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Dear Dane,

SUBMISSION ON DEFAULT PRICE-QUALITY PATHS – UPDATED DRAFT MODELS

Centralines Limited (Centralines) 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.* We have contributed to the development of the ENA's submission and support the recommendations contained. In this submission we focus on key issues for Centralines, rather than duplicate the responses in the ENA's submission.

In this submission we address the following:

- Revised circuit length data
- Capex allowance
- Updates to the CPI forecasts
- Normalising half hours
- Replacement of major events with the boundary value

FINANCIAL MODEL DATA

Revised circuit length data

It was identified in July 2019 that the total circuit length (for supply) in Schedule 9c of the Information Disclosure Schedules for the years ending 31 March 2015, 2016, 2017 and 2018 can be more accurately disclosed due to recent system and data accuracy improvements. Centralines disclosed the revised data to the Commission on 30 July, after obtaining Director certification for the completed Schedules.

The information previously provided to the Commission was not incorrect at time of disclosure. However, the rules and method for extracting asset counts, and data accuracy improvements have resulted in revised data that more precisely reflects Centralines' circuit length. The below table shows the disclosed and revised circuit length data to update the Commission's Default Price-quality (DPP) models.

	2015	2016	2017	2018
Disclosed circuit length data	1945	1902	1798	1804
Revised circuit length data	1845	1851	1857	1862

Capex allowance

In Centralines' submission on the Draft DPP Decision[1], we submitted support at a general level, of the Commission's approach to setting capex allowances, including its use of forward-looking Asset Management Plans (AMP). However, we are very concerned on how the use of percentage caps relative to historical performance causes significant problems for small EDBs. Centralines is impacted by both the 120% cap on total capex, and the capping of Centralines' 'capex acceptance rate' for 'other capex' at 68%.

In Centralines' 2019 AMP we identify a required uplift in expenditure to build a new depot and administration building[2]. Centralines effectively has little choice but to build a new depot and administration building for the following reasons:

1. The existing administration building and depot site have an inefficient layout and are unreasonably cramped;
2. It would be impractical (highly disruptive) to rebuild on the existing site because the main administration building must be demolished, whilst maintaining BAU functionality. It would be highly costly to temporarily relocate; and
3. Access from the road on the southern boundary of the existing depot is to be designated as a State Highway, which will effectively limit site access and hamper site efficient operations.

Centralines has purchased an alternative depot site and is currently in the design process for a new administration building. The new depot and administration building will inevitably push Centralines capital expenditure requirements above the 120% cap on total capex, and above the sliding scale cap on non-network capex expenditure.

We reiterate our concern from the perspective of a small EDB, when confronted with lumpy capital expenditure requirements which are invariant to EDB scale, small EDBs are disproportionately impacted and face the options of:

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

It is not in the interest of the consumer-owners' of Centralines to apply for a CPP to gain revenue allowances for such one-off investments. In such a situation Centralines would effectively be forced to absorb these costs by under-performing against the WACC.

Centralines strongly recommends that the Commission considers an alternative methodology that provides for smaller EDBs to reasonably undertake such activities without requirement to apply for a CPP. The same kind of expenditure in a larger EDB could be absorbed within a wider portfolio of investments. We request the Commission consider the additional step proposed in our earlier DPP submission:

[1] Centralines, DPP3 Draft Decision, Submission to the Commerce Commission, 18 July 2019
[2] In the 2019 AMP, Centralines has budgeted $6 million across 2019 and 2020 to construct the new depot and administration building.

After the application of the 120% cap, where an EDB has provided in its AMP, or as separate information certified by its Directors, evidence of one-off projects that exceed 20% of annual capex, these projects will be included in the capex allowance. If the project does not proceed a capex wash-up will be required in the following regulatory period to eliminate the benefit to the EDB of the additional capex allowance.

It is important that the resulting policy issues associated with the small EDBs facing such unavoidable lumpy expenditures are reviewed when considering the appropriate methodology. Without such analysis small EDBs will be disproportionately impacted. The resulting under-performance against the WACC for such EDBs will be to the detriment of often consumer-owned networks.

CPI forecasts
The global economy continues to show signs that is weakening quickly. If this continues to put a significant check on CPI inflation, such that it does not rise to the RBNZ's forecasts, EDBs' returns will not meet the lowered WACC. Centralines remains extremely concerned that the CPI forecasts are too high in the context of global indicators to the very likely detriment of our shareholders.

We recommend that Commission review the updates to the CPI forecasts in the Final Decision for the outer years of the 2020-2025 regulatory period. Given the deteriorating international outlook the CPI forecasts appear significantly optimistic. In light of substantial downside risk to businesses with the already reduced WACC, forecasting of the CPI should be conservative.

QUALITY STANDARDS AND RELIABILITY INCENTIVES

The complexity of the proposed new approaches creates risk that an EDB will not correctly apply the intended methodologies for normalisation. We recommend that following the publication of the Final Decision there is real need for further industry workshops for the Commission to explain the approaches, including how they link into the wider framework and enforcement criteria.

Normalisation
We agree with the proposal to adopt a 24-hour normalisation approach as being more consistent with operational practices, though we are unsure that it is fully effective in normalising half hours that do not reach the boundary value within the 24-hour period, when operating performance may be impaired.

Replacement of major events with the boundary value
Centralines reiterates its strong concern with the replacement of major events with the boundary value. The approach means that EBDs who face more than the assumed frequency of major events, would therefore face resulting financial penalties and a greater risk of breach.

As a rurally-based network, facing significant challenges associated with managing affordability for its consumers, Centralines is concerned that it may need to over-invest to avoid risks of breach. Increased (over) investment may be the only solution for EDBs if there are years with more than the assumed frequency of major events (more storms on average for a year), resulting in the EDB trying to meet SAIDI targets much lower than set in those years to achieve compliance.

The Commission has not addressed the policy rationale for penalising EDBs for higher frequency of severe weather events, than assumed in setting the targets, nor the reason for effectively penalising consumers for benign weather years. In addition, the outcomes are not symmetric, EDBs face the jeopardy of both penalties and costly engineering investigations, whereas consumer exposure to good weather is limited to zero MEDs.

We strongly recommend that the Commission reviews its proposed approach to ensure that it does not result in over-investment by networks. The possibility of severe consequences for compliance breaches may incentivise EDBs to over invest to avoid the risk of breach in years where there are more severe weather events than average. Such a result is likely to be inconsistent with the price/quality trade-off requirements of our consumers.

CONCLUDING COMMENTS

In conclusion we:

- **Request** the Commission update the total circuit length (for supply) for the years ending 31 March 2015, 2016, 2017 and 2018.
- **Recommend** the Commission consider the impact of the 120% cap on 'total capex' and 68% cap on 'other capex' on small EDBs, and give effect to an additional approval step for one-off projects to ensure small EDBs are not disproportionately impacted.
- **Review** the updates to the CPI forecasts in the Final Decision for the outer years of the 2020-2025 regulatory period given the deteriorating global economy outlook, taking into account the substantial downside risk to businesses.
- **Recommend** the replacement of major events with the boundary value is reviewed in the context that it may incentivise EDBs to over invest to avoid the risk of breach in years where there are more severe weather events than average.

We would be happy to discuss any of the points made in this submission with the Commission.

Yours sincerely,

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE