of these days would be identified as major event days. Significantly, one of the days that would not reach the SAIFI trigger would still contribute more than 100 SAIDI minutes, close to double our annual SAIDI allowance. This would be an uncapped breach of the SAIDI quality target in just one day! Clearly this should be identified as a major event day.
- 23 On the other hand, the SAIFI trigger would identify one additional day that is not identified as a Major Event Day using the SAIDI trigger. On that particular day an outage was caused by a digger contacting 66kV lines affecting a large number of customers but only for a brief period of time. Power was restored within 20 minutes and it would be difficult to defend this as a major event day.
- 24 We therefore submit that to suggest that SAIFI provides a better trigger is demonstrably incorrect.
- 25 The appropriateness of the SAIDI or SAIFI triggers largely depends on the attributes of the network. A SAIFI trigger in a network dominated with an urban population will

not identify wide scale outages in surrounding lower density rural areas. For smaller networks, a SAIDI trigger will not identify short duration outages on key supply lines.

- 26 To accommodate both situations, Orion submits that both SAIDI and SAIFI boundary values must be used to identify major event days and cap daily reliability results. Interestingly, the draft DPP determination takes this approach for the single year in which it applies to Orion (see schedule 3, clause 2(b) and 4(b)).
- 27 Regarding the use of boundary values on MED days – we have on a number of occasions provided strong empirical evidence that this does not eliminate the impact of extreme events. For example, MED days from 5 separate wind storms alone accounted for 41% of our annual SAIDI allowance in FY2014. We submit that the best approach to boundary values is to set MED results to nil, or at the very most, the average of non-zero (non-MED) day results (consistent with the ENA working group recommendation). MEDs are too irregular to suggest that the approach is of lower consequence because it applies equally to the reference period and the assessment period.
- 28 We acknowledge the Commission’s concern regarding incentives when nearing a boundary value on a MED. Perhaps a reasonable compromise is to set the first 2 MEDs in each one year period to the boundary value, and set any further MEDs to nil (and take this approach in both the reference period and assessment period).
- 29 We support the proposed approach (in para 3.37) to reduce the boundary value in relation to the number of zero interruption days targeting the statistical expectation of 2.3 MEDs per year. However, we would prefer that an adjustment consistent with IEEE work in this area was applied.

### **Reference period**

- 30 In principle, we prefer a 10 year reference to a five year period as, other things equal, the bigger the sample, the better the conclusions. However, this does depend on there being no underlying trend in the time series, and that any extreme events in the reference period are appropriately dealt with.
- 31 As noted above, we agree that having a target based on an average of the reference period (with appropriate adjustments) is reasonable within the context of a symmetric financial incentive scheme. However, since the proposal also treats SAIDI and SAIFI results above the historical average as a breach subject to investigation and enforcement action, EDBs face a materially higher risk of breach. We submit that the target for enforcement action should remain at 1 standard deviation above the average. In other words, the financial incentive applies for reliability below 1 standard deviation while enforcement action deals with reliability results worse than that. (For consistency we take the view that this should also be assessed on a “two-out-of-three” basis as now.)
- 32 Orion supports fixed targets applying for a regulatory period (para 4.19).

**Concluding remarks**

- 33 Thank you for the opportunity to make this submission. Orion does not consider that any part of this cross submission is confidential. If you have any questions please contact David Freeman-Greene (GM Commercial), DDI 03 363 9848, email david.freeman-greene@oriongroup.co.nz.

Yours sincerely



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