



VECTOR CROSS-SUBMISSION TO COMMERCE COMMISSION DEFAULT PRICE-QUALITY PATH DRAFT DECISION

12 AUGUST 2019

CONTENTS

Contents	2
Executive Summary	3
Cash flow that supports investment.....	5
Unindexed RAB	5
Alternatives to non-indexation	6
Quality standards	9
Expenditure allowances	14
Capital expenditure	14
Capex IRIS	15
Operating expenditure.....	16
Other matters	19
Revenue smoothing	19
Re-opener for large unforeseen connections	19
Attachment A – Estimated meter data costs for LV monitoring.....	21

EXECUTIVE SUMMARY

1. Our previous submissions on the draft Default Price-Quality Path for 2020-2025 (DPP3)¹ and proposed input methodology (IM) amendments² highlighted (among other points) that:
 - 1) Electricity supply is evolving rapidly – the regulatory settings need to keep up if we want to collectively deliver the outcomes that consumers and other stakeholders want;
 - 2) Cash flow is insufficient to fund the capital expenditure that is needed to deliver those outcomes – an issue that is becoming increasingly critical in light of historically unprecedented falls in interest rates, which are in turn driving an expected sharp drop in the Weighted Average Cost of Capital (WACC). This comes on top of sustained under-recovery over the current DPP2 period;
 - 3) Cash flow needs to be looked at now if the regulatory regime is to remain sustainable – as highlighted in our previous submissions, an obvious solution would be to allow electricity distribution (EDBs) the option of an unindexed Regulated Asset Base (RAB), as has previously been applied to Transpower and airports. Without this option, Vector may need to consider either curtailing investment or raising capital contributions substantially, neither of which will meet consumer interests or wider stakeholder objectives;
 - 4) Inconsistency between price / revenue allowances and the quality standards will lead to inefficient trade-offs being made that harm consumers. At a minimum, the System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI) targets should be adjusted to reflect the current operating environment, including prudent health and safety practices – for example, by removing the 5% cap on inter-period changes;
 - 5) Going forward, regulatory innovation is needed to develop new measures of quality that better reflect what customers actually want. Our vision is that a

¹ Vector Limited, 18 July 2019, *Submission to Commerce Commission Default Price-Quality Path Draft Decision*.

² Vector Limited, 5 July 2019, *Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower*.

guaranteed service level (GSL) scheme should ultimately replace the quality standards and work in harmony with a quality incentive scheme;

- 6) Draft expenditure allowances are being set in a way that arbitrarily caps what EDBs are funded to deliver without any obvious consideration of consumer impacts – an EDB should at least be able to make the case for greater expenditure where this is clearly warranted without having to pursue a costly and time-consuming customised price path (CPP) application.
2. Although some of these challenges may be more acute for us than other EDBs, we are not alone. In these times of change, a flexible regulatory regime that promotes the interests of consumers both now and in the future is essential. In fact, many of our points above were made in other submissions to the Commerce Commission (the Commission) on the draft DPP3 and proposed IM changes.
 3. In this cross-submission we consider those and other submissions, further elaborating on our early submissions where appropriate.
 4. We also stand by our strong recommendation that the Commission reinstate its past practice of holding workshops with stakeholders and – importantly – Commissioners. This will give all interested parties an opportunity to discuss key issues that will help shape electricity supply for consumers over the DPP3 and subsequent periods.
 5. We look forward to working with the Commission and other stakeholders on getting the regulatory settings right for the DPP3 period.

CASH FLOW THAT SUPPORTS INVESTMENT

6. As we explained in our submissions on the DPP3 Draft Decision and the IM amendments,³ we are concerned that the current IMs and draft DPP3 do not provide enough cash to fund the significant capital investment that we need to make to deliver the outcomes that our consumers and other stakeholders expect of us – and which we have set out in our 2019 asset management plan (AMP).⁴

Unindexed RAB

7. To address this concern, we proposed that the Commission should introduce an option for an EDB to apply for non-indexation of the Regulated Asset Base (RAB), similar to what the Commission has previously allowed for Transpower and New Zealand airports. The circumstances currently facing Vector are comparable to those that applied to Transpower, given the significant increase in capital investment needed to fund unprecedented growth in Auckland. Changes to the way our network is being used and to the technology available (as set out in our AMP as the symphony strategy) requires us to make investment now to deliver long-term benefits to our consumers.
8. In its cross-submission on the IM amendments, Transpower agreed that the scale of the increase in capex needed to meet Auckland demand growth is comparable to what Transpower faced.⁵ Transpower noted that Vector's situation highlights the challenges that can arise trying to operate the DPP regime in a low-cost manner, while the individual circumstances of regulated suppliers can vary a great deal. Transpower also noted that:

*One of the potential outcomes of Vector's capex programme is that the average age of its network will reduce substantially, as has happened with our own network over the last 15 years. This is likely relevant to the matter of technology risk individual regulated suppliers face, and relevant to decisions over, for example, accelerated depreciation.*⁶

³ Vector Limited, 5 July 2019, *Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower*.

⁴ Vector Limited, March 2019, *Electricity Asset Management Plan 2019 – 2029*.

⁵ Transpower New Zealand Limited, 19 July 2019, *Cross-submission on Proposed Amendments to Input Methodologies*.

⁶ Ibid.

9. Similarly, Infrastructure New Zealand's submission was concerned that the Commission's current DPP3 proposal does not adequately account for the growth challenges facing EDBs, including cash flow for meeting investment needs.⁷
10. Although cash flow constraints are a particularly pressing issue for Vector at present (as they were for Transpower), it is likely that similar circumstances will play out for other EDBs in the future. Investment needs change over time, as network conditions, age, and demands evolve. Regulatory settings should at least allow the option for cash flow profiles to be adjusted to support long-term consumer interests and wider local and central Government objectives.
11. As we have noted previously, moving to a non-indexed RAB would be net present value (NPV) neutral for consumers – it does not affect the total amount of revenue recovered by Vector, merely the timing of recovery.

Alternatives to non-indexation

12. If we are not given the option of adjusting our cash flow profile via an unindexed RAB, it will be very challenging for Vector to maintain the investment trajectory needed to support Auckland's growth and the energy transition that is occurring across our industry.

Financing constraints

13. Raising additional debt could have adverse impacts on our credit rating metrics, which would in turn increase borrowing costs – with negative impacts for our customers. As we mentioned in our submission on the IM amendments, Standard & Poor's (S&P) have noted that the draft DPP3 decision would lead to lower cash flows for EDBs, reducing the ratings buffer (i.e. a signal that the risk profile has increased).⁸
14. As explained in our IM submission, we generally stagger our debt raising over time to align with investment needs and to minimise re-financing risk, consistent with many other large infrastructure firms. In doing so, we look to get the best rates and transaction costs that we can. However, this only gets us so far. If the cash inflows (from regulated revenue) are depressed, then it can be harder to raise debt at reasonable costs. Ultimately this adds costs that mean we have to reduce spend on capex and opex that

⁷ Infrastructure New Zealand, 18 July, *Infrastructure New Zealand feedback on the draft decision for the default price-quality paths for electricity distribution businesses from 1 April 2020*, page 2

⁸ <http://www.alacrastore.com/s-and-p-credit-research/Bulletin-Draft-Decision-To-Cut-Rating-Buffer-For-New-Zealand-s-Regulated-Utilities-2240844>

would otherwise benefit our consumers. A similar scenario would likely play out for other EDBs and other consumers across the country.

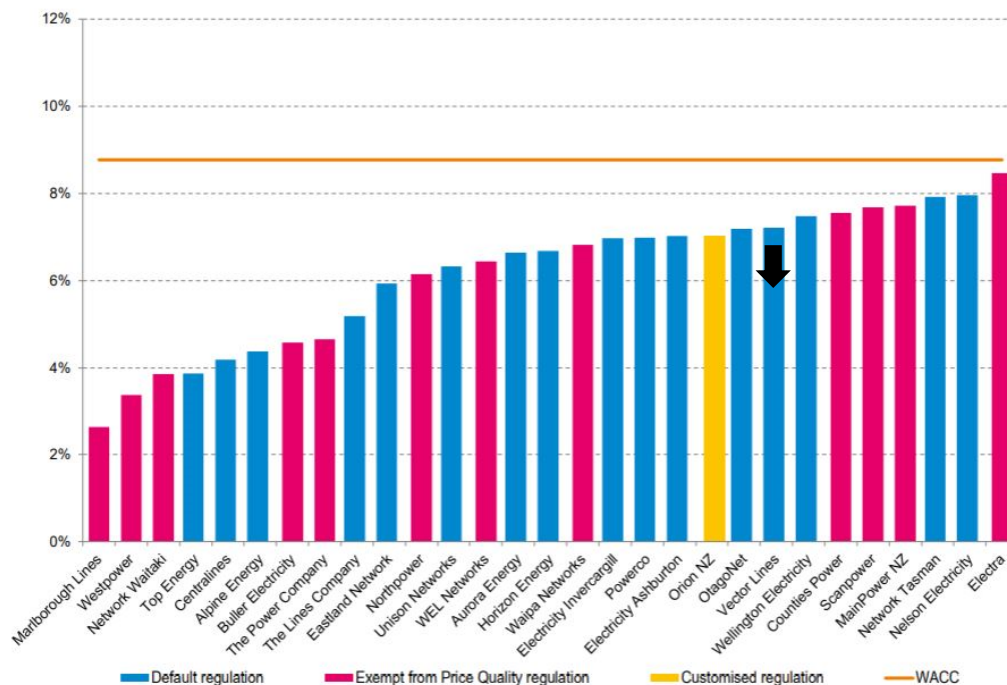
15. This is of particular concern given the expected sharp fall in the Weighted Average Cost of Capital (WACC) in the DPP3 period. As we explained in our submission on the IM amendments, the Commission's proposed approach to setting the allowed WACC is expected to undercompensate efficient financing costs in the current low risk-free rate environment due to how inflation is forecast, the market risk premium is set, and the cost of debt is estimated. The situation has become even more urgent following the recent decision by the Reserve Bank of New Zealand (RBNZ) to reduce the Official Cash Rate (OCR) by 0.5 percentage points to a historically unprecedented level of 1.0%.
16. Our concerns over the WACC were echoed by other respondents. For example, Centralines noted:

the WACC... seems likely to fall to around 4.7% by the time of the final decision. Once the 2% 'revaluation' gain is removed from this, and EDBs pay their nominal cost of debt, the cashflows available to EDBs for their activities will be substantially reduced... 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.⁹
17. This is compounded by our under-recovery over the DPP2 period where – like most EDBs – we have not recovered the allowed WACC. As we have noted previously, analysis by the Ministry of Business, Innovation and Employment (shown in Figure 1 below) shows sustained and material under-recovery over the last few years for most EDBs.

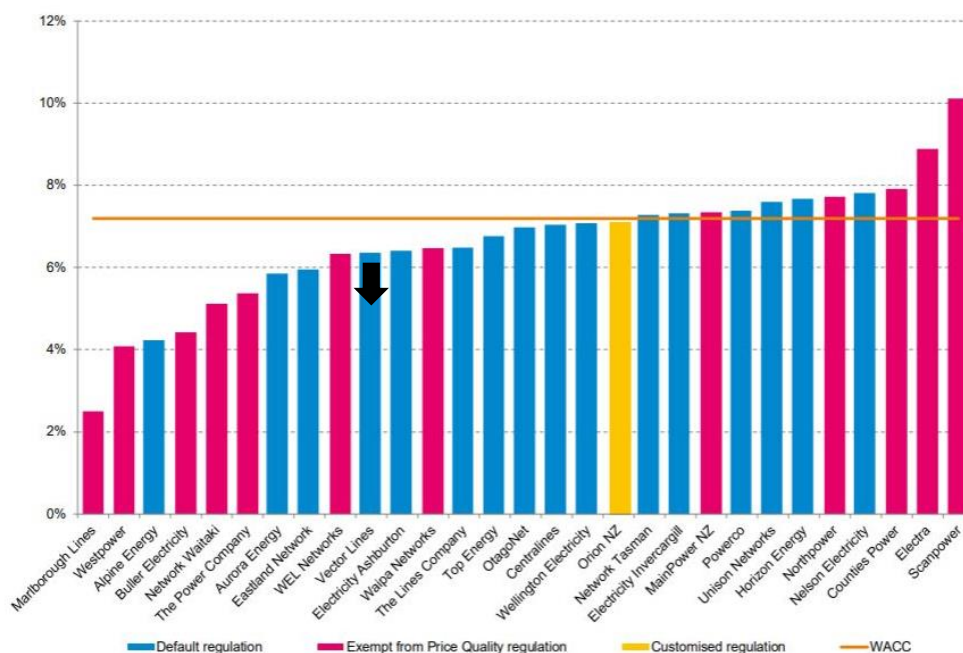
⁹ Centralines Limited, 18 July 2019, *Submission on DPP reset - public version*, pages 1-2.

Figure 1: EDB profitability against the allowed WACC

Panel A: 2013 – 2015 period (profits compared with 8.77 per cent WACC)



Panel B: 2016 – 2017 period (profits compared with 7.19 per cent WACC)



Source: Ministry of Business, Innovation and Employment analysis of Commerce Commission data.

Capital contributions

18. Given the constraints on raising finance described above, if Vector is not able to have sufficient cash flow, then one of our alternatives would be either to restrict or defer investment, which we clearly do not favour. Another alternative is to increase capital contributions. For example, we could introduce a 'deep augmentation charge' to recover the network reinforcement costs associated with new connections. This would be similar to the approach taken by lines companies in Australia and Watercare in Auckland. Further work is being done to determine how such a charge could be designed and at what level the charge would need to be set to fund our proposed step up in capex.
19. If we were required to raise contributions to fund investment (because there was no other source of cash flow), we would do so reluctantly. Raising capital contributions could result in a materially worse outcome for Auckland customers than that produced by an unindexed RAB, as it would impose significant additional costs on new developments (for both commercial developers and households) at a time when increasing the supply of affordable housing and infrastructure growth is critical.
20. We also note, in the context of Auckland development, the impact of increases to electricity contributions cannot be considered in isolation. Watercare and Auckland Council also require contributions from new developments to recover the costs of infrastructure. For example, Watercare's Infrastructure Growth Charge imposed on all new connections is \$12,020 (GST exclusive) per residential unit in metropolitan areas and rises to between \$19,120 - \$28,440 (GST exclusive) in outer suburbs.

Conclusion

21. In summary, financing risk is a critical issue facing Vector and other EDBs in the DPP3 period. The macro environment has changed significantly since 2009, when one focus of the regulatory settings was managing inflation risk. The regulatory regime needs to be flexible to address these new concerns.
22. We look forward to engaging further with the Commission and other stakeholders on these critical issues. As noted in our submission on the DPP3 Draft Decision, we believe that 'meeting cash flow needs' would be a prime candidate for a workshop with the Commission and industry.

QUALITY STANDARDS

23. Many respondents shared the concerns we raised regarding the proposed approach to quality standards in the DPP3 Draft Decision.

24. In particular:

- 1) Several EDBs agreed strongly that the 5% cap on inter-period changes in SAIDI/SAIFI was too low, and proposed alternative caps of 10-15% to better reflect variability in performance;¹⁰
- 2) EDBs are concerned that moving to an annual assessment from the current ‘two-out-of-three’ rule will increase compliance costs and the risk of false positives, and that the increase in the unplanned limit from 1 to 1.5 standard deviations is insufficient to compensate for this;¹¹
- 3) Some EDBs noted that the proposed standards could lead to over-investment in networks to achieve reliability standards beyond what consumers expect and would be willing to pay for.¹² Similarly, both the Electricity Retailers Association (ERANZ) and Major Energy Users Group (MEUG) stated that changes to service quality should be considered on the basis of cost incurred relative to consumers’ willingness to pay;¹³
- 4) There continues to be a lack of clarity regarding how the ‘no material deterioration’ standard is to be understood and applied. Centralines noted that “there is a risk that the revenue allowances to meet this standard are potentially not aligned”,¹⁴ while Unison stated that they “remain puzzled by the approaches to the enforcement actions to date” and “strongly submit that the Commission consult on and issue an enforcement guideline and criteria for assessing breaches”;¹⁵
- 5) Unison also specifically referenced the Commission’s conclusions in Vector’s breach assessment that we should have established new depots in response to foreseeable growth in congestion in Auckland. Unison noted that this appears inconsistent with the DPP philosophy, where expenditure allowances

¹⁰ For example, see Alpine’s submission at para 46; Aurora’s submission at para 17 and Wellington Electricity’s submission at page 22;

¹¹ Electricity Networks Association, 18 July 2019, *DPP3 draft decision: submission to the Commerce Commission*, para 127

¹² See: Wellington Electricity’s submission at page 4 and Unison’s submission at page 22

¹³ Major Electricity Users Group, 18 July 2019, *EDB DPP3 reset*, para 4; and Electricity Retailers’ Association of New Zealand, 18 July 2019, *ERANZ submission on the default price-quality paths for electricity distribution businesses from 1 April 2020 (DPP3) draft determination*, para 3.5.2

¹⁴ Centralines Limited, 18 July 2019, *Submission on DPP reset - public version*, page 18

¹⁵ Unison Networks Limited, 18 July 2019, *Submission on the DPP3 Draft Decision*, para 62

are not forward looking. In this context, Unison noted that there are a variety of foreseeable impacts on costs and reliability over DPP3 which should be accommodated through adjustments to either the quality standards, opex allowances, or both. These include strengthened traffic management requirements, increased controls for work on low voltage assets, impacts from climate change on the frequency and severity of extreme weather events, and increased traffic congestion;¹⁶

- 6) EDBs generally do not support the introduction of a new 'extreme event' standard.¹⁷ Our submission on the DPP3 Draft Decision noted, for instance, that a more sensible approach would be to require more comprehensive reporting of such events in the information disclosures;
 - 7) Powerco stated that the proposed 'notified planned outage' incentive discount is excessively complex and likely to create perverse incentives.¹⁸ We agree that, if this mechanism is retained, then the criteria should be adjusted to allow for longer outage windows, alternative days, changes to notifications, and cancellations of outages where there are good reasons.
25. We also support the view of the Major Energy Users Group (MEUG) regarding the importance of moving forward with the development of new measures of quality of service.¹⁹ As we noted in our submission, SAIDI and SAIFI are imperfect measures – for example, they fail to account for other performance outputs that consumers care about, such as connection times, and they only measure average performance across all consumers. In our submission we encouraged the Commission to consider adopting a Guaranteed Service Level (GSL) scheme for us over the DPP3 period, possibly on a trial basis. This would enable the worst-served consumers to benefit from having their experiences recognised explicitly through the mandated payments that such a scheme will provide for.
26. As we noted in our submission on the draft decision, we have undertaken analysis to understand how the quality standard limits would change if our recommendations – many of which were raised in other submissions – were adopted.

¹⁶ Unison Networks Limited, 18 July 2019, *Submission on the DPP3 Draft Decision*, para 2 and 70

¹⁷ Electricity Networks Association, 18 July 2019, *DPP3 draft decision: submission to the Commerce Commission*, para 150

¹⁸ Powerco Limited, 18 July 2019, *Powerco - Submission on Electricity DPP Reset Draft Decision*, page 4

¹⁹ Major Electricity Users' Group, 18 July 2019, *EDB DPP3 reset*, para 20

27. First, if the inter-period cap on unplanned SAIDI and SAIFI were removed, then our limits (based on data for the 10 year period from 2009-10 to 2018-2019) would increase as follows:

Table 1: Revised unplanned SAIFI and SAIDI targets without applying a 5% cap, but excluding any specific adjustment for health and safety changes or other external factors

Measure	Draft DPP3	Revised targets	Difference
Unplanned SAIFI (interruptions)	1.3591	1.3591	-
Unplanned SAIDI (minutes)	102.13	127.31	25.18

28. Secondly, averages should be adjusted to explicitly account for changes in operating environment, for example our isolation for safety practice. We estimate the effect of our health and safety practice changes over the 2017-2019 regulatory years as:
- 1) 0.57 interruptions for SAIFI; and
 - 2) 25 minutes for SAIDI;
- both calculated as the average estimated impact over 2017 to 2019 regulatory years.
29. Finally, we have undertaken additional analysis of the impact of adopting a 5-year rather than 10-year reference period for planned SAIDI (using data up to 2018). This would increase the planned SAIDI limits as follows:

Table 3: Proposed changes to planned SAIDI and SAIFI

	10-year reference period	5-year reference period	Difference
Approach	<i>Limit set at 3 times the 10-year historical average</i>	<i>Limit set at 2.5 – 3 times the 5-year historical average</i>	
SAIDI	92.09	114.05 – 140.05	21.96 – 47.96

Note: A 2.5 – 3 times range was used in the scenario where the 5-year reference period was used, in part to recognise that the 3 times multiple is somewhat arbitrary and that it was previously being applied to a 10-year average that reflects old planned work practices.

30. These adjustments are needed to ensure that the quality limits better reflect our current and expected operating environment – the same environment that we have planned for in our 2019 AMP that forms the basis of the Commission’s expenditure forecasts in the draft DPP3.
31. As we have reiterated, the Commission has the opportunity through the DPP3 setting process to ensure that there is better alignment between quality standards and expenditure allowances. A failure to align – as we argue is the case in the draft DPP3 – risks setting up EDBs to make trade-offs that are not in consumers long-term interests.
32. We look forward to engaging further with the Commission on this point.

EXPENDITURE ALLOWANCES

Capital expenditure

33. Respondents also echoed many of our concerns with the capex allowance proposals in the DPP3 Draft Decision. One of the key issues for EDBs is the proposed application of a 120% cap on aggregate capex, which is seen as simplistic and arbitrary rather than evidence-based, and likely to lead to poor outcomes for consumers especially where there are good reasons to spend beyond the cap. Concerns were also raised regarding the proposed caps and gates for category-level spending.

34. For example, Alpine stated:

an aggregate cap of 120% is overly simplistic and may not adequately reflect EDBs expenditure needs in DPP3. For the small to medium EDBs projects like substation refurbishment... could easily exceed the 120% cap if no similar sized projects were undertaken in the prior regulatory period.²⁰

Similarly, Centralines highlighted that:

a 20% increase in capex... is likely to amount to less than \$1 million, effectively making it impossible for Centralines to invest in lumpy new assets.²¹

35. The Commission's logic in applying these caps is that an EDB should apply for a customised price path (CPP) if it considers that expenditure above the caps is justified against the expenditure objective set out in the IMs. However, applying for a CPP is both time-consuming and costly, and it would be far preferable for the DPP to include some flexibility to deal with expenditure in excess of the caps.

36. In Unison's words:

EDBs should have some opportunity to justify their expenditure programmes where these exceed the 120% cap, particularly where there are one-off or major programme elements that are causing an uplift over historical levels.²²

37. The concerns raised by other EDBs reinforce the recommendation we made in our submission that tests on capex expenditure (both overall and by category) should be used as a first pass assessment only rather than a 'bright line' test. If the test is failed,

²⁰ Alpine Energy Limited, 18 July 2019, *Submission to the Commerce Commission on Electricity Distribution Services Default Price-Quality Path Determination 2020-2025*, para 24

²¹ Centralines Limited, 18 July 2019, *Submission on DPP reset draft decision - public version*, page 3

²² Unison Networks Limited, 18 July 2019, *Submission on the DPP3 Draft Decision*, para 50

then the Commission should investigate further and/or provide EDBs with the opportunity to provide additional information, rather than simply cap expenditure without further thought to the consequences to EDBs or their consumers.

38. Other regulators use such tests as a first pass. The AER, for instance, uses high level techniques such as benchmarking and category analysis to assess expenditure forecasts.²³ If failed, it then will typically use more detailed techniques such as cost benefit analysis and governance or methodology reviews.
39. As noted in our previous submission, if capex tests are retained without the flexibility that we propose above, then there is a real risk that capex that is essential for our network is not funded by the regulatory regime – leading to difficult trade-offs being made that are unlikely to be in the long-term interests of consumers. When combined with the cash flow constraints outlined earlier, there is a real risk that key components of our capital programme could be compromised. This would have negative impacts for consumers and undermine Government policy around issues such as Auckland growth, transport electrification and housing affordability.

Capex IRIS

40. Our submission on the draft decision noted the potential to undermine consumer outcomes if the capex IRIS retention factor is increased while the capex allowance is too low.
41. The risk of creating inappropriate expenditure incentives that lead to negative outcomes for consumers was raised by several submitters. For example, Unison submitted that:²⁴

[it] would be detrimental to the long-term interests of consumers if the operation of a relatively arbitrary cap limits Unison's ability to undertake these additional projects. This is particularly a concern with the lift in capex IRIS incentive factor to 26%.

42. Similarly, Wellington Electricity submitted that:²⁵

capital expenditure by nature is lumpy and is difficult to smooth. The IRIS is based on capex allowances that may have been reduced under the capex

²³ AER, November 2013, *Better Regulation – Expenditure Forecast Assessment Guideline for Electricity Distribution*, pp. 11-12.

²⁴ Unison Networks Limited, 18 July 2019, *Submission on the DPP3 Draft Decision*, para 49

²⁵ Wellington Electricity Lines Limited, 18 July 2019, *Default price-quality paths for electricity distribution businesses from 1 April 2020 - Draft Decision*, page 17

gateways and may not reflect the actual capital expenditure profile needed by an EDB. EDBs will often have genuine reasons for spending more than the capex allowance. This could include unexpected expenditure like reacting to repairs from major events or expenditure needed to support a rapid growth in emerging technology.

43. We agree with this analysis and consider the capex IRIS should not apply to expenditures that are above the cap but below an EDBs' AMP forecast.

Operating expenditure

44. Our comments on operating expenditure issues were reinforced by other respondents to the draft decision.
45. A key concern for EDBs is the proposal to set the opex partial productivity factor at 0%, whereas the analysis undertaken by NERA for the ENA clearly sets out that a negative productivity factor of between -1.74% and -1.97% would be appropriate. As NERA notes, an historically-derived productivity factor captures more than just productivity improvements and so assuming a 0% assuming productivity unfairly assumes away the impact of other cost drivers, such as the regulatory burden increasing.^{26,27} We share Alpine's view that "partial productivity of zero, when the real world state is not zero, unjustifiably punishes EDBs".²⁸
46. ERANZ has argued that a Partial Productivity Factor (PPF) of zero is too low, for example compared with settings in other jurisdictions. We do not agree for these reasons:
- 3) The 'productivity factor' used in the base, step and trend method applied by the Commission should capture the residual factors that drive opex that are not otherwise captured in other elements of that method – if it does not, then those factors (which would affect any efficient entity) are not compensated for;

²⁶ See: NERA, 18 July 2019, *Opex Partial Factor Productivity for DPP3, Electricity Network Association*.

²⁷ Our expectation that regulatory costs will continue increasing over time is informed by expectations that the Commission itself will spend more to administer regulation more generally. For instance, the Commission's operating expenditure on regulating electricity lines services has increased from \$5.5 million in 2017 to \$6.8 million in 2018, a 24% increase.

See: Commerce Commission, 4 December 2018, *Annual Report 2018*, p. 40; and Commerce Commission, 30 November 2017, *Annual Report 2017*, p. 29.

²⁸ Alpine Energy Limited, 18 July 2019, *Submission to the Commerce Commission on Draft Electricity Distribution Services Default Price-Quality Path Determination 2020-2025*, para 16

- 4) As NERA has shown, those residual factors have historically led to higher opex – there is no reason to believe that this would not be the case over the DPP3 period;
 - 5) *If* productivity were isolated for all other residual factors, then it may be appropriate to assume a positive factor – however, that is not the circumstance that we find ourselves in as those other residual factors are not otherwise dealt with in the opex setting method;
 - 6) Other regulators, such as the Australian Energy Regulator (AER), allow for step changes and other adjustments that at least partially capture those other residual factors – the Commission in its draft DPP3 does not;
 - 7) Therefore, it would be inappropriate to either ignore those residual factors or to intentionally not compensate for them, especially if they reflect drivers that an efficient EDB faces in the real world.
47. ERANZ observes – as we have – that measured ‘productivity’ across EDBs appears to have declined over recent years. This is exactly what NERA finds. The explanation, however, is more complicated than just saying that actual productivity has declined. As noted above (and by NERA), measured ‘productivity’ is actually a factor that picks up many different drivers of opex. Productivity is a part, but so is changes in regulation, changes in operating environment (e.g. weather and climate), changes in consumer expectations, changes in what is considered good industry practice, among many other factors.
48. Given the inherent challenges in measuring true productivity, it is not possible to infer that it has decreased based on an imperfect measure of productivity. Other regulators have recognised this too. Many allow for adjustments caused by factors outside of an EDBs control that are not otherwise reflect in the other trend components.
49. Moreover, ERANZ suggests that setting a forward-looking productivity factor at zero removes the incentive for an EDB to ‘innovate and become productive’. This is not true as a matter of economic principle. Ex ante regulatory price or revenue setting of the form adopted by the Commission creates an incentive for a regulated business to outperform those allowances irrespective of the level at which they are set. In the case of opex, this incentive is further enhanced by the opex IRIS – where an EDB is rewarded for reducing opex and penalised for it increasing it, again regardless of what the initial allowance is.
50. The key concern, however, is that if allowances are set too low – i.e., are insufficient to fund efficient opex – then an EDB will be forced to make trade-offs that lead to other

problems (e.g. less capex, worse reliability, negative impacts on other service outcomes). The productivity (or residual opex) factor should be set in a way that does not exacerbate this concern.

51. As Centralines and Orion point out in their submissions, there are significant expectations on EDBs to meet additional regulatory requirements and prepare for new energy technologies that are rapidly coming onstream.²⁹ Basing opex allowances on historical expenditure fails to recognise these cost pressures. As we highlighted in our previous submission, some areas where new opex costs are likely to arise over DPP3 include (but are not limited to):

- 8) LV monitoring costs, including the acquisition of consumer meter data to assist with outage management. We have provided confidential figures in Appendix 1 on the potential scope of these costs, based on recent negotiations with Metrix and AMS;
- 9) Tree regulation changes, in light of MBIE's review of the regulations which is expected to transfer additional responsibility for the cost of tree trimming to EDBs;
- 10) Growing cyber-security threats, which should be addressed through collective industry-wide action; and
- 11) Cloud computing, as software providers are increasingly offering their products in the form of subscription-based 'Software as a Service' (SaaS), which constitutes opex rather than capex.

52. To mitigate downside risk to EDBs on operating expenditure, the Commission needs to either allow for step changes over the course of DPP3 or allow EDBs to apply for a re-opener. However, we note that re-openers are subject to materiality thresholds that can mean that prudent and efficient costs remain unfunded by the regulatory settings, which undermines the Section 52A purpose.

53. Stakeholders have frequently expressed concern that the regulatory settings cause EDBs to prefer capex solutions over opex. In practice, EDBs cannot consider non-wire alternatives if there is no allowance for them in the DPP. We recommend introducing a mechanism for EDBs to 'trade' opex and capex to allow EDBs to realistically consider non-wire alternatives.

²⁹ Centralines Limited, 18 July 2019, *Submission on DPP Reset Draft Decision - Public Version*, page 7-8 and Orion New Zealand Limited, 18 July 2019, *Submission on EDB DPP3 Reset - Draft Decision*, para 10

OTHER MATTERS

Revenue smoothing

54. Revenue smoothing is an important mechanism for reducing price volatility or otherwise promoting consumers' interests.
55. For example, we and many other submitters have raised concerns with the Commission's approach to setting the WACC in the current environment of low RFRs. At historical lows, there is not much room for them to go lower – and so there is a good chance they will increase in the future, pushing up allowed revenue. Revenue smoothing could be used to buffer consumers from such a price shock.
56. On the other hand, revenue smoothing would also help to mitigate the initial price impacts if EDBs are given the option of moving to an unindexed RAB. Similarly, revenue smoothing of distribution charges could be used to offset the impact of transmission pricing changes recently proposed by the Electricity Authority (EA), which if adopted will increase transmission charges to Aucklanders later in the DPP period.
57. In summary, these concerns reinforce our key recommendation that the Commission should allow some flexibility over how revenue allowances are smoothed over a DPP period. This would be in the long-term interests of consumers.

Re-opener for large unforeseen connections

58. Most submitters supported introduction of a re-opener for large unforeseen connections in principle but found its current design too narrow. For example, Aurora noted:³⁰

a percentage threshold effectively sets a sliding scale that benefits smaller distributors and disadvantages larger distributors.

59. Wellington Electricity submitted:³¹

the proposed reopener criteria needs to be flexible enough to capture all of the potential changes the New Zealand Government are proposing in their climate change and accelerated electrification initiatives. WELL suggests removing the restriction of a single new connection and allowing it to also be applied to existing connections which require adaptation investment (climate change zero carbon bill) or reinforcement to support electrification (in the case of transport and process heat initiatives).

³⁰ Aurora Energy Limited, 18 July 2019, *Aurora Energy's Submission in Response to the Commission's DPP3 Draft Decision*, para 7.3

³¹ Wellington Electricity Lines Limited, 18 July 2019, *Default price-quality paths for electricity distribution businesses from 1 April 2020 - Draft Decision*, page 8

60. We agree with concerns raised by Aurora and other submitters that larger distributors could be disadvantaged by the percentage threshold. To address this concern the threshold should be set as the minimum of 5% of revenue or \$5 million (whichever is the smaller).
61. We also support Wellington Electricity's suggestion to allow re-openers to be applied to existing connections which require adaption investment.
62. As discussed in our submission on the draft decision, we recommend the re-opener be expanded to cover relocations where they do not form part of the expenditure allowances. Relocations can be equally as uncertain and material as new connections so there is no obvious basis for adopting inconsistent treatment.

ATTACHMENT A – ESTIMATED METER DATA COSTS FOR LV MONITORING

63. See attached PDF. These figures are commercially sensitive and not for publication.