
Submission to the Commerce Commission

on

Proposed Default Price-Quality
Paths for Electricity
Distributors From 1 April 2015

Made on behalf of 19 Electricity Distribution Businesses

*PwC submission on
behalf of group of 19
EDBs*

15 August 2015



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Submission on DPP Reset: Main Policy Paper

1. This paper forms our submission on the Commerce Commission's (Commission) paper, "Proposed Default Price-Quality Paths For Electricity Distributors From 1 April 2015" released on 4 July 2014 (the DPP Policy Paper). This submission has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 19 Electricity Distribution Businesses (EDBs or distributors):
 - Alpine Energy Limited
 - Aurora Energy Limited
 - Buller Electricity Limited
 - Eastland Network Limited
 - EA Networks
 - Electricity Invercargill Limited
 - Horizon Energy Distribution Limited
 - MainPower New Zealand Limited
 - Marlborough Lines Limited
 - Nelson Electricity Limited
 - Network Tasman Limited
 - Network Waitaki Limited
 - Northpower Limited
 - OtagoNet Joint Venture
 - The Lines Company Limited
 - The Power Company Limited
 - Top Energy Limited
 - Waipa Networks Limited
 - Westpower Limited.
2. Together these businesses supply 26% of electricity consumers, maintain 44% of total distribution network length and service 75% of the total network supply area in New Zealand. They include both consumer owned and non-consumer owned businesses, and urban and rural networks located in both the North and South Islands.
3. The DPP Policy Paper describes the key policy decisions for the forthcoming Default Price-Quality Path (DPP) reset which is to apply to 16 non-exempt EDBs from 1 April 2015. It is proposed that Orion New Zealand is not included in the DPP reset at this time, due to their recent CPP Determination.

4. The DPP Policy Paper is supported by a number of accompanying papers and models. We have also submitted today on the DPP Forecasting Paper and associated models.¹ We plan to make further submissions on the remaining papers², to be submitted by 29 August.
5. This submission presents the views of the 19 EDBs which support this submission, and largely follows the structure of the DPP Policy Paper. We also note and support the ENA's submission on the DPP Policy Paper.
6. We trust this submission provides useful input in setting the 2015 DPP. We would be happy to answer any questions you may have regarding this paper.
7. The primary contact for this submission is:

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¹ Commerce Commission, Low Cost Forecasting Approaches for Default-Price-Quality Paths, 4 July 2014

² As published at <http://www.comcom.govt.nz/regulated-industries/electricity/electricity-default-price-quality/default-price-quality-path> from 2015

Summary

8. In summary, we submit:

- a. That the forecasting methods employed to reset the price path must be fit for purpose and use information which is as up to date as possible at the time of the reset.
- b. The proposal to introduce expenditure efficiency mechanisms places additional weight on the forecasts for this next regulatory period.
- c. Applying for a CPP is not a viable or reasonable solution for addressing forecasting error in the DPP. Accordingly:
 - DPP forecasts must be improved and we have submitted in our accompanying DPP Forecasting Submission the key changes which we believe should be made.
 - A fixed additional opex allowance should be included, for those businesses where the forecast differences between DPP and own business forecasts are less than \$5m, in recognition of the risks of applying for a CPP, which are not captured in the method used to estimate the impact of forecast error, and the smaller revenue gain available under the CPP option.
- d. The industry wide X factor should be set in a robust way, supported by empirical evidence and expert analysis, such as that undertaken by Pacific Economics Group and Economic Insights. Neither of these reports derives a Total Factor Productivity (TFP) trend of 0% (which is the recommended value) for NZ EDBs.
- e. The EDBs which support this submission support consideration of price shocks and the use of alternative X factors to mitigate price shocks as proposed. We suggest that those EDBs which are potentially affected by the proposed 5% price capping threshold, are consulted as to their preferred revenue recovery profile. Thus they will be able to consider the needs of their consumers and their own circumstances, subject to retaining present value equivalence, as proposed.
- f. We support consideration of improvements to the way in which pass through and recoverable costs are able to be recovered.
- g. We support the proposal to introduce a new recoverable cost allowance to allow capped revenues from the current regulatory period to be recovered within the next regulatory period.
- h. We believe that time value of money adjustments should be made using a consistent method across all elements of the price path, including the proposed new incentive schemes for expenditure efficiency, quality of service and energy efficiency and demand side management initiatives. We consider the cost of capital should be used for this purpose as this is the opportunity cost of deferred revenue recovery/penalty payment for a supplier.
- i. We acknowledge that the DPP is intended to rely on relatively low cost methods; however we submit that any learning from the current period should reasonably be expected to be incorporated into the methods to apply in future periods.
- j. We also submit that recent data should be incorporated throughout the DPP models before the final Determination is made.
- k. A quality incentive scheme has previously been supported by industry participants, and we are currently considering the detailed proposals and will respond more fully in due course. In the interim we note:

- We support the retention of own network SAIDI and SAIFI as the quality of service measures for the next regulatory period.
 - We support the use of historical data (including the most recent data available) for each EDB to determine the quality limits or targets.
 - We support an approach which normalises for the impact of major events which are largely outside the control of EDBs, in order to derive a measure of underlying reliability. We do not consider that the current proposals achieve this.
 - Absent reasonable normalisation for major events, we believe that the incentive scheme, in practice, will generate financial rewards and penalties which reflect year on year variation in weather, rather than underlying improvements or reductions in service quality.
 - We support the proposal to cap revenue at risk for the next regulatory period at a small percentage of maximum allowable revenue.
 - We agree any incentive scheme in principle should be symmetrical.
 - We believe that the proposal to adjust the quality targets and caps and collars downwards to reflect the impact of previous breaches is flawed because it mixes different methods and standards. It also unduly penalises EDBs for prior period performance, when no penalty was deemed necessary when the breaches were investigated.
 - We do not support the proposal that EDBs will be non-compliant with the quality target if their annual SAIDI or SAIFI performance (calculated in a similar way to the target) exceeds the target. Accordingly we do not agree with the statement that the proposed revenue-linked incentive scheme helps reduce uncertainty for distributors.
 - We believe that the proposed incentive rates are unlikely to be sufficient to fund the level of investment necessary to make a difference to quality performance. Accordingly, the financial penalty for reduced quality (reliability) is also weak. While we support the level of financial incentive proposed for the next regulatory period, we consider that this needs to be understood to better manage expectations about the scheme.
- l. We support the addition of energy efficiency and demand side management (EEDM) incentive mechanisms to the DPP. We support the proposal for EDBs to make applications for financial compensation where EEDM initiatives reduce revenues, to be approved by the Commission before the incentive payment is recovered through prices. We agree with the ENA, that the proposed carve out of pricing structure impacts falls short of the requirements of s54Q and should be removed
- m. Normalising incentives for expenditure efficiency over time is a useful enhancement to the current DPP, and we agree the incentives for expenditure efficiencies are currently distorted within and between regulatory periods. In this respect:
- The proposed mechanisms are complex, and it is proving difficult to understand what they mean in practice for each EDB.
 - There is some concern as to whether it is appropriate to introduce an IRIS into the DPP because of the low cost forecasting approach. The IRIS adjustments will capture forecasting error in addition to expenditure efficiencies or inefficiencies.
 - Penalising businesses for not achieving the DPP forecasts is a real prospect for a number of the EDBs which support this submission.
- n. We support the spur asset transfer initiatives but note that:

- Opex allowances for assets transferred prior to 1 April 2015 are insufficient and EDB forecasts should be used
 - The proposed approach to calculating the recoverable allowance requires refinement as it will omit genuine avoided transmission costs from the allowance, contrary to its purpose.
- o. We support a DPP reopener for catastrophic events, and the associated recoverable cost allowance, which could also be applied to other reopener circumstances.
9. We note that we will be submitting more fully on the Quality of Supply Incentive, IRIS proposals and DPP Compliance papers in our 29 August submissions.

Price path

Proposed approach

10. The DPP Policy Paper proposes that the DPP price path is reset for 16 non-exempt EDBs on the basis of current and projected profitability, to be derived using similar methods to those employed for the 2012 DPP Reset. While the EDBs which support this submission broadly support this approach, we believe that the forecasting methods employed must be fit for purpose and use information which is as up to date as possible at the time of the reset. Our detailed comments on the proposed forecasting approaches are set out in our submission on the DPP Forecasting Paper.
11. We note that there is considerable discretion available to the Commission in how it determines price paths based on current and projected profitability. While the Input Methodologies (IMs) specify some of the methods which must be used, the methods for projecting capex, opex and real revenue growth are largely up to the Commission. Each of these can have a material impact on the absolute value of the revenue allowance for each EDB. Forecasting methods must also be determined for CPI, disposals and other income.
12. In addition, we note that the proposal to introduce Incremental Rolling Incentive Scheme (IRIS) mechanisms,³ the purpose of which is to introduce financial penalties or rewards for expenditure which is above or below the base allowances in the DPP price paths, places additional weight on the forecasts for this next regulatory period. We will be responding to the IRIS proposals in our forthcoming submission on the relevant consultation papers.
13. We also note, and as acknowledged in the DPP Policy Paper, there are a number of obligations which an EDB must meet, outside of the Part 4 regulated requirements for prices and quality standards. These include statutory obligations for power quality, health and safety, requirements to maintain supply, and other industry protocols. They also include commercial arrangements with retailers including service obligations for consumers and obligations under the Consumer Guarantees Act. This requires an adequate level of investment (in opex and capex) to ensure these obligations are met.

CPP option

14. We acknowledge that the option of applying for a Customised Price-Quality Path (CPP) exists alongside the DPP. The EDBs which support this submission do not see this as a viable or reasonable solution however for addressing forecasting error in the DPP. In our view, the DPP should apply to most non-exempt EDBs, most of the time.
15. We understand that significant step changes in planned work programmes, customer requirements and/or expected quality outcomes would not be expected to be accommodated within a DPP. If necessary a CPP would be the appropriate option to provide realistic price and quality standards under such situations. Absent expectations of a significant change, it is reasonable however to expect that the DPP will provide forecast revenue allowances which are consistent with and sufficient for business as usual situations.
16. We note the assessment of the impact of forecasting uncertainty in Attachment B of the DPP Policy Paper in this regard. We understand this assessment is intended to provide for an additional allowance in DPP price paths for businesses where the cost of applying for the CPP is expected to outweigh the value of potential forecasting errors in the DPP. The EDBs which support this submission are

³ Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme, 18 July 2014

- concerned that the analysis presented concludes that no EDB warrants an additional allowance for this purpose.
17. *Prima facie*, the analysis presented suggests that 11 of the 16 non-exempt EDBs may be sufficiently incentivised to apply for a CPP, given the difference between the proposed DPP price path, a DPP price path consistent with businesses own forecasts, and an assumed CPP cost of \$2.5m. This is because the proposed DPP forecasts generate materially lower revenues relative to the businesses own forecasts, and hence it is proposed that the potential CPP benefit justifies the cost.
 18. We are concerned by this outcome which we believe is contrary to the design of the DPP/ CPP regulatory model. When Part 4 of the Commerce Act was drafted, it provided for a maximum of four CPP assessments per sector in any one year. It is recognised in the legislation that deferrals (with claw-back provisions) may be required in the event of more than four applications being received in a year. The current proposition would mean that if all 11 EDBs applied for a CPP (assuming the applications were submitted towards the end of the first year of the DPP), the final CPP determinations would not be made until the fourth year of the DPP (and they would apply from the beginning of the fifth year).
 19. This is a highly risky proposition for an EDB, because the benefit or otherwise of a CPP is largely dependent on the counterfactual, and for those with lengthy deferrals, the counterfactual would primarily be determined by the DPP in the following regulatory period. This would be unknown at the time of the CPP application. We cannot conceive that the CPP option was designed with this outcome in mind.
 20. Accordingly we do not support the forecasting error approach, because it does not take into account these legislative constraints or the actual risks associated with a CPP application. In addition to the deferral impacts noted above, the analysis also ignores the way in which a CPP differs to a DPP, for example the cost of capital differs and there is considerable discretion available to the Commission as to the price paths which are set when the CPP comes to an end. These are factors which will influence the costs and benefits of applying for a CPP.
 21. We also note that the \$2.5m CPP cost assumption appears to exclude the costs which are classed as recoverable costs (eg: application fees, assessment, verifier, engineering and audit costs). We believe that the full costs of a CPP application are relevant to this assessment as they represent the costs of addressing the forecast error (which are shared between suppliers and consumers when an application is lodged and accepted for assessment by the Commission).
 22. There will also be additional costs which are not able to be readily quantified, which we believe will deter EDBs, especially smaller EDBs from applying for a CPP. These include the demands on key resources within a business, which are expected to conflict with their core management and operational responsibilities. The recent Orion CPP experience has highlighted the tremendous effort involved for the business in reaching a CPP Determination. EDBs which support this submission do not feel that the amount of effort required could realistically be achieved.
 23. We therefore consider that the approach to assessing a forecasting error cost is biased against smaller EDBs, which, as demonstrated in Table B1 of the DPP Policy Paper, have a lot less upside available to them than the larger EDBs. We believe that the CPP option itself is biased against smaller suppliers, as CPP costs or demands are not scalable to any great extent. The \$2.5m direct cost is a very small proportion of the potential revenue impact of forecasting variances for larger EDBs, however it exceeds 50% of the estimated revenue impact (using the narrow DPP counterfactual approach) for four EDBs, and at least 25% for four others. If the recoverable costs are taken into account, these percentages increase.
 24. If we assume another \$1.5m for the CPP recoverable costs, then the total costs of applying for a CPP barely outweigh the estimated revenue impact for four EDBs; exceed 50% for two others, and 40% for two more. Given the other risks that a supplier faces when applying for a CPP, and the expected disruption to their businesses, we submit that there is little a supplier within these error bands can do in practice to address the forecast error.

25. In order to address this bias we believe that:

- DPP forecasts must be improved and we have submitted in our accompanying DPP Forecasting Submission the key changes which we believe should be made. We have highlighted a number of assumptions which have been proposed in the draft decision, which result in lower revenue forecasts than we consider are justified, given the supporting data and analysis
- A fixed additional opex allowance is included, for those businesses where the forecast differences are less than \$5m, in recognition of the risks of applying for a CPP, which are not captured in the method used to estimate the impact of forecast error. This could be set at 50% of the estimated forecast error, which would be less than the costs of a CPP application.

26. Without these resolutions, we consider that EDBs, particularly those which fall within the lower error bands, will not have an expectation of earning normal returns, contrary to the Part 4 Purpose Statement.

Core elements of the price path

27. The price path that is to be reset, excludes pass through and recoverable costs, which are largely outside the control of EDBs. This approach is consistent with the IMs applying to DPPs.

28. The price limits reflect starting prices and a rate of change relative to the CPI for the remainder of the regulatory period. The starting prices are determined from estimates of current and projected profitability. Our comments on the proposed approach to estimating current and projected profitability are included in our DPP Forecasting Paper submission.

Productivity-based rate of change

29. Attachment C of the DPP Policy Paper sets out the proposed productivity rate of change to be included in all DPP price paths. A value of 0% is proposed, based on a study conducted by Economic Insights (EI)⁴ which measures the long run average productivity improvement rate of electricity distributors in New Zealand. The EDBs which support this submission are not experts in measuring industry productivity through the statistical methods employed by EI. This is why we support the ENA's decision to employ Pacific Economics Group (PEG)⁵ to undertake similar analysis, and to comment on the EI report. We refer the Commission to the PEG reports, submitted by the ENA in this respect.

30. We acknowledge that where starting prices are set using current and projected profitability (as proposed), the productivity rate of change only affects the profile of recovery, not the value of revenue to be recovered within the regulatory period. It will also influence the step change in prices at the next reset. The profile of recovery is relevant to the CPP application decision, as it influences the proportion of revenue recovered in the early years of a DPP period, prior to a CPP taking effect.

31. For this reason, we believe that the X factor should be set in a robust way, supported by empirical evidence and expert analysis, such as that undertaken by PEG and EI. Neither of these reports derive a Total Factor Productivity (TFP) trend of 0% for NZ EDBs:

- PEG states that the value of the X factor used in the rate of change formula should be between **-1.06%** and **-1.52%** (PEG, page 5)
- EI settle on a value of **-1%**, although there are a range of observations presented based on different time series, and model specifications (EI, pages iv and v)

⁴ Economic Insights, Electricity Distribution Industry Productivity Analysis: 1996-2013, 24 June 2014

⁵ Pacific Economics Group, Productivity Trends of New Zealand Electricity Distributors, June 2014

- However EI also ignore their empirical analysis, and recommend 0% where prices are set with reference to current and projected profitability, it appears largely on the expectations of the Australian Energy Regulator and the Australian Energy Market Operator that electricity demand growth will increase in Australia. (EI, page iv)
32. We note that the recommendation is contrary to EI's analysis which shows, "five of the six TFP specifications we have examined have pointed to a negative TFP growth rate for the last decade" (EI page iv). We don't find this recommendation credible because it ignores the empirical data, is speculative, is derived from Australian information, and is outside the core expertise of EI.
 33. We note that the Act requires the X factor to be set to reflect an estimated productivity rate of change based on the long run average productivity improvement rate of distributors (s 53P(6)). Alternative rates of change may be set to avoid price shock or financial hardship (s 53P (8)).
 34. The DPP Policy Paper does not explain why an industry wide X factor of 0% is proposed which is contrary to the empirical analysis which underpins it. Accordingly we submit that before the price path is set, a robust rationale for the selected X factor value must be developed, with reference to the analysis presented by PEG and EI. We note that we have responded to the EI proposals for opex partial productivity in our submission on the Forecasting Paper.

Alternative rates of change to minimise price shocks

35. As for the 2012 price path reset, where the proposed price path is materially above the current path, alternative X factors are proposed to smooth the price impact on consumers. The EDBs which support this submission support consideration of price shocks and the use of alternative X factors for this purpose.
36. We note that it is proposed that initial price caps will apply when the expected price step is 5%. This is less than the 10% threshold used in 2012. We note that as distribution prices form only a small part of the total electricity bill, the impact on consumers (on average) is well below these thresholds.
37. We also note that the smaller the initial step, the higher the alternative rate of change for the remainder of the regulatory period. This influences the profile of revenue recovery over the period, which will determine the likely price step into the next regulatory period (which may be a step down as a result of a steeply sloping price path). As noted above, it also potentially impacts the option of applying for a CPP, as it influences when revenue is able to be recovered within a regulatory period.
38. We suggest that those EDBs which are potentially affected by the proposed 5% threshold, are consulted as to their preferred revenue recovery profile which reflects the needs of their consumers and own circumstances, subject to retaining present value equivalence, as proposed. It may be that some EDBs prefer deferring revenue recovery, possibly into the next regulatory period and others may not. We believe it is reasonable to accommodate different circumstances in this instance.

Pass through and recoverable costs

39. Pass through and recoverable costs are well established mechanisms (included in the IMs) which enable costs which are outside the control of EDBs to be recovered through prices. As the DPP Policy Paper highlights, there are some practical impediments to achieving this outcome in practice because of the way in which the price path has been specified to date. We support consideration of improvements which address these issues and will comment on the specific proposals in our forthcoming submission on the Compliance Paper.⁶
40. We note that some submitters have suggested that it may not be appropriate for pass through or recoverable costs to be passed on in full to consumers because it removes incentives for distributors to

⁶ Proposed Compliance Requirements for the 2015-2020 Default Price-Quality Paths for Electricity Distributors, 18 July 2014

focus on these costs. We note that the costs in question are already subject to significant public and legislative scrutiny (for example transmission charges are regulated, and local body rates and industry levies are highly scrutinised).

41. In addition, we do not consider that EDBs are, in practice, able to influence these costs to any extent, as they reflect costs for services which are not undertaken by the EDB, and suppliers of these services have the right to seek to recover them from EDBs.
42. We note that there are a number of new recoverable cost categories proposed, and also some amendments to the process for calculating and approving a number of different recoverable costs. Our detailed responses to these proposals will be addressed in forthcoming submissions, however in the interim we note:
 - We support the proposal to introduce a new recoverable cost allowance to allow recovery in the next regulatory period, of capped revenues from the current regulatory period
 - We note the discussion as to whether the cost of debt or cost of capital should be used to calculate the time value of money adjustment for deferred revenue recovery. We believe that time value of money adjustments should be made using a consistent method across all elements of the price path, including the proposed new incentive schemes for expenditure efficiency, quality of service and energy efficiency and demand side management initiatives. We consider the cost of capital should be used for this purpose as this is the opportunity cost of deferred revenue recovery/financial penalties for a supplier.
 - We are concerned at the proposals to introduce pre-approval processes for some types of recoverable costs. Unless these processes are able to be completed in a timely way, EDBs may face deferral of, in some cases, significant recoverable cost amounts. This potentially leads to pricing and cash flow instability. The proposed avoided cost of transmission approval process is of particular concern, for this reason.

Forecasting methods

43. We acknowledge that the DPP is intended to rely on relatively low cost forecasting methods; however we submit that any learning from the current period should reasonably be expected to be incorporated into the methods to apply in future periods. We therefore support efforts to test the performance of the forecasting methods employed, and as a result suggest potential improvements to them.
44. We also submit that recent data should be incorporated throughout the DPP models before the final Determination is made. The next regulatory period ends in FY20. We see no reason to ignore actual data prior to the start of the period, if available. Any potential forecast error within the regulatory period is compounded if data which is up to date, and available, is ignored.
45. We note the plan to introduce FY15 forecasts with ex post wash-ups for certain capital items which influence the price path. We support this approach, which is consistent with our view that information which is current at the time of the reset should be used where possible.
46. We understand the concerns about year on year variability in actual data, which may unduly influence forecasts. This is why we supported, in our submission on the Process and Issues Paper⁷, the use of data from FY13 and FY14 for establishing the base year opex allowance for each EDB.
47. Our detailed comments on the proposed forecasting approaches are contained in our accompanying submission on the DPP Forecasting Paper.

⁷ PwC, Submission to the Commerce Commission on behalf of 20 EDBs, Default price-quality paths from 1 April 2015 for 17 electricity distributors: Process and issues paper, 30 April 2014

Quality targets and incentives

48. The DPP Policy Paper proposes a change in the design of the quality standard component of the DPP. It is proposed that a revenue incentive scheme is introduced in place of the current/pass fail quality standard tests. A quality incentive scheme has previously been supported by industry participants, which partly reflects the work of the ENA's Quality of Supply and Incentives (QoSI) working group in assessing how quality may be assessed and measured and possible refinements to the quality path approach for the DPP.
49. Our detailed comments on the proposal will be provided in our forthcoming submission on the Quality Incentives Paper.⁸ However in the interim we note:
- We support the retention of own network SAIDI and SAIFI as the quality of service measures for the next regulatory period. While we acknowledge that it may be appropriate to expand the range of measures for future regulatory periods, we believe that it is more appropriate to introduce additional measures through Information Disclosure in the first instance. This will enable new measures to be developed, and relevant data to be collected and tested, including with consumers, prior to possible inclusion in the DPP.
 - We support the use of historical data (including the most recent data available) for each EDB to determine the quality limits or targets. Historical data provides the appropriate benchmark against which future performance can be assessed, and reflects the current status of each network.
 - We support an approach which normalises for the impact of major events which are largely outside the control of EDBs, in order to derive a measure of underlying reliability. We believe the IEEE standard, which has been widely adopted globally is an appropriate reference point for this purpose. We understand that there are challenges in this respect in a New Zealand context, due to the predominance of small networks, with relatively few outages.
 - We believe that there is a possibility that an incentive scheme, in practice, will generate financial rewards and penalties which reflect year on year variation in weather, rather than underlying improvements or reductions in service quality. This potential outcome is relevant to the design of the normalisation methods and the compliance and enforcement procedures associated with the quality standard.
 - We support the proposal to cap revenue at risk for the next regulatory period at a low percentage of maximum allowable revenue (which we note excludes recoverable and pass through costs) in order to test the operation of incentive scheme in the next regulatory period. We agree that any incentive scheme in principle should be symmetrical.
 - We believe that the proposal to adjust the quality targets and caps and collars downwards to reflect the impact of previous breaches is flawed because it mixes different methods and standards. We also consider that the proposal unduly penalises (including in financial terms) for prior period performance. We are aware that the breaches have been investigated and no fault was determined and no compensation sought.
 - It is proposed that EDBs will be non-compliant with the quality target if their annual SAIDI or SAIFI performance (calculated in a similar way to the target) exceeds the target. This means that on average, half of the non-exempt EDBs will be non-compliant each year,

⁸ Proposed Quality Targets and Incentives for Default Price-Quality Paths From 1 April 2015, 18 July 2014

on each measure, due to normal variation. This is the same situation which led to the introduction of the standard deviation buffer and two out of three year test for the first DPP in 2010. These features were introduced in recognition of sampling variability in reliability data.⁹ We do not consider that annual performance which exceeds the target is the appropriate threshold for compliance purposes. The reasons for this are the same reasons acknowledged in footnote 53 of the DPP Policy Paper

- Accordingly we do not agree with the statement in the DPP Policy Paper that the proposed revenue-linked incentive scheme helps reduce uncertainty for distributors as there will be more certainty as to how the Commission will assess and enforce compliance. We agree that the method for deriving the financial incentive is certain, but the enforcement and compliance process is not, and as noted above, non-compliance will apply in many more instances than under the current pass/fail model due to the proposed non-compliance threshold and potential enforcement action.

Outage response

50. We are concerned at the statements at paragraph 6.12 of the DPP Policy Paper which infer that distributors may be able to control all of the determinants of reliability in the longer term (but not the short term), and that the distributor is able to control how long it takes to resolve an outage. Networks are not designed with sufficient redundancy to provide alternative supply to all consumers in the event of an outage, or multiple outages. The costs of doing so would be prohibitive, and hence so would consumer prices. Similarly the costs of providing immediate restoration for all outages would be prohibitive. Assets could be undergrounded to avoid the impact of wind, snow, vegetation etc, but underground networks are not immune to outages, they may be more difficult to repair than overhead reticulation, and they are considerably more expensive.
51. The most critical factor determining how long it is before an unplanned outage is restored is safety. The EDBs which support this submission are very concerned that the safety aspects of network fault response are not acknowledged in the DPP consultation papers. It is the immediate safety circumstances which determine when and how a fault is responded to. The safety of the fault staff and the public overrides all other factors, including financial penalties and rewards, or other Part 4 regulatory settings.
52. During major weather events, it is often too unsafe for staff or contractors to commence their fault location and restoration tasks immediately, particularly at night. In addition crews must be rotated on and off during significant events to ensure they are able to operate safely. This is why we challenge statements such as those included in paragraph 6.12, which suggest a distributor could choose to do better in extreme weather circumstances.
53. We also note that distributors are acutely aware of the disruption to their customers during an outage, particularly an unplanned outage. We believe the customer response is one of the most critical and effective drivers which ensure outages are restored in a timely way. Customers are also understanding of the safety risks, particularly as they are experiencing the same conditions. We therefore challenge a number of the assumptions which have been applied when designing the proposed incentive scheme, particularly how the targets are set, and the normalisation methods determined.
54. While we will be responding in more detail in due course, we note that in the UK, Australia, and the IEEE methods developed in the US, exclude major event days from regulated quality performance standards, and subject those days to separate assessments. We believe that this approach is more

⁹ Refer Commerce Commission, Initial Reset of the Default Price-Quality Path for Electricity Distribution Businesses, Decisions Paper, 30 November 2009 (paragraphs 6.35-6.48)

suiting to an incentive regime; otherwise the financial penalties and rewards are unduly influenced by the frequency and severity of weather events.

Financial incentives

55. While we agree in principle that a quality incentive scheme provides a source of funds for EDBs to invest in improvements in quality performance, in reality the incentive rates proposed are very low and accordingly, if implemented the financial incentive will be weak for the next regulatory period. While we agree that this is appropriate for a first time implementation, we believe that this feature of the proposal needs to be well understood in order to manage expectations.
56. In this respect we note that the proposed opex forecasting approach includes no allowances for changes in reliability other than what is achievable within the existing base opex spend. The proposed capex spend may or may not, depending on whether an EDB has planned for reliability based projects, and whether the planned spend has been capped. In reality, the capex allowance provides a slower source of funds than opex, as it is recovered over the life of the assets.

Pass/Fail regime

57. The DPP Policy Paper suggests that there were a number of weaknesses with the current pass fail regime. These were also set out in the Process and Issues Paper. In our submission on the Process and Issues Paper we examined the suggested weaknesses and provided our views on each of them. This input does not appear to have been considered when preparing the DPP Policy Paper. Accordingly we have repeated our views below for ease of reference.
- ***The statistical allowance in the reliability limit may provide scope for a material deterioration in reliability over time without EDBs being non-compliant.*** It is possible that the statistical allowance could lead to higher average reliability over time without there being a breach of the quality standard. However, the point of the allowance was to avoid the opposite; a breach of the quality standard where there had been no deterioration in long-term reliability. That is, a reliability limit based on the average would have resulted in more breaches where there was no long-term deterioration in reliability, simply due to normal year on year variation. This is because annual reliability is expected to be greater than the average roughly half the time, all other things being equal. While the DPP quality limit is one reliability measure, it is not the only one, and as demonstrated in EDB asset management plans, and through annual statistical reporting, there is no evidence to suggest that the DPP limit has resulted in material deterioration in reliability performance, or that EDBs are forecasting such deterioration.
 - ***The two years out of three compliance assessment rule may incentivise distributors to exceed their reliability limit once but not two times in a row.*** We are also not convinced this issue is a material risk. EDBs actively seek to avoid breaching the reliability limit in every year, and as noted above this is not the only measure against which EDBs set their performance targets. While a breach of the reliability limit in one year increases the pressure on the business to not breach the next year, there is no incentive to breach in the first year. The uncertainty surrounding the timing and severity of weather events creates too much risk to adopt such a strategy. It is also fundamentally contrary to the commitments made to consumers and published annually in AMPs and Statements of Corporate Intent.
 - ***The quality regime may have created an inefficient timing incentive for planned work, as EDBs delay planned works to provide more headroom for unplanned interruptions.*** We agree that it may not be in consumers' best interests that planned work is delayed where EDBs are close to breaching the reliability limit. However, this could also be addressed under the cap and collar approach through disaggregation of the quality standard into planned and unplanned reliability and the adoption of a wider cap and collar and lower

revenue at risk for planned outages. Alternatively, as suggested above, the two could remain aggregated but a lower weighting given to planned interruptions in the reliability limit.

- **The Commission currently has discretion over the enforcement action that may be taken where the quality standard is breached, creating uncertainty for EDBs.** We agree that too much uncertainty exists regarding enforcement actions that the Commission might adopt, however this issue can be addressed through a number of ways, including enforcement guidelines and precedent.

Other incentive mechanisms

58. The DPP Policy Paper proposes that other incentive mechanisms are introduced for the next regulatory period including:

- Incentives for energy efficiency, demand side management and the reduction of losses
- Incentives to control expenditure during the regulatory period under an incremental rolling incentive scheme (IRIS) mechanism.

Energy efficiency, demand side management and reduction of losses

59. We have previously acknowledged the research of the ENA's Energy Efficiency Incentives working group and their recommendations for appropriate incentives for these outcomes. We note that it is a legislated requirement for the Commission to promote incentives and avoid imposing disincentives to achieving these outcomes (via section 54Q).

60. We support the addition of energy efficiency and demand side management (EEDM) incentive mechanisms to the DPP. We support the proposal for EDBs to make applications for a financial compensation, to be approved by the Commission before the incentive is recovered through prices. We note that this proposal does have some challenges for smaller EDBs, as the costs of preparing a proposal are unlikely to be scalable, however the size of the potential revenue incentive will be. We suggest that over time this disadvantage may reduce as precedents become available.

61. We agree that it is sensible to base the approval process largely on the Australian model for the forthcoming DPP regulatory period. Further refinement can be considered for future resets once there is a body of evidence and both EDBs and the Commission have some experience with the practical challenges of implementing the proposed scheme.

62. With regard to the specific proposals:

- We have previously noted that distributors have actively promoted demand side management for many years, and while the ways in which that can be implemented change overtime, the opportunity and desire to control demand at peak times is not new. We agree that an incentive which compensates distributors for foregone revenue associated with demand side management initiatives is consistent with section 54Q, and should be implemented into the DPP.
- The proposal to design the capex IRIS to include a wash-up for the difference between assumed asset lives for commissioned assets and actual outcomes appears to be a sensible way to remove the disincentive against investing in shorter life assets, an issue raised by the Energy Efficiency Working Group. The proposal to reduce the differences in the strength of the incentives between opex and capex via IRIS also appears to be consistent with the desire to enable equitable choices between opex and capex for EEDM initiatives. We will be responding more comprehensively on the IRIS proposal in our forthcoming submission on that paper.
- We note that there will be instances where the benefits of investments in EEDM initiatives may be shared between electricity lines businesses and other businesses. We note and support the intention to provide clarification as to the types of investments that would be deemed to fall within the regulated business. We also note the role of the cost (and asset) allocation IM for allocating shared costs and assets between regulated businesses and other businesses. We believe that this IM is also relevant to addressing this potential complexity.

- In addition, businesses may choose different structural options which mean that the investments in assets designed to achieve EEDM outcomes may sit outside the regulated business. Charges may be levied on the regulated business (subject to related party rules) to reflect those services which are relevant to the regulated business.
 - Tariff design is one tool available to distributors to influence EEDM outcomes. As the DPP price path is a weighted average price cap, not a revenue cap, EDBs actual revenues relative to the price cap are influenced by changes in volumes. It is these volume impacts that an incentive arrangement should address, in order to achieve outcomes consistent with s54Q. The proposed incentive scheme is limited to revenue compensation for demand side management initiatives. We agree with the ENA, that this falls short of the requirements of s54Q and the proposed carve out of pricing structure impacts should be removed.
 - We acknowledge that tariff restructure does introduce potential compliance risk, particularly due to the lagged quantity approach adopted for the DPP.¹⁰ We believe that additional guidance as to how EDBs should prepare their PxQ schedules is a useful way to clarify the rules. We are considering the proposal to introduce a pre-approval process for some types of price restructure and will respond further in our forthcoming submission on compliance issues.
63. However, the real issue with the price path is that volume risk deters investments which may generate EEDM outcomes, as reduced volumes mean reduced revenues. A number of suggestions for reducing this risk have been put forward previously including:
- A volume wash up mechanism
 - Moving to a revenue path approach
 - Modifying and improving the real revenue growth forecasting approach adopted for determining each EDB's price path.
64. We address these issues further in our accompanying submission on the DPP Forecasting Paper.

Incentives to control expenditure

65. The proposed capex and opex IRIS schemes are described in detail in the Expenditure Incentive Paper which was released on 18 July. We will be responding to that paper in our forthcoming submission. In principle, the EDBs which support this submission believe that in respect of the proposed IRIS:
- Normalising incentives for expenditure efficiency over time is a useful enhancement to the current DPP, and we agree the incentives are currently distorted within and between regulatory periods.
 - The proposed mechanisms appear complex, and it is proving difficult to understand what they mean in practice for each EDB. This partly reflects the potential interplay between the various incentive mechanisms and other elements of the DPP (for example the treatment of spur asset acquisitions, and the forecasting methods employed in the draft DPP decision).
 - There is some concern as to whether it is appropriate to introduce an IRIS into the DPP because of the low cost forecasting approach. Our initial view is that the opex recoverable cost allowance will in practice reflect the ability of an EDB to meet the DPP opex forecast.

¹⁰ Lagged volumes are used because they are known with certainty when prices are set. However where a business restructures its prices, volumes are only available from the date that the new prices are introduced, which introduces a requirement to estimate volumes, and thus risk being non-compliant with the price path.

EDBs are concerned about this particularly as the DPP opex allowances are currently lower than the businesses own forecasts in most instances. Penalising businesses for not achieving the Commission's forecasts is therefore a real prospect for a number of the EDBs which support this submission.

- The capex scheme is more complicated because of the proposed RAB wash-ups, the proposed capex caps which affect different businesses in different ways, the impact of customer initiated capex and the impact of changes in commissioned asset values in one regulatory period which are reflected in prices paths in future regulatory periods. These impacts need to be considered when evaluating the capex proposal.

Acquiring spur assets

Asset acquired before the regulatory period

66. Where businesses plan to (or have already) acquire assets from Transpower prior to the next regulatory period, the costs of owning and operating those assets should be included in the price path, as the boundary between distribution and transmission changes once the assets are transferred.
67. Similarly the responsibility for the reliability performance of those assets transferred to the EDB, needs to be taken into consideration when setting the quality standard to apply for the next regulatory period.
68. The EDBs which support this submission therefore support the intent to include RAB, capex and opex allowances for assets which are transferred before 1 April 2015. We acknowledge the proposal to wash-up for differences between forecast and actual values associated with the assets to be transferred in FY15.
69. We consider that the proposed forecast opex allowances for spur assets are inadequate and that EDBs' own forecasts should be used. The opex forecasting method will not provide for sufficient opex for spur assets if they were transferred during or after the opex "base year" (which is currently proposed to be FY13). Without a full base year allowance, insufficient opex will be provided for.
70. In addition, the proposed scale adjustments will not generate opex allowances as regional population forecasts will not change as a result of the transfer, and historical circuit km adjustments are unlikely to contribute much additional opex, and certainly not commensurate to the assets involved, as the circuit km scale factors represent analysis performed on historical distribution circuits (which have entirely different characteristics to transmission circuits).
71. We acknowledge that an avoided cost, recoverable cost allowance is to apply for five years from the date of the purchase. We comment further on this allowance below.

Assets acquired after the regulatory period

72. The recoverable cost allowance for avoided transmission charges provides a source of funds for opex and return of and return on capital of assets which may be acquired in the next regulatory period.
73. It is proposed that this allowance is to be calculated in a new way and pre-approved by the Commission. We will comment fully on the proposed approval process in our forthcoming submission on the DPP Compliance Paper.
74. We consider there are some issues with the proposed new method for calculating the recoverable cost allowance, as follows:
 - The proposed method does not deal well with avoided interconnection charges, which are based on historical RCPD peaks from a 12 month historical period. The information is applied in November in the following pricing year. This means that avoided

interconnection charges will not be included in the year one estimate after a transfer (due to the lag in measuring the impact of the transfer on the RCPD data) and may only be partially included in a second year estimate, particularly where the transfer occurs after the peaks are measured (ie: in the second half of a pricing year). The proposed recoverable cost methodology will therefore fail to capture these genuine avoided Transpower charges.

- The proposal to maintain the recoverable cost in nominal terms after year one underestimates the true avoided cost of transmission as Transpower's forecast interconnection charges are expected to increase in nominal terms and connection charges also change year on year.
75. Thus we propose that a more reasonable approach (which is consistent with the intent that the recoverable cost would provide for the avoided costs of transmission) is for EDBs to calculate their avoided costs each year, with reference to connection agreements, and current data for RCPD peaks and interconnection rates, where relevant. These calculations can be provided to the Commission for approval as per the IMs.
76. We also believe that avoided transmission charges should also apply where capex is required on the assets after they have been transferred, and no allowance is included in the price path. Avoided charges are able to be calculated using the standard transmission pricing methods. Otherwise transfers will be dis-incentivised during the next regulatory period where investment is required in the assets after transfer.
77. We note that the papers do not consider how the recoverable cost is to be calculated for asset transfers which have already occurred, ie: are past year one of the five year recoverable cost period. We believe that the current approach should continue to apply to those transfers which have already occurred, as to change means retrospective adjustments to regulatory rules which compromises regulatory certainty, and the information on which the decision to invest was initially made.

Catastrophic events

78. It is proposed that a new catastrophic event price path re-opener is introduced. This is consistent with the direction of the High Court following the IM merits review appeals. We support this proposal in principle as we do not believe that the only option for remedy following a catastrophe should be to apply for a CPP, as it was for Orion.
79. As demonstrated in Orion's case, the immediate consequence of the Canterbury earthquakes was the service disruption due to damage to the network, and damage to the homes and businesses of its consumers. Thus Orion was unable to meet its DPP quality standards following the earthquake. We therefore submit that the catastrophic reopener is extended to apply to all aspects of the DPP including the price path, the quality standards and all incentive mechanisms.
80. We note that reopening the DPP does not preclude a supplier applying for a CPP following a catastrophic event, however, we would expect the reopened DPP to provide sufficient recognition the impact of the event from the date of the catastrophic event (or events) until the end of the DPP regulatory period. This will include adjustments for changes in volumes that occur as a result of the event that would not otherwise have been assumed when the price path was reset.
81. We acknowledge the intent to introduce a new recoverable cost to allow for delayed recovery of the impact of the event between the date of the event and the reopened DPP coming into effect. While the DPP Policy Paper explains that it is intended that the impacts will be shared between consumers and businesses, we do not believe that it is appropriate for the Commission to predetermine which financial impacts it will include in the recoverable cost allowance.
82. There were a number of consequences for Orion and their customers, and some of these may not have been fully anticipated in advance (for example the inability of customers and Orion to access areas of their network due to cordons, and the under recovery of pass through and recoverable costs due to demand reductions as a consequence). We suggest that if future catastrophic events occur, there may be other unanticipated consequences that need to be considered and thus the Commission should keep an open mind about what is able to be included in the proposed recoverable cost allowance.
83. Lags between other reopener events and the reset price path should also be addressed by the same recoverable cost mechanism.