
Submission

In response to the Commerce Commission's request for

Feedback on the process for resetting default price-quality paths for electricity distributors

10 April 2014

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1 Introduction

Aurora Energy welcomes this opportunity to respond to the Commerce Commission's request for "Feedback on the process for resetting default price-quality paths for electricity distributors", dated 27 February 2015.

We support the submissions made by the ENA and PwC on this matter.

If the Commission has any queries regarding Aurora's submissions, please do not hesitate to contact Alec Findlater:

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2 Opening Comments

Aurora considers that asking for feedback on process is good regulatory practice, and we are pleased to see the Commission repeating this step after the latest reset of default price-quality paths (DPPs).

Aurora was mostly happy with the way the Commission ran its 2015-20 DPP reset process; however, we would urge the Commission to seek feedback immediately after the final determinations are made in the future, while the consultation and process is still at the forefront of interested parties' minds.

We appreciated that the Commission clearly took on board feedback from the previous DPP reset process. Early release of the DPP model was a good example of the Commission's response to the last round of feedback, despite the fact that subsequent updates of revised modelling were not, in our view, managed or communicated quite so effectively.

The Commission clearly had an open mind on most issues arising from the draft determination, and we were pleased to see substantial improvements made between the draft and final determinations. Aurora has traditionally tended to rely on the submissions of the ENA and PricewaterhouseCoopers, so we were pleased to see that the Commission addressed many of the concerns we raised about the draft determination; e.g., the proposed 10% cap on capital expenditure, and the base-year selection (though only partially, as the Commission adopted an averaged base-year (years 3 and 4), rather than year-4 as we proposed).

We were also pleased that the Commission was quite clear about how it saw DPPs evolving from the 2015 reset to the 2020 reset; e.g., in relation to the service quality incentive scheme, where it was starting cautiously.

There will always be room for improvement. This is what makes seeking feedback and reviewing past performance so useful.

3 Commission Engagement

There were aspects of submissions which we did not feel the Commission actively engaged on. We were disappointed, for example, that the Commission did not respond to our comments about “reasonable investor expectations”.¹

Our submissions, and those of other parties, raised concerns with the way service quality was being treated in the 2015 DPP reset, which we felt were not entirely resolved in the final determination.

For example, the ENA submitted that:

*“Normalisation for major events – we do not consider that the proposed approach achieves reasonable outcomes because the frequency and magnitude of major events will primarily determine whether a business complies with the quality standard, and whether the cap or collar is reached in any year. The proposed approach to normalisation is contrary to international methods. It is our preliminary view that this is not suitable for a revenue incentive scheme. As a consequence the financial penalties and rewards will be unduly influenced by the weather and other drivers of significant unplanned events”.*²

In our view, the matter of normalisation was satisfactorily resolved in the final determination; however, the underlying concerns regarding the influence of extreme events on the financial penalties and rewards of the incentive scheme were not addressed.

Price-quality paths should be in balance, and the fundamental concern we have is that the Commission has effectively raised the service quality requirements (the quality path) without commensurate compensation through its capital and operational expenditure assumptions (affecting the price path). To illustrate this, while quality compliance remains unchanged³, Aurora now needs to produce quality results that are 11.7 percent (SAIDI) and 10.4 percent (SAIFI) better than the respective compliance limits, year-on-year, in order to remain financially “whole” throughout the regulatory control period. Our analysis of Aurora’s historic reliability performance, adjusted to account for the 2015–2020 quality compliance regime, suggests that such an outcome is unlikely – see Table 1, below.

Year	SAIDI	SAIFI	Limit Breach?		Incentive		
			SAIDI	SAIFI	SAIDI	SAIFI	Combined
2004/05	72.4536	1.3921			\$63,792	-\$180,910	-\$117,118
2005/06	76.2430	1.4146			-\$56,489	-\$222,652	-\$279,142
2006/07	79.8033	1.5376		Yes	-\$169,500	-\$282,560	-\$452,060
2007/08	71.3462	1.3544			\$98,940	-\$110,865	-\$11,925
2008/09	63.5579	1.1876			\$282,560	\$198,908	\$481,468
2009/10	62.4113	1.2632			\$282,560	\$58,479	\$341,039
2010/11	91.1487	1.3969	Yes		-\$282,560	-\$189,764	-\$472,324
2011/12	83.2478	1.3962			-\$278,833	-\$188,454	-\$467,287
2012/13	63.5537	0.8877			\$282,560	\$282,560	\$565,120
2013/14	80.8688	1.1222			-\$203,319	\$282,560	\$79,241
Total					\$19,710	-\$352,698	-\$332,988

Table 1 - Incentive Calculation Based on Historic Data

Under a well-functioning service quality incentive scheme, we would expect to see compliance action partially substituted by financial penalties. That is, relatively minor

¹ We discuss this further in our Submission in response to the Commerce Commission’s Open letter on our proposed scope, timing and focus for the review of input methodologies. 31 March 2015.

² Electricity Networks Association. *Submission on proposed default price-quality paths for electricity distributors from 1 April 2015*. 15 August 2015, paragraph 87a.

³ Allowing for changes to the normalisation methodology, including de-weighting planned service interruptions, which are embedded in the reset compliance limits.

breaches of the compliance limit are dealt with by way of penalties, rather than lengthy and costly (to EDBs and the Commission) investigations. In order to preserve the price-quality balance, however, this would necessitate the incentive target (the financial zero-point) being set equal to the compliance limit.

4 Evidence-based Decisions

We consider that there were material aspects of the Commission's DPP determination (the draft more so) that were based on assumption and judgement, and not adequately supported by evidence. We consider that the High Court IM Merit Appeal decision⁴ provides useful precedent and guidance as to the appropriate level of evidence required to support submissions. The Commission's Part 4 IM WACC percentile decision also provides a useful benchmark for providing quantified evidence; limiting, to the extent practicable, the degree to which judgement needs to be relied upon (however, we note that varied and divergent expert evidence brings judgement back into play, and requires that judgement to be well reasoned and clearly articulated).

Evidence-based decision making was a particular concern in relation to the draft determination. Our view was that the Commission placed undue weight on assumptions that year-4 operational expenditure was inflated (and therefore unsuitable for selection as the base-year), and that previous capital expenditure forecasts had been inflated by some regulated suppliers. Our submission, for example, detailed evidence⁵ why year-3 operational expenditure was actually abnormally low (rather than year-4 being artificially high), and that we would be undertaking substantial new capital expenditure in the 2015-2020 period.

5 WACC Percentile an Unnecessary Distraction

The Commission clearly put a lot of time and resource into the consultation on WACC percentile last year, as did submitters. The addition of this unscheduled consultation and decision placed considerable additional pressure on Commission staff and stakeholders.

We had concern that 2014 was already a "peak load" regulatory year, with the electricity DPP reset (exacerbated by the short-period since the previous reset), the Transpower IPP reset and the Telecommunications Act TSLRIC FPP determination process for both UCLL and UBA services.

This would, inevitability, have resulted in re-prioritisation of Commission work-streams. While we do not have visibility over this, we wonder what the WACC percentile review process came at the expense of, and was this the best use of scarce Commission and stakeholder resources?

2015 would have afforded the Commission considerably more time to review such matters, and would have enabled review of WACC percentiles/uplifts for airports, copper, electricity and gas to all occur in unison. We consider that obiter dicta statements regarding the WACC percentile in the High Court's IM Merit Appeal decision were sufficiently persuasive that the Commission needed to take heed; however, we remain unconvinced that the Court, insulated from stakeholder lobbying, anticipated an advanced, out-of-cycle, review (The Court merely acknowledging, in paragraph 1486 of the decision, the IMs would be reviewed).

⁴ Wellington International Airport Ltd and others v Commerce Commission [2013] NZHC 3289. 13 December 2013.

⁵ Aurora Energy Ltd. *Submission Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015 and Low Cost Forecasting Approaches for Default Price-Quality Paths*. 15 August 2014, section 6.

6 Outstanding Matters

While the operational and capital expenditure allowances set out in the final DPP reset determinations were a considerable improvement on the drafts (not solely relying on year-3 as the base-year for operational expenditure⁶, or imposing a 10% cap on capital expenditure under certain conditions), we consider that establishing reasonable forecasts of both operational and capital expenditure is an outstanding 'work-in-progress' for the next resets.

This is a very important area in terms of ensuring ongoing investment and expenditure required to maintain and improve service quality. Vector, for example, argued that:

"The Commission's [draft] forecasts of capex and opex deliver insufficient revenues to maintain necessary investment levels on our network. The forecasts have the effect of cutting the capex and opex Vector can spend below the level we believe is prudent and necessary ... ; this will affect the quality of service that is provided to consumers. The Commission should acknowledge the potential impacts and incentives that result when they arbitrarily reassess judgements made by regulated suppliers in this way".⁷

An observation that we found interesting, in terms of the Commission's forecasting, is that while it had been very bullish about growth in demand for electricity (moderated in the final determination), the Commission has been criticised for the exact opposite in the copper FPP draft determinations; applying a zero broadband growth assumption despite very high, and ongoing, increases in demand over the last year/several years.

The consistent issue between the EDB DPP reset and the Chorus' copper price FPP determination appears to be that the Commission's forecasts of demand growth was not adequately informed by analysis of historic revenue demand growth trends.

7 Multi-stage Consultation

We are generally supportive of the Commission endeavours to manage significant work-streams, like the DPP reset, staggering its consultation.

It is important, though, to consider the extent to which particular consultations can be done on a stand-alone basis, or not. For example, in order to adequately submit on the DPP draft decisions around service quality, we found it necessary to review the Commission's separate consultation paper on "Proposed Quality Targets and Incentives for Default Price-Quality Paths from 1 April 2015".

By necessity, our submission on the "Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015", 4 July 2014, also submitted on the consultation papers on:

- Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors, 18 July 2014;
- Proposed Quality Targets and Incentives for Default Price-Quality Path From 1 April 2015, 18 July 2014;
- Proposed amendments to Input Methodologies for Energy Distribution Services, 18 July 2014; and
- Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme, 18 July 2014.

⁶ We maintain the view that use of 2003 as the operational expenditure base-year was not appropriate, though we acknowledge there were differing views amongst EDBs on whether 2013 should be included with 2014. The general message was that 2013 was an atypical year not 2014.

⁷ Vector Ltd. *Submission on the Default Price-Quality Paths from 1 April 2015: Main Policy Paper*. 15 August 2015, paragraph 1.

This effectively meant that we had two weeks less to review the subsequent four consultation papers.

If the additional four papers had been stand-alone, we could have reviewed the reset draft determination independently, and then separately reviewed the additional papers, submitting our responses at the later consultation dead-line.

While this was not a fatal issue with the Commission's process we consider it is something that could be readily tidied up for the future.