



Submission to Commerce Commission

Default price-quality paths from
1 April 2015 for 17 electricity
distributors

Submission in respect of:

Proposed default price-quality paths for electricity distributors from 1 April 2015,
Proposed compliance requirements for the 2015-2020 default price-quality paths for electricity distributors,
Proposed amendments to Incremental rolling incentive scheme,
Proposed quality targets and incentives for default price-quality paths from 1 April 2015,
and related documents

29 August 2014

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1. Executive Summary

1. Eastland Network Limited (“Eastland”) appreciates the opportunity to respond to the Commerce Commission’s (the “Commission”) default price path decision, proposed input methodology (“IM”) amendments and other related documents. Due to the extent of the matters subject to consultation in respect of the default price-quality paths to apply from 1 April 2015, we have combined all our submission points into this single document.
2. We recognise that some matters covered in this submission relate to aspects included in the initial papers released on 4 July 2014, and hence are being submitted after the specified submission date. We consider that a number of the matters raised in the main policy paper of 4 July 2014 are inter-related to matters raised in the subsequent release of papers on 18 July 2014, hence we have sought to coordinate and combine our submission. We consider this to be a constructive approach to dealing with a significant volume of material with limited resources, and we wish for our submission to be considered by the Commission with this in mind.

Default price paths

3. Eastland considers that the costs of owning and operating assets that are transferred prior to the beginning of the regulatory period should be reflected in the price path. Inclusion of these costs will ensure that the incentives to undertake these transactions are not diminished.
4. We support the Commission’s proposal to include in the price path the forecast value of spur assets purchased in the final year of the current regulatory period and we also support the proposal to include forecast capex that is associated with the spur assets transferred prior to the regulatory period.
5. However, we disagree with the proposal to exclude from the price path the forecast opex for spur assets transferred after the beginning of the base year. We consider that the proposed approach will result in an inconsistent allowance for opex associated with spur assets transferred prior to the regulatory period. The result is that some spur asset transfers will not gain any opex in the price path for the forthcoming regulatory period.
6. We submit that the electricity network business’s (“ENB’s”) forecast opex associated with spur assets acquired prior to the commencement of the regulatory period should be included in the price path.

Calculation of ACOT

7. The Commission’s proposed process for calculating the avoided transmission cost allowance following a spur asset transfer introduces unnecessary complexity. In particular, the proposal to hold avoided transmission costs constant in nominal terms in years two to five (of the avoided transmission cost recovery period) is inconsistent with the policy intent for incentivising spur asset

transactions, which is to provide an incentive equivalent to the avoided Transpower charges. We submit that the current approach achieves reasonable outcomes and we consider it should be retained.

Compliance requirements

8. The Commission's proposed *ex ante* approval for new investment charges paid to Transpower, and ACOT allowances arising from spur asset transfers will add complexity and compliance costs, and increases uncertainty for no apparent benefit. We submit that an *ex post* approval process, consistent with that currently required, is sufficient for these costs.

Incremental rolling incentive scheme

9. As mentioned above, we submit that ENB's spur asset opex forecasts should be included in the price path where the assets were purchased prior to the commencement of the regulatory period. If, however, the spur asset opex forecasts are excluded from the price path (as currently proposed), the opex IRIS would treat expenditure on spur assets as inefficient. Without prejudice to our primary position in respect of the inclusion of spur asset opex in the price path, should the Commission not include this opex in the price path, we submit that expenditure on spur assets should be excluded from the opex IRIS for the regulatory period where no spur asset opex has been included in the price path. This avoids the inappropriate treatment of such expenditure as inefficient.
10. The proposed opex IRIS does not differentiate between increases in expenditure that are inefficient and increases in expenditure that are due to quality improvement initiatives. We submit that any increase in expenditure required to meet, or improve, quality should not be included in the opex IRIS as we do not consider this type of expenditure to be "inefficient". We consider that the extent of the additional expenditure could be requested as part of the IRIS assessment (and would be subject to Director certification and audit).
11. The proposed capex IRIS does not take into account the uncontrollable and variable nature of consumer connection capex (and capital contributions and vested assets). The impact on actual capex (and capital contributions and vested assets) due to new industrial connections can be material for small ENBs due to the scale of connection costs and the inability for ENBs to forecast these costs. Eastland submits that forecast and actual capex in relation to consumer connections (and capital contributions and vested assets) should be excluded from the capex IRIS assessment.

Quality incentive scheme

12. We consider that the reliability targets should be set to reflect the underlying network reliability and that the measurement of reliability should seek to reveal the underlying reliability outturn. That is, target setting and measurements should not be unduly influenced by extreme weather or high consequence and low probability events.

13. We consider that the scheme presently proposed by the Commission is heavily influenced by the frequency of major event days and that high consequence and low probability events will not be properly normalised.
14. We submit in support of the approach proposed by the ENA in respect of normalising reliability data, specifying targets, determining the revenue at risk, specifying caps, collars and incentive rates. In our view, and as demonstrated in the body of this submission, the ENA proposal is more effective at revealing performance trends, and the ENA approach to non-compliance is more effective at identifying trends in poor performance.
15. We do not support the proposed compliance and enforcement standards for the quality incentive scheme as, in particular, it materially increases regulatory uncertainty and it is inconsistent with the serious consequences for non-compliance with price-quality regulation within the Commerce Act.
16. Eastland submits that non-compliance with the quality standards should be determined where annual performance exceeds the cap (on either measure), two out of three years in a row. This appropriately seeks to identify material deterioration in performance.
17. We also submit in support of the proposal to adjust targets following the purchase of spur assets. Historical reliability for spur assets (for the same measurement period as used to determine the proposed target) should be included when setting revised targets.
18. We note, and support, the ENA proposal in respect of normalising the major event day ("MED") through the use of the daily average as the normalisation factor. In our view this approach more effectively normalises for low probability and high consequence events associated with transmission outages (this is a significant issue for Eastland as 75% of Eastland's consumers are supplied by one double circuit 110kV transmission line).

2. Introduction

Introduction to Eastland Network

19. Eastland owns and operates the electricity distribution network located in the upper East Coast of the North Island. Eastland is 100% owned by the Eastland Community Trust with the Gisborne District Council as the capital beneficiary of the trust.
20. Eastland distributes approximately 280 GWh of electricity to approximately 25,000 consumers of which almost two thirds are located in Gisborne City and Wairoa township. The remaining consumers are widely dispersed across two isolated networks covering approximately 12,000km². This results in an overall consumer density of 7 connections per circuit km, less than the industry average of 13 connections per circuit km and the industry median of 9 connections per circuit km. Eastland has considerable diversity across the network, with rural connection density less than 3 connections per km, and urban connection density approximately 25 connections per km.
21. We have experienced little growth for the past decade, as most of our consumers are domestic users, and many of them with relatively small consumption. A significant proportion of our revenue is recovered via variable tariffs. In addition, our network supply area is one of the lowest socio-economic regions in New Zealand, and this is reflected in low energy consumption growth due to resistance to retail electricity prices.
22. We are working with Transpower New Zealand Limited (“Transpower”) to conclude the sale and purchase of the transmission spur assets (“spur assets”) that connect the Eastland network to the core transmission grid. The transaction is material for Eastland in respect of the value of the spur assets and their impact on the security of supply to the region. The settlement date for the transaction is planned for 31 March 2015.
23. The transfer of the spur assets will provide benefits to Eastland consumers over the long term through a combination of:
 - (a) A lower overall cost of operating the combined assets;
 - (b) Greater optimisation of capital expenditure (across transmission, distribution, and embedded generation); and,
 - (c) Improved reliability.
24. Achieving efficiency gains and reliability improvements is not without risks, hence appropriate incentives need to be maintained for these types of transactions to occur.

The focus of this submission

25. The purpose of this submission is to highlight certain aspects of the Commission's proposals that could have a material impact on the spur asset acquisition and/or assessment of quality performance. In particular we have submitted on:

- Inclusion of Spur Asset values, opex and capex;
- Calculation of ACOT in respect of spur asset purchases;
- Approval for transmission recoverable costs;
- Impact of opex IRIS on spur assets;
- Impact of opex IRIS on reliability improvement expenditure;
- Impact of uncontrollable consumer connections on capex IRIS;
- Normalisation of quality data;
- Accounting for the impact of spur assets on quality assessment;
- Quality assessment compliance issues.

Support for other submissions

26. In addition to the detail provided in this submission, Eastland Network has read and supports the submissions prepared by the ENA and PwC in respect of the proposed default price-quality paths for electricity distributors from 1 April 2015, proposed IM amendments, and other related documents.

3. Proposed default price-quality paths for electricity distributors from 1 April 2015

Incentives for the purchase of spur assets from Transpower

27. The Commission considered the acquisition of spur assets when it developed the IMs in 2010. The Commission considered that it was in the long term interests of consumers that electricity network businesses (“ENBs”) were incentivised to acquire assets from Transpower, as customers were likely to benefit from lower overall electricity prices as a result. The incentive to acquire assets from Transpower comprised:
- (d) EDBs being able to continue to pass through the avoided Transpower charges associated with the spur assets for a period of five years (known as avoided cost of transmission or “ACOT”);¹ and,
 - (e) EDBs being able to recover a return on, and of, capital and operating costs from the date of the first regulatory reset following the asset transfer.²
28. The Commission also considered the treatment of spur asset transfers in its determination of Orion’s customised price path (“CPP”). In this determination the Commission included spur asset RAB, opex and capex in the price path for Orion where the spur asset transfer occurred prior to the commencement of the CPP regulatory period.³ Orion was also allowed to recover ACOT from customers for five years.⁴ This approach was consistent with its previous input methodology reasoning.

Inclusion of spur asset value, opex and capex

29. Eastland considers that the costs of owning and operating assets that are transferred prior to the beginning of the regulatory period should be reflected in the price path. Inclusion of these costs is consistent with the Commission’s previous reasoning and ensures that the incentives to undertake these transactions are not diminished.
30. Hence, we:
- (a) Support the proposal to include forecast asset values for spur asset purchases undertaken in the final year of the current regulatory period;

¹ Refer paragraphs J2.24 to J.2.26 of the 2010 input methodologies reasons paper.

² Refer paragraph J2.27 of the 2010 input methodologies reasons paper.

³ Refer to paragraphs M4 of the Commission’s reasons paper for setting the CPP for Orion. Also refer to Orion’s CPP proposal for the inclusion of opex and capex associated with the spur assets (refer pages 515, 549, 557 as examples of where expenditure in relation to the spur assets was included in their proposal).

⁴ Refer to paragraphs M5 of the Commission’s reasons paper for setting the CPP for Orion.

- (b) Support the proposal to include forecast capex that is associated with the spur assets transferred prior to the regulatory period;
- (c) Disagree with the proposal to exclude from the price path the forecast opex for spur assets transferred prior to the regulatory period. The Commission is proposing that the current opex forecasting method will apply, which results in spur asset opex only being included in full where the acquisition occurred prior to 01 April 2012. We consider that the proposed approach will result in an inconsistent allowance for opex associated with assets transferred prior to the regulatory period. The result is that some asset transfers will not gain any opex allowance in the price path for the regulatory period.
- (d) Submit that forecasts of spur asset opex should be established using information already provided by the ENB under the s54ZD submission.

31. We note the Commission is proposing to make the inclusion of capex conditional on the forecasts aligning with Transpower's plans. In most cases we would expect ENB's forecast capex to be similar to that of Transpower. In the case of Eastland Network, we adopted Transpower's forecasts, with some minor adjustments that were recommended following independent review during due diligence. We consider that the approach we followed was appropriate to establish capex forecasts.

Process to calculate ACOT in respect of spur assets purchases

32. The Commission proposes a new process for calculating the avoided transmission cost allowance following a spur asset transfer, whereby:

- (e) Transpower calculates a counterfactual cost by running its pricing analysis assuming the assets are not transferred;
- (f) The difference between the counterfactual and factual (i.e: with the assets transferred) determines the recoverable costs for year one;
- (g) The cost for years two to five should be the same cost as in year one, held constant in nominal terms.

33. The proposal to hold recoverable costs constant in nominal terms in years two to five is inconsistent with the policy intent (refer to paragraph 27), which is to provide an incentive equivalent to the avoided Transpower charges.

34. We submit that the current approach achieves reasonable outcomes and we consider it should be retained.

4. Proposed compliance requirements for the 2015-2020 default price-quality paths for electricity distributors

Ex-ante approvals for transmission recoverable costs

35. The Commission proposes that *ex ante* approval is gained for new investment charges paid to Transpower, and ACOT allowances arising from spur asset transfers. The process also requires ENBs to provide certain documentation in support of the approval.
36. We are not aware of, nor has the Commission presented, any problems which would justify the need for an *ex ante* review of these costs. The proposed approach will add complexity and compliance costs, and increases uncertainty for no apparent benefit.
37. We do not consider that *ex ante* approval is required as there are specific definitions in the IMs in respect of recoverable costs whereby Directors and auditors can appropriately assess evidence (against those definitions) in respect of new investment charges paid to Transpower, and avoided transmission costs arising from spur asset transfers.
38. We submit that an *ex post* approval process, consistent with that currently required, is sufficient for these costs.

5. Proposed amendments to IMs: Incremental rolling incentive scheme

Impact of opex IRIS on spur assets

39. The Commission's current proposal is to exclude some, or all, spur asset opex from the price path where the spur asset purchase occurred after the commencement of the base year. We disagree with this approach and submit that ENB's spur asset opex forecasts should be included where the assets are purchased prior to the commencement of the regulatory period (refer to paragraph 30). If this approach is adopted, then the IRIS will operate as intended in respect of spur assets.
40. However, if as currently proposed, the forecast spur asset opex is excluded from the price path, then the opex IRIS will treat spur asset opex as "inefficient". That is, the proposed IRIS does not adjust for actual expenditure relating to spur assets in the regulatory period (where no spur asset opex has been included in the price path). Without prejudice to our primary position in respect of the inclusion of spur asset opex in the price path, should the Commission not include spur asset opex in the price path, we submit that the opex associated with spur assets should be excluded from the opex IRIS for the regulatory period in which no spur asset opex has been included in the price path. This avoids the inappropriate treatment of such expenditure as inefficient. We do not believe that treating spur asset opex as inefficient is the intent of the scheme.
41. ENB's spur asset opex forecasts have been provided to the Commerce Commission in the 2014 asset management plan and in the s53ZD information requests.

Impact of opex IRIS on reliability improvement expenditure

42. As the Commission will be aware, Eastland breached its quality path in 2011 and 2012. We have treated this matter seriously and we are implementing a number of projects to improve reliability. However, the forecasts that will be used in the opex IRIS model (and in price path) will cause Eastland to face "inefficiency" penalties in respect of the additional opex⁵. In our view, any additional expenditure required to meet, or improve, quality should not be included in the opex IRIS as we do not consider this type of expenditure to be "inefficient". We consider that the extent of the additional expenditure can be submitted as part of the IRIS assessment (and hence will be subject to Director certification and audit).

Impact of capex IRIS due to uncontrollable capex

43. The proposed capex IRIS does not take into account the uncontrollable and variable nature of some capex categories. In particular, consumer connection capex (and capital contributions and vested assets), can vary materially as a result of third party requests for connection. The impact on capex due to new industrial connections can be material for small ENBs due to the scale of connection

⁵ Strata Energy Consultants, "Report on the performance of Eastland Networks Limited", 09 July 2013, paragraph 14 (a) – (g).

costs (relative to the underlying, and more consistent, residential and commercial connection costs) and the inability of ENBs to accurately forecast these costs. By way of an example, since the beginning of August 2014 Eastland has been made aware of two proposals that will require significant capital investment in excess of \$1 million each (which, if both projects eventuated, would result in a 600% increase in forecast consumer connection costs⁶). Should these projects eventuate, Eastland will be adversely penalised under the capex IRIS scheme.

44. Eastland submits that forecast and actual capex in relation to consumer connections, capital contributions and vested assets, should be excluded from the capex IRIS assessment.

⁶ Including consumer connection, capital contributions and vested asset expenditure forecasts.

6. Proposed quality targets and incentives for Default Price-Quality Paths from 1 April 2015

Normalising is important to reveal the underlying (non-severe weather related)

45. Reliability performance is influenced by many events that are outside the control of ENBs. Hence it is appropriate for reliability measurement to normalise for the impact of such events, in order to derive a measure of underlying reliability performance. We consider that the reliability targets should be set to reflect the underlying network reliability and that measurement of reliability should also seek to reveal the underlying reliability outturn. That is, the target setting and measurements should not be unduly influenced by extreme weather or high consequence and low probability even
46. We consider that the scheme presently proposed by the Commission is heavily influenced by the frequency of major event days and that high consequence and low probability events will not be properly normalised.
47. It is our view that a scheme which is unduly influenced by the weather, and which does not effectively normalise for high consequence and low probability events, does not meet the underlying objective of revealing underlying reliability issues in such a way that deterioration in performance can be monitored (and penalised if the circumstances warrants).
48. We also do not support the proposed pro-rata adjustments for prior period breaches. This proposal unduly increases compliance and financial risks where no fault or negligence on the behalf of the ENBs concerned has been determined⁷.

The ENA methodology reveals underlying reliability trends better

49. We have analysed the ENA and Commission proposed methodologies for normalising the data and determining target reliability. We analysed the historic SAIDI performance compared to historic interruptions per 100km caused by defective equipment.⁸ Our analysis is illustrated in the Figures below. The significant result is that the ENA normalisation method has a correlation coefficient of 0.84 (between normalised SAIDI and defective equipment interruption rate) whereas the Commission's method has a correlation coefficient of 0.66.
50. The ENA correlation can be considered strong, and the Commission correlation can be considered moderate. Hence, we submit that the ENA methodology is better at revealing the underlying asset failures, and hence more appropriate in terms of revealing underlying reliability performance of the assets.

⁷ Commerce Commission, "Summary of the Commission's enforcement decisions in response to non-compliance with the default price-quality path quality standards for electricity distributors for the 2012 assessment period", 26 June 2014.

⁸ Our analysis of defect equipment was limited to interruptions (not all faults) as we used the Commission's 2005 to 2014 data set. We do not consider that there will be a material difference between interruptions and faults given the largely N network security across the Eastland Network.

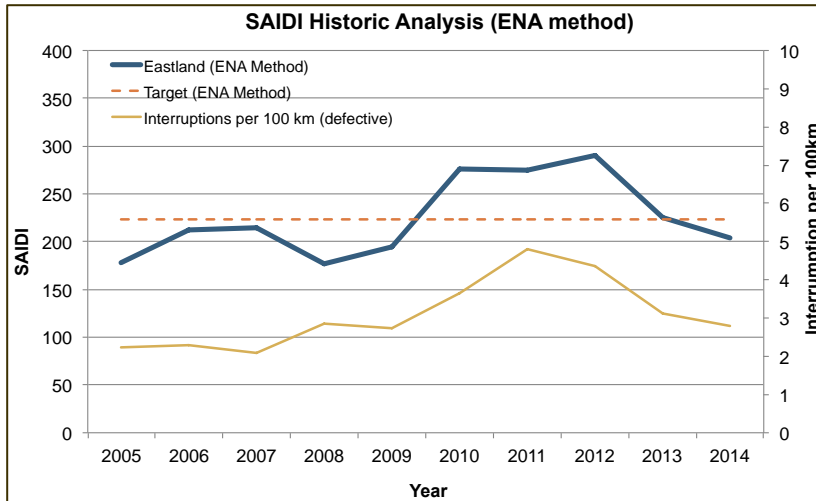


Figure 1: Historic analysis of SAIDI (using the ENA methodology) and defective equipment interruptions

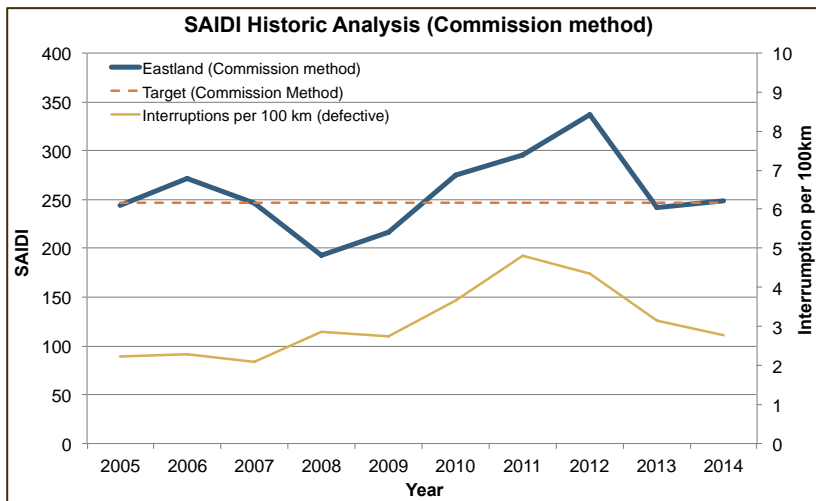


Figure 2: Historic analysis of SAIDI (using the Commission's methodology) and defective equipment interruptions

51. We also analysed the cause of interruptions during MED (using the ENA methodology) and this revealed that only 12% of interruptions in major events were as a result of defective equipment. We consider that this supports the view that the ENA MED methodology is not unduly impacting underlying asset reliability measurement.

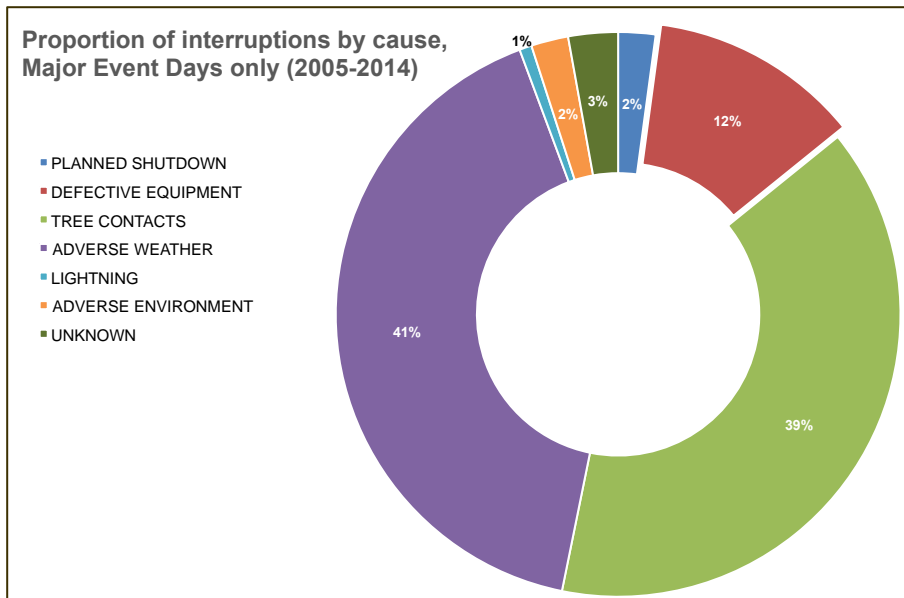


Figure 3: Analysis of fault cause for MED interruptions

52. We note, and support, the ENA proposal in respect of normalising the major event day (“MED”) through the use of the daily average as the normalisation factor. In our view this approach effectively normalises for low probability and high consequence events associated with transmission outages. This is a significant issue for Eastland as 75% of Eastland’s consumers are supplied by one double circuit 110kV transmission line.
53. We also note the alternative approach included in the ENA submission. Unfortunately at the time of drafting this submission we have not fully considered this approach.

Adjusting quality targets for the impact of spur assets

54. The Commission proposed to adjust quality targets for spur assets purchased. We support this proposal as ENBs will take on responsibility for the performance of those assets, once ownership is transferred.
55. We are expecting the Commission to adjust quality targets for spur assets which have been, or are forecast to be, transferred prior to the regulatory period. We submit that historical reliability data for spur assets (for the same measurement period as used to determine the proposed target) should be included when setting revised targets
56. An adjustment for assets which are forecast to be transferred in the final year of the current regulatory period, where the transaction does not occur, could be introduced, similar to the proposed asset value wash up.

Compliance issues

57. In terms of assessing compliance with the quality scheme, the Commission currently propose that performance above target is deemed non-compliant, but where no enforcement action would be taken where performance is under the cap, except in exceptional circumstances.
58. In our view this greatly reduces regulatory certainty and introduces a significant risk of not complying on either target in each year. The historic analysis (refer to Figure 1 and Figure 2 above) supports this assessment.
59. We strongly oppose this proposed approach to determining compliance with the quality standard we consider it to be inconsistent with the intent of the scheme which is to allow choice (with financial consequences) to operate above or below the target, to better reflect how consumers value reliability, and it reduces regulatory certainty, as (assuming annual performance is symmetrical around the average) half of the ENBs will be non-compliant every year, on each measure.
60. We submit that the proposed compliance standard is unreasonable, and inconsistent with the serious consequences set out in the Act for contravening price-quality regulation.⁹
61. We also submit that the quality incentive cap is the appropriate benchmark to assess non-compliance subject to the application of the two out of three year test (applied across SAIDI and SAIFI measures) that is currently employed.
62. We consider that the two out of three year test is particularly necessary to identify material deterioration and provide an appropriate “filter” for low probability and high consequence events that are not linked to underlying asset reliability. We consider that this test has worked reasonably well in the current regulatory period.

⁹ Part 4 of the Commerce Act sets out the penalties for suppliers who contravene the requirements of applicable price-quality regulation.