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POWERCO – SUBMISSION ON ELECTRICITY DPP RESET DRAFT DECISION

This is Powerco Limited's submission on the Commerce Commission's (the Commission) Electricity Distribution Services Default Price-Quality Path (DPP) Draft Decision. Our high-level views on quality standards and consumer connection risks are:

Quality standards

- The proposed regulation is consistent with the Commission's focus on good asset management practices
- We are concerned the overall risk of breaching quality standards is materially increased - for no benefit to customers

Consumer connection risks

- Despite the introduction of a re-opener for large unforeseen new connections we think the approach can be amended to:
  - improve customer outcomes; and
  - remove win/loss incentives on distributors for a cost that accelerated electrification could materially impact

Attachment 1 has a summary of our views and Attachment 2 has more detailed comments about aspects of the Draft Decision that we have concerns about. We look forward to the next steps in consultation process. If you have any questions on this submission, please contact Nathan Hill (Nathan.Hill@powerco.co.nz).

Yours sincerely

Stuart Marshall
General Manager – Regulation and Commercial

Attachment 1: Summary of Powerco’s views

Topic	Subtopic	Powerco view
Forecasting capital expenditure		• Powerco supports the Electricity Network Association (ENA) submission points on ‘forecasting capital expenditure’. To avoid duplication, we have not included comments on capital expenditure forecasting in this submission
Forecasting operating expenditure		• Powerco supports the Electricity Network Association (ENA) submission points on ‘forecasting operating expenditure’. To avoid duplication, we have not included comments on operating expenditure forecasting in this submission
Overview of draft decision on quality standards and incentives		• The proposed regulation is consistent with the Commission’s focus on good asset management practices • The draft decision introduces a lot of complexity. We are not convinced that it is entirely necessary nor creates the correct incentives • The proposed regulations would require material changes to existing data management and reporting and auditing processes. • We are concerned the overall risk of breaching quality standards is materially increased • There is increased uncertainty associated with introducing significant and untested changes
Quality of Service measures (general)	Separation of planned and unplanned interruptions	• We think separation is appropriate because: o It supports delivery of maintenance and investment programmes that benefits consumers in the long run o It removes perverse incentives to reduce planned construction and maintenance to manage unplanned outages

Topic	Subtopic	Powerco view
	Extreme event standard	• We think that the proposed extreme event quality standard is unsuitable because: o The financial penalties and onerous investigations associated with a quality standard breach may incentivise distributors to over-invest to avoid asset failure. This could result in outcomes that are inconsistent with customers' price/quality trade-off preferences o It is not a measure of material network deterioration o There is likely to be issues with the definition of outages causes o Unknown causes may wrongly capture events unrelated to asset management • Instead of implementing an extreme event quality standard, Powerco considers that it is preferable to incentivise distributors to invest to avoid 'controllable' extreme events through additional information reporting and / or monitoring.
	Customer service measures	• Powerco is disappointed the proposed quality standards do not include any new customer service measures that reflect customers' preferences. We believe the Commission is missing an opportunity to act on behalf of customers. However, including this information in information disclosures should be positive as it will allow for the inclusion of customer service measures in DPP4
	Additional disclosure reporting in event of a breach	• Powerco supports publication of the quality standard breach disclosure requirements – transparency and predictability is appreciated • We think the Commission should publish enforcement guidelines. This would provide regulatory certainty by improving stakeholder understanding of the consequences of non-compliance
Unplanned interruptions	Removal of the two-out-of-three-year rule and SAIDI / SAIFI limits set at 1.5 standard deviations above the historical average	• Powerco considers that removing the two-out-of-three-year rule would be inconsistent with the objective of identifying material network deterioration and mitigating the risk of false positives. We hold this view because: o The ENA's analysis shows the incidence of unplanned breaches increases significantly under the proposed DPP3 rules compared to the DPP2 rules. Meaning the risk of breaches and false positives is significantly higher o One-off poor performing years alone may not constitute an underlying material deterioration of reliability. A sustained trend of poor performance is therefore a more appropriate assessment
	A ±5% limit on inter-regulatory period changes in unplanned SAIDI and SAIFI limits	• Powerco supports a ±5% limit on inter-regulatory period change in unplanned reliability limits. • We agree that a limit is appropriate. Without a limit, deteriorating performance would be inappropriately rewarded with more relaxed standards and improved performance inappropriately penalised through stricter standards.

Topic	Subtopic	Powerco view
	10-year historical reference period	• Powerco supports use of a 10-year historical reference period for unplanned interruptions
Planned Interruptions	5-year assessment	• Powerco supports the proposal for a 5-year planned standard because: o Assessing the standard once for the regulatory period will improve a distributors ability to optimise construction and maintenance programmes in a way that is best for consumers o It correctly recognises the benefits to consumers of planned interruptions / investment
	Planned SAIDI/SAIFI limits set at 3 x historical average	• Powerco supports the proposal to set planned SAIDI/SAIFI limits set at 3 x historical average because: o It correctly recognises the benefits to consumers of planned interruptions / investment o It offers significantly more flexibility to carry out investment and maintenance work o It allows for some of the impact from changing work practices – e.g. reductions in live line work
	10-year historical reference period	• Powerco's preference is for the Commission to use a 5-year historical reference period • We consider that a 5-year reference period will provide a more accurate forecast of expected performance as it is more consistent with distributors' current work practices and planned expenditure levels
Quality incentive scheme		• Powerco supports the Electricity Network Association (ENA) submission points on the quality incentive scheme. To avoid duplication, we have not included comments about the proposed changes to the quality incentive scheme in this submission
Planned notification incentives	Additional notice incentive	• Powerco supports an additional notice incentive. However, we consider the draft proposal is unsuitable because it is unrealistic, excessively complex, difficult to audit and provide assurance and worryingly it creates perverse incentives; meaning where possible it is likely to be ignored by distributors • We think that the additional notice incentive should be retained, but that it needs to be modified to make it workable – this is especially relevant in light of the lack of any other customer service measures drafted
MED identification and normalisation	3- Hour major event	• Powerco has mixed views on the Commission's proposed normalisation approach. We think the proposed approach is an improvement on the DPP2 method, but because it is untested, we are concerned that it might be unsuitable and impractical

Topic	Subtopic	Powerco view
Unforeseen new connections		• Powerco supports the Commission's intention to create the correct incentives for large and unforeseen new connections. However, we consider that the current proposal is ineffectual and too narrow because: o The expenditure threshold does not treat customers equally because it is based on a percentage of revenue. The same unforecast cost would meet the threshold on one network but not another o Distributors (and customers) will still be exposed to financial risk because expenditure below the threshold will be material. For example, if a prudent forecast excludes the impacts of a set of customer connection decisions then those customers also bear an additional cost of the IRIS incentive o Because some expenditure is customer driven and difficult or unable to be forecast, the capex IRIS incentive scheme unnecessarily exposes distributors and consumers to forecast risk o The re-opener doesn't apply to parties currently on a CPP – however the issue does not differentiate distributors based on how they are regulated. o The re-opener process is cumbersome for both distributors and the Commission and not the least cost / most effective way to produce the desired outcome for customers. • A better approach is to o Remove the incentive on distributors
Innovation allowance		• Powerco supports the Electricity Network Association (ENA) submission points on the proposed innovation allowance. To avoid duplication, we have not included comments about the innovation allowance in this submission

Topic	Subtopic	Powerco view
Incentives for efficiency	Setting the capex IRIS retention factor equal to the opex retention factor	• Powerco does not support an increase to the capex IRIS retention rate • We think increasing the capex retention rate is inappropriate because: o There is no evidence that the current IRIS settings are creating a problem o The decision is not consistent with the Commission's past evidence based decision-making approach o We are concerned that increasing the capex IRIS retention rate is not consistent with good asset management because it may incentivise distributors to defer network investment at a time when it is needed. This may significantly increase the risk consumers suffer higher costs or degraded quality in the long-term because of underinvestment in the near-term o Tying the capex IRIS retention rate to the opex retention rate introduces inter-regulatory period inconsistency for capex o The quality measures are an insufficient safeguard of customers' interests
Revenue cap		• To minimise the potential for significant wash-ups and large price increases we think it would be sensible for the Commission to include a forecast of 'Other Regulated Income' (ORI) in distributors' maximum allowable revenue calculations. We think distributors FY19 ORI could be used as the basis for a reasonable forecast • We think the Commission should make it clear in the DPP Determination that ORI includes 'gains / losses on asset disposals' • We found it challenging to bring forward the calculation of ORI for the first year of compliance reporting under a revenue cap. This is because ORI relies on inputs that are finalised as part of the RAB / RIV calculations that are usually completed in the annual Information Disclosure report which is finalised and approved in August. We think the Commission should engage with distributors to establish if this advance timing is going to be problematic
Powerco's DPP2 price-quality path		• Powerco supports the Commission's decision to set it quality standards but not starting prices

Attachment 2: Commentary on key topics

1. Extreme event standard

Additional reporting is the most appropriate way to incentivise distributors to mitigate the risk of 'controllable' extreme events

Extreme event standard

The Commission has proposed a new extreme event quality standard for DPP3 that applies to outages caused by human error, defective equipment, or unknown causes. These causes are considered to be within a distributor's control. To comply with the quality standard a distributor must not have an extreme event in the assessment period.

This proposed standard, which is limited to 'controllable' events, reflects the Commission's concerns that the unplanned quality standard may miss large outage events that result from a lack of good industry practice; eg under-spending on network maintenance and investment. These large outage events are, for the most part, currently excluded because of major event day normalisation.

Whilst Powerco agrees that distributors should be appropriately incentivised to take practicable steps to minimise the likelihood of 'controllable' large outage events. We do not consider this incentive should take the form of a new quality standard.

We think the proposed extreme event quality standard is unsuitable because:

- The financial penalties and onerous investigations associated with a quality standard breach may incentivise distributors to over-invest to avoid asset failure. This could result in outcomes that are inconsistent with customers' price/quality trade-off preferences
- The proposed compliance test is not a measure of material deterioration
- Due to some subjectivity there is likely to be issues with identifying outages causes
- Including 'unknown causes' may incorrectly capture events unrelated to asset management because these outages can be triggered by uncontrollable events.

Powerco's suggestion:

- **Incentivise distributors to invest to avoid 'controllable' extreme events through additional information reporting and / or monitoring.** Powerco considers this is preferable to implementing an extreme event quality standard.

  Extreme event reporting, which could include detailed information about the reasons for the event, would provide distributors with additional incentives to identify and mitigate the risks of 'controllable' extreme events. It would also provide the Commission with enhanced visibility of the incidence and reasons for these events.

2. Unplanned interruptions

Removal of the two-out-of-three-year rule conflicts with the objective of identifying material deterioration and mitigating the risk of false positives

Removal of the two-out-of-three-year rule

Powerco agrees with the Commission that reliability limits need to balance the identification of material deterioration in overall reliability against the risk of false positives due to random volatility.

In DPP2 the Commission mitigated for the risk of false positives by;

- including a two-out-of-three-year rule to allow for one-off poor performing years;
- setting the reliability limits 1 standard deviation above the historical average;
- normalising major events

For DPP3 the Commission is proposing to remove the two-out-of-three-year rule. The Commission's justification being that setting reliability limits 1.5 standard deviations above the historical mean and reducing the impact of major events, via changes to the normalisation approach, are a more effective means of reducing the risk of false-positives.

Powerco's suggestion:

Powerco does not support the removal of the two-out-of-three-year rule. We think the Commission should retain the two-out-of-three-year rule because:

1. Removal would be inconsistent with the Commission's past policy

Powerco is concerned the proposed approach is a marked and surprising departure from the Commission's long-established position on multi-year compliance assessment. The Commission's previous position on multi-year assessment is outlined in a number of its past price-quality path decisions. For example, in the DPP2 final decision *quality standards, targets, and incentives paper* the Commission noted:

> *The quality standards employ the two-out-of-three year rule because this allows for one-off poor performing years, which alone may not constitute an underlying material deterioration of reliability (for example, due to natural variability).*[1]

and in the Draft Decision paper for the initial reset of the DPP in 2009 the Commission noted:

> *The Commission considers that the combined effect of an appropriately defined dead-band with a multi-year assessment framework will mitigate the potential for 'false positives'. While a dead-band could be made sufficiently wide to manage the potential for 'false positives' alone, the Commission considers that a combined approach is more appropriate and can have an equivalent effect. In particular, the Commission considers that a combined approach would*

[1] Commerce Commission, Quality standards, targets and incentives paper - Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020, 28 November 2014, p.10

retain a greater degree of incentive and oversight as it retains a more stringent annual standard.[2]

2. Removal of the rule conflicts with the objective of identifying material deterioration

Powerco considers that removing the two-out-of-three-year rule would be inconsistent with the objective of identifying material network deterioration and mitigating the risk of false positives. We hold this view because:

- The ENA's analysis of distributors' historical quality of service data shows the incidence of unplanned breaches increases significantly under the proposed DPP3 rules compared to the DPP2 rules. Meaning the risk of breaches and false positives is significantly higher.
- As noted by the Commission in its DPP2 decision papers, one off poor performing years alone may not constitute an underlying material deterioration of reliability. A sustained trend of poor performance is therefore a more appropriate assessment
- The two-out-of-three-year rule appropriately recognises the fact that unplanned outages are often caused by external events beyond the immediate control of distributors

[2] Commerce Commission, Initial reset of the default price-quality path, Draft Decisions Paper, 8 September 2009, paragraph 7.64

3. Planned notification incentives

The proposed 'additional notice' incentive is likely to be ignored by distributors because it is unrealistic, excessively complex and it creates perverse incentives

Additional notice incentive

Under DPP2 all planned interruptions are de-weighted by 50% when calculating planned SAIDI and SAIFI assessed values. This reflects that the impact on customers of planned interruptions is generally less than that of unplanned interruptions.

To strengthen the incentive for distributors to improve customer notification of planned interruptions the Commission is proposing to change how planned SAIDI and SAIFI assessed values are calculated in DPP3, so that:

- the 50% de-weighting of planned interruptions only occurs where 'additional notice' is given and the planned interruption occurs within the notified start and end time
- interruptions that did not eventuate, but where 'additional notice' was given are counted against the planned quality standard and reliability incentives. The SAIDI and SAIFI impact is de-weighted by 50%.

Powerco supports the Commission's intention to reflect within the planned quality standards and reliability incentives customer preferences for improved outage notifications. This decision is consistent with our customer surveys that have found good communication about interruptions is highly valued by consumers.[3]

Whilst we support an 'additional notice' incentive, we do have concerns about features of the Commission's draft proposal. We consider that the current proposal is unsuitable because it is unrealistic, excessively complex and it creates perverse incentives; meaning where possible it is likely to be ignored by distributors.

Why we have these concerns:

1. Heightened health and safety risk because of additional time pressure

Limiting qualifying interruptions to a maximum of 4 hours is likely to place additional time pressures on field workers. We are concerned about the psychological effects time pressure can introduce to workers and the heightened risk of this impacting sensible decision making and good risk management practices. Ultimately this could lead to a greater level of errors, incidents and injuries being experienced.

Time pressures, even those which are only perceived pressures, such as toward the end of a project /day /shift / week, can greatly impact safety and decision making. There appears to be a strong correlation between time pressure and the incidence of rushing, poor decision making and

[3] Powerco CPP consultation report, 12 June 2017, p.65

short cuts.[4] This could mean that field workers, either consciously or unconsciously, take unacceptable risks including:

- "Making do" with the tools and equipment they have on hand – even if they are not the right ones for the job
- Cutting robust risk discussions short or not taking the time to step back routinely throughout the job to assess whether any new risks have arisen
- Implementing "quick-fixes" instead of more effective controls which may take a greater time to implement
- Not taking proper breaks when they are required leading to fatigue

We are concerned that by incentivising shorter interruptions, we could inadvertently be incentivising a compromised safe work environment and accepting a higher degree of worker harm both in the short term (physical injuries) as well as in the long term (mental injuries as a result of compounding stress / fatigue). We could also see an increase in the frequency of outages because of rectifying errors that have been made as a result of this time pressure / psychological stress.

2. A 4-hour window is often unrealistic and inefficient

- A 4-hour window is too short to complete major planned works
- A 4-hour window doesn't support good risk management practices. For example, it can take up to an hour to complete a safe isolation at the beginning and the end of a job. The remaining 2 hours will generally not be long enough to complete the planned works
- Unrealistic timing for tasks can lead to compromising quality and heighted safety risks
- Longer planned interruptions shouldn't be excluded as they can result in better outcomes for consumers
- A 4-hour window may create a perverse incentive to break outages into shorter periods; this is likely to be inefficient and more inconvenient to consumers

3. The 5-woking day notice period is too short and not consistent with current industry practice and electricity market protocols

4. Time restrictions are unnecessary

The quality standards and reliability incentives already provide strong incentives for distributors to minimise the length of planned outages.

5. Reporting and auditing challenges

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[4] This is Powerco's view. It has been formed over a number of incident investigations that we, our service providers and industry have undertaken. This view is also supported by recent research, such as that outlined here https://www.ishn.com/articles/103452-deadlines-can-erode-safety-and-promote-risk-taking

- As currently drafted, proving 'additional notice' will mean a considerable reporting and auditing burden. Under the Commission's draft proposal, the following new information would need to be recorded and reported by distributors and audited each year[5]
  - website / social media notifications
  - notifications to retailers
  - notifications to the 10 largest consumers affected by the interruption
  - notifications to all consumers affected by the interruption
  - cross checks of actual planned interruptions start and end times against the notified start and end times
  - cross checks to see if additional notice was given but the interruption didn't occur
- Reporting and auditing of the proposed information will likely require distributors to implement new processes and / or systems which will come at a cost to consumers, but not themselves provide any benefit to customers.
- The inclusion of interruptions that were notified but did not occur within the quality standards and reliability incentives means distributors can't completely opt out. Distributors will need to be able to evidence if 'additional notice' was given or not for all planned interruptions to do not eventuate.
- From the date of the DPP re-set final decision distributors will have around 4 months to implement new processes and systems before the first year of DPP3 begins. Given the complexity of the current proposal this short timeframe is likely to be very challenging for distributors to meet.

Powerco considers that the proposed 'additional notice' incentive should be retained, but for the reasons noted above, it needs to be modified.

Powerco's suggestion:

- **Remove the time window**. As we have noted above, the quality standards and reliability incentives already place strong incentives on distributors to minimise the length of a planned interruption. Removal of the time window would also eliminate any heighted health and safety risks and any inconsistency with distributors' operational practicalities.
- **To reflect that longer interruptions can cause a greater inconvenience for consumers, include a requirement that distributors provide more detailed notifications for longer interruptions**. This could include information about why a longer interruption is the best option. We suggest that longer interruptions are defined as those that exceed 8 hours.
- **Remove the requirements for website and social media notification**. While the use of digital means is a useful secondary method of providing information, experience tells us that the industry has not 'cracked it' with how to use digital channels effectively, and customers have not transitioned sufficiently to use it effectively. We see this is a 'work on area' and likely to be better placed as a requirement for DPP4.

[5] In addition to reporting this information, distributors will also need to be able to demonstrate to their auditors and directors that the information is accurate and complete.

At present, this information is likely to be difficult to record, report and audit. It appears to be an unnecessary duplication of the notification. Customer surveys results also suggest that it is not valued by customers.[6]

- **Redefine the requirement to notify large consumers**. It appears that the Commission's intention here is for distributors to inform major customers.[7] But the draft Determination only refer to the 10 largest consumers affected by the interruption. We recommend that the Commission amend the Determination so that it explicitly references major customers.
- **The length of notification should be aligned with the Electricity Authority's EIEP5A 10 working-day notification protocol**
- **Don't count within the quality standards and reliability incentives interruptions that were notified but did not occur.** We are concerned that the likely impact of 'intended interruptions' on SAIDI and SAIFI assessed values has not been quantified. Because the size of the problem / impact is unknown, we think it would be sensible to include this as a reporting obligation in information disclosure first.
    - Regarding the Commission's concerns about over notification, we consider that distributors already have natural incentives to mitigate this risk e.g. limiting consumer complaints and maintaining consumer trust.
- **Retain no de-weighting where additional notice is not given**

[6] Powerco CPP consultation report, 12 June 2017, p 36

[7] Paragraph M51 of the draft decision reasons paper suggests the intention is to inform major customers - "the distributor must provide retailers and **major consumers**, or directly to all consumers, with at least five full working days' notice of a planned interruption"

4. MED identification and normalisation

We think the proposed approach is an improvement on the DPP2 method, but because it is untested, we are concerned that it might be unsuitable and impractical

The Commission is proposing to significantly change the DPP 'Major Event Day' normalisation approach. This includes:

- defining major events as three-hour rolling periods (assessed in 30-minute blocks), rather than as calendar days;
- setting the major event boundary value at the equivalent of the 25th highest rolling 3-hour period within the 10-year reference dataset
- replacing the actual SAIDI or SAIFI for a major event with a pro-rated boundary value;

Powerco has mixed views on the Commission's proposed normalisation approach. We think the proposed approach is an improvement on the DPP2 method, but because it is untested, we are concerned that it might be unsuitable and impractical.

Aspects of the approach that we welcome:

- A higher proportion of SAIDI and SAIFI will be normalised out. This appropriately reduces the distorting impact of MEDs on reliability results and provides a clearer indication of the underlying reliability of the network
- The rolling event approach is an improvement as it avoids the arbitrary cut-off between calendar days

We are concerned the proposed approach may be unsuitable because:

- It deviates from the established Institute of Electrical and Electronics Engineers (IEEE) methodology for normalisation and is unique to New Zealand.
- It is untested and there is no evidence that it is based on research or is consistent with distributors' actual network response capability
- It is significantly more complex than the DPP2 approach. We expect this complexity will make it difficult to estimate and manage SAIDI and SAIFI outcomes in real time

Powerco's suggestion:

- **Retain the IEEE methodology for normalisation but;**
  - modify it to allow major events to roll across calendar days;
  - replace major events with a reduced value, such as the pro-rated daily average or boundary value, as opposed to the boundary value of the entire day, to reduce the distorting impact of MEDs on reliability results

5. Unforeseen new connections

The Commission should remove incentives for distributors to alter the timing and quantum of customer-initiated capex so that customers connections are not unnecessarily distorted

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Powerco welcomes the Commission's proposal to implement a mechanism to mitigate the financial risks of large and unforeseen new connections. This proposal appropriately recognises the limited ability for distributors to control the demand for this kind of capex. It also reflects that a revenue cap can be a barrier to the efficient connection of significant new demand and low carbon technologies.

While Powerco supports the Commission's intent, we consider the current proposal is ineffectual and too narrow. The outcome we're seeking is that customer can connect when they want and pay an appropriate cost. We don't think distributors (and ultimately customers) should be in a financial win/lose situation because customer connections didn't match a historic trend that didn't account for behaviour driven by new policy/market settings.

Our key concerns with the proposal are outlined below:

1. If retained, the expenditure threshold should be a nominal figure

To qualify for the re-opener the Commission's draft proposal requires additional expenditure by the distributor (net of the capital contributions) of at least 5% of the distributors' net allowable revenue.

We are concerned this threshold doesn't treat customers and distributors on a level playing field because $1m of expenditure might trigger a reopener for one distributor, but not another purely based on a distributor's net allowable revenue. For example, to qualify for the re-opener Vector would need to spend over $20m on a new connection project whilst there are 9 distributors who would qualify by spending less than $2m.[8]

Applying the threshold to Powerco, we think it unlikely expenditure on a single new connection or conversion project will exceed the 5% threshold ($14m).[9] Powerco's *total* forecast customer connection capex is shown below and was forecast to be around $10m per annum over the coming years. A 5%/~$14m threshold above this forecast would be a significant departure from historic levels.

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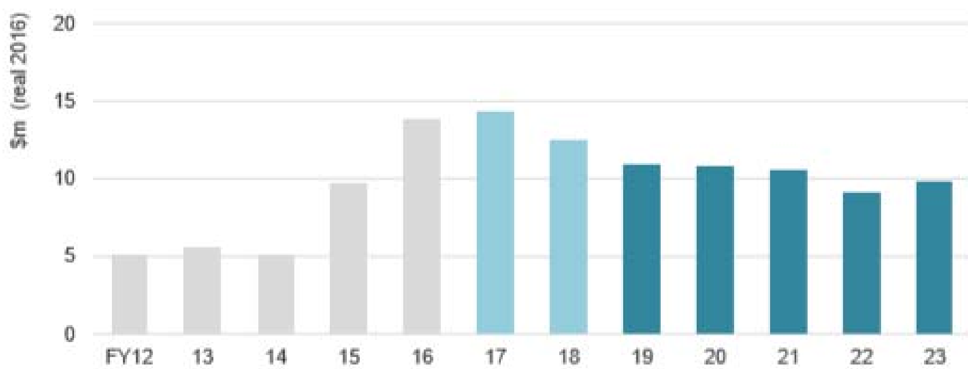
[8] Expenditure threshold based on 5% of DPP3 draft decision maximum allowable revenue

[9] Expenditure threshold based on 5% of Powerco's FY20 allowable revenue

13.5.3 Proposed expenditure

Our forecast consumer connections Capex (net of capital contributions) during the CPP Period, with equivalent historical spend, is shown in Figure 13.3.

Figure 13.3: Proposed consumer connections Capex (net of contributions)



At the proposed level, the Commission is effectively excluding large distributors who serve most customers from accessing the re-opener. This appears to be inconsistent with the Commission's specified policy intent and the Part 4 purpose to provide incentives for distributors to invest.

2. **Customer-initiated capex will still expose distributors and consumers to significant and unnecessary financial cost/benefit**

Powerco considers, despite the implementation of this re-opener, that distributors and consumers will still be exposed to significant and unwanted financial risks relating to customer-initiated capex. This is because:

- **Expenditure above forecast and below threshold is still significant**

  Even with the introduction of this new re-opener, significant financial risk will persist if the expenditure threshold is set too high. This is because expenditure excluded from the re-opener will be significant and potentially unrecoverable. A distributor faced with this situation will be strongly incentivised to alter the timing and / or quantum of this unforeseen customer-initiated expenditure to avoid financial losses. This can result in delays/losses for consumers if their connection projects are unable to be completed on time. It doesn't match with our view of what a workably competitive market would deliver when demand exceeds a forecast.

  Examples of material new and unforecast connection projects on Powerco's footprint that have come up within the regulatory period include:

  [CI

[redacted]

[redacted]

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We expect that a focus on electrification will only increase the frequency of these sorts of requests. Fonterra's recent announcement[10] to stop installing coal boilers could mean that there is a quick and material response required from a distributor. It also could not have been forecast.

- **Because most expenditure is customer driven, difficult / impossible to forecast, and not within the distributor's control, the capex IRIS exposes distributors to forecast risk**

  Distributors' consumer connection, system growth and asset relocation allowances have a high probability of forecast error. This is because this expenditure is customer driven and impossible to accurately forecast beyond the immediate known projects - connection to the network is just one of many factors in bringing a new business/ connection/ project to life.

  For example, at the time of preparing customer connection capex forecasts for CPP, we said we were

  a. not aware of any specific projects of material size beyond FY18

  b. confident that our approach delivers an efficient and prudent level

  c. applying a robust approach with puts developed by an independent economic consultancy.

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[10] https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=12250501

Because the IRIS incentive scheme applies to *all* capex – including customer connection capex - distributors are rewarded / penalised for this forecast error. We don't think they should be. With a forecast locked in, exposure to this forecast error provides a strong incentive for distributors to alter the timing and quantum of customer-initiated capex to attain financial benefits / avoid losses. If the forecast is prudent and assumes no new connections, like Powerco's CPP forecast, then this incentive is all about managing the downside. Potential IRIS penalties supports deferral of customer-initiated expenditure that would otherwise be prudent and efficient, and most importantly, meet customer needs. The choice of a higher capex retention rate for DPP3 will further magnify this incentive.

- **The re-opener doesn't apply to parties on a CPP – however the issue does not differentiate distributors based on how they are regulated**

  The proposed re-opener would not be available to distributors regulated under a Customised price-quality path. This doesn't treat customers and distributors on a level playing field because the risk the re-opener is attempting to address does not differentiate distributors based on how they are regulated.

  The current CPP Input Methodologies does include an 'unforeseen projects' reopener, but due to the high expenditure threshold, it is ineffective in mitigating the financial impact /risk of significant unforeseen consumer connection and system growth expenditure.[11]

Powerco's suggestion:

- **Exclude consumer connection, system growth and asset relocation expenditure from capex IRIS calculations to remove incentives for distributors to alter the timing and quantum of customer-initiated capex so that customers connections are not distorted**
- **Apply the large and unforeseen new connection re-opener to CPPs to ensure all distributors and their customers are treated on a level playing field.**
- **If retained, the expenditure threshold for the re-opener should be defined as a consistent dollar amount and allow triggering from multiple projects.** This would ensure all customers and distributors are treated on a level playing field. When setting an appropriate expenditure level, we recognise that the Commission needs to balance distributor and consumer interests against the number of re-opener requests to ensure the DPP remains relatively low-cost. Given that the cost of a re-opener could reasonably be charged to the customer driving the request, a multiple of this cost should be used as the threshold.
- **Include asset relocation expenditure in the re-opener**

[11] Commerce Commission, Electricity Distribution Services Input Methodologies Determination 2012, 31 January 2019, IM 5.6.6 – expenditure must exceed 10% of a distributor's annual revenue

6. Capex IRIS retention rate

Increasing the capex IRIS retention rate may significantly increase the risk consumers suffer higher costs or degraded quality in the long-term because of underinvestment in the near-term

The Commission’s draft decision is to set the capex retention factor equal to the opex retention factor, or 26% for the draft decision.

The intention of this proposed change is to ensure distributors have a consistent incentive to spend both opex and capex. This change reflects the Commission’s concern that a lower capex retention factor will incentivise distributors to favour capital solutions and consequently be a barrier to innovative and potentially lower cost opex solutions being chosen.

In principle, Powerco supports the need for neutral policy settings, including any incentives that distributors face around operational and capital expenditure. This is important in ensuring the most efficient/ lowest cost investment option is chosen regardless of expenditure type. However, we believe that an increase in the capex retention rate is not appropriate and not in the best interests of consumers.

Powerco does not support increasing the capex IRIS retention rate.

We think increasing the capex retention rate is inappropriate because:

1. There is no evidence that the current IRIS settings are creating a problem

Given the immaturity of IRIS in the New Zealand context, there is not yet enough evidence to determine if the incentive scheme with its current settings is causing a bias for capex that is preventing innovative and potentially lowest cost opex solutions from being chosen by New Zealand distributors.

2. This decision is not consistent with the Commission’s past evidence based decision-making approach

We are concerned this decision is a marked departure from the Commission’s input Methodologies (IM) review evidence based decision-making approach. The IM review exercise in 2016 was excellent because it was based off experience. Applying the IM approach to this DPP decision suggest that any changes should be delayed until clear evidence of a problem emerges.

3. It is not consistent with good asset management

We are concerned that increasing the capex IRIS retention rate is not consistent with good asset management because it may incentivise distributors to defer network investment at a time when it is needed.

The general aging of asset fleets across New Zealand distribution networks is resulting in declining network performance and reliability. This is generating a need for increasing levels of capital network investment to ensure distributors continue delivering the safe, reliable and efficient service customers expect. The Powerco CPP is a clear example of the need for increased network investment.

We anticipate that incentivising distributors to defer network investment, at a time when it is needed, may significantly increase the risk consumers suffer higher costs or degraded quality in the long-term because of underinvestment in the near-term.

4. It will result in inter-regulatory period inconsistency

Tying the capex retention rate to the opex retention rate, that varies with the value of the WACC, introduces inter-regulatory period inconsistency for capex. We think that it would be odd and undesirable for $1 of capex avoided in one regulatory period to be worth more or less than $1 avoided in a different period.

5. The quality measures are an insufficient safeguard of customers' interests

Powerco's suggestion:

- **Don't align the capex IRIS retention rate with the opex retention rate**. There is not yet enough evidence to determine if the incentive scheme with its current settings is causing a problem