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Name of submitter:

Electricity Networks Association

Industry/area of interest:

Utilities/infrastructure

Contact details

David de Boer. Principal Advisor

Address:

Level 5, Legal House

101 Lambton Quay

WELLINGTON 6011

Telephone:

64 4 471 1335

Email:

david@electricity.org.nz

DPP for EDBs from 1 April 2020

Updated draft models – companion paper

Submission to the Commerce Commission

Final

From the Electricity Networks Association

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1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission to the Commerce Commission (Commission) on the consultation paper, **Default price-quality paths for electricity distribution businesses from 1 April 2020 – Updated draft models, Companion paper, 25 September 2019**, (the Companion paper) and associated models.
2. The ENA represents all of New Zealand's 26 electricity distribution businesses (EDBs) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network) electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

2. The updated draft decision

3. The Companion paper presents the results of updates to certain inputs and assumptions to be applied in the default price-quality paths (DPPs) to apply to non-exempt EDBs from 1 April 2020. The key changes since the May 2019 Draft Decision reflect an updated cost of capital estimate, the inclusion of 2019 information disclosure data and forecasts, and updated price index forecasts.
4. The Companion paper explains that the final decision may differ from the updated draft decision due to a number of other factors which are under consideration, including potential data issues. It is anticipated that further changes could have a significant impact on the final decision.¹
5. In addition, the final decision will incorporate changes to reflect the recent consultations on the impact of IFRS 16 (operating leases) on the input methodologies (IMs) and the financial models used to determine regulated revenue paths². An operating lease model has been included in the model suite released with the Companion paper.
6. The updated draft decision also presents two potential policy changes for consideration. These impact capex allowances and quality standards. The models provided with the Companion paper

¹ Companion paper, para 2.26

² Commerce Commission, Treatment of operating leases: Issues Paper, 6 June 2019, and Draft decision paper, 28 August, 2019

demonstrate the impact of the potential change to determining capex allowances, but not the proposed new approach to the quality standards.

7. The ENA appreciates the opportunity to comment on the updated draft decision. We address the key features of the updated draft decision below.

3. Comments on the updated draft decision

Expenditure allowances

8. In our submission on the Draft DPP Decision³ we challenged the Commerce Commission (the Commission) to reconsider the approach for determining opex allowances, including recognition of the impact of non-scale factors on EDB opex requirements and the partial productivity factor assumptions. We are disappointed that the updated draft decision does not respond to our submission points, although we understand that the opex allowances are still under consideration.
9. We reiterate our view that EDBs are facing ongoing challenges in their operating environments which must be reflected in the DPP opex allowances. The base-step-trend approach reflected in the updated draft decision, does not address these issues, and should be revised to include a trend factor allowance to accommodate these pressures.
10. The capex allowances have been updated. New data has resulted in significant changes in capex allowances for some distributors. In addition, a new method for setting the allowance for system growth capex is proposed.
11. It is now proposed that system growth capex is scrutinised together with customer connection capex. The Companion paper explains that this change is in response to submissions on the Draft Decision which challenged the previous proposal to assess system growth capex against expected zone substation capacity growth.
12. We agree that the previous proposal had shortcomings. This is because system growth expenditure is not solely associated with increases in zone substation capacity, it is lumpy, and the forecast data in Schedule 12 of the information disclosures which was relied on has some limitations.
13. We consider that the alternative proposal, to scrutinise both forecast customer connection and system growth expenditure against connection growth is a useful approach for an initial gating test. However, we do not think it is reasonable to rely solely on this test, because of the lumpiness of system growth expenditure. This would not be expected to line up with

³ ENA, DPP3 Draft Decision, Submission to the Commerce Commission, 18 July 2019

connections growth in the short to medium term. One reason this is problematic for DPP3 is the data series which is to be used starts in 2013, providing just six years of trend data.

14. Therefore, we submit that a two-step gating test should be applied to system growth expenditure, as follows:
 - i. Apply the system growth test against connections growth as proposed and accept the system growth forecasts for those EDBs which pass this test. Table 2.8 in the Companion paper suggests that all but four EDBs pass this test.
 - ii. For those EDBs which fail the test, examine their AMPs, and assess whether the forecast system growth expenditure is adequately justified, based on the information presented in the AMP, and discussions with EDBs where necessary.
15. This second step is similar to the approach adopted for the current DPP for gas pipeline businesses (GPBs). We consider that this process is manageable for the EDB DPP, and consistent with the low-cost intent of DPPs, as it was for gas businesses. This will involve additional scrutiny of just one capex category for four EDBs.
16. Furthermore, this capex category is typically supported by clear justification in AMPs, because it is targeted at solving specific network constraints which have been identified. We also suggest that the Commission engage directly with the four EDBs affected, (as for the GPBs), to test the AMP evidence where necessary.
17. For the record we also consider that household growth is a better explanatory variable for system and connection growth than is population growth and that any concerns about the alignment between territorial wards and EDB boundaries for this data are resolvable.

Operating leases

18. In our submission on the operating leases draft decisions paper⁴ we expressed concerns that the paper did not provide more explicit analysis of the impact of the proposals on the EDB DPP revenue paths to be set at 1 April 2020. In that submission we requested that the Commission clarify the treatment of leases in the updated draft EDB DPP decision due to be released before the end of September.
19. We acknowledge that the latest model suite includes an operating lease model. We also understand that the Commission is currently reviewing and clarifying the information provided by EDBs in response to the s53ZD notice on this topic. We also appreciate the opportunity to discuss the proposed approach with Commission staff during the preparation of this submission.
20. The proposed impact of the changes to IFRS 16 on the regulatory settings is complex. It is particularly complex during the initial transition. Some EDBs have adopted the standard early,

⁴ ENA, Treatment of operating leases, Submission to Commerce Commission, 18 September 2019

and others are not planning to make any changes for materiality reasons. In addition, because the standard transfers costs which were previously recognised as opex to assets, the changes disrupt regulatory time series information, and the IRIS expenditure incentive schemes. As we have stated in our earlier submissions, it is important that the incentive properties of these schemes are preserved.

21. However, the impact of the proposed treatment of operating leases on the DPP3 revenue paths and opex and capex allowances remains uncertain. We are disappointed that this uncertainty persists at this late stage of the decision-making process. While we acknowledge that there are some data issues to be resolved, the format of the operating lease model, the ambiguity in how to interpret the data switches within that model, and the lack of clarity about how the outputs of that model will affect the DPP financial model are of concern to us.
22. We are reluctant to make guesses about the impact on the DPP revenue allowances of the operating lease model provided, for the reasons outlined above. We understand that the Commission has been corresponding directly with EDBs about their lease information, and that the outcomes of those discussions may result in changes to the modelling.
23. Accordingly, we request that the Commission release a further version of the DPP financial model for review, once all of the lease information has been incorporated consistent with the proposed changes to IMs, before the final decision is made.
24. For clarity we set out our current understanding of the proposed modelling for operating leases below.
 - Capex allowances for IRIS will be determined using a capex gating method (still under consideration as noted above). This will ignore any right of use assets (ROU)⁵ which may be included in the historical and forecast capex information.
 - Capex allowances for DPP building block allowable revenue (BBAR) will reflect the above plus any ROU assets forecast to be commissioned during the regulatory period. These values will be derived from s53ZD information provided by each EDB, and will include values commissioned prior to the start of the next regulatory period, for the purpose of the financial model.
 - Opening RABs and RAB depreciation on existing assets will include ROU assets commissioned during RY18 and RY19. Regulatory tax values will also include opening deferred tax values for these assets. These values will be used to derive forecasts of the revenue building blocks for existing assets during DPP3.

⁵ For the purpose of this discussion we ignore any ROU assets which reflect leases which are recovered as recoverable and pass through costs, and finance leases which are included in RABs under clause 2.2.11 of the IMs.

- Revenue building blocks for additional commissioned assets will reflect ROU assets commissioned from RY20 onwards. Adjustments to deferred tax balances will be made from RY20 onward for these assets. We have previously submitted for a wash-up for unrecovered depreciation on these assets due to the default asset life assumed for the DPP BBAR.
- Opex allowances for IRIS will include opex leases and are to be established using the RY19 base year, step and trend approach (acknowledging that the base-step-trend method may be refined for the final decision). Opex leases will be added back to the base year for opex IRIS allowances where they had been removed by those EDBs which adopted the standard early.
- Opex allowances for the DPP BBAR will exclude opex leases. This is to be calculated by deriving a deduction from the IRIS opex allowance in the next regulatory period, based on EDB forecast data.

25. We encourage the Commission to provide further explanation if the modelling for the final decision differs to this understanding.

Draft quality standards and incentives

26. The updated draft decision reflects the application of the RY10-RY19 reference datasets for planned and unplanned outages. The Companion paper provides updates to the parameters for each of the proposed quality standards which were included in the Draft Decision, which reflect this new data. The updated incentive rates for the quality incentive scheme also reflect the change to the cost of capital estimate.
27. Minor changes have also been made to the boundary value calculations for Nelson Electricity and Electricity Invercargill and to the way that the inter-regulatory period cap has been calculated.
28. The most significant aspect of the updated draft decision on quality standards is the proposal to change the way that major event days are identified and normalised.
29. It is not clear from the Companion paper whether other changes may be made to the quality standards for the final decision. We reiterate our previous views that:
- the 2 out of 3 year test is retained for unplanned outage compliance
 - the planned outage standard is determined using five years of historical data or forecast data
 - no extreme event standard is required, and additional reporting for major events is sufficient

- revenue at risk is capped at 1% of allowable revenue for the quality incentive scheme.⁶

30. We note that the quality standard models provided with the Companion paper do not incorporate the proposed new normalisation method. The quality parameters in the paper also do not reflect this new method. Accordingly, it is difficult to assess its impact on the quality standards that might apply to each EDB during the next regulatory period.

31. Our understanding of the proposal is as follows:

- Major event days are identified on a 24-hour rolling basis, rolling on the half hour
- The boundary value is selected as the 1104th highest half hour period (incorporating 24 hours of outage data) across the ten-year reference dataset. This equates to 23 major event days during the reference period, which is consistent with DPP2.
- During a major event day, each half hour is substituted with 1/48th of the boundary value, where the recorded outages for that half hour exceed the pro-rated boundary value. This differs to DPP2 where the entire major event day is substituted with the full boundary value.

32. As previously noted, we retain some concerns about adopting an overly granular and statistical approach to normalising for major event days. As we have stated previously there is a real risk that in compressing the duration impact of an interruption into the half-hour period when the interruption commences, the Commission loses the visibility of the operational impact on a business of a major event.

33. The proposed alternative normalisation method retains the half hour view of data, but it is now proposed to assess this on a rolling 24-hour basis, rather than the 3-hour rolling basis which was proposed in the Draft Decision. We suggest that such a granular view of the data provides sufficient confidence to remove all outages when normalising major events, to further limit their impacts on the annual assessments.

34. However, we consider that the proposed approach is an improvement on the Draft Decision (and DPP2) for the following reasons:

- It is more aligned with the IEEE method which identifies MEDs as 24-hour periods, and assumes 2.3 MEDs on average per year
- It incorporates rolling 24-hour periods, so is not limited to calendar days – an issue which the ENA's QoS working group identified with the DPP2 method

⁶ As explained in full in our submission: DPP3 Draft Decision, Submission to the Commerce Commission, 18 July 2019

- It reduces the impact of MEDs on normalised outage statistics compared to an approach which substitutes each MED with the boundary value (as per DPP2) or a pro-rated boundary value (as per the Draft Decision)
- It extends the duration of a MED to a minimum of 24 hours, reflecting the stress placed on networks during major events, similar to DPP2.

35. We wish to reiterate our concerns about the use of 10 years of historical planned SAIDI data for the SAIDI incentive – this concern had unanimous ENA support in the earlier DPP3 consultations. We continue to find it alarming that the Commission is creating a SAIDI target based on planned works executed in 2009, when the assets were 10 years younger.

IRIS model error

36. The updated model for calculating IRIS recoverable costs⁷ contains a significantly improved calculation of the capex IRIS recoverable costs (compared to the earlier illustrative model). We are disappointed this model was not republished along with the updated draft decision. We suggest that the Commission republish the model with the final DPP Decision.

37. However, the model retains some inconsistencies with the IMs, which means it is not fit-for-purpose. These errors should be corrected to ensure EDBs understand and implement the capex IRIS mechanism correctly. In particular:

- In the calculation of the "retention adjustment", the present values are calculated by applying a full year of discounting to annual commissioned assets. However, assets are commissioned throughout the year (and the DPP assumes mid-year). Therefore, discounting them to the end of the year requires discounting by 0.5 rather than 1.0 (refer row 27 of the 'Capex incentives' tab).
- In the "RAB update" tab, the remaining life values which are replaced with actuals are out by one year. The actual remaining life specified for assets commissioned in RY16 is applied to assets commissioned in RY15, the actual value specified for RY17 is applied to RY16, and so on. Note that the assets commissioned in RY15 should not have their depreciation adjusted as part of this calculation, while for assets commissioned in RY20 there is no adjustment made to depreciation within the RY16-20 period.
- A weighted average asset life is used as the 'actual' for assets commissioned in each year, rather than a series of asset-specific lives which would be consistent with the IMs. It is possible for the revised model to generate comparable outcomes to an asset-by-asset by approach, but only if the weighted average life is calculated based on the opening ID RAB and ID depreciation in the year after commissioning.

⁷ Issued in June 2019.

Weighting the ID asset lives by commissioned asset value will not generate a correct result. For this model to be easily used, we suggest it include specific guidance regarding the required method for determining the actual weighted average asset lives for commissioned assets.

Cost inflators and CPI

38. We note that the Commission has updated the DPP3 input cost inflators from the earlier draft (including a review by NZIER of the LCI) but has retained the same CPI forecast for both the price path and for revaluations. We support the re-forecast work but also retain our earlier views that it may be appropriate for the Commission to make specific adjustments to the All Industries LCI to tailor it to the circumstances affecting the EDB labour market. The Commission is proposing a very small level of growth in real wages for EDBs over DPP3, which we think is implausible in a labour market operating at full employment, with high participation, rising demand for electrical workers and is heavily unionised.
39. As an end note, we found an error in the models – they do not use the September quarter CPI movement for forecasting pricing CPI movements - which should be corrected.

Appendix- member support

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

1. Alpine Energy
2. Aurora Energy
3. Buller Electricity
4. Counties Power
5. Eastland Network
6. Electra
7. EA Networks
8. Horizon Energy Distribution
9. Mainpower NZ
10. Marlborough Lines
11. Nelson Electricity
12. Network Tasman
13. Network Waitaki
14. Northpower
15. Orion New Zealand
16. Powerco
17. PowerNet
18. Scanpower
19. The Lines Company
20. Top Energy
21. Unison Networks
22. Vector
23. Waipa Networks
24. WEL Networks
25. Wellington Electricity Lines
26. Westpower