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18 July, 2019

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Dear Dane,

SUBMISSION ON DPP RESET DRAFT DECISION – PUBLIC VERSION

Centralines welcomes the opportunity to submit on the Commerce Commission's *Default price-quality paths for electricity distribution businesses from 1 April 2020, Draft Decision.* We have contributed to the development of the ENA's extensive submissions and support the recommendations in those submissions. In this submission we focus on key issues for Centralines, rather than duplicate the responses in the ENA's submissions.

In this submission we address the Commission's proposals in two parts:

1. Financial aspects, including the determination of maximum allowable revenues and financial incentive mechanisms; and

2. Quality standards and reliability incentives.

While we take this two-part approach, Centralines submits that the Commission does need to ensure that the two aspects of the regime are internally consistent. We are concerned that what is meant by the "no material deterioration" standard is not well understood. Accordingly, there is risk the revenue allowances to meet this standard are potentially not aligned. Reliability outcomes are heavily influenced by changing external factors, yet revenue allowances are heavily determined by historical performance (e.g., opex allowances largely anchored to past opex and caps on capex based on historical comparisons). Without a clear explanation of the Commission's enforcement approach and criteria, there is a substantial aspect of the consultation on the Draft Decision missing. The absence of this explanatory detail limits EDBs' ability to make meaningful and considered comments, including an ability to consider whether the expenditure allowances are sufficient to meet the quality standards and reliability targets.

Before moving into the two parts, Centralines wishes to note at the outset that the WACC, while simply a mechanical part of the DPP3 reset, seems likely to fall to around 4.7% by the time of the final decision. Once the 2% "revaluation" gain is removed from this, and EDBs pay their nominal cost of debt, the cashflows available to EDBs for their activities will be substantially reduced. In an environment of rising capital expenditure requirements, Centralines submits that there is an

even sharper requirement on the Commission to accurately forecast EDBs expenditure requirements. With recent dramatic declines in 5-year Government bond yields, with yields now negative in real terms, we are very doubtful that the regulated WACC will provide reasonable compensation to investors for the risk they take. With CPI-based revaluations providing a major source of returns to equity (around half), for Centralines' the biggest risk over the DPP3 period is the accuracy of RBNZ's forecasts. With the deteriorating world economic outlook and significant risks associated with trade-wars and financial instability, we think there are substantial downside risks to CPI returning to the mid-pint of RBNZ's target band.

Centralines would not normally prepare such a lengthy submission, relying more on Unison and the ENA to represent its views. However, in this instance, we are highly concerned that the expenditure allowances and the underpinning methodologies will severely under-compensate EDBs for the reasonable costs of their activities. There appear to be strong expectations from both the Commission and Electricity Authority that EDBs will play a significant role in facilitating transformation of the electricity market and, very likely, EDBs will have to contribute to the Government's climate change goals. Centralines would of course want to play its part, but we also wish to make very clear there is no allowance for such activities in the proposed revenue allowances. Therefore, any new requirements on Centralines will need to be funded from sources other than lines charges.

COMMENTS ON THE FINANCIAL MODEL

High-level perspective

As outlined in the introductory comments, Centralines is highly concerned that *ex ante* the proposed revenue allowances and approach to setting quality and reliability standards will not provide Centralines with reasonable opportunity to earn its cost of capital over the regulatory period (i.e., on the basis of the draft decision Centralines does not expect to achieve the NPV=0 test). Centralines holds that view for several reasons:

1. Operating expenditure ("opex") allowances for businesses like Centralines, who are experiencing limited customer and line length growth, are effectively frozen in real terms. However, there are growing expectations on EDBs to facilitate transformation of the energy market, by providing open access platforms for others to provide new services to consumers. Although Centralines seeks to manage these costs through its management outsource arrangements, the costs of meeting new regulatory requirements, including compliance and reporting obligations are still expected to be significant. The Commission has made no provision for these costs, nor the proposed increased reporting obligations under the DPP3 and Information Disclosure requirements. In addition, we set out a number of opex risk factors below that suggest there is asymmetric risk on opex to the downside (i.e., adverse impact on Centralines).

2. Small EDBs, such as Centralines, are unreasonably and unfairly disadvantaged by their scale. The Commission proposes percentage caps on increases in capital expenditure above historical averages. For Centralines a 20% increase in capex over historical expenditure is likely to amount to less than $1 million, effectively making it impossible for Centralines to invest in lumpy new assets that are required periodically without significant negative financial consequence. Centralines has a committed, one-off project that will take it over the proposed 120% cap. It is not in the consumer-owners' of Centralines interest for Centralines to apply for a CPP to gain revenue allowances for such one-off investments. In such a situation Centralines would effectively be forced to absorb these costs by under-performing against the WACC.

   Centralines submits that the Commission needs to consider a more proportionate approach to assessing reasonable capital expenditure levels, including making specific allowance for capital expenditures for smaller EDBs who are disproportionately impacted by lumpy capital expenditures. Centralines submits that it should have the opportunity to provide direct evidence provided of expenditures where these tip capex projections over the 120% cap.

3. When assessing forecast risk across the key elements making up the cost building blocks calculations, Centralines' assessment is that downside risk (potential for negative impact on returns) is much greater than upside risk. The forecast risk assessment is set out in the table below. Centralines requests the Commission provide a similar table with its Final Decision addressing how the Commission has achieved symmetry in the risks associated with the selection of point estimates in setting the components of the BBAR, which is necessary to support the achievement of the expected NPV=0 standard:

Key forecast variable	Commission proposal	Forecast risk assessment

Real opex growth	Allowance only for increases in opex due to forecast increases in customer numbers and network length.	Downside risk substantially exceeds upside risk for the following reasons:
		• "Trend" model accounts only for opex growth due to increased customer numbers and line length
		• The "Trend" model has substantially under-forecast opex in DPP2, with no adjustments to the model to address this problem
		• Compliance costs are forecast to increase due to:
		  o H&S requirements
		  o EA regulatory requirements (e.g., costs of meeting IPAG recommendations)
		  o Commission compliance requirements from DPP3 and associated ID requirements
		• Network pricing reform is expected to be a costly undertaking
		• Costs associated with maintaining assets as they reach end-of-life (rising inspection and maintenance requirements before replacement)
		• Rising costs of managing information (cyber security)
		• Increasing insurance costs
		
		On upside risk, Centralines is unaware of any significant potential for productivity break-throughs that would offset the risks above. We note that Centralines has realised significant managerial efficiencies through out-sourcing its entire network operational control and management to Unison.
		
		Centralines is not aware of any Government initiatives to reduce the legal and regulatory requirements on EDBs that would assist in reducing costs.

CPI for revaluations	RBNZ is forecasting inflation to lift to average 2.06% over DPP3	The weakening global outlook creates a risk that inflation will be much weaker than forecast as weaker global demand puts a lid on consumer price movements. This risk appears much greater than the potential for higher inflation based on a strengthening global economy. Accordingly, the contribution to return on equity from revaluations has significant downside risk.
CPI for revenue growth	RBNZ is forecasting inflation to lift to average 2.03% over DPP3	As above, CPI forecast risks to the downside appear much more likely than upside CPI risk given the deteriorating global economy. Accordingly, revenue growth risk faces a higher downside risk.
Labour cost inflation	NZIER forecasts weak real wage growth in all industries LCI of an average of 0.3% per annum, with negative real wage growth in the final year	Centralines considers that the Commission's use of NZIER's wage growth forecasts for all-industries LCI needs to be reconsidered in the context of EDB services. Field workforces are heavily unionised, there are strong wage pressures coming through given observed public sector settlements of substantial above-CPI wage rises, and significant increases in the minimum wage. There is also growing recognition by local authorities of the need to address infrastructure deficits in the non-energy utilities sector, there are likely to be significant wage pressures

		affecting EDBs. Additionally, with the Commission's approvals of Powerco's CPP and ramp-ups in expenditure by Aurora, there is strong demand for experienced electrical workers.[1] [ ]. **Centralines Confidential Information.** Centralines considers that there is remote upside risk that wage inflation would fall below the Commission's projections.
Productivity growth	Commission proposes 0% without evidence	Evidence from NERA shows a strong and enduring trend reduction in <u>measured</u> opex partial productivity in EDBs, of the order -1.7—3.1% per annum.[2] The problem appears to be that the Commission's opex trend model (which is not a trend model at all) does not capture any other drivers of opex than changes in customer numbers and line length. But there are in fact numerous other drivers and outputs provided by EDBs (e.g., new requirements driven by changing laws and regulations, regulatory reporting requirements etc). There is strong downside risk that trends in <u>measured</u> opex partial productivity decline will continue.
PPI inputs growth		The forecast appears not unreasonable and Centralines has no particular quantitative or qualitative information to consider that forecast risks are asymmetric. While a weakening global economy may reduce pressure on materials prices, stronger labour price inflation (people produce materials) may be offsetting.
CGPI inflation growth		The forecast appears not unreasonable and Centralines has no particular quantitative or qualitative information to consider that forecast risks are asymmetric. Like PPI inflation, CGPI inflation will have contributions from materials and labour prices and Centralines has no particular information to indicate which risks may dominate.

4. As previously submitted Centralines considers it is unreasonable for the Commission to apply the capex IRIS adjustment to Centralines' revenue allowances in DPP3. Centralines has substantially under-recovered against its DPP allowance in DPP2. The effect of the capex IRIS adjustment would be for Centralines to refund money to consumers that it has never actually collected. If Centralines, which is consumer owned, had followed the Commission's CPI+7% path during DPP2, it would have increased prices to its consumers by around 40% in real terms. Centralines is already in a position where its charges are already some of the highest in the country due to the low density of its network and small urban population size.

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1 Centralines recommends that the Commission take this into account in approving future CPP applications. Centralines seeks to maintain a stable workforce and a relatively consistent approach to lifecycle asset management that avoids significant variations in expenditure levels. Businesses that adopt models where there are substantial swings in labour resource requirements should be required to demonstrate that delivery of the CPP should include training of their own workforce rather than causing resource challenges for other EDBs.

2 NERA (2019) *Opex Partial Factor Productivity for DPP3*

It is unrealistic of the Commission to claim that Centralines should have increased its prices during DPP2 in anticipation of the capex IRIS mechanism effects during DPP3.[3] We fail to see how such an approach is in the long-term interests of consumers. Centralines was protecting its consumers from undue hardship in DPP2, but now faces an incongruous situation of earning sub-WACC returns in order to refund money it never collected. The Commission's indicative IRIS calculations model suggests that Centralines will face a negative capex IRIS incentive adjustment of around $300k per annum from 2021-25. This amounts to a 0.5% decrement to returns over that period: a substantial and unjustified impact.

In summary, the combined effect of the Commission's proposals is that Centralines will almost certainly be unable to achieve the WACC in DPP3 on an expectation's basis, with significant downside risks to a number of forecast elements. The CAPEX IRIS adjustment would further negatively impact on Centralines' performance by a significant degree.

In the following sections we address key elements of the components making up the revenue allowances in more detail.

3 Draft Decision para E73

Operating expenditure – calculation of real opex allowances

The Commission's model for calculating operating expenditure allowances is based on the following high-level approach:

$opex_t = opex_{t-1} \times (1 + \Delta \text{ due to network scale effects}) \times$
$(1 - \Delta \text{ opex partial productivity growth}) \times$
$(1 + \Delta \text{ input prices}) \pm$
Step changes

The Commission assumes that productivity growth will be 0% and EDBs will face no substantive step changes in their operating environment over the next five years. Accordingly, the model essentially collapses to an allowance for changes in network scale effects and price inflation.

As noted in Centralines' high level response, businesses with low growth in customer numbers or line length are disadvantaged by the opex growth model.[4] Although the Commission states that the econometric model under-pinning the scale adjustments explains 90% of the variation in operating expenditure between EDBs (para A71), we understand that more correctly it explains 90% of the variation in the log(opex), which is not the same thing. When converted back to the explanation of the variation in costs between EDBs at the absolute level (i.e., non-log form) there is substantial unexplained variation in opex. This means that in reality the model is not capturing drivers of operating expenditure that are unrelated to growth in line length and numbers of customers.

The Commission itself identifies that in DPP2, the opex adjustment model has significantly under-forecast growth in real aggregate opex by some $59 million to date (4.5% of total opex). However, no attempt has been made to address this, and therefore this error is likely to be continued in DPP3 – in fact it would be exacerbated by the Commission's draft decision to increase the estimate of opex partial productivity improvement to 0% from -0.25%.

A good example of the model's failure is how it fails to consider costs, such cyber security, that are unrelated to the number of consumers served or network length. These costs are increasing as businesses must invest in controls and protections to attempt to keep pace with ever-increasing cyber threats. Changes in cyber security costs have absolutely no relation to the number of consumers served or the length of the network, so are a non-scale effect. The Commission's models have no capacity to recognise such cost drivers or trends, unless they exceed 1% of revenue and are triggered by new Government legislation, or can be anticipated as a step change (with very restrictive criteria on what the Commission is prepared to include as a step change).

The step change allowance is an ineffective mechanism to address the myriad of factors that EDBs must address in the course of the five year regulatory period. Although in their own right, the following examples of additional expenditure requirements on EDBs over the next five years are likely to be small, they are likely to cumulate to material additional costs:

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4 In an annex to this submission, Centralines provides a revised statement of growth in line length, which addresses the current negative growth in line length used in the Draft Decision, but even with this adjustment real growth in opex allowances is expected to be very low.

1. The DPP3 proposals indicate both new disclosure and requirements, with consequential impacts on data capture, reporting and audit costs. These new costs to Centralines may be of the order $40-60k per annum.

2. Similarly, it is expected that there will be new costs on EDBs to meet the requirements arising from IPAG's recommendations to the EA. Again, these costs may be relatively small, but are uncompensated.

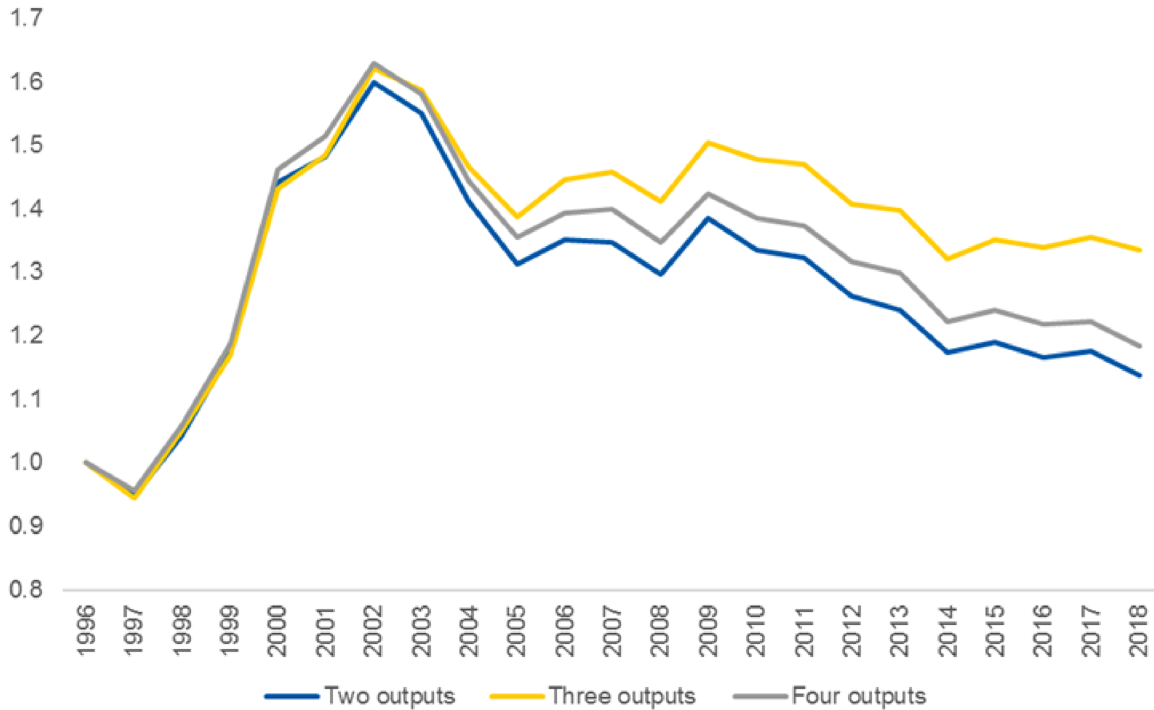
3. Recent changes in traffic management requirements arising from the lessons from the tragic deaths of three Higgins workers increase the timeframes for undertaking works as additional traffic management. Set-ups are required for even very minor jobs such as operating a switch on a road-side pole. In the scheme of existing costs, these may be relatively small, but once gain they are still uncompensated costs in the Commission's opex growth model.

4. Overall, the compliance burden on EDBs continues to increase incrementally, and it is only a rare occasion that compliance obligations reduce – in fact Centralines cannot identify a single piece of regulation or legislation applicable to Centralines that has been rescinded in the past five years.

Taking into account these factors, the only way that Centralines can expect to operate within the Commission's proposed opex allowance is to make offsetting efficiency improvements, or defer, or cease other activities to cover these new and increasing costs. Accordingly, we do not believe that the Commission is operating within the intent of the legislative framework whereby EDBs are required to share efficiency gains with consumers (section 52A(1)(c)). In effect, the Commission is using efficiency and productivity gains to fund new operating expenses driven by new requirements on the EDB: there is no sharing between consumers and EDBs.

Centralines has been provided with a copy of the NERA report on measured productivity trends experienced by EDBs. Their report identifies a clear and persistent trend decline in <u>measured</u> opex partial productivity that averages between 1.7% and 3.1% decline per annum since 2002, as illustrated in the following diagram reproduced from their report:

Figure: Distribution Industry Opex Productivity Indices (1996-2018)



Centralines does not consider it plausible that actual opex productivity has declined at these levels. The problem with the productivity measurement approaches for EDBs is that they cannot distinctly identify all the inputs that an EDB uses to deliver its services, nor all its outputs. For example, there is no doubt that advances in IT can assist in productivity improvements (e.g., easier data capture and communications etc), so there are almost certainly productivity gains being achieved by EDBs. The problem is that these gains cannot be disentangled from the other unmeasured changes in inputs and outputs in the productivity models. For example, if an EDB improves resilience by expending more on business continuity programmes, there is an increase in operating expenses. However, there are no increases in outputs, except potentially during a major natural disaster, so this would show up as a measured productivity decline. Accordingly, what the measured opex partial productivity data effectively shows is that the trend increase in obligations and other non-scale-related outputs are more than offsetting productivity improvements to the tune of 1.7 - 3.1% per annum. The trends are highly stable since the industry settled down after the structural separations at the end of the 1990s.

To address the inflexibility of the opex growth model to reflect the myriad small changes in the operating environment that are driving costs higher, Centralines suggests an amendment for the overall framework for setting opex allowances as follows:

$opex_t = opex_{t-1} \times (1 + \Delta$ due to network scale effects$) \times$
$(1 + \Delta$ due to other business impacts$) \times$
$(1 + \Delta$ input prices$) \pm$
Step changes

The term due to “other business impacts” would represent the combined opex partial productivity factor and other impossible-to-measure effects of business requirements not captured by changes in network scale. As noted above, the NERA study identifies that the trend in these

effects is of the order 1.7 – 3.1% per annum, so Centralines submits that the value for "other business impacts" should fall within this range. Importantly this adjustment term would recognise that the business environment impacting on EDBs is changing in multiple dimensions and this term provides compensation to EDBs for these rising requirements. Centralines submits that the selection should be from the upper end of the identified range, reflecting that EDBs are expected to face increased regulatory requirements and costs arising from:

1. Implementation of recommendations from IPAG, including increasing disclosure and network monitoring requirements;

2. Rising cyber security controls and protections to keep pace with increasing and changing cyber threats;

3. Pricing reform. These costs are not present in 2018/19 data, and this is expected to be a significant initiative between 2020 and 2025;

4. Rising costs of resilience. With Local Authorities increasingly turning their minds to community resilience, EDBs will be expected to play their part in engaging with their Local Authorities and Civil Defence agencies to address the effects of climate change and sea level rise;

5. Continuing increases in health and safety related costs. A significant factor that is starting to arise for EDBs is the need to address the increasing potential for back-feeds on to the low voltage networks from customers with their own generation. Additionally, EDBs are still working through the process of improving their asbestos management programmes under the Health and Safety at Work (Asbestos) Regulations 2016, and more generally the requirements on PCBUs as is being clarified by case law on health and safety prosecutions;

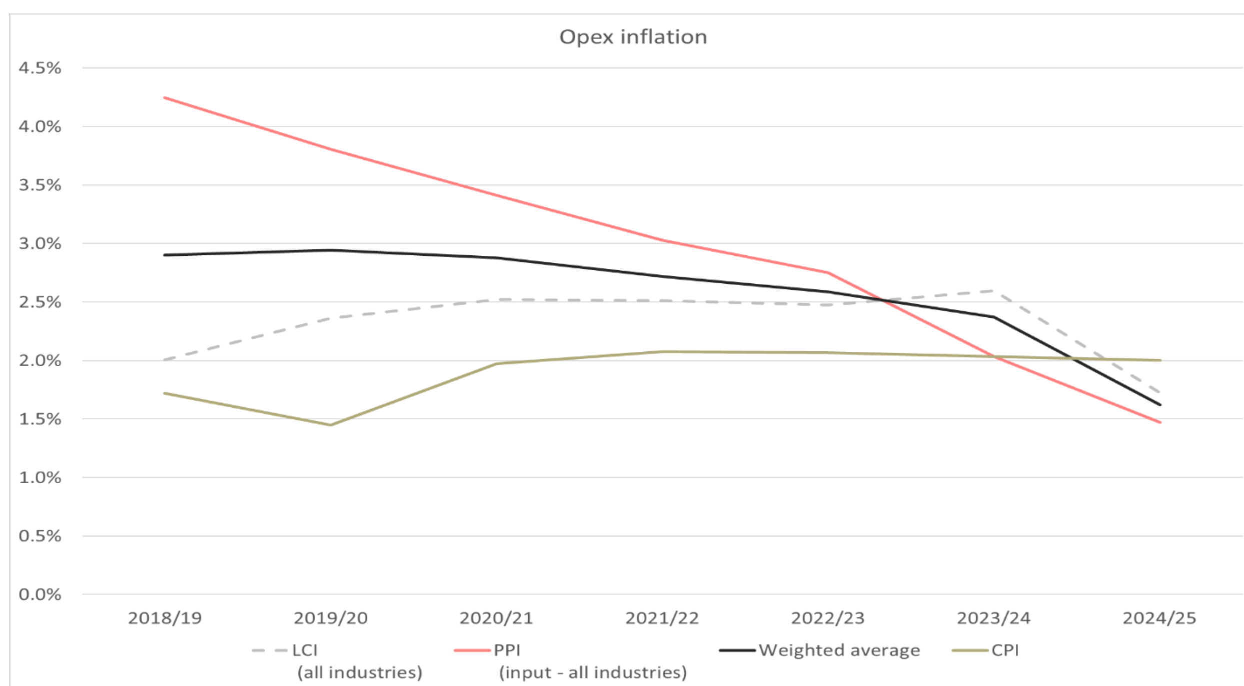
6. Insurance costs. For areas of New Zealand subject to greater risks of an earthquake, insurance costs are rising strongly; and

7. Increased requirements for consumer engagement by EDBs, modelled on regulatory requirements in other jurisdictions.

Overall, Centralines submits that the Commission needs to provide appropriate allowances for EDBs to meet the costs of changes in non-scale related variables. The NERA study provides compelling evidence that there is a long-term trend of rising opex due to non-scale-related requirements on EDBs of between 1.7-3.1% per annum. The Commission's proposal to adopt 0% as the partial productivity factor would suggest that something is about to change significantly in the New Zealand environment that would bring this long-term trend to a halt. Centralines submits that the Commission should make an evidence-based decision on how to accommodate "other business impacts", including the effects of productivity improvements. The NERA study provides a strong evidence basis for the Final Decision.

Operating expenditure – inflation allowances

The Commission's proposed allowances for opex inflation (based on NZIER forecasts) are as follows:



Without access to any commentary from NZIER on the drivers of these forecasts it is difficult to comment on how they have been derived.[5] Nevertheless, Centralines notes the following:

1. PPI forecasts in the short-term appear reasonable. We expect ongoing pressure on the New Zealand dollar and therefore tradeables inflation to be relatively high. We are unsure what drives the reduction in the longer term, but the dip below forecast CPI inflation in 2025 is surprising. Centralines requests that the Commission provide further information on the basis for the PPI forecast;

2. NZIER's all-industries LCI forecasts show very weak real wage growth, amounting to an average 0.3% per annum over the forecast period, and dipping below forecast inflation in 2024/25. Given the strong expected growth in demand for skilled electrical workers, an aging workforce, high level of unionisation of the workforce, and Powerco and Aurora CPPs creating additional demands, Centralines considers that the application of the all-industries LCI forecasts to EDB labour costs is inappropriate and almost certain to under-compensate EDBs for wage inflation. It is also unclear how NZIER has factored in the precedent impacts of public sector wage demands and rises in the minimum wage. **CCI [**

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3. Centralines also notes that Treasury's most recent BEFU forecasts wage growth to exceed 3% per annum over the forecast period. In addition, NZIER's most recent consensus forecasts similarly has private sector average hourly earnings growth at 3.2-3.3% per annum over the next three years.

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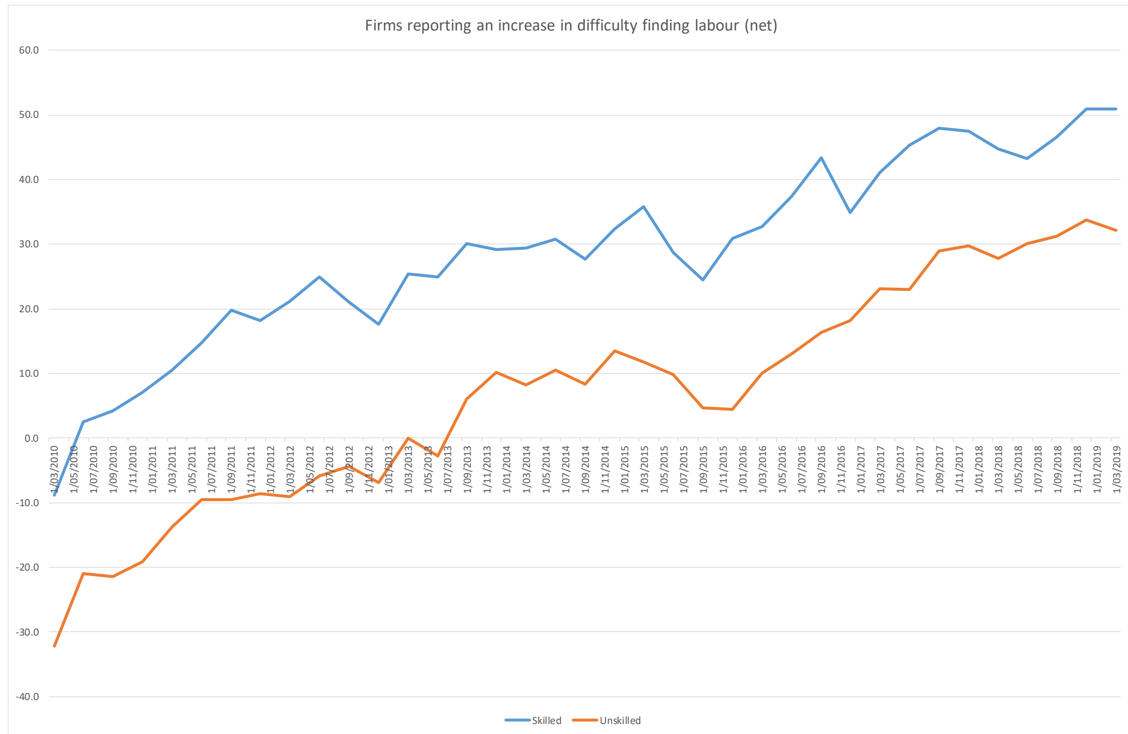
5 As a matter of transparency and the promoting an ability for EDBs to provide meaningful submissions, the Commission should provide the underpinning consultant reports and/or explanations for the basis of the forecasts

4. The following chart taken from RBNZ's most recent MPS shows the challenge for businesses of finding both skilled and unskilled labour – both at their highest levels in the last ten years. This suggests that there is likely to be a significant lift in wage inflation, particularly as the economy is effectively operating at full employment, with very high participation rates:



5. Centralines supports the Commission's use of NZIER as an independent forecasting agency to predict industry inflation growth. For the Final Decision, Centralines recommends that the Commission seek updated forecasts. Centralines also submits that the Commission seeks NZIER's expert opinion on whether any adjustments should be made to the all-industries LCI forecasts to account for the factors that Centralines has identified above. We do not think it is plausible that real wage growth will be negligible in an economy essentially at full employment, let alone in the environment confronting EBDs.

6. Centralines also questions the use of the LCI index as the basis for adjusting for input price inflation. The LCI is intended to be a measure of the change in the cost of labour that is required to produce the same quantity and quality of work, which is why it lags measured wage growth inflation. In comparison wage growth includes changes in the quality of employees. Centralines submits that measures such as private-sector wage inflation are more appropriate measures of the change costs that EDBs are likely to experience over time. The reality is that competency requirements grow over time (for example, line workers continue to grow competency around health and safety management, new methodologies for undertaking works, develop much greater IT skills to enable more effective asset information and data capture, etc). These quality improvements are real and required to run a modern EDB and are reflected in wage movements: EDBs pay wages, not "labour costs".

7. Centralines also recommends that the Commission ensure there is internal consistency between the CPI forecasts (which are based on RBNZ's forecasts and reversion to the mid-point of the policy targets for out-of-period forecasts) and the input price inflation

forecasts produced by NZIER. Potentially this may explain the reason that LCI and PPI inflation fall below CPI inflation in 2025.

Real capex allowances

The Commission proposes a five-step approach to setting capex allowances, involving various tests of proposed AMP expenditure applied to the different categories of expenditure.

At a general level, Centralines is supportive of the Commission's approach, including its use of forward-looking Asset Management Plans. However, the use of percentage caps relative to historical performance causes significant problems for small EDBs. For example, a $1 million switchboard replacement would represent 25% of Centralines annual capital expenditures, whereas for Unison, it would represent only 2% of their annual expenditure. Accordingly, when confronted with lumpy capital expenditure requirements which are invariant to EDB scale, small EDBs are disproportionately impacted and face the options of:

1. Applying for a CPP; or
2. Absorbing the excess in capex over the allowance; or
3. Taking more risk by cutting back other areas of expenditure.

Realistically, Centralines is not in a position to apply for a CPP (it does not have the resource capability to put together an application and Unison, Centralines Management Service provider, does not have the current capacity to provide this service), and very likely the costs of a CPP would exceed the reduced return under option 2. Option 3 would not be in the long-term interests of consumers, and is impractical, as Centralines could not temporarily lay-off workers while the one-off expenditures are being undertaken.

In Centralines' 2019 AMP we identify a required uplift in expenditure to build a new depot and administration building. These expenditures will push Centralines capital expenditure requirements above the 120% cap on total capex, and above the sliding scale cap on non-network capex expenditure. Centralines submits that the Commission needs to consider an alternative methodology that provides for smaller EDBs to reasonably undertake such activities without requirement to apply for a CPP. The same kind of expenditure in a larger EDB could be absorbed within a wider portfolio of investments. For example, we note that in the Gas DPP reset, businesses were able to furnish additional information to the Commission to substantiate their asset management plans where proposed expenditures exceeded a cap. Centralines submits that this type of approach should be available to small EDBs to ensure that they can undertake one-off investments without severe financial detriment[6]. We propose that as an additional step in the assessment process after the application of the 120% total cap:

> Where an EDB has provided in its AMP, or as separate information certified by its Directors, evidence of one-off projects that exceed 20% of annual capex, these projects will be included in the capex allowance. If the project does not proceed a capex wash-up will be required in the following regulatory period to eliminate the benefit to the EDB of the additional capex allowance.

Centralines submits that this approach would:

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6 Even taking into account the partial mitigation by the capex IRIS adjustment.

1. Limit the administration costs to the Commission of considering expenditures above the 120% cap;

2. Be in the long-term interests of consumers, by providing for small EDBs to undertake lumpy capital expenditure investments without needing to resort to a CPP;

3. Ensure that small EDBs are not unduly penalised by the 5-step assessment approach which relies on percentage comparisons rather than absolute expenditure levels; and

4. Appropriately protect consumers against one-off expenditure allowances that do not end up proceeding, or end up being deferred, because conditions do not materialise (e.g., forecast demand growth is slower than forecast).

In respect of Centralines depot project, Centralines effectively has little choice but to build a new depot and administration building for the following reasons:

1. The existing administration building and depot site have an inefficient layout and are unreasonably cramped;

2. It would be impractical (highly disruptive) to rebuild on the existing site because the main administration building must be demolished, whilst maintaining BAU functionality. It would be highly costly to temporarily relocate; and

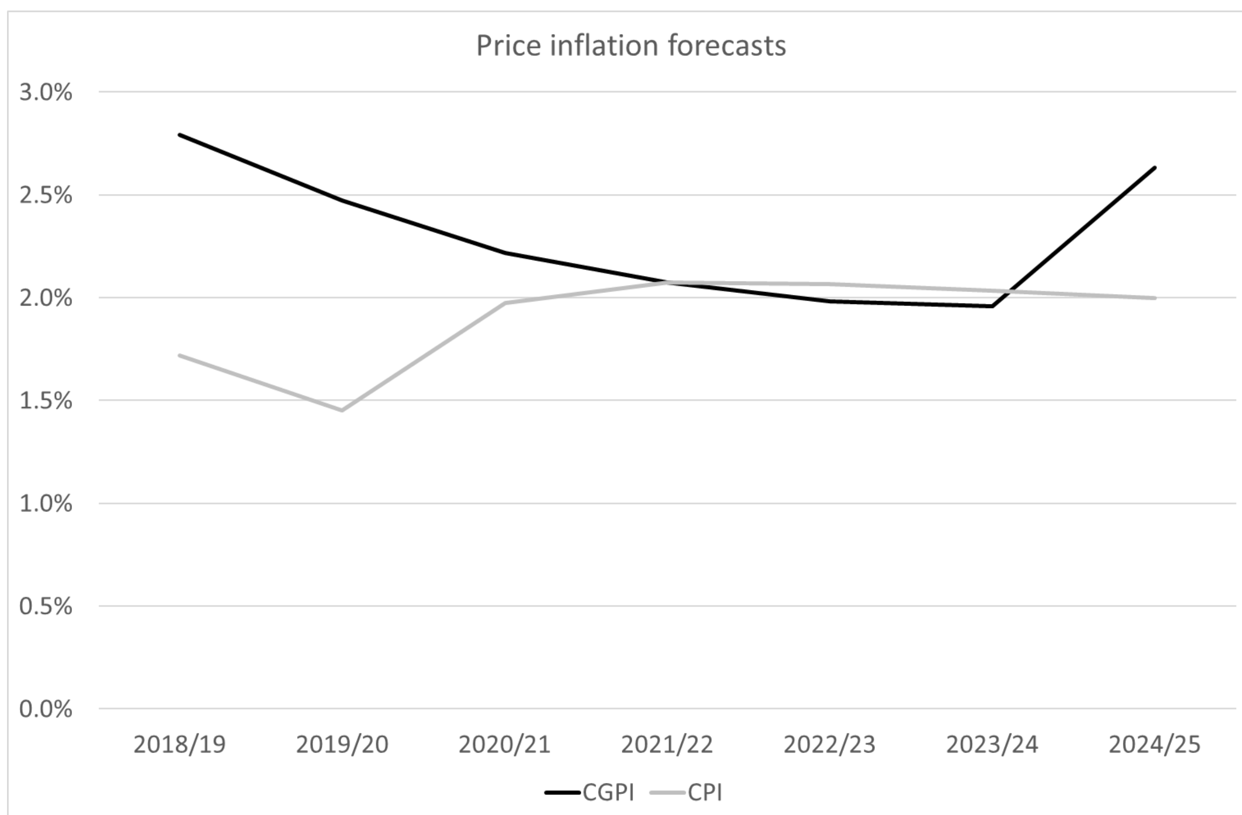
3. Access from the road on the southern boundary of the existing depot is to be designated as a State Highway, which will effectively limit site access and hamper site efficient operations.

Accordingly, Centralines has purchased an alternative depot site and is currently in the design process for a new administration building. There is 100% certainty that the project will proceed, although final construction costs are not yet known as the project has yet to be tendered.

In the 2019 AMP, Centralines has budgeted $6 million across 2019 and 2020 to construct the new depot and administration building.

Capex price escalators

The Commission relies on NZIER forecasts of CGPI inflation as follows:



In real terms NZIER's forecasts show a degree of real cost growth in 2021, slightly falling real costs in 2022-24, and an increase in 2025. Centralines does not consider that this is likely to be a credible pattern of CGPI movements because around 50% of capital works are comprised of labour costs. As noted earlier, Centralines considers that wage inflation for EDBs is not likely to be **CCI [ ]** per annum for several years. Again, Centralines submits that the Commission should seek updated forecasts for the Final Decision and make a specific request of NZIER to consider the factors impacting on the labour market confronting EDBs.

Capex IRIS adjustment and incentive rate

During DPP2 Centralines has materially underspent its Capex allowance, which would result in significant negative Capex IRIS adjustments during DPP3. The Commission's model suggests that these adjustments will amount to around $300k per annum from 2021 to 2025. However, as has previously been submitted to the Commission, Centralines has also significantly under-recovered relative to its allowed price path. In the most recent year, Centralines under-recovered its notional revenue allowance by $3.7 million, substantially more than necessary to offset the revenue benefits of the reduced capital expenditure.

There are various reasons for Centralines under-recovering its allowable revenues. But most significantly, Centralines considered the returns it was making on investment (i.e., reflecting the lower than forecast expenditure) and, more importantly the significant consumer hardship that would arise if Centralines priced up to its cap during DPP2. If Centralines took full advantage of its allowance, prices would have increased by around 40% in real terms over the DPP2 period.

A portion of the increase would have been recovered revenues that the Commission shifted from DPP1 and insisted that Centralines must either recover in DPP2 or forego completely. Centralines already has the third highest lines charges in New Zealand due to the geographic spread of its network and limited number of consumers. Under the CAPEX IRIS mechanism, despite Centralines substantially under-collecting its revenues, the Commission proposes that Centralines must incur the CAPEX IRIS adjustment and in effect refund customers money that it has not collected. This would clearly be a perverse outcome that the Commission surely cannot have intended.

At paragraphs E68 to E77, the Commission explains the reasons why it proposes not to make a change to the CAPEX IRIS adjustment for Centralines. It notes:

> E73 In assessing voluntary undercharging in DPP2, we considered that a change was not appropriate. We consider that it should be known what rules were in place during DPP2, so any undercharging should have been undertaken anticipating the incentive outcome. In the case of Centralines, we cannot be sure there was a direct link between the undercharging and lower capex spend, or whether the undercharging was for other reasons.

Centralines submits that the Commission's approach is inconsistent with the long-term interests of consumers. Centralines rightly considered the consumer hardship of increasing its charges, and determined that it would be unreasonable to lift charges given the adequacy of the returns it was earning, and the impact it would have on the community. For the Commission to suggest that Centralines should ignore the interests of its community, to essentially save-up the consequential IRIS effects and then refund them to consumers in DPP3, suggests a focus on implementation of rules and not the genuine long-term interests of consumers.

In addition, on 20 June 2018, the Commission advised[7] that it had calculated that Centralines would incur capex IRIS incentive payments of between $105-127k per annum. The Commission's calculated payments were much lower than what Centralines had calculated, and what the Commission's model now estimates is $300k per annum. The Commission also stated that it would respond to Centralines on how it would address the anomalous outcome of refunding customers money it had not collected; however this guidance has not been provided to date. Centralines is now in a position where it cannot adjust its 2019 prices to accumulate an offset to the CAPEX IRIS adjustment, which is a significant procedural unfairness to Centralines.

Centralines submits that the only reasonable outcome is to adjust Centralines' revenue allowance to offset the capex IRIS adjustment. We note that the Commission has stated that it would make a step change adjustment for any EDB that has included pecuniary penalties in opex to ensure that the opex IRIS mechanism does not allow the EDB to pass-through 74% of the penalty to consumers – an outcome that it considers would be perverse (para A60). Centralines submits that it would be similarly perverse for the Commission to insist Centralines provides refunds to consumers for money it has not actually collected. A step change should therefore be provided on the same basis.

At a more general level, Centralines is becoming increasingly concerned that the Commission views the Capex and Opex IRIS adjustments as a basis for taking the risk on under-compensating EDBs through capex and opex allowances, because in the event that costs are not accommodated in the opex and capex allowances, the EDB "only" bears 26%[8] of the lifetime NPV

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[7] Email from Simon Wakefield to Nathan Strong.

[8] At the current WACC.

cost. Centralines strongly submits caution in respect to this approach as it undermines confidence that the Commission will provide a regulatory environment where EDBs can, on an expectations basis, achieve its WACC.

Centralines is also unsure that the Commission's objective of achieving neutrality between opex and capex incentives will be achieved by setting the capex retention factor equal to the implied share of NPV benefits retained by an EDB with a permanent opex saving. In particular, we note that the method for setting capex allowances permits growth in allowed capex above historic levels of up to 20%, whereas opex allowances are anchored to historic expenditure levels. Accordingly, it would be financially disadvantageous to procure network alternatives, compared with network investments. We also note that at DPP4, the WACC is more likely than not to increase, so it is not clear that a 26% capex retention factor determined by the current low WACC neutralises opex-capex trade-offs.

Innovation allowance

The Commission proposes an innovation allowance of 0.1% of revenues, subject to the EDB contributing an equal amount and having an engineer verify the innovation. For Centralines, the innovation allowance would amount to $10,000 per annum, which would be insufficient allowance to fund any innovation project, let alone make any contribution to an engineering report.

Realistically, Centralines is a "follower" and supports the ENA's proposals for pooling of the innovation allowance and allowing for centralised innovation projects with lessons shared with project contributors.

QUALITY STANDARDS AND RELIABILITY INCENTIVES

Centralines notes the extensive changes proposed to the quality standards and reliability incentives. We acknowledge the work the Commission has carried out to address many of the issues raised by the ENA's Quality of Supply Working Group. Nevertheless, Centralines is concerned that the proposals have been too heavily influenced by an interrogation of the historical reliability data. While this is important and necessary, we are concerned that this has not been balanced by engineering and network operations considerations. It is quite possible that the proposals are an improvement over DPP2, but as there are many novel and untested aspects, there exists the potential for significant risks and unintended consequences. For example, as there are significant penalties for breach of the quality standards, there is a risk that the proposals will drive risk aversion and approaches on the part of EDBs which are not in the long-term interests of consumers.

Additionally, the complexity of the proposed new approaches has meant that even at this point we are not sure we fully understand the new approaches, especially the new approach to normalisation of major events. Centralines considers there is real need for further industry workshops for the Commission to explain the approaches, including how they link into the wider framework and enforcement criteria.

The ENA has made extensive submissions on the proposed changes to the quality standards and reliability incentives. Centralines restricts its comments to key matters of concern. These are:

1. Centralines strongly supports the Commission's proposals to limit changes in unplanned SAIDI and SAIFI incentives to a maximum of 5%. From Centralines perspective, although reported performance during DPP2 has seen a significant improvement relative to the prior reference dataset, we see this as a result of a relatively benign period of weather impacting the Centralines' network. It has avoided significant effects from all major storms such as Cyclone Cook, for example. Though the network is performing well, Centralines does not consider that there has been a material improvement in the quality of the network or any major improvements in operational performance (e.g., fault response). Accordingly, if weather patterns return to more normal levels of variation, Centralines would expect performance to be more consistent with the existing targets. Notably, the proposed targets and limits are much closer to Unison's, which is unexpected. More rurally-based networks, such as Centralines, would be expected to have much higher levels of SAIDI and SAIFI as inherently there is much less potential to economically build redundancy into the network or have higher levels of interconnection.

2. Centralines strongly supports the ENA's recommendation that planned outage standards be based on a five-year reference dataset. More recent planned outage performance is likely to be a better indicator of requirements to undertake planned work than performance ten years ago. In addition, more recent data will better reflect changes in operating practices that have been required to meet the requirements of the Health and Safety at Work Act.

3. Centralines has strong reservations about the proposed new approach to normalising major events based on three-hour rolling windows. It appears to be based on a data-mining approach, rather than the engineering / operational considerations underpinning the IEEE standard. We are concerned that it may not appropriately normalise major events that impact over more than three hours. Also, that it does not account for the

operational impacts of initial storm responses on capability to respond to subsequent outages, where response potential is reduced because of mandatory employee stand-down requirements following extended hours of work. The three-hour approach may even drive perverse prioritisation of responses. For example, the de-prioritisation of repairs for outages triggered in the initial three-hour block compared to outages occurring outside the normalisation window. Although, that would be the logical commercial response to minimise SAIDI penalties, such behaviour would not coincide with the interests of consumers. Centralines favours use of the IEEE standard, including adhering to the requirement of the standard to exclude major events from the normalised dataset completely and addressing major events separately.

4. Centralines does not support the proposal to move to an annual assessment process for breaches of the unplanned SAIDI and SAIFI limits. Reliability does not "materially deteriorate" within a year. The Commission's proposal is likely to generate significant numbers of false positives and therefore costly investigations. Centralines supports the status quo of two-out-of-three year assessment approach.

5. Centralines does not support the proposed new extreme event standard. To understand the Commission's view, Centralines requests that the Commission provide more detail on the basis for the proposal and the engineering considerations that underpin it. As a rurally-based network, facing significant challenges associated with managing affordability for its consumers, Centralines is concerned that it may need to over-invest to avoid risks of breach. We note that exceeding quality standards is a contravention of the Commerce Act, and without any understanding of the Commission's enforcement criteria for exceeding the standard, creates significant uncertainty for businesses. We support the ENA's proposals for additional reporting on such events, noting also that they are subject to the reliability incentive payments, so EDBs do have an incentive to avoid them.

Overall, while there are some aspects of the proposals that Centralines supports such as separate treatment of planned and unplanned outages, and the Commission's intent to reduce the impact of major event days, Centralines expresses reservations that the practical implementation of the proposals may result in significant un-intended consequences.

Centralines submits in the strongest possible terms that the Commission urgently explains its enforcement criteria and breach assessment methodology. Although the overarching standard has been stated as seeking "no material deterioration" in reliability, our interpretation of the enforcement actions to date is that if external factors are causing SAIDI and SAIFI to deteriorate, then EDBs must improve their networks or operational performance to counteract those external effects. However, as operating expenditure allowances are anchored in historical expenditure levels, EDBs facing a deteriorating operating environment have no additional financial resources to respond. The focus of engineering investigations also appears to have been on whether an EDB has met the standard of "good industry practice", rather than whether there has been a "material deterioration in reliability", so Centralines is highly confused by what the standard really is. Centralines recommends that the Commission consult on and release enforcement guidelines and assessment criteria with the Final Determination.

CONCLUDING COMMENTS

In conclusion, Centralines is highly concerned that the Commission's proposals will not provide EDBs with reasonable opportunity to earn their cost of capital over the coming regulatory period. We appreciate that DPP regulation is challenged in quantifying forward-looking expenditure allowances that take account of the changing environment. Nevertheless, we believe there is clear evidence to support a view that the obligations and pressures on EDBs are increasing, not decreasing, relative to DPP2. The NERA report provides a strong evidence base to make an appropriate adjustment to real opex forecasts to accommodate the net trend in productivity improvements and other non-scale factors that have driven overall EDB opex levels higher.

We reiterate our commendation that the Commission has invested significantly in developing proposals to improve on the quality standards and reliability incentives operating within DPP2; but recommend that the Commission engage further with the ENA's Quality of Supply Working Group to ensure that the statistical analysis underpinning the draft decisions is appropriately balanced by operational and engineering considerations.

We would be happy to discuss any of the points made in this submission with the Commission, and hope that the points made provide useful guidance to the Commission in the process of finalising its decisions.

Yours sincerely,

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE