

**Submission of PowerNet Limited
To the Commerce Commission
On the DPP3 Draft Decision**

18 July 2019

1. Introduction

1.1 The Commerce Commission (Commission) has invited interested persons to give their views on the Commission's 29 May 2019 paper and associated documents – the "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision" (the paper).

1.2 This submission is supported by Electricity Invercargill Limited (EIL), The Power Company Limited (TPCL) and the OtagoNet Joint Venture (OtagoNet) and provides views with respect to the preliminary views in the paper.

1.3 The general approach of our submission is to raise issues we are aware of with the proposals in the paper. Where possible we have provided solutions or recommendations however in general we prefer to rely on the Electricity Networks Association (ENA) submission for this input.

1.4 We would be pleased to answer queries or discuss our submission further with the Commission if required and have appreciated the Commission's attention paid to issues raised by Electricity Distribution Businesses (EDB's) throughout the DPP2 period and the attempted solutions in the DPP3 draft decision paper.

1.5 In particular we would like to compliment the Commission for attempting to deal with some of the issues facing the sector including:

- steps changes in planned outages due to health and safety legislation impacts on live line work
- unforeseen major new connection capital expenditure
- the likely addition of FENZ levies on the sector
- the introduction of a voluntary undercharging limit

1.6 The shift towards using and trusting EDB's AMP's (if only in part) is a welcome step forward.

2. Background

2.1 PowerNet Limited (PowerNet) is an electricity management company with head offices based in Invercargill. We manage the non-exempt EDB's of EIL and OJV, the exempt EDB of TPCL and the non-grid connected Stewart Island Electric Supply Authority (SIESA). PowerNet is jointly owned (50/50) by TPCL and EIL.

2.2 PowerNet provides services to over 70,000 customers through 14,100 circuit kilometres and manage the fourth largest suite of EDB assets in New Zealand. TPCL operates in Southland and West Otago, EIL in Invercargill and Bluff, OJV in Frankton and Wanaka and the rural and coastal Otago region that surrounds Dunedin City and SIESA on Stewart Island.

3. Other Submissions

3.1 TPCL, EIL and OJV have indirectly participated in the submission of the ENA. PowerNet supports this submission in principle.

3.2 PowerNet may make further cross submissions as part of this process after having seen the submissions of other parties.

4. Specific Comments

4.1 Labour Costs

4.1.1 PowerNet is of the view that labour costs in the DPP3 period will significantly exceed inflation and this should be factored into the forecasts in the paper.

4.1.2 PowerNet is experiencing a very tight labour market in the Southland and Otago region. We are presently in negotiation with the Etu field services union, their pay demands are at the highest level seen for many years. This is in part due to the work force shortages from the well documented significant increase in Aurora Energy capex and opex. Both Unison Contracting and Connectics have established depots in the Dunedin and Central Otago areas and a number of PowerNet staff have taken up roles in these regions, reportedly at higher remuneration.

4.1.3 We are responding in the short term by contracting in crews from outside the region and have launched a weekend overtime plan at penal rates to help manage the labour shortfall. Both these alternatives come at increased costs. Resource planning workshops are being held to address what is a real issue for our people resources.

4.1.4 Our continuous investment in new trainees is a solution, however this can only be done safely and efficiently at particular levels. The trainee tap is simply not able to be turned on due to safety reasons and we expect cost increases to recruit or retain staff in the region in the medium term until Aurora Energy return their works programme levels to a long term normal position towards the end of their 10 year asset management plan window.

4.2 Partial Productivity Factor

4.2.1 Despite being in an industry focused on productivity and efficiency improvements the sector and the country continues to incur increased costs due to a variety of factors. The cost increases we have seen and expect to continue include:

- Increased insurance costs, along with FENZ levies
- Increased regulatory compliance (e.g. related party input methodology requirements)
- Health and safety changes (e.g. removal of asbestos from a number of sites and an increase in ratio of elevated platform vehicles per field staff member)
- Traffic management changes (e.g. more onerous following the Higgins fatalities)
- New technology costs (e.g. the addition of new technology team at PowerNet)
- Cyber security costs

4.2.2 We support the ENA view that “the opex forecasting models do not adequately capture opex-drivers” based on the examples noted above.

4.3 Large Unforeseen Connection Reopener

4.3.1 PowerNet supports the general approach taken in the paper of having a major connection reopener, however we are not sure how clauses 4.40.1 and 4.40.2 would allow the situation to operate in practise.

4.3.2 OtagoNet as an example has included in its Asset Management Plan (AMP) two major connection enquiries as contingent projects that require a potential new grid exit point and distribution investment of more than 10% of its RAB. While the projects are not included in the forecasts considered when setting the capex approvals they were clearly foreseen as they were included as contingent projects.

4.3.3 This has the effect of disallowing the expenditure and then precluding it from being able to meet the reopener test.

4.3.4 We would also like to see the re-opener test extended to include non-network capex where one off expenditure is incurred, such as a one in 50 year property rebuild required due to building code earthquake rating issues where no material non-network expenditure has been incurred in the past.

4.3.5 Alternatively the AMP of the EDB could be used without the need to go through the gates for capex acceptance by category as summarised in Table 5.10 of the paper.

4.4 Recoverable Costs

4.4.1 PowerNet supports the inclusion of both the Fire and Emergency New Zealand (FENZ) levies and an innovation allowance as new recoverable costs. We in particular commend the Commission for the recognition of the innovation allowance.

4.4.2 We agree with the ENA submission that recommends the widening of FENZ recoverable costs to include insurance premiums in general given the cost movements seen in this area. At a minimum we suggest the inclusion of material damage insurance costs as a recoverable cost.

4.4.3 While the inclusion of an innovation allowance is commendable we would like to comment on the practicality of the allowance given the steps required to achieve approval. The cost benefit, in particular for smaller EDB's, given the level is set at 0.1% would make it very difficult to justify an application. For EIL, a relatively small EDB, the allowance would be \$12,000, hardly enough to recover the initial cost of a consultant or an application.

4.4.4 Innovation is an area the PowerNet board driven by the expectation of our EDB customers is taking seriously, we have already recruited a team in the new technology space and invested in a smart home with studies being undertaken. The annual budget for this team is significant and close to seven figures, a \$12,000 allowance for EIL to recognise this cost while a commendable start in principle does not compare to the costs involved.

4.4.5 We recommend:

- a minimum allowance per EDB of \$50,000,
- an increase in the percentage allowance above the 0.1% and
- allowing EDB's to pool their allowances in making an application

4.5 Capital Expenditure

4.5.1 PowerNet appreciates the Commissions move towards using EDB's AMP's as the basis of determining capital expenditure allowances, however we do have some concerns on the impact on EDB's of the method of applying scrutiny checks as outlined in the paper. Two areas of particular concern are consumer connections and non-network assets.

4.5.2 As noted in section 4.3 of our submission we are concerned regarding non-network capex where one off expenditure is incurred, such as a one in 50 year property rebuild required due to building code earthquake rating issues, where no material non-network expenditure has been incurred in the past.

4.5.3 For non-network capital expenditure we recommend the approval of one off non-network capex without passing a gating test. A gating test simply cannot work effectively when past expenditure has been immaterial especially when a one off safety led investment in the region of 5% of RAB is encountered. Alternatively we recommend non-network expenditure is able to be treated as the basis of a reopener.

4.5.4 As noted in the paper, in footnote 287, EIL is forecasting costs associated with connecting major consumers, in particular a publicised CBD block redevelopment (by a major Southland business and Invercargill City Council – the investment is presently being publicly consulting on). The area being redeveloped accounted for over 1% of EIL's revenue and the site construction and the network new connection costs are to be spread over a number of years.

4.5.5 OtagoNet is also in a situation where it is competing with Aurora Energy in the Frankton (Queenstown) and Wanaka areas. Running a gate test for connection expenditure using past connection growth and forecast population growth cannot be applied to OtagoNet as OtagoNet chooses to compete with Aurora Energy for new connections.

4.5.6 PowerNet is prepared to confidentially share with the Commission the commercial aspects around the forecast new connection growth relative in the Wakatipu / Wanaka areas, in particular the relativity to total ICP's.

4.5.7 Finally, for OtagoNet there is a bizarre aspect to the combination of the revenue cap, gating approach for new connections and the operation of the capex incremental rolling incentive scheme. The combination is providing a disincentive for OtagoNet to compete in the area. In summary, creating a potential barrier to competition.

4.5.8 We recommend the Commission gives further thought to the capital expenditure forecasting issues raised here including putting further trust in the AMP forecasts of EDB's in the area of consumer connections and non-network assets.

4.6 Quality Tests

4.6.1 PowerNet is concerned with the proposed move away from the quality path two out of three year test. We understand from the Commission that the probability of breach under a one out of one year test with a 1.5 standard deviation and the three hour approach for major event days has been calculated.

4.6.2 We are however somewhat sceptical of the possible results and are concerned we will see a return to the long list of quality breaches that existed in DPP1. Should the Commission retain the one out of one year test could we request the data is rechecked and furthermore suggest the standard deviation applied to the normalised reference period average is increased further.

4.6.3 PowerNet appreciates the effort that has gone into the change in the quality approach and in particular the recognition to de-weight the impact of planned outages given live line work changes seen since the introduction of the Health and Safety at Work Act in 2015.

4.7 General Observation

4.7.1 PowerNet is very concerned about the impact of a combination of factors on the EDB sector including;

- Significant reductions in the WACC from DPP2, which is not likely to be mirrored by falls in EDB's cost of debt
- DPP2 IRIS (dis)incentives to be applied in DPP3
- Increasing compliance, labour and new technology costs not being factored into DPP3 opex
- Five years of CPI increases well below treasury forecasts used in the DPP2 resulting in permanently "lost" revaluation gains and RAB values
- The increase in capex IRIS rates by equalising these with opex combined with the gating / scaling of new connections and non-network capex

4.7.2 The combination of these matters amongst others will put significant pressure on EDB's operating cash flow and affect their ability and incentive to invest in the EDB sector. It is clearly going to be the toughest five year period for the sector.

4.7.3 PowerNet's shareholders have already made significant investments in electricity renewable generation where the returns are substantially higher and compliance costs are substantially lower. The competing decision of where to invest despite the pressures of the quality path will be a decision faced by many EDB's.

4.7.4 The balance of risk versus return for EDB's may well have tipped too far and impact on their decision to invest which may not be in the long term interest of consumers in the sector.

We look forward to the opportunity to make further cross submissions as part of this process.

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