Submission

Commerce Commission: Default price-quality paths for electricity distribution businesses from 1 April 2020 – Updated draft models: Companion Paper

9 October 2019

Table of Contents

1 Introduction

1.1 Aurora Energy welcomes the opportunity to submit on the Commerce Commission's (Commission) *"Default price-quality paths for electricity distribution businesses from 1 April 2020 – Updated draft models: Companion Paper"*.

1.2 No part of this main submission is confidential, and we are happy for it to be publicly released. Enclosed with this submission is a confidential Annex, which we would ask the Commission to withhold as it contains confidential and commercially sensitive information, the disclosure of which would prejudice Aurora's commercial position.

1.3 If the Commission has any queries regarding this submission, please do not hesitate to contact:

Alec Findlater
General Manager Regulatory and Commercial
Aurora Energy Limited
alec.findlater@auroraenergy.nz
027-222-2169

2 Executive summary

2.1 In our submission on the draft DPP3 decision, dated 18 July 2019[1], we outlined several matters relating to Aurora's specific circumstances that we considered the Commission could and should take into account in resetting Aurora's DPP, and on which we wished to engage further with the Commission.

2.2 Aurora faces significant challenges as it seeks to restore a level of safety and service reliability that its stakeholders expect. Since historic underinvestment in the network became apparent at the close of 2016, Aurora's shareholder has acted prudently and decisively; establishing a new management team committed to refocusing investment and dealing with the inherent challenges associated with establishing Aurora Energy as a standalone business entity. Over this period, we have engaged transparently and productively with the Commission. The Company's shareholder has committed to significantly increased levels of investment and is presently exposed to the financial consequences of having done so whilst remaining under the current DPP2 price path which was fixed in 2014/15 and extends to 2020. The company has incurred significant cashflow deficits in each of the RY18 and RY19 (and RY20) regulated periods and faces unrecoverable costs through the significant future negative expenditure incentive adjustments that will apply as part of the DPP3 process. Cashflow deficits and unrecoverable losses will continue until the company's regulated revenues are aligned to the company's costs and essential network investment levels.

2.3 Aurora has publicly committed to applying for a CPP in 2020, to commence at the beginning of the 2021 pricing year. Consequently, Aurora anticipates being subject to the DPP3 for a single year only (RY21).

2.4 As we noted in our submission of 18 July 2019, the current draft decision will significantly undercompensate Aurora in RY21 as a result of the step change in its expenditure incurred over the past few years, combined with the obvious need for this elevated level of targeted investment to continue into the next regulatory period. This has been well foreshadowed in our most recent Asset Management Plans (2018 and 2019).

2.5 Specifically, the gap between our AMP expenditure forecast for RY21 and the Commission's expenditure allowances is significant and if left unchanged will have negative and material implications for the company's financial position.

[1] 2019. Aurora Energy, Aurora Energy's submission in response to the Commission's DPP3 Draft Decision, 18 July 2019.

2.6 Separately, while we understand the rationale behind the Commission's alternative x-factor of 8.9%, the Commission does not appear to have considered the impact of IRIS penalties in RY21. Once those penalties are considered, Aurora's prices will actually drop in RY21 from their current level, which seems perverse given the longer-term trajectory for Aurora's distribution prices under both the DPP and future CPP. The deferral of cash that results from the x-factor will also adversely affect Aurora's financial position at a time when the balance sheet is already under considerable pressure.

2.7 The Commission's DPP3 draft decision is therefore not financially sustainable for Aurora and is not in the long-term interests of consumers. Aurora's circumstances are unique, in that the DPP3 will only apply for a single year and the Company commenced its well-publicised step change in network investment mid-way through the current DPP(2) period. There are several areas where the Commission could exercise its discretion, consistent with the low-cost DPP framework, in order to mitigate these risks and better meet the Part 4 purpose statement.

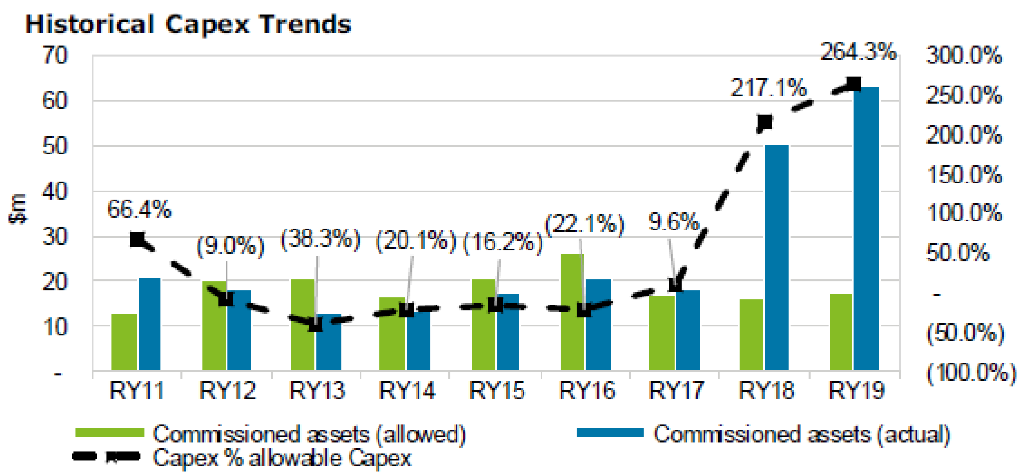
2.8 Specifically, Aurora requests that the Commission uses its discretion to:

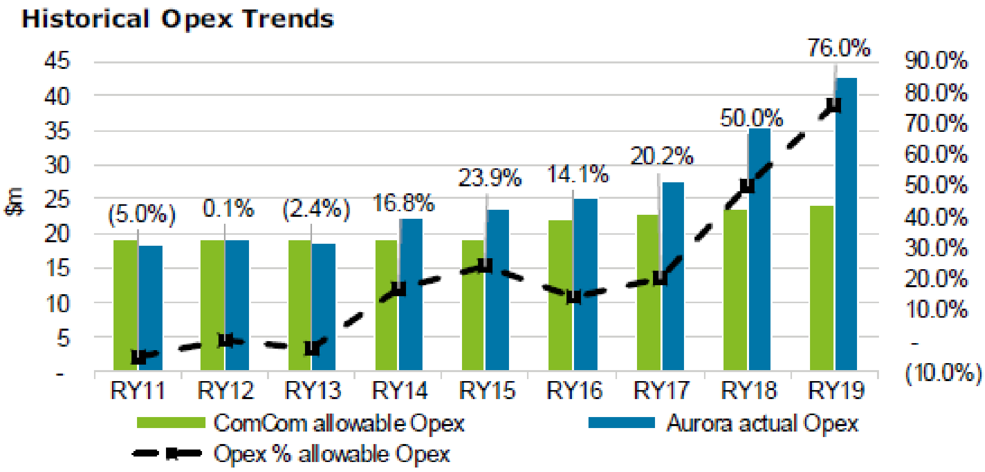
1. decrease the proposed alternative x-factor from -8.9% to 0%; and
2. either:
    a. increase Aurora's capex expenditure allowances, or relieve Aurora of the IRIS consequences of over-spend in that regulatory year, by:
        i. changing the historical reference period for the overall capex threshold for Aurora from seven years to two years; and/or
        ii. setting the retention factor for the capex IRIS to zero for RY21; or
    b. engage with Aurora on a framework and criteria to apply claw-back through the CPP to recover uncompensated costs in RY21.

3 Financial impact of the DPP3 draft decision

3.1 It is on public record that Aurora's expenditure in the later years of DPP2 has been significantly in excess of the Commission's expenditure allowances. This was principally driven by Aurora's actions to remedy historic under-investment in the network, improve its asset management practices and operational maturity and implement a full separation from Delta.

3.2 The two graphs below illustrate the increase in Aurora's expenditure (opex and capex) from RY18 onwards, relative to the Commission's allowances:





3.3 This over-spend in DPP2 was prudent considering the issues identified by the Commission, Deloitte (in their 2016 report) and WSP in their 2017 independent review of the state of Aurora's network and Aurora's asset management maturity. However, the resulting IRIS incentive adjustments will mean that a large part of this already committed investment will not be fully recovered and will be to the cost of Aurora's shareholder. This continues to put considerable pressure on the company's financial position.

3.4 The Commission's draft DPP3 decision would result in a significant cash shortfall in RY21 and beyond, and therefore would have a material adverse financial impact on Aurora. In particular, the opex and capex allowances are materially below the levels forecast by Aurora to meet all of its safety, reliability and operational requirements as set out in the AMP.

3.5 The financial impact of the Commission's DPP3 draft decision is further detailed in the enclosed confidential Annex.

3.6 It is imperative that:

(a) Aurora has the ability to bring forward cash to RY21 to help fund its forecast expenditure; and

(b) that the expenditure allowances reasonably reflect Aurora's requirements in that period.

4 Alternative rate of change

4.1 The Commission's draft decision proposes to adopt an alternative x-factor for Aurora of -8.9% to smooth the price path over DPP3. This alternative x-factor has the effect of back-loading cost recovery. Absent this smoothing, the Commission says that Aurora's starting price adjustment would have been +24% in real terms. The alternative x-factor of -8.9% has been set to smooth the increase in real allowable net revenue over the regulatory period.

4.2 We support measures to mitigate price shocks to consumers and this will form a key consideration of the Company's CPP proposal.. However, the proposed smoothing of Aurora's DPP3 maximum allowable revenue does not:

(a) consider the impact of IRIS adjustments as a consequence of Aurora's over-spend in DPP2 which, if the price path is left unaltered, will see customer prices drop, and then have to sharply increase at the time Aurora's CPP comes into effect;

(b) consider the fact that Aurora has committed to applying for a CPP in early 2020, so anticipates being on DPP3 only for one year; or

(c) recognise that Aurora will have a significant cash shortfall in RY21 and therefore applying an alternative x-factor to Aurora that has the effect of pushing revenues to the end of the regulatory period will be financially unsustainable, especially when considered in conjunction with the significant cash shortfalls that have occurred since around the commencement of RY18.

4.3 We therefore propose an alternative x-factor of 0%.

Impact of IRIS adjustments

4.4 As a result of the step change in Aurora's expenditure, Aurora's opex and capex significantly exceeded the allowances set by the Commission under DPP2, which will result in substantial IRIS adjustments in RY21.

4.5 As set out in more detail in the Annex, the Commission's alternative x-factor of 8.9% results in an initial decrease in prices in the first year of DPP3, rather than an increase. This is a perverse result given prices overall in DPP3 will necessarily be higher than DPP2 (whether under a DPP or CPP) as a result of Aurora's increased expenditure. It also creates a significant price increase for consumers in RY22.

Transition to CPP

4.6 The Commission should also consider, when setting the starting prices and the annual rate of change, that Aurora expects to transition onto a CPP from RY22, which is expected to result in a further increase in prices (based on Aurora's most recent AMP forecasts). Accordingly, any smoothing of the DPP price path should consider the likelihood of a further increase in RY22.

4.7 If the starting prices for RY21 are too low, this just defers a more significant price increase to the CPP period. The Commission's proposed x-factor would result in an uneven price trajectory for consumers over DPP3 and the upcoming CPP period as:

(a) the alternative x-factor would result in a price reduction for consumers in RY21 due to the forecast IRIS adjustment; and

(b) this would likely be followed by significant price increases in subsequent years as Aurora enters its CPP period.

4.8 Taking this into account allows the Commission to smooth price increases over a longer period of time: RY21 as well as the period of the CPP from RY22 onwards. Minimising price shocks is in the long-term interests of consumers, and therefore helps to achieve the s 52A purpose statement.

Financial impact of deferring cash

4.9 Finally, as the Commission knows, Aurora has been spending substantially in excess of its expenditure allowances to improve the condition of its network assets and address its reliability challenge. The consequence of this overspend has been to put significant financial pressure on the business as described more fully in the confidential Annex.

4.10 As the Commission knows from Aurora's most recent AMP, Aurora expects to continue to invest significantly in its network assets for the foreseeable future. Consequently, the timing of cash flows is more than usually important for Aurora's ability to prudently manage its finances.

4.11 This is a further reason to reduce the x-factor and bring forward the recovery of Aurora's costs.

5 Expenditure allowances

5.1 The proposed draft DPP3 decision will result in a significant cash shortfall in RY21 and beyond. This will have a material adverse financial impact on Aurora.

5.2 We propose that the Commission revisit its approach to setting Aurora's expenditure allowances to minimise this adverse impact. In our view the questions the Commission needs to consider are:

(a) does it have the necessary information to support an increase in Aurora's expenditure allowances;

(b) if so, would the long-term benefit of consumers be better served by increasing Aurora's expenditure allowances to minimise the variation between Aurora's forecast and the DPP; and

(c) is this consistent with the low-cost objective of the DPP?

<u>Information to support an increase in Aurora's expenditure allowances</u>

5.3 The Commission has imposed an overall limit on capex of 120% of historic expenditure (measured against a seven year reference period). The Commission has explained that it prefers to use as long a reference period as possible in order to mitigate the effects of year-to-year volatility.

5.4 The use of an historic reference period is premised on the proposition that the most informative guide to future capex requirements is past capex requirements. However, the approach does not adequately capture cyclical changes in capital investment requirements. Specifically, in Aurora's case the use of a seven-year reference period significantly understates Aurora's future capex requirements. This is because of Aurora's low level of historic investment, which has resulted in deterioration of network assets that now requires remediation (as set out in detail in our 2018 AMP and 2019 AMP update).

5.5 The Commission has sufficient information relating to Aurora's actual and forecast expenditure that supports the proposition that a seven year average is not reflective of Aurora's expenditure requirements in the next regulatory period. These sources of information include:

(a) the WSP report into the state of Aurora's network, which was produced pursuant to a tripartite deed with the Commission, and with the Commission's involvement; and

(b) the information the Commission has obtained in the course of investigating Aurora's breaches of the quality standards in the current regulatory period.

5.6 The Commission has expressed to Aurora its conclusion that the period 2010 to 2016/17 represented systematic underinvestment in the network. This entails an acceptance that actual capex in that period is not a reasonable guide to current or future prudent capex requirements.

<u>Long-term benefit of consumers</u>

5.7 The Commission's decision-making is guided by the section 52A purpose statement. Whether under a DPP or CPP, the Commission is required to set a price-quality path that is consistent with the long-term benefit of consumers, particularly as elaborated in section 52A(1)(a)-(d). The Commission has elaborated on the purpose statement by adopting key economic principles that guide its decision making. One of the Commission's key economic principles is that a regulated supplier should have an ex ante expectation of maintaining its financial capital in real terms (FCM).

5.8 The fact that Aurora will substantially under-recover its costs in RY21 under the DPP draft determination represents a risk for both Aurora and consumers. If Aurora is prevented or unable to recover this expenditure, Aurora will not maintain its financial capital. This weakens incentives to invest in network assets, contrary to s 52A(1)(a). As the Commission has recognised in its various decisions on WACC percentile, underinvestment represents an asymmetric risk to consumers, which should prompt the Commission to resolve forecast or estimation uncertainty in favour of compensating the supplier.

5.9 The under-recovery implied by the DPP draft decision is particularly problematic given the Commission's publicly stated concerns about historic underinvestment by Aurora and its implicit direction to remedy this underspend. The draft decision means that the Commission is on the one hand directing Aurora to invest commensurate with the acknowledged needs of its network, but simultaneously setting an expenditure allowance that is manifestly inadequate.

5.10 Accordingly, Aurora submits that the particular circumstances described above suggests that the Commission should exercise its discretion to increase Aurora's expenditure allowances to mitigate the deficit between forecast and allowed expenditure.

Consistent with the low-cost DPP objective?

5.11 Finally, we recognise that the legislative constraints on the DPP prevent the type of scrutiny that can occur under the CPP, with corresponding implications for the Commission's ability to approve expenditure that departs from historic trends.

5.12 However, Aurora's circumstances are unique, because the Commission has already formed a view about the inadequacy of Aurora's past investment and the need for increased expenditure in the current and next regulatory period. The Commission is therefore able to rely, not only on the AMP, but also on additional supporting information that it has obtained that validate Aurora's expenditure proposals.

5.13 In these circumstances, the Commission can confidently increase Aurora's expenditure allowances without undertaking the type of scrutiny that would ordinarily be reserved for a CPP. Because that information is already available to the Commission, and the Commission has already formed a view of Aurora's investment requirements, doing so would not violate the low-cost objective of the DPP.

Proposed amendments to draft DPP determination

5.14 We have identified several different options to mitigate the adverse effects of the variance between Aurora's forecast expenditure the allowances in the draft decision. These are not mutually exclusive, and hence could be applied coherently in combination.

1. *Shorten the historic reference period for capex*

5.15 As we explained in our submission of 18 July 2019, the seven year historic reference period captures five years in which Aurora's capex was, by the Commission's assessment, inadequate. Capex in years RY18 & RY19 are therefore a better guide to future capex requirements than RY13-19.

5.16 We therefore submit that the Commission should, in Aurora's case, apply a two-year reference period to set the overall cap on capex.

2. *Set the capex IRIS retention factor to zero for RY21*

5.17 The capex retention factor is determined in the DPP determination, and thus it is open to the Commission to determine an alternative retention factor for Aurora.

5.18 The issue Aurora is facing is limited to RY21. From RY22 onwards Aurora expects to be subject to a CPP.

5.19 Accordingly, Aurora proposes that the Commission set the capex retention factor to zero for Aurora and for RY21 only, so that Aurora will not incur a capex IRIS adjustment for that year.

6 Alternative approach: clawback through the CPP

6.1 An alternative approach would be to resolve the under-recovery through Aurora's CPP, utilising the claw-back mechanism that is already set out in section 53V.

6.2 Claw-back allows the Commission to set prices under the CPP that allow Aurora to recover some or all of any shortfall in its revenues that occurred under the prices previously charged by Aurora through the DPP.

6.3 The EDB IMs already recognise that it will be appropriate in some circumstances for suppliers to recover pre-CPP costs through the CPP regulatory period. In the 2015/16 IMs review the Commission introduced the concept of an "urgent project allowance", which allows a supplier to recover additional net costs that:

(a) exceed those already provided for in a DPP determination or CPP determination;

(b) will not otherwise be recovered by the EDB; and

(c) will be prudently incurred by the EDB before commencement of the resulting CPP regulatory period in responding to an urgent project that occurred in the time between the submission of a CPP proposal and determination of the resulting CPP determination by the Commission.

6.4 We understand that urgent project allowances are intended to provide for costs: (a) incurred after submission of a CPP application, and (b) which respond to an urgent project. As part of our CPP application, we would propose that the definition of "urgent project allowance" be extended to include all costs that relate to the CPP application and which are prudently and efficiently incurred in the regulatory year in which a CPP proposal is submitted. In Aurora's case, this would permit Aurora to recover, through the CPP, costs not provided for in the DPP determination that are prudently and efficiently incurred in the course of RY21. This extension of the definition of urgent project allowance does not require an amendment to the IMs as it can be implemented by means of an IM variation in the course of evaluating Aurora's CPP application.

6.5 By analogy with the concept of the urgent project allowance, this extension would recognise that there is an unavoidable lead-in time for a CPP proposal (including a stand-down period in the year immediately preceding a DPP reset), but that the supplier may be prudently incurring costs to which the CPP application relates during this period. Allowing suppliers to recover these costs would neutralise the adverse effect of the unavoidable delay in preparing a CPP application.

6.6 The Commission, when discussing the concept of an urgent project allowance, expressed a concern that extending the qualifying period too far back would disincentivise timely submission of CPP applications. We recognise this concern, but consider that an option to recover costs incurred in the year of submission: (a) is not likely to result in the deferral of CPP applications, and (b) reflects a realistic assessment of the challenge involved in preparing a CPP application to the standard set out in the IMs.

6.7 The downside for Aurora in pursuing claw-back rather than an increase in the DPP expenditure allowances is that Aurora lacks certainty about its ability to recover its costs. This will affect Aurora's incentives in the intervening period. This adverse effect on incentives can be mitigated by engagement between the Commission and Aurora now to outline a framework and criteria against which Aurora's pre-CPP costs would be evaluated. We would welcome the Commission's indication that this solution is in principle available.

6.8 We consider that the long-term interests of consumers will not be served by subjecting Aurora to extreme financial pressures. Ultimately, Aurora looks to the outcome of its forthcoming CPP application to provide some level of financial stability, but we believe that how the DPP is settled is also an important stabilising factor.

7 Proposed changes to system growth capex

7.1 We support the proposed changes to the scrutiny test for system growth expenditure.

7.2 There is a stronger relationship between system growth expenditure and population growth, coupled with historic ICP growth, when compared with the relationship to zone substation capacity, which makes the proposed test more suitable.

7.3 However, as with the scrutiny of the consumer connection category, we reiterate our previous comments in our submission of 18 July 2019 that we disagree with the proposed caps on consumer connection capex (which are now equally applicable to system growth) where forecasts fail scrutiny. We suggest that expenditure caps should be consistent with independent assessments of cost drivers, when appropriate.

8 Normalisation of major events

8.1 In our submission of 18 July 2019, we questioned the overall gain of the Commission's proposed change to move away from a calendar day approach to identifying major events, and moving to rolling periods. We again question what is being achieved by the Commission proposing another change to the approach and whether this is only adding unnecessary complexity to the regulatory framework.

9 Quality standards

9.1 In our submission of 18 July 2019, we presented our view that quality standards must be reasonably capable of compliance, and that it would be inappropriate to set limits that essentially 'forced' a future breach of the price-quality path. As Aurora is acutely aware, a breach of a price or quality determination, whether justified or not, has significant and enduring financial, reputational and personal consequences.

9.2 We note that the updated draft decision on quality standards remains generally unchanged and presents a compliance target that Aurora Energy is very unlikely to meet in the first year of the DPP, particularly in respect of unplanned reliability which, over the course of a single year, is difficult to substantially influence. This is exacerbated somewhat by the current uncertainty over the measurement of SAIFI (subject to the outcome of the Commission's current consultation on this topic).

9.3 We are currently considering the practicalities of proposing a quality standard variation, in accordance with clause 4.5.5 of the IMs, once the final standards have been determined. We are concerned, however, by the challenge and efficacy of running additional consumer consultation, in addition to the CPP, and it is likely that any variation proposal submitted by us will rely on consumer's views of quality, elicited through CPP consultation.