Submission to the Commerce Commission

on

Draft Electricity Distribution Services Default Price-Quality Path Determination 2020-2025

18 July 2019

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Introduction

1. Alpine Energy welcomes the opportunity to submit on the Commerce Commission's *Draft Electricity Distribution Services Default Price-Quality Path Determination 2020* (Draft DPP3 Determination) and its *Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decisions, Reasons Paper* (the Reasons Paper).

2. In this submission, we express our views on the proposed:

   i) price path, specifically:

      - the setting of the opex allowances:
        - the weighting of the input price inflators is around the wrong way
        - the growth assumptions don't reflect the drivers of growth on our network
        - 0% for a step change and partial productivity is too conservative
      - the setting of the capex allowances:
        - the setting of the capital expenditure (capex) allowance using 2010 to 2014 historical Capex as DPP1 (i.e. 1 April 2010 to 31 March 2015) is not representative of future Capex
        - there are better alternatives to a uniform capex cap of 120%
        - the all-industries CGPI is not a good indicator of what inflates our costs
      - the reopener for large unforeseen new connections needing more flexibility:
        - definition of 'unforeseen' is too narrow
        - 5% threshold of annual revenue is too big
        - the need for a mechanism that accounts for unforeseen volume growth

   ii) Quality standards, specifically:

      - retaining the 'two-out-of-three-year rule.'
      - increasing the cap on changes in unplanned SAID and SAIFI to 10
      - the need for guidelines on the automatic reporting requirements.

3. In all other matters, our views are expressed by the Electricity Networks Association's and PricewaterhouseCoopers (PwC) submissions.

Proposed price path

The setting of the opex allowance

4. In its Draft DPP3 Determination, the Commission is proposing to retain the same base step approach that was used to set the opex allowances for the current period, i.e. 1 April 2015 to 31 March 2020 (DPP2). Overall, we appreciate the Commission's approach and ask that it reconsider the following three matters before making its final DPP Determination:

    i) the weighting of the input inflators around the wrong way

    ii) growth assumptions don't truly reflect the drivers of EDB costs

    iii) partial productivity is not 0; it is negative.

The weighting of the input price inflators should align to an EDBs load growth

5. We are of the view that the weighting of the labour cost index (LCI) being higher than the producer price index (PPI) is around the wrong way for EDBs that are experiencing load growth.

6. EDBs that are experiencing an increase in load growth will expense more on materials than they do for labour. EDBs with steady-state load growth will expense roughly the same on materials as they do on labour. And EDBs that are experiencing declining load growth will expense less on materials and more on labour. Accordingly, the Commission's proposed weighting puts EDBs with growing or steady state load growth at a disadvantage.

7. We are of the view that a 3% growth in wage inflation over the next 3 years needs to be factored into the inflators as this is our expected increases over the next 5 year period.

8. As an alternative, we suggest that the Commission allow EDBs to evidence their current and future load growth and that the Commission assign price inflators that align to the EDBs circumstances. The default position could be the Commission's proposed price inflators, and the onus would be on the EDBS to apply and then evidence an alternative.

Growth assumptions don't reflect the drivers of growth on our network

9. The Commission is proposing to use the change in ICP numbers, or circuit length reflect the underlining costs to serve. We are of the view that this approach could apply to urban EDBs where population growth, in-fill housing and subdivisions are the drivers of growth. However, our growth is driven by dairy conversions and expansions, neither of which necessarily result in more ICPs or longer circuit lengths. And accordingly, are not

reflected in the change in ICP numbers or circuit length.

10. Further, much of our network opex has increased proportionately to our aging assets and increased quality of supply expectations from customers (and the Commission). The growth in our non-network opex is driven by the increased cost to serve, especially around the health and safety, economic, market and financial regulatory frameworks.

11. We are of the view that the Commission should include a measure of the change in systems demand and transformer capacity to the drivers of growth. Changes in system demand and transformer capacity would capture system growth on networks that are experiencing growth at existing connections rather than growth in connections.

Partial productivity is not 0%

12. We are of the view that the Commission's conservative approach of setting both the step change and partial productivity rates at 0% is overly conservative and punishes unjustifiably.

13. The Commission states in its Reasons Paper that it considers zero to be appropriate as a zero-productivity factor results in EDBs sharing industry-wide productivity gains through the IRIS and avoids the downside of entrenching productivity gains or sharing gains with consumers before the gains are realised. The proposed partial productivity factor of 0% for DPP3, is based on an assessment of overseas productivity trends.

14. The Commission considered maintaining the -0.25% applicable in DPP2 but, it is of the view that a negative partial productivity factor entrenches declines in efficiency thereby weakening the incentive to improve efficiency, which is inconsistent with workably competitive markets.

15. However, in its Reasons Paper, it also recognises that RIIO ED1 Ofgem set the productivity factor between - +0.8% and +1.1[1].

16. The partial productivity sets a baseline against which to reward us for improved efficiencies (or punish us for increased inefficiencies) over DPP3. Partial productivity of zero, when the real world state is not zero unjustifiably punishes EDBs and accordingly, we urge the Commission to take the extra steps to set the partial productivity factor at the real rate.

The setting of the capex allowance

17. In its Draft DPP3 Determination, the Commission is proposing to change the method that it proposes to use to set the Capex allowance in DPP3 from what it used in DPP2.

[1] Commerce Commission, Reasons Paper, Table 5.7, on page 83.

For DPP3 the Commission is proposing to set the Capex allowance by relying on EDB constant price AMP capex forecasts, subject to a cap based on historical expenditure.

18. The Commission is proposing to follow a five-step process:

Step 1—scrutinising past forecast performance by assessing how closely actual expenditure has tracked to the AMP forecasts and has there been a persistent upward trend in forecasts.

Step 2—scrutinise forecast expenditure for consistency with cost drivers for the three most significant categories of Capex (Major Capex):

(i) consumer connection
(ii) system growth
(iii) asset replacement and renewal (ARR).

Step 3—fall back to average historical expenditure where the AMP forecasts are 'disjointed' from the cost drivers or set an alternative allowance based on an external assessment of the key cost drivers.

Step 4—cap the minor categories of:

(i) asset relocations

(ii) non-network expenditure.

Using the same sliding scale used in DPP2 for non-network expenditure.[2]

Step 5—apply an aggregate cap of 120% of historical expenditure.

19. Overall, we understand the Commission's proposed approach to the setting of the capex allowances for DPP3 and ask that it reconsider the following three matters before making its final DPP Determination:

i) the past is not always a good predictor of the future

ii) there are better alternatives to 120% capex cap

iii) CGPI is not a good indicator of what inflates EDBs costs.

The past is not always a good predictor of the future

20. We are of the view that the use of suppliers AMP forecasts provides the Commission with the necessary information that enables it to make an informed decision when

[2] For more information on the sliding scale applied in DPP2 refer to Commerce Commission, *Default price-quality paths for electricity distributors from 1 April 210 to 31 March 202—Main Policy Paper*, footnote 8, at page X8.

setting allowances. However, we do not support the Commission's proposed approach to using five-year historical Capex based on DPP1 expenditures (i.e. 1 April 2010 to 31 March 2015) as the historical reference point.

21. The expenditure from two regulatory periods is too far removed from where EDBs are likely to be going in the future, i.e. the past (or at least not that far in the past) is not necessarily a good predictor of the future.

22. We proposed that the Commission consider an alternative approach. Where the Commission has less than 100% confidence in an EDBs AMP forecasts the EDB be permitted to submit its capex forecasts to the Commission based on the principles in the customised price-quality path (CPP) IM. EDBs would not be obligated as the requirements of the CPP IM are detailed. However, the Commission and EDB could right size the requirements depending on the lack of the Commission's confidence in the EDB's AMP forecasts and the level of Capex needed by the EDB.

23. Our alternative approach would enable the Commission to work through its concerns with the EDB rather than applying a process that effectively punishes the EDB for failing to meet an undisclosed standard.

There are better alternatives to 120% capex cap

24. We are of the view that an aggregate cap of 120% is overly simplistic and may not adequately reflect EDBs expenditure needs in DPP3. For the small to medium EDBs projects like substation refurbishment, which is standard capex, could easily exceed the 120% cap if no similar sized projects were undertaken in the prior regulatory period. A cap of 120% could result in EDBs needing to apply to the Commission for a CPP for what is routine and expected expenditure.

25. We are of the view that where an EDB that needs a 'step change in Capex' it is appropriate that the EDB apply for a CPP. However, an increase in Capex of more than 120% is not necessarily indicative of a step change in Capex; rather it could simply be replacement of material assets on the network (e.g. sub-transmission assets) during the EDBs life cycle management. A CPP should be the exception and not the rule, particularly for foreseen asset replacement.

26. We are of the view that there is an alternative approach, by which the Commission allows EDB's to apply to the Commission for an alternative cap that better reflects their future spends. The application would be based on the principles of the CPP IM and would need the EDB to demonstrate that the future expenditure is prudent and efficient.

27. Under our prosed alternative approach, EDBs would not be obliged to apply for an alternative cap, and the proposed 120% cap would remain the failsafe.

CGPI is not a good indicator of what inflates EDBs costs

28. We are of the view that the Commission's use of CGPI on its own is not reflective of the inflators to our costs. An alternative could be a hybrid of industry indicators such as prices paid by producers price Index (Input PPI), salary wages rates, including overtime (Labour cost index), import prices for goods (overseas trade index) as well as the CGPI.

More flexibility needed for reopener

29. We are of the view that the proposed reopeners for large unforeseen new connections need more flexibility if the mechanism is to be used by EDBs.
30. The Commission's definition of 'unforeseen' means that capex for large connections is likely to be too narrow as it will exclude capex for connections that were included in an EDBs AMP forecasts and did not pass the Commission scrutiny process. Many EDBs will have had consumers show interest in connecting to the network, but may not have the level of detail, or be able to publish the level of detail about that connection hat the Commission requires to pass scrutiny. EDBs do not control the flow of detailed connection information; rather, the customer controls the detail and disclosure of that information.
31. The Commission's definition of 'large' being the expenditure on a connection that is 5% threshold of annual revenue is too big for many if any new connections to be considered large enough to support an application for a reopener.

Allow a second chance

32. The Commission is proposing to base their scrutiny of the AMP forecasts on a low-cost approach by using available public information. EDBs are often subject to strict non-disclosure agreements that prevent them from making the details of new connections public and necessitating more vagary in the AMPs. Therefore, the Commission may not have all the information 'at hand' when applying their scrutiny of the AMP forecasts.
33. As an alternative approach, we propose that the Commission allow an EDB to apply for a reopener for a large new connection even if the EDBs had included that Capex in its AMP forecast, but excluded from the Capex allowances provided the EDB can evidence good cause for the inclusion of that Capex. The onus would be on the EDB to prove that the lack of evidence to support the inclusion of the Capex in the AMP in the first instance was on good grounds (such as commercial in confidence) and not some other reason (such as lack of rigorous forecasting practices).

A 5% threshold of annual revenue is too big

34. The Commission's propose a 5% threshold of annual revenue for a new connection to

be considered 'large'. We are of the view that 5% is too high and that the Commission consider a lower threshold of 2%.

35. At 5% of annual revenue in our case, a new connection would need to cost upwards of $2.4M. In our experience, connections in the realm of $2.4M are a one in 20-year event. We do, however, get several applications for smaller connections at around 2% of our annual revenue, i.e. over $940k. Cumulatively these connections can well exceed the 5% threshold, but not individually.

36. Under the Commission's proposed approach, the connections would not meet the threshold and if these were not brought to our attention before the DPP reset these would not be in our AMP forecasts. Accordingly, we would have four options:

    i) ask the customer for 100% capital contribution

    ii) absorb the cost of the connection within existing forecasts by deferring other capex

    iii) maintain our capex spend and overspend our allowances thereby taking the hit under the IRIS

    iv) turn the customer away.

37. All four options have their advantages and disadvantages, but none in our view is in the long term best interests of consumers.

Allowing for unforeseen demand growth

38. We are of the view that the DPP3 Determination needs to have a mechanism that takes account of unforeseen demand growth.

39. Paragraph 4.27 of the Reasons Paper refers to our submission on the Commission's *Proposed Quality Targets and Incentives for Default Price-Quality Paths from 1 April 2020* (the Issues Paper)[3] about the need for a mechanism to account for unforeseen volume growth. And paragraphs 4.23 to 4.51 of the Reasons Paper discuss the uncertainty that EDBs face from unforeseen volume growth. While the Commission intends to have a provision for reopeners for large unforeseen new connections, it is not making any allowance for aggregate unforeseen demand growth.

40. The Commission state at paragraph 4.39—

> 'This mechanism does not cover general growth in demand due to

[3] Alpine Energy Limited, *Submission to the Commerce Commission on Quality Targets and Incentives for Default Price-Quality Paths from 1 April 2020*, 20 December 2018.

> decarbonisation, such as high uptake of electric vehicles. Introducing a reopener for general demand growth would undermine the IMs, which require the use of a revenue cap rather than a weighted average price cap. Furthermore, we consider that the risk of outturn network expenditure based on demand growth differing from forecast can be positive or negative, whereas a reopener would be asymmetric, i.e., the reopener would only result in a distributor potentially receiving more revenue allowance, not less.'

41. The Commission's proposed approach means that to the extent that EDBs experience unforeseen general growth in demand, any increased cost will be reflected in the incremental revenue incentive scheme (IRIS) only.

42. We ask that the Commission reconsider its position as we are of the view that the stance the Commission has taken is overly simplistic. Growth on our network is due to dairy conversions and not decarbonisation or the uptake of electric vehicles. While a single dairy conversion is unlikely to be material, the aggregate impact of multiple conversations on parts of our network is material. It is very difficult for us to predict when and where that growth might occur as the driver of dairy conversions are outside of our sphere of influence such as international milk prices, availability of irrigation, and approval of water consents.

43. The Commission's decision to trivialise general volume growth puts us at very real risk of not being kept whole during DPP3. As stated in our submission to the Issues Paper under the proposed pure revenue cap the point of disadvantage has been shifted from EDBs with declining volumes to EDBs with unforeseen increasing demand—

> '…we urge the Commission to be mindful when drafting its determination that there are EDBs with growth on their networks and that there must be a rigorous mechanism for these EDBs to be kept whole under the revenue cap without having to default to [applying for] a customised price path (CPP) proposal.'[4]

44. Accordingly, we ask that the Commission reconsider the need for a mechanism to take account of unforeseen demand growth.

Proposed quality standards

45. In its Draft Determination, the Commission is proposing not to add any new quality metrics as part of the quality standard or revenue-linked quality incentive scheme. It is proposing to keep the current quality metrics with some changes, including:

    i) assessing unplanned and planned outages separately

    ii) using a 10-year reference point of 1 April 2008 to 31 March 2018

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4 Supra n3, paragraph 8.

iii) capping the movement to ± 5% for unplanned SAIDI and SAIFI between regulatory periods

iv) assess unplanned outages over a rolling three-hour period

v) unplanned outages are assessed annually and planned outages over the regulatory period

vi) extreme outage event (i.e. major event days) standard will be three times the unplanned SAIDI for outages caused by human error, defective equipment, or unknown causes

vii) introducing automatic reporting requirements following contravention of any quality standard

viii) linking revenue incentives to SAIDI only.

46. Overall, we appreciate the Commission's proposed approach and ask that it reconsider three matters:

i) retaining the two-out-of-three-year rule

ii) increase the cap on changes to SAIDI and SAIFI targets between regulatory periods from ± 5% to ± 10%

iii) providing a guideline as to the Commission's expectation for the automatic reporting requirements.

The 'two-out-of-three-year-rule' should stay

47. The Commission is proposing to replace the two-out-of-three-year rule with a 'simpler annual limit for unplanned SAIDI and SAIFI'. The simpler limit would reduce the impact of major events by increasing the buffer between the historical mean and the limit from 1 standard deviation to 1.5 standard deviations.

48. The Commission's intention to increase the standard deviation by 0.5 is intended to continue to address the volatility that the two-out-of-three-year rule addressed and at the same time remove the instances of 'false positives'. False positives being instances whereby the exceedance of the quality path was within the control of the EDB, but the rule meant that the instance would not be a contravention and therefore subject to investigation by the Commission.

49. We disagree with the Commission's conclusion that false positives are occurring and are of the view that the two-out-of-three-year-rule has worked as was intended and should remain.

50. The quality standards were put into place to ensure that EDBs did not sacrifice quality

to increase profit[5]. The Commission measured the long-term benefit to consumers by considered contraventions of the standards (exceeding the quality path), based on, 'material deterioration'. Material deterioration means a decline in performance that is increasing in severity over time (i.e. more and longer interruptions year on year).

51. The measure of material deterioration allowed for a trend around performance that could take account of 'one-off years' where events such as 1 in 100-year snowstorms could cause an EDB to exceed its standards, but otherwise, the EDB had tracked year on year under the quality path. Performance, therefore, was not material deteroriation, but rather a one-off event rather that did not need further investigation.

52. The Commission recognised the merits of the approach in its Main Policy Paper at DPP2—

> 'The quality standards employ the two-out-of-three-year rule because it allows for one-off poor performing years, which alone may not constitute an underlying material deterioration of reliability (for example, due to natural variability).'[6]

53. The Commission also recognised that—

> 'The reliability limits for the quality standards are set at one deviation above the historical SAIDI and SAIFI average to allow for a reasonable level of variability in reliability performance. Allowing for reasonable natural variability means that the quality standards better reflect underlining network performance.
>
> These different approaches to reduce the number of false positives work together as a package…They do this by taking extreme events and some variability into account. Therefore, the quality standards are more focused on performance over time than a single annual non-normalised measure.'[7]

54. Given that investigation into contraventions of the standards are resource intensive for both the Commission and EDBs the rule allowed the Commission to focus on those EDBs that are more likely to be experiencing material deterioration and have fewer investigations to conduct, and EDBs to focus on running the network rather than answering to how it managed one-off events.

55. The Commission appears to be moving away from forward-looking measures to retrospective measures. The Commission is changing is focus on how is an EDB performing over time to how is it operating.

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[5] The theory is that faced with constrained revenues and entity will reduce costs by providing a lower level of service unless that level of service is mandated.

[6] Commerce Commission, Main Policy Paper EDB DPP 2015 – 2020, November 2014, paragraph 6.9, on page 33.

[7] Supra n6, paragraphs 6.11 and 6.12 on page 33.

56. We are of the view that contraventions of the path are a poor way for the Commission to enquire into EDB operations. Accordingly, we are of the view that the two-out-of-three-year rule should be retained to signal the need for the Commission to investigate following an exceedance of the quality path; and if the Commission wants to explore operations of EDBs, it finds a different approach by which to achieve that aim.

Increase the proposed cap to 10%

57. The Commission is proposing to cap changes on SAIDI and SAIFI targets between regulatory periods to ± 5%. The cap prevents EDBs from being punished for an improvement in performance or rewarded for a decline in performance over the reference period (i.e., historical performance between 2008 and 2018).

58. We agree with the intent in that no cap would provide a perverse incentive to underperform during a period, or at least not to improve performance by too much. It would also mean that improved performance would be less of a case of sharing than a resetting of the quality path that might not be achievable in future years.

59. We are, however, of the view that 5% is too small and that the cap should increase to 10% for the final DPP Determination. 10% better reflects the natural variability of performance over the long term than does 5%. 10% also better reduces the perverse incentive to underperform while also sharing, but not giving, all the benefit to consumers.

Release guidelines for automatic reporting

60. The Commission is proposing to require EDBs to report quality contraventions when they occur automatically. We understand the concept in principle and are of the view that the Commission should release guidelines around what its expectations are around content and what process it will take when assessing the reports.

61. We accept that the Commission will not dilute its discretion to take account by giving certainty around the outcome and we are of the view that the Commission can and should give certainty around process. A guideline will go a long way to providing EDBs with the certainty of process.

Closing comments

62. We hope our submission is helpful to the Commission in making its determination of the price-quality paths to apply from 1 April 2020.

63. The primary contact for this submission is—

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