Orion

12 August 2019

Dane Gunnell

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Commerce Commission

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By email: regulation.branch@comcom.govt.nz

Dear Dane

Cross submission on EDB DPP3 Reset- Draft Decision (the Paper)

Introduction

1. Orion welcomes the opportunity to cross submit on the Draft Decision on default price-quality paths for electricity distribution businesses from 1 April 2020.
2. We support the ENA cross submission and place emphasis on their points relating to WACC and inflation, labour cost index and allowing for non-scale factors for opex allowances.

Operating and Capital Allowances

3. In support of more appropriate outcomes better use of EDBs AMPs, an important information disclosure requirement, is promoted by submitters[1] as a way to enhance informed setting of capex and opex expenditures.

[1] DPP3 submissions, Wellington Electricity page 11 and 16, Vector page 5 and 36, Centralines page 13, PowerNet page 4, Unison page 18

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Opex

4. There is acknowledgement in submissions that the environment in which EDBs operate has changed, driving costs into our businesses[2]. Heightened national focus on climate change, customer response to emerging technology choices and increasing pressures from regulation are driving non-scale factor operating costs into EDB businesses. Concurrently, many EDBs have capital expenditure pressures from system growth, and asset replacement and renewal as the lifecycle of existing assets come to end of life.
5. EDBs are united in their submissions that allowances for operating expenditure are too low. Allowances must be appropriate to support investment requirements signalled by EDBs. Specifically,
   - A lack of consideration for non-scale factors (i.e. not line length and ICP growth) importantly influencing operating forecasts leads EDBs to convey a growing list of non-scale factors increasing opex expenditure. None of these myriad changes in the operating and legislative environment during DPP2 have been sufficient to trigger DPP reopeners. We don't intend to relist these here except to convey that the message has been consistent beginning with submissions to the DPP3 issues paper.
   - The partial productivity factor is an appropriate factor that can recognise these non-scale factors in determining opex expenditure. These non-scale factors mask any productivity improvements by EDBs during DPP2. It has to do the job of both productivity adjustment and account for non-scale related trends due to the limitations placed on the Commission in undertaking a forward-looking assessment[3], and for DPP3 it needs to be between-1.7% and -3.0%[4] as per the ENA submission supported by the NERA report.
   - The all industries labour cost index is considered not reflective of wage growth in our industry, with calls to seek further advice from NZIER for appropriate wage growth forecasts for our industry[5]. We support this suggestion.

[2] DPP3 submissions, Eastland page 1, PowerNet page 2, Vector page 33
[3] Unison DPP3 submission page 9 point 19
[4] ENA DPP3 submission page 5 point 13
[5] Wellington Electricity DPP3 submission page 12 point 5.5

- EDBs suggest various ways to provide certainty for particular costs that should form part of the operating expenditure allowances. Wellington Electricity[6] and PowerNet[7] suggest including insurance costs as a recoverable cost or step change in the operating expenditure allowance. Wellington Electricity[8] also suggest including additional audit and reporting costs as a step change should the planned notification requirement be retained, and for LV reinforcement. Transpower[9] says IMs should be amended to allow costs of third party finance contracts with unrelated third parties, to fund costs under investment contracts, are recoverable. Vector[10] suggest increases in vegetation management should be treated as a step change.

6. We submit that the Commission carefully consider whether including the non-scale factor costs, highlighted by submitters, as step changes or recoverable costs has merit.

Capex

7. Entrust submits that,

   "Particular care is needed around elements of price-quality regulation which impact the extent lines companies can invest and maintain or improve network resilience and reliability." and

   Centralines comments,

   "…, with yields now negative in real terms, we are very doubtful that the regulated WACC will provide reasonable compensation to investors for the risk they take." and

   PowerNet go so far as to say,

   "The balance of risk versus return for EDB's may well have tipped too far and impact on their decision to invest which may not be in the long term interest of consumers in the sector."

   We agree with these statements and support them.

8. In particular;

   - On capital expenditure, refinements to the gating tests to avoid unintended consequences due to their simplistic nature are suggested and we agree these are needed to ensure valid investment can continue.

[6] Wellington Electricity DPP3 submission page 10
[7] PowerNet DPP3 submission page 2
[8] Wellington Electricity DPP3 submission page 12
[9] Transpower DPP3 submission page 1
[10] Vector DPP3 submission point 116

- The 120% cap of historical level is problematic. PowerNet[11] says the test doesn't work for non-network capex and that this should be accommodated through review of the AMP or a reopener. The Lines Company[12] says the gate test doesn't reflect if an EDB has improved its systems, processes and resourcing so that forecasts are now more reliable. Vector and Wellington say that AMPs and EDB justification should be used where gate tests fail.
- Typical costs related to system growth, particularly new build, are not accommodated by the system growth gate tests e.g. land purchase, cables and switchgear. It assumes a linear relationship between cost and MVA[13] that does not follow through in practice. We support these comments.

9. We submit that the Commission take time to refine their gating tests, consider removing the 120% historical cap and using AMPs for expenditure justifications where gate tests fail.

IRIS

10. We support the following statement from Vector,

"108. As a minimum, the Commission should consider the interdependency between the retention factor and capex allowance when setting the retention factor. If the capex allowance is capped to a level below what is needed to deliver the outcomes that consumers and other stakeholders want, then raising the retention factor can further compromise an EDB's ability to achieve those outcomes – it would create unnecessarily more pressure for such an EDB to economise on capex. Conversely, if the draft retention factor is retained, then the Commission should provide a more realistic capex forecast."

Quality

11. Infrastructure New Zealand makes an important contextual comment when it submits that,

"Both affordability and reliability are of paramount importance. The Commission should not promote total reliability if it makes the network unaffordable, but neither should it drive affordability at the cost of an unreliable and non-resilient network.

We are concerned that the current default price-quality path (DPP) does not fully allow for the substantive and long-term investment needed to ensure reliability for customers."

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[11] PowerNet DPP3 submission page 4
[12] The Lines Company DPP3 submission page 11
[13] Vector DPP3 submission page 27

12. A common theme of submissions is the need to make a strong link between allowed capex and opex expenditure and the quality regime. Unison comment,

    "We encourage the Commission to consider the links between the quality aspects of the regime and expenditure allowances to ensure they are aligned". We agree.

13. The design of quality measures that maintain the 'no material deterioration' principle is an important overlay to quality related proposals for DPP3. Submitters, including MEUG[14] and ERANZ[15], question whether some new measures will actually be of benefit to consumers.
14. Broadly, the submissions reflect differing viewpoints on quality. The extent of change and complexity proposed for quality aspects of the regime has created uncertainty and concern.
15. We submit that moving forward ad hoc changes should be avoided in favour of considered changes during the next reset period that ensure performance is to reliability levels that are right- that is at a level customers are willing to pay for.
16. The lack of alignment between allowances, which will necessitate planned outages, and the quality aspects of the regime are noted. MEUG reflect on the content of their NZIER report; "Ideally a discussion of measures to improve service quality would begin with a comparison of consumer willingness to pay for improved service reliability and an estimate of the cost of delivering the reliability..." We agree while also concurring on the complexities involved in such an approach. To alleviate this to some extent, EDB submitters advocate for a 5 year historical dataset for setting planned targets and limits to better reflect the planned outage activity supporting expenditure.
17. Submitters want the 2 out of 3 rule retained because there is potential for false positives that lead to a breach, as a result of the newly proposed untested normalisation process for unplanned outages (a three hour rolling major event) even with a move to a 1.5 standard deviation. It is important that the implications of the normalisation approach are well understood and appropriate. We submit that the 2 out of 3 rule should be retained for DPP3.

[14] MEUG DPP3 submission page 3
[15] ERANZ DPP3 submission page 9, 3.5.5.2

18.Aurora[16] submits that the notice group definition, relating to the notified planned interruption, extends the notification obligation so that distributors are required to notify the 10 largest consumers affected by the interruption. We agree with their view that this additional requirement is not practicable, and that the obligation should be limited to notifying the affected retailers (which will notify all consumers affected).

19.Calls for enforcement guidelines, to provide certainty and manage cost during breach investigations, are reiterated by submitters reinforcing submissions to the earlier issues paper[17]. We agree that enforcement guidelines are required.

20.The Commission has arranged a workshop on 16 August to discuss three aspects from submissions- the extreme event standard, incentivising notification of planned interruptions, and identifying and normalising major events (3 hour rolling). We agree these are three important areas that need greater consideration and we reserve our position on these subject to the workshops because:

- the extreme event standard does not measure material deterioration or a systematic issue before a breach can occur
- there are unintended consequences on operational decision making from the way the new planned notification incentive is defined
- the normalisation departs from IEEE standard and is untested with potential perverse outcomes

Unforeseen major connection reopener

21.The introduction of an unforeseen major connection reopener, given the move to a revenue cap, is supported by submitters. Submitters make suggestions for refinements to the form of the reopener, in particular, that the threshold is set too high to be of use, and doesn't provide a level playing field for smaller EDBs. We agree that the reopener is positive and that the threshold proposed is too low.

22.Vector[18] suggests updating the threshold to be a minimum of 5% of annual revenue (excluding pass through and recoverable costs) or \$5 million (whichever is the smaller). We agree with this principle but resubmit[19] that \$1 million is a more appropriate threshold rather than \$5 million. This would ensure a level playing field between distributors no matter their size.

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[16] Aurora DPP3 submission page 20 point 12.8
[17] DPP3 submissions, Horizon page 2, Powerco page 4, Vector Attachment A
[18] Vector DPP3 submission page 8
[19] Orion DPP3 submission page 7 point 37

23.Both Vector[20] and Powerco[21] suggest that the reopener is extended to include asset relocations. We consider that there could be merit in this approach if capital contributions is excluded from the reopener claim. Orion has experienced significant asset relocation activity during its post-quake CPP that is no doubt reflective of the current Auckland high development environment, and potentially what might occur in other regions also.

Innovation Allowance

24.We support ENA's cross submission on the innovation allowance.

25.The proposed innovation allowance is supported by the majority of submitters, excluding retailers. Retailers tend to overlook that EDBs, unlike in a competitive market, are unable to increase their risk/return to reflect the risker nature of network focussed innovation initiatives.

26.We support the submissions for an increase in the allowance from 0.1% to a 1% of revenue innovation allowance.[22]

Revenue smoothing/Limit on annual increase

27.We agree with Wellington[23] and Vector's[24] suggestion that the 10% limit on annual increase in forecast revenue on prices should apply net of pass through and recoverable costs.

Efficiency

28.Contact Energy states that "The regulated monopoly lines costs represent around 27% of residential consumer bills so there is considerable scope to improve the efficiency." The Part 4 regulatory regime is designed to allow distributors to recover their prudent and efficient costs, and the price outcome of that is an arithmetic result, not a performance measure. Their statement is non-sequitur: the "considerable scope" does not follow from the distribution share of the bill. What is important here is that any reduction in the distribution price is passed through fully to customers in a timely manner.

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[20] Vector DPP3 submission page 29 point 100
[21] Powerco DPP3 submission page 5
[22] DPP3 submissions, Callaghan page 1, EmhTrade page 1, ETNZ page 4/5
[23] Wellington Electricity DPP3 submission page 18
[24] Vector DPP3 submission page 68

29. Opponents to appropriate levels of opex and capex expenditure must not overlook the important role distribution has to enable physical delivery of energy to and from connections across the energy system. Our ability to invest appropriately, to maintain reliability, safety, resilience, and service, benefits all customers and stakeholders alike including retailers now and into the future.

Concluding remarks

Thank you for the opportunity to provide this cross submission. We do not consider that any part of this cross submission is confidential. If you have any questions please contact Dayle Parris (Regulatory Manager), DDI 03 363 9874, email dayle.parris@oriongroup.co.nz.

Yours sincerely

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Chief Executive Officer