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Dane Gunnell

Acting Manager, Price-Quality regulation

Commerce Commission

regulation.branch@comcom.govt.nz



Wellington Electricity  
Lines Limited

85 The Esplanade  
Petone, PO Box 31049  
Lower Hutt 5040  
New Zealand

Tel: +64 4 915 6100  
Fax: +64 4 915 6130

Dear Dane Gunnell

## **Default price-quality paths for electricity distribution businesses from 1 April 2020 – Issues paper**

### **1. Introduction**

Wellington Electricity Lines Limited (WELL) welcomes the opportunity to make a submission in response to the Commerce Commissions (Commission) issues paper “Default price-quality paths for electricity distribution businesses from 1 April 2020” published on 15 November 2018. This submission refers to this paper as the “Issues Paper”.

WELL’s submission covers the following key issues:

Section 2 – Executive summary

Section 3 - Transition from CPP

Section 4 – CPP application window

Section 5 – Forecasting operating expenditure

Section 6 – Forecasting capital expenditure

Section 7 – Reliability standards & incentives

Section 8 - Other measures of quality of service

Section 9 – incentives to improve efficiency

Section 10 - Energy efficiency, demand-side management, and reduction of losses

Section 11 – Implementing changes from IM review

Section 12 – Proposed changes to financial model

Section 13 - Closing

The Electricity Network Association (ENA) has also provided a submission in response to the Issues Paper. WELL supports the views of the ENA submission, except where it explicitly states it does not. This submission should be read as a supplement to the ENA submission.

The ENA's submission provides a good overview of the external factors that will impact the DPP3 reset. This includes New Zealand commitment to a net of zero emissions by 2050, impact of emerging technologies, increasing weather events, continued bedding in of the Health and Safety at Work Act 2015, potential changes to fire levies and the impact of Electricity (Hazards from Trees) Regulations.

## **2. Executive Summary**

WELL welcomes the opportunity to provide a submission in response to the Commission's Issues Paper. Overall, WELL is concerned about the potential changes to the incentive regimes and the increase in reporting and compliance. The changes add both downside risk and cost to EDBs. The changes to the incentive schemes in particular, could add significant volatility to an EDBs expected return.

WELL is also concerned that the general forecasting approach doesn't reflect the change to a revenue cap. Under a price cap, more of the forecasting responsibility sat with the Commission – the Commission forecast volume changes which in turn drove opex and capex expenditure. Under a revenue cap, the role of forecasting has shifted to the EDB. The EDB is now responsible for forecasting volume driven changes in their opex and capex resource requirements. The proposed approach towards forecasting hasn't changed to reflect this.

The key points of our submission are:

- We support the Commission's emerging view that WELL will be included in the DPP3 reset process which will be used to set a starting price. WELL would be transitioned to the DPP3 revenue path on 1 April 2021. We look forward to assisting the Commission in refining the transition process, particularly how the Commission might apply any updated inputs before the March 2021 transition and how the quality standards and incentives might be set.
- WELL considers the 'step and trend' approach used in the DPP2 reset a good approach but has a number of weaknesses that should be addressed for the DPP3 reset:
  - WELL accepts using the 2019 disclosure year as the base level of operating expenditure, if the base year can be adjusted for significant, known changes that the EDB will incur going forward and are not included in the base.
  - WELL supports the step mechanism with the principle that any step changes to operating expenditure had to be applicable to most, if not all, distributors. WELL recommends that a low cost process would involve allowing step changes that have been quantified and independently audited or verified.
- Cost drivers could provide a good indicator of network scale growth if there is a strong correlation between the driver and operating expenditure. Our concern is that the simple cost drivers proposed are not good predictors of growth. We are also concerned that changing factors like new technology and a maturing asset base may mean that cost drivers that were good predictors of growth in the past, may not be in the future. AMP forecasts of drivers like ICP

growth and network length changes could be useful, but the forecast models may need strengthening if greater importance was to be put on the result.

- Previously, the Commission engaged Economic Insights to estimate a partial productivity adjustment. WELL supports a similar approach of gathering empirical evidence as part of the reset process. There are new drivers that could contribute towards a negative factor, including further tightening of the industry specific labour market, increasing extreme weather events and further bedding in of the Health and Safety at Work Act.
- WELL considers that the AMPs produced by EDBs should continue to be relied on for forecasting both network and non-network capex. AMPs are developed through a robust internal planning process based on detailed knowledge of asset performance, local economic drivers and network characteristics, are subject to internal review and robust governance arrangements, and have received Director Certification of the reasonableness of expenditure forecasts. The AMP also incorporates the lifecycle of assets in its forecasting, whereas forecasting using historical expenditure does not.
- Smoothing or limiting capex can produce sub-optimal investment decisions. However, WELL understands why the Commission supports the need for a cap on capital expenditure. If a cap is applied, WELL would like a mechanism that would allow one-off capital programmes within the DPP model for capital expenditure over the cap.
- If a cap based on historical expenditure is applied to the capex, WELL considers it more important for the historical data used to calculate the cap to be robust, than for the data set to span a longer period of time. Data prepared post 2013 using the current ID rules will provide a more sensible (apples with apples) comparison than data prepared using a different set of rules.
- WELL would support using internal or external ratios to validate the capex, if the ratios are shown to have a strong correlation to expenditure and are low cost to calculate and apply.
- WELL does not support separating planned and unplanned outages. WELL has comparatively few planned outages because its customers prefer to keep power on (using generators) during planned works.
- WELL supports reducing the reference period to five years and using the most recent data set. Using a five year data set of the most recent information ensures the data set captures current work practices.
- WELL does not support removing a limited number of high and low (symmetrical) extreme events from the reference period. Removing selected events could inadvertently skew the dataset so that it is no longer representative of the drivers that influence the performance of the network. We would prefer to retain the events in the data set and categorise them as extreme events.
- WELL supports the ENA's suggestion that EDB's should have the ability to adjust their outage reference datasets to be used for the DPP3, to reflect the impact of changes in their operating environments which have occurred during the current regulatory period. Changes to the Health and Safety at Work Act 2015 have added ~15% to WELL's SAIDI performance.
- WELL supports a revenue linked quality incentive scheme that incentivises distributors to provide services at a level of quality that customers demand. For an incentive scheme to be effective, EDBs must be able to influence the quality outcome with a reasonable level of investment. We are concerned that many events that impact the quality targets are

uncontrollable and therefore EDBs may not be rewarded for their investment in improving quality.

- For the above reason, WELL strongly opposes increasing the revenue at risk for the current service quality measures. EDBs should have confidence that they will be rewarded for their investment before the incentives are increased. Increasing the revenue at risk while the quality measures still include uncontrollable events, will create down side risk and increase return volatility. WELL is also concerned that increasing the revenue at risk will promote a level of investment beyond what customers want. Our own surveys show customers are not willing to pay more for improving service quality. 85% of WELL's customers said they would not be willing to pay a little more if it meant fewer power cuts. Increasing the revenue at risk will encourage more investment in service quality – contrary to what customers want.
- WELL would support a wider cap and collar on the quality incentive framework (but not increasing the revenue at risk). This may provide a low cost way of recognising the high degree of variability of quality performance (EDBs are exceeding the cap and collar 50% of the time). However, there may be better ways of addressing the high variability in quality performance. Reducing the impact of uncontrollable events and setting more realistic targets could provide an alternative to widening the cap and collar.
- WELL supports refining how major event days are normalised. This includes identifying a major event day that falls within a rolling 24 hour period and aggregating multi day events. We also agree that major event days should be substituted with the average daily SAIDI and SAIFI. The current method of substituting major events with the boundary value almost guarantees an EDB will exceed its quality limits if there is more than the ten year average number of major events within a year.
- WELL does not support the need to collect LV performance data and does not support LV data being provided as part of the information disclosure. The DPP is intended as a low cost regulatory regime. LV performance monitoring and reporting will require significant investment to implement effectively. WELL would support LV performance monitoring if customers want it to be implemented and agreed to fund it. Retailer's charges for smart meter data would need to be passed through to customers.
- WELL does not support the introduction of two new customer metrics. To effectively implement and monitor the proposed performance measures will require significant investment. This is not consistent with a low cost regulatory approach.
- WELL does not support increasing the capex retention rate. Capital expenditure by nature is lumpy and is difficult to smooth. The IRIS is based on a cap that may not reflect the actual capital expenditure profile needed by an EDB. EDBs will often have genuine reasons for spending more than the capex cap. Increasing the capex retention rate could result in EDBs being further penalised for necessary expenditure. Increasing the revenue at risk by changing the incentive regimes also adds volatility to returns and risk.

### **3. Transition from CPP**

WELL supports the Commission's emerging view on how it will transition WELL from its current CPP to a DPP on 1 April 2021 (assuming WELL doesn't apply for another CPP).

WELL would be included in the DPP3 price setting process to set a starting revenue path. The Commission would retain the ability to update the forecasts in 2021. Given the CPP and the DPP only overlap by a year, WELL suspects that the need for updates would be limited – this does assume that WELL is able to adjust for known and verifiable changes that are not included in its base year. This is discussed in section 5.1 and 0.

The Commission does not have a view on how quality standards and incentives will be set yet.

WELL looks forward to assisting the Commission in refining the transition process.

#### **4. CPP application window**

WELL supports the options of moving to a single final date for CPP applications. This would provide EDBs with more flexibility in preparing for an application.

#### **5. Forecasting operating expenditure**

WELL considers that the general ‘step and trend’ approach used in the DPP2 reset is a good approach, but has weaknesses that should be corrected for the DPP3 reset. We agree that a large proportion of operating expenditure relates to activities that reoccur. However, there is also a growing element of increasing expenditure relating to mature assets. The current approach should be refined to allow the forecast to be adjusted for significant, known changes that the EDB will incur going forward and are not captured in the base year or in the current step mechanism. Without this ability, EDBs may have to reduce their operating capability to fund legitimate increases in operating expenditure.

##### **5.1. Base year**

The 2019 disclosure year provides a good starting point for forecast expenditure. It is also important that an EDB has the ability to adjust the base year for significant, known changes that the EDB will incur going forward and are not included in the base.

It is important that the base year of opex used for forecasting future opex is representative of an EDBs underlying opex requirements. The latest available set of actual expenditure will provide the closest representation of current work practices, employment terms and conditions, network conditions, network scale, input costs and regulatory obligations. This will provide a good starting point. However, there may be operating costs changes that are not included in the base. This could include significant contract changes, changes in work practices or employment terms which have only partially been applied to the base year.

EDBs should have the ability to adjust the base year for significant known changes that can be proven. Alternatively, this adjustment could be made as a step change, if step changes that are unique to an individual EDB could be applied (discussed in section 0).

## **Step changes**

WELL supports the ability to make step adjustments in operating expenditure for identifiable changes. The ENA submission provides a good overview of the industry changes that will increase operating costs - these include the implementation of new prices, changes in tree regulations and Fire Service levies. This could also include changes in maintenance costs relating to asset criticality assessments. Refinements to the asset management plan process have encouraged more rigor in assessing critical assets.

### **5.2. Network scale growth**

Under the revenue cap, EDBs are now responsible for forecasting volume driven changes in their opex resource requirements. EDBs need the ability to forecast the actual resources needed, rather than being limited to resources predicated by high level drivers.

WELL supports using the economic drivers if the analysis shows a strong correlation between:

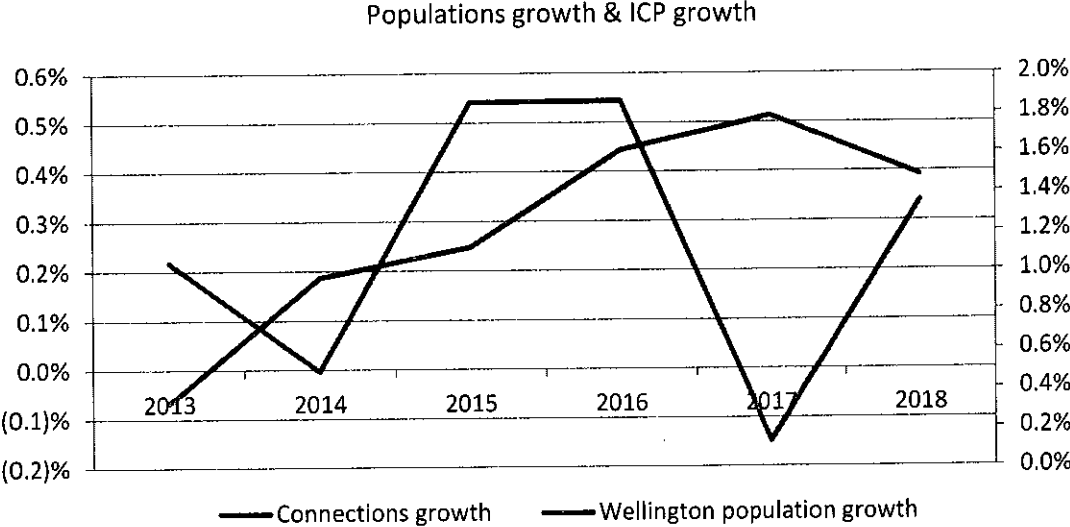
- The drivers and operating expenditure; and
- The proposed driver forecast and the driver.

Our concern is that the simple cost drivers proposed are not good predictors of growth. We are also concerned that changing factors like new technology and a maturing asset base may mean that cost drivers that were good predictors of growth in the past, may not be in the future.

#### **5.2.1. Using regional population growth to forecast ICP growth**

The relationship between population growth and ICP growth is weak. On average, connections grew at 0.2% between 2013 and 2018 and the population grew at 1.2%. WELL has previously noted during the DPP2 reset that the misalignment between residential ICP growth and population growth could be due to the increasing presence of embedded networks (e.g. apartment dwellings). The increasing trend towards embedded networks has the effect of reducing ICP count as it consolidates to a 400V level and aggregates to a gateway meter. Figure 1 below illustrates the relationship.

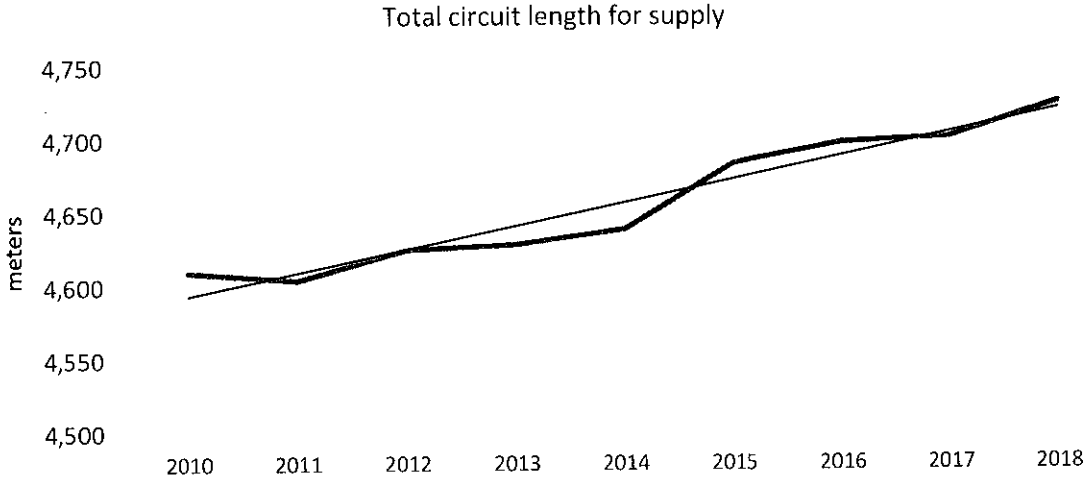
**Figure 1: Relationship between population growth and ICP growth**



**5.2.2. Using historical line length to forecast line length**

At a high level, historical growth in line length appears to be stable and could be useful for forecasting future growth. However, consideration would have to be given to any potential changes that might cause future growth to vary from historical trends. For example, increased uptake of new technology like EVs could accelerate network growth.

**Figure 2: Historical growth of circuit length**



**5.2.3. Using AMP to forecast ICP growth**

Aligning the AMP with the DPP reset forecast would provide consistency between the two models. It would also allow an EDB to consider and reflect network specific factors into its forecast.

The Commission have indicated that any EDB forecast would also require a level of scrutiny. Consideration would need to be given to the additional cost and complexity this option might add and the additional value it would provide.

**5.2.4. Collecting line length forecast information from EDBs**

WELL supports using EDB’s own forecasts for line length growth - EDB’s have the local knowledge and expertise to develop accurate forecasts. Consideration would need to be given to the additional cost and complexity this option might add and the additional value it would provide.

**5.3. Disaggregation of network and/or non-network to the operating expenditure**

WELL is cautious around disaggregating operating expenditure further. Disaggregation and developing further cost drivers will increase compliance costs and add complexity to the regulatory model. Careful consideration would need to be given to the value further disaggregation would provide.

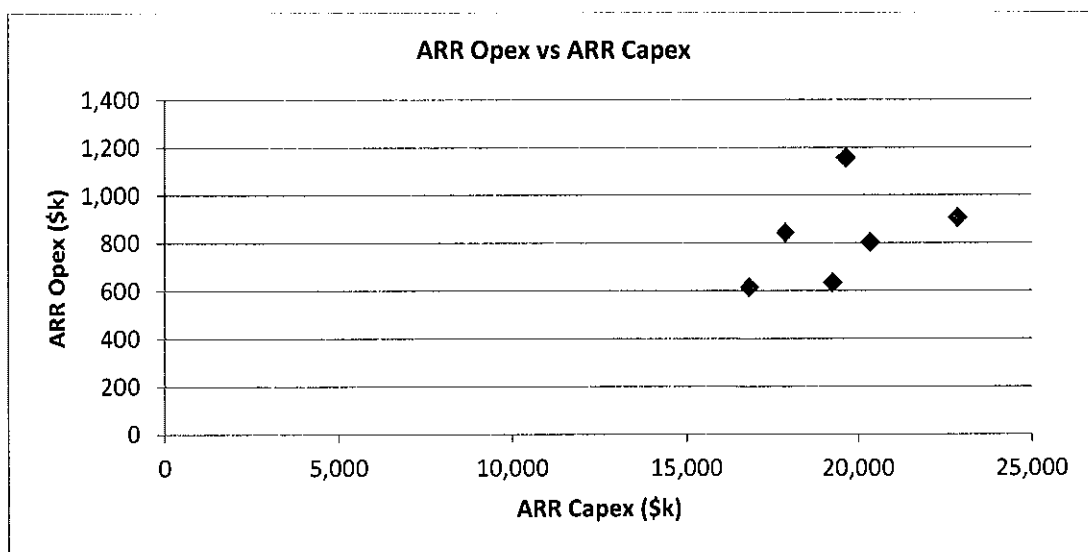
**5.4. Economic drivers – potential new drivers**

We have considered the potential new economic drivers at a high level. Further analysis, including measuring the strength of the correlations, would need to be completed before WELL would be comfortable with any potential economic drivers.

**5.4.1. Relationship between capex and asset replacement and renewal opex**

There is not a strong inverse relationship between asset replacement operating costs and capital costs on the WELL network.

**Figure 3: Relationship between capex and asset replacement and renewal opex**





#### **5.4.2. Vegetation management & overhead line length**

Line length is not a driver of WELL's vegetation management (VM) expenditure. We have a gradually reducing length of overhead line due to new construction being required to be underground. Offsetting this is an increasing VM expenditure as we work to maintain reliability levels.

#### **5.5. Partial productivity factor**

Previously, the Commission engaged Economic Insights to estimate a partial productivity adjustment. WELL supports a similar approach of gathering empirical evidence as part of the reset process. Many of the reasons for a negative productivity factor may have escalated and there are new drivers that could also contribute towards a negative factor:

- Labour cost escalations to enable the retention of specialised staff continue to escalate and may not be captured in the opex base.
- Further increases to regulatory obligations which result in cost increases but do not result in increases to the quality of services. This includes the continued bedding in of the Health and Safety at Work Act.
- The introduction of new technology can require an initial investment before consumer volumes are large enough to fund it.
- Impact of climate change on insurance and maintenance costs. The Insurance Council of NZ has recently reported that extreme weather events are becoming more frequent<sup>1</sup>.

#### **5.6. Opex price inflation considerations**

WELL supports the Commissions approach of using operating expenditure specific inflators to convert nominal dollars rather, than CPI. This reflects that operating expenditure prices grow at a different rate than general prices.

WELL has historically supported using the EGWW inflators for the reasons outlined in the issues paper – they are more reflective of labour and production price growth.

The ENA's submission also highlights the potential upside risk to the current modest labour inflation forecasts. The economy is approaching full capacity which could result in higher labour inflation than what is currently forecast.

WELL would like to understand the forecasts for the EGWW inflators – is there expected to be differences in the change in input costs between the all industry forecasts and the industry specific forecasts?

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<sup>1</sup><https://www.icnz.org.nz/media-resources/media-releases/single/item/insurers-pay-226m-to-support-recovery-from-extreme-weather/>

## **6. Forecasting capital expenditure**

### **6.1. Overall approach to capital expenditure forecasts**

WELL considers that the AMPs produced by EDBs should continue to be relied on for forecasting both network and non-network capex. AMPs are developed through a robust internal planning process based on detailed knowledge of asset performance and network characteristics, are subject to internal review and robust governance arrangements, and have received Director Certification of the reasonableness of expenditure forecasts.

WELL also supports the ENA's view that the capex reference period should be based on the 2019 AMP for both the DPP draft decision and the final decision. The 2019 AMP will be available April 1 2019, before the draft decision is due.

Unlike opex, recent actual capital expenditure is unlikely to provide a useful base to extrapolate a forecast from – by definition a capital items will not need replacing in subsequent years and often have an economic life which is longer than a pricing period. A step and trend model is not appropriate for capital forecasts.

We also do not support a Commission derived capex model as it would be an inefficient use of resource and would not be low cost (Part 4 requirements). The Commission would be replicating capital planning functions which already exists in the EDB. The forecasts would also be unlikely to take into account the specific requirements on each EDB network as the Commission are unlikely to have the same level of network knowledge.

WELL understands the Commissions view that there is a need for a level of scrutiny of the AMP capital plans. Care will be needed to ensure that the scrutiny does not restrict an EDB's ability to effectively plan its capital programme or the investment needed to avoid a degradation of quality.

### **6.2. Disaggregation of capital expenditure forecasts**

WELL understands that capital expenditure will need to be disaggregated to provide scrutiny to the AMP forecast. Caution is needed about the additional resource and cost more complex levels of scrutiny will add.

Consideration should be given to materiality. Limiting disaggregation to the larger capital expenditure classes, (asset replacement, system growth and consumer connections) would help reduce the costs.

### **6.3. Expenditure scrutiny**

#### **6.3.1. Historical cap**

Smoothing or limiting capital expenditure can produce sub-optimal investment decisions. Asset replacement is timed with asset deterioration, customer connections with new developments and system growth with energy demand requirements. Limiting how much capital can be spent within a

year or pricing period can result in assets being replaced too early or late, delays to new connections or the network not meeting its energy demands.

However, WELL understands why the Commission supports the need for a cap on capital expenditure. It provides a low cost control over the level of capital expenditure while still providing planning flexibility within the cap.

If a cap is applied, WELL would like a mechanism that would allow one-off capital programmes within the DPP model that allows capital expenditure over the cap. This would allow EDBs and customers to avoid an expensive CPP process. The mechanism could be included as a verifiable step change or as part of the capital scrutiny process.

While WELL does not support a cap on capital expenditure, it understands why it might be applied and has provided feedback on the different application options.

#### *Reference period*

WELL considers it more important for the historical data to be robust than for the data set to span a longer period of time. Data prepared post 2013 using the current ID rules will provide a more sensible (apples with apples) comparison than data prepared using a different set of rules. The more recent data set is also more representative of the asset management practices currently employed.

#### *Forecast comparison period*

WELL strongly supports using a comparison over the entire period, where expenditure as a whole is limited. As per our earlier point in this section, restricting capital expenditure can result in sub-optimal investment (for example, delaying the replacement of an assets due to expenditure restrictions could result in quality deterioration). Applying the cap as a total over the entire period will give the EDB more planning flexibility and reduce (but not eliminate) the risk of sub-optimal investment due to expenditure restrictions.

#### *Type of Cap*

WELL supports a uniform percentage cap. A cap in proportion to past spend will allow a consistent application across EDBs. A uniform dollar cap will either be adjusted to the size of a EDB network and mimic a percentage cap, or the cap may not reflect network size.

### **6.3.2. Internal ratio analysis**

WELL supports the general approach using the drivers provided in the AMP to explain the capital forecast. This has the advantage of being:

- Relatively low cost – the models have been developed as part of an EDBs asset management practices but will probably need refining to simply and clarify the comparison.
- The ratios could provide checks and balances that the EDBs could apply without the input of the Commission.
- Leverages the local network knowledge and expertise.
- Would allow adjustments for changes in technology and practices.

The Commissions quality breach reviews provide a similar review process using these drivers. The review of WELLS most recent quality breach compared its asset health monitoring and criticality assessment with its asset replacement programme and confirmed the programme correctly prioritized asset replacement.

However, WELL has concerns around whether simple ratios will effectively reflect the level of expenditure needed. WELL uses the drivers mentioned to influence expenditure but it also includes other drivers and inputs.

WELL would also like to understand how the ratios would be applied. A rigid application of ratios that aren't strongly correlated to expenditure levels could result in sub-optimal investment decisions.

WELL would support using simple ratios if they provide a good correlation with expenditure and are applied reasonably to the capital forecasts.

#### *Consumer connections*

We agree that this may need disaggregating further and EDBs may need to invest in strengthen the forecast processes. Consumer connection forecasting is complex.

#### *Systems growth*

Forecast may also need to include the impact of new technology which could be used to defer investment.

#### *Asset replacement and renewal*

Asset life is not the sole driver of asset replacement. Asset health and asset criticality are more important. Any internal ratios would need to include these aspects to be effective.

#### *Other cost categories*

WELL agrees with the Commissions view that these categories are unlikely to merit further scrutiny because of their materiality and lack of clear quantitative drivers.

### **6.3.3. External ratio analysis**

WELL would support using external independent drivers if they provided a strong correlation and were simple and inexpensive to implement - our concern is that the external drivers do not provide the strong correlation required. Like with internal ratios, we are also concerned that changing external factors could mean that drivers that provide a good historical fit may not provide a good fit in the future.

WELL would also like to understand how the ratios would be applied. A rigid application of ratios that aren't strongly correlated to expenditure levels could result in sub-optimal investment decisions.

### *Consumer connections*

As outlined in section 5.2.1, population growth does not appear to be correlated with consumer connection growth and therefore would not be useful as an external driver. Local Government building consent applications or other indicators of new developments might be useful.

### *Systems growth*

We would support this approach if the forecasts were shown to be effective and could be implemented at a low cost. We do have concerns whether this could be achieved - the expert forecasts may have to be developed for each network for it to be effective which could become expensive.

### *Asset replacement and renewal*

We agree with the Commissions comment that a replacement expenditure model goes beyond what's practical in a DPP. The model would also have to include inputs like asset health and asset criticality to be effective. Differences in asset management practices between EDBs could also make modelling difficult.

#### **6.3.4. Qualitative scrutiny**

We agree with the Commissions view that this would be expensive and would not align with a low cost approach. The Commission may also not have the specific network expertise to make an effective judgement of the reasonableness of expenditure increases.

#### **6.4. Capex cost escalators**

Our view of an appropriate cost escalator does not differ from that provided for opex cost escalators (outlined in section 5.6)

#### **6.5. Treatment of spur asset purchases**

From time to time Transpower engages with lines companies around the sale and transfer of their spur assets. WELL would evaluate a sale case by case.

WELL believes that the current treatment of spur assets needs refining to ensure the increase in operating costs relating to a new spur asset doesn't trigger penalties under the IRIS. The IRIS mechanism should be adjusted to exclude any expenditure relating to the operation of a newly purchased spur (or an adjustment that would have the equivalent financial impact).

WELL also believes that the historical quality data used to measure quality performance would also need to be adjusted to include the past performance of a new asset.

### **7. Reliability standards and incentives**

WELL supports the ENA's view that regulatory mechanisms, including mechanisms that regulate reliability standards and incentives, should focus on what an EDB can sensibly control. WELL also

supports the ENA's view that many of the proposed changes to the quality of service regulation require data that is not currently collected. This requires additional resources and investment which has yet to be quantified.

## **7.1. Quality standard**

### **7.1.1. Treatment of planned interruptions**

WELL does not support separating planned and unplanned outages. WELL has comparatively few planned outages because it prefers to keep power on during planned works. Where we can, we de-energise the work area and use generators to provide power to affected customers. In the last year this has cost WELL around \$600k p.a. in direct costs – a cost that will have no impact on the SAIDI result and will not be recovered in the incentive regime.

### **7.1.2. Consideration of the two out of three rule**

WELL supports retaining the 'two out of three rule' as it recognises that unplanned events like weather can cause year on year volatility and can be out of an EDB's control. Measuring a breach as sequential non-compliance reflects this volatility.

### **7.1.3. Reference period**

WELL supports reducing the reference period to five years and using the most recent data set. Using the most recent five year period will ensure the data provides a good representation of current work practices. Work practices in DPP0 and DPP1 included more live work which required less planned outages - work practices in DPP2 has changed to more de-energised planned outages.

### **7.1.4. Removal of highest and lowest years from reference period**

WELL does not support removing a limited number of high and low (symmetrical) extreme events from the reference period. The reference period should be reflective of the underlying variability of the networks performance. The dataset should include extreme event days where the network is unable to operate within its designed limits.

### **7.1.5. Step change adjustments to reference period**

WELL supports the ENA's suggestion that EDB's should have the ability to adjust their outage reference datasets to be used for the 2020 DPP, to reflect the impact of changes in their operating environments which have occurred during the current regulatory period. Changes to the Health and Safety at Work Act 2015 added 15% to WELLs quality performance. To mitigate some of the impact that changes to the Health and Safety at Work Act is having, WELL is using portable generators to provide customers with power during planned maintenance work that is now de-energized. In the last year this has cost WELL around \$600k p.a. in direct costs – a cost that will maintain the SAIDI result, will not be recovered in the incentive regime and is in addition to its current allowances (i.e. we have reduced our opex spend elsewhere to achieve this result).

WELL agrees with the ENA's reasons provided in its response to the Issues Paper, that the DPP reopener and the CPP quality only applications are not practical mechanism for adjusting the quality targets. The ENA's suggestion of standardising the adjustment process (while referencing the spurs asset purchase mechanisms) would provide a low cost solution.

#### **7.1.6. Automatic compliance contravention reporting**

WELL supports standardising the automatic reporting requirements for a breach of the quality standards, if the further information requested would have been requested in every breach.

To meet the 'low cost' DPP approach, the automated compliance reporting should only include information that will always be requested.

### **7.2. Incentive scheme**

#### **7.2.1. Keeping an incentive scheme?**

WELL supports a revenue linked quality incentive scheme that incentivises distributors to provide service at a level of quality that customers demand. Any incentive scheme should reflect a reasonable cost-quality trade-off, encouraging investment needed to adjust or maintain quality to the level that customers want. Conversely, an incentive scheme should dis-incentive over investment.

The current DPP quality performance to date show significant variation in performance - within the industry the reliability caps were exceeded on 26 occasions (27%), the reliability collars were outperformed on 22 occasions (23%), with the remaining half falling within the cap and collar range. The weighted average of rewards and penalties nets to a 0.34% penalty.

The ENA working group surveyed EDBs responses to DPP compliance issues. It found that significant investments had been made in response to DPP compliance. However, the responses were not able to mitigate the breaches caused by major events or by external changes to work practices. WELL supports the ENA's view that the financial incentive scheme is essentially a financial penalty for EDB's for events that are out of the EDB's control.

The current scheme does appear to be encouraging EDB's to invest in improving its quality performance. However, the investments are not always effective at improving service quality because of events that are largely uncontrollable. WELL would like to focus on ensuring the scheme is effective before contemplating expanding the size of the penalty/reward revenue pool.

#### **7.2.2. Revenue at risk**

WELL strongly opposes increasing the revenue at risk for the current service quality measures. In addition to our concerns highlighted in section 7.2.1 around the effectiveness of the current mechanism, WELL is also concerned that increasing the revenue at risk will promote a level of investment beyond what customers want. When WELL surveyed its customers, they found that customers were not willing to pay more for an improvement in service level. 85% of WELL's customers said they would not be willing to pay a little more if it meant fewer power cuts. 71% of



WELL's customers said they would not be prepared to have slightly more power cuts if it meant paying less. The issues paper highlighted that the ENA's customer survey had similar results. Increasing the revenue at risk will provide greater incentives to invest in assets that will improve SAIDI and SAIFI results beyond what customers want – a result contrary to what customers want and therefore contrary to the purpose of the incentive mechanism. EDBs who invest to improve reliability will get two benefits – a return on the additional investment, and the revenue incentive.

WELL is also concerned about the impact the changes in the incentive regimes might have on overall risk. Increasing the revenue at risk and adding more incentive measures will result in volatile returns – especially because a large component of the current quality measure is uncontrollable and creates asymmetric rewards and penalties. The DPP3 process does not allow the asset risk beta to be adjusted. Care should be given to ensure that changes to the incentive schemes are not adding risk that cannot be reflected in a corresponding change in rewards.

WELL agrees with the ENA that there are aspects of the scheme that need refining before increases to the revenue at risk pool could be contemplated:

- Ensure that EDB's have control over their quality measures. EDB's should be able to make informed investment decisions about how to improve their quality performance. Uncontrollable events should be removed from the quality measures.
- The size of the investment needed to improve quality should relate to the size of the return from the incentive.
- Confirm the level of quality customers want. Specially test whether customers are comfortable with the current level of service in extreme storm events i.e. they accept extreme storm events are beyond the control of an EDB and they don't want prices increasing to harden the network when an interruption once in 10 years is acceptable.
- Gathering more data on the impact that legislative changes have had on SAIDI and SAIFI and adjust the quality measures to reflect these changes. The current performance history does not reflect changes in work practices that have resulted from changes to the Health and Safety Act 2015. For WELL, this has added 5-6 SAIDI minutes per year.

WELL does see some potential to increase the overall revenue at risk pool if other measures were also included. This would require a better understanding of what customers want and reviewing whether the current measures capture this.

### **7.2.3. SAIDI and SAIFI incentives**

We see the merit in adjusting the proportion of the revenue at risk allocated between the measures to reflect what customers find more important. For example, if the duration of an outage is more important than the number of outages, then SAIDI could be allocated a higher proportion of the revenue at risk.

### **7.2.4. Caps and collars (and buffer between historical average and limits)**

Including a buffer between targets and the limits (cap and collar) is important for unplanned outages as it reflects variations between years. The issues paper contemplates an option of increasing the



width of the cap and collar with an increase in the size of the revenue at risk. As outlined in section 7.2.2, WELL does not agree with increasing the size of the revenue at risk.

The reliability caps were exceeded on 26 occasions (27%), the reliability collars were outperformed on 22 occasions (23%), with the remaining half falling within the cap and collar range. The high proportion of EDBs breaching the cap and collars suggests either the quality targets were not realistic or there is a high degree of variation in year-on year SAIDI/SAIFI results, perhaps caused by volatile quality drivers like the weather. The Insurance Council of NZ has recently reported that extreme weather events are becoming more frequent<sup>2</sup>.

WELL would support improving the quality targets for each EDB (provided the improvements are funded) so they are:

- Realistically achievable (without being too easy) and controllable.
- Provide a sensible link between quality and investment – the rewards encourage the right level of investment to improve quality, without over investing.

As the ENA have outlined in their submission, improving quality targets better aligns with the 52A purpose statement, than increasing the width between cap and collar.

WELL would also be comfortable with increasing the width between the cap and collar (but not with increasing the size of the revenue at risk). This may provide a low cost way of recognising the high degree of variability of quality performance.

#### **7.2.5. Incentive rate (limiting to value of lost load)**

WELL considers it more appropriate to set the incentive rate at a level which encourages a reasonable level of investment to support the level of quality that customers wants. The incentive rate should not be too high to encourage overinvestment, or too low so that under investment results in asset deterioration.

Using the value of lost load to set the incentive rate could also be problematic because it is an average across the country. The value individual customers put on lost load will be different depending on how they use power. Larger business for example will place a much higher value on lost load than residential customers.

### **7.3. Normalisation and assessment**

#### **7.3.1. Expectation of a major event day**

WELL does not support the using the 23rd highest day to define the boundary value for Major Event Days (MEDs) where a ten year reference dataset applies. The recent Insurance Council report indicates that storm events are becoming more frequent. The ten year data set may not be representative of future storm events. Consideration should be given to an alternative measure of MEDs that considers the increasing frequency of bad weather.

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<sup>2</sup><https://www.icnz.org.nz/media-resources/media-releases/single/item/insurers-pay-226m-to-support-recovery-from-extreme-weather/>

### **7.3.2. Identification of a major event day**

WELL supports moving to a rolling 24 hour period. This would capture events that are less than 24 hours in total, span two day and where the impact on either of the two calendar days would not trigger an event individually.

### **7.3.3. Major events lasting more than one day**

WELL considers it appropriate to aggregate multi-day events and/or follow-up interruptions for extreme weather events and disasters. This option simplifies the normalisation process and removes the risk of perverse incentives.

### **7.3.4. Treatment of major event days**

WELL supports the ENA's view that major event days should be substituted with the average daily SAIDI and SAIFI. This method would be applied to the historical data set and complemented with more scrutiny of the causes of major events.

The current method of substituting major events with the boundary value almost guarantees an EDB will exceed its quality limits if there is more than the average number of major events within a year. Most major events are weather driven and outside of the EDB's control – the penalty for breaching the limits would be unavoidable without significant and, likely, uneconomic investment. It is important that EDB's are not encouraged to strengthen their networks to withstand extreme weather as this is a level of service customers do not want.

Moving to substituting major event days with the average SAIDI and SAIFI will require more transparent information. WELL supports the need for collecting additional information if the Commission moves to the alternative treatment of major event days.

### **7.3.5. Consistency between DPP and ID normalisation methodologies**

WELL supports addressing the differences in normalisation approaches between the DPP and ID. WELL also supports those adjustments taking into account the potential to change normalisation methods.

### **7.3.6. Interruption data on LV lines**

WELL does not support the need to collect LV performance data and does not support data being provided as part of the information disclosure. The DPP is intended as a low cost regulatory regime. LV performance monitoring and reporting will require significant investment to implement effectively. Its implementation would be a step change in expenditure.

WELL does understand that LV information will become more important as new technologies are introduced that connect directly to the LV network (residential solar, electric vehicles etc.). WELL would support LV performance monitoring in the future if customers supported its implementation

and were happy to fund it. This might require a business case outlining the implementation costs and the benefits expected.

#### **7.3.7. Momentary average interruption frequency index – MAIFI**

WELL does not support collecting MAIFI data as part of the information disclosures. WELL believes it is not needed for regulatory purposes and is better used as part of an EDBs asset management function. With LV performance data, many EDBs only have limited data. Installing the required monitoring and communications systems to accurately record MAIFI performance data could involve considerable expense.

#### **7.3.8. Interruption reporting by location, network types, and customer types**

WELL is open to collecting disaggregated interruption data. WELL would have to assess if it is able to collect the data accurately and if there are additional costs associated.

#### **7.3.9. Disclosure of electricity losses**

Recording the load lost due to delivery interruptions requires the ability to measure load at the time of an interruption, as well as a solid understanding of load patterns, in order to allow accurate forecasts of likely load during the time of the interruption. To do this accurately, significant investment would be required.

WELL would like to understand the value that collecting this data could provide customers – would the benefits exceed the investment required.

#### **7.3.10. Adjusting performance metrics to changes in live line policies**

Changes in live line practices has added around 15% of SAIDI minutes to WELL's quality performance. WELL strongly supports adjusting the performance targets to reflect this. WELL's preferred option would be to make an explicit 'step change' adjustment to SAIDI and SAIFI targets/compliance thresholds.

Using a shorter reference period would not capture the full impact of the changes in practices unless this was for the last 2 years only (since the HWS has made an impact on practices). Live line practices were implemented over multiple years – only the most recent years have the full impact included.

WELL does not agree with making no allowance. While live line practices differ between EDBs and some EDBs take a more conservative approach, most have made changes which impact performance quality

WELL does not support the removal (or separation) of planned outages from the measure because planned outages are part of the service provided to consumers and should be included, albeit at a halved rate as per historical practice.

## **8. Other measures of quality of service**

### **8.1. Customer service measures**

WELL does not support the introduction of two new customer metrics. To effectively implement and monitor the proposed performance measures will require significant investment. This is not consistent with a low cost regulatory approach.

### **8.2. Power quality**

Voltage stability measures are already included as part of the technical regulation and is therefore not necessary to include as part of the part 4 regulation. Collecting voltage fluctuation information would also be expensive to implement.

### **8.3. GSL scheme**

As part of the ENA working group, WELL supports the introduction of a GSL scheme as described in more detail in the ENAs submission. The scheme would require considerable resources and investment to implement.

## **9. Incentives to improve efficiency**

WELL supports the use of retention factors to encourage efficiency savings in operating and capital expenditure – the IRIS scheme allowing the benefits from savings to be retained by the EDB in the short term and passed to customers in the long term.

### **9.1. Operating expenditure IRIS incentive rate**

WELL is comfortable with continuing with the current scheme which uses the DPP3 WACC to discount future benefits.

### **9.2. Capital expenditure IRIS incentive rate**

WELL does not support increasing the capex retention rate for a number of reasons. Capital expenditure by nature is lumpy and is difficult to smooth. The IRIS is based on caps that may not reflect the actual capital expenditure profile needed by an EDB. EDBs will often have genuine reasons for spending more than the capex cap. This could include unexpected expenditure like reacting to repairs from major events or expenditure needed to support a rapid growth in emerging technology. It could also be because assets need replacing to maintain current service quality but the replacement costs does not fit under the cap. The extra expenditure may not be large enough to justify an expensive CPP. Increasing the capex retention rate could result in EDBs being further penalised for necessary expenditure.

As discussed in section 7.2.2, increasing the revenue at risk by changing the incentive regimes adds volatility to returns and risk.

WELL does not believe that the current retention rate influences how costs are classified - International financial reporting standards dictate how expenses are classified and statutory audits ensure the rules have been applied correctly.

#### **9.2.1. What retention rate should be used?**

The retention rate should not increase from its current 15%.

### **9.3. Smoothing operating expenditure incentive amounts**

WELL understands that the operating expenditure incentive could create price shocks and supports the concept of a NPV neutral smoothing mechanism if the mechanism is low cost to implement and operate.

### **9.4. Operating leases**

WELL understands that the Commission will be addressing operating leases in a separate consultation paper. However, WELL encourages the commission to treat operating leases consistently with the International Financial Accounting Standards. WELL will be applying the new standard to its accounting practices – the consistent treatment of leases will avoid two sets of audited calculations, keeping costs low.

More importantly, the intention of the new standard is to recognise that leases are an alternative way of financing an asset which is used to provide distribution services. Recognising leases on the balances sheet reflects that the EDB will receive medium to long term benefits (more than a year) and will have a medium to long term financial commitment. The approach also aligns well with an EDBs long term approach to asset management.

## **10. Energy efficiency, demand-side management, and reduction of losses**

WELL strongly supported moving to a revenue cap model and agree with the benefits this had on encouraging energy efficiency.

### **10.1. Reduction in energy losses**

WELL does not support the inclusion of an energy loss regime for the reasons outlined in the ENA submission. In addition, WELL also have concerns about whether customers would receive the benefits of their investment in reducing energy losses. Theoretically, a reduction in energy losses would mean a reduction in the amount of electricity that needs to be generated. This should result in lower prices and savings to customers. In practice, electricity generators are not regulated and would not be participating in the energy loss incentive regime. Customers may not receive back the value of their investment in EDB energy loss initiatives. Furthermore, savings made from reduced generation would be passed back to all consumers, not just those who have funded the energy loss investment.

We also have concerns about whether the benefits received from reducing losses would be greater than the cost. Our loss factor is currently at the industry average. To meaningfully reduce this factor further this would require significant investment and it is possible the benefits will not outweigh the high cost. We suggest a cost-benefit analysis for each EDB be completed. This should include both the investment to reduce losses and the additional reporting and monitoring that will be needed to track the results.

## **11. Implementing changes from the IM review**

### **11.1. Revenue cap wash-up**

WELL notes that the proposed revenue cap is based on what has been applied to Powerco. This is also the same model that WELL operates under.

WELL also notes that the “Commission may specify in a DPP determination or CPP determination an annual maximum percentage increase in forecast allowable revenue as a function of demand” but they are not proposing to limit allowable revenue and a function of demand. However the Commission do consider price shocks from forecast allowable revenue as a risk that needs addressing.

WELL understands why revenue smoothing is important but are concerned around the implications it might have. It could impact on our annual performance reported in our statutory accounts as we are unable to accrue under IFRS. We are also concerned it may dilute the purpose of incentive regimes and may lead to perpetual wash-up balances.

WELL is still considering different smoothing methods to reduce price shocks. Attributes WELL would like to see in revenue smoothing mechanism could include:

- Simple and low cost to implement.
- Applied to an aggregate of all causes of changes in revenue (including changes to allowable revenue, IRIS recoveries and transmission pass throughs). There may be some natural offsetting once they are aggregated.
- Not too restrictive - avoids perpetual wash-up balances.
- Not too restrictive – avoids the dilution of incentive regimes.
- NPV neutral.

If a revenue smoothing regime is introduced, WELL would hope that Transpower would have similar revenue smoothing applied. We would be uncomfortable having to also smooth Transpower revenue.

## **12. Proposed changes to the financial model**

WELL supports the revenue cap and therefore support the changes to the financial model.

### 13. Closing

WELL appreciates the opportunity to provide a submission on the Commerce Commissions issues paper "Default price-quality paths for electricity distribution businesses from 1 April 2020". The issues paper provides a good opportunity to refine the model before it's used to calculate the draft decision.

If you have any questions or there are aspects you would like to discuss, please don't hesitate to contact Scott Scrimgeour, Commercial and Regulatory Manger, at [sscrimgeour@welectricity.co.nz](mailto:sscrimgeour@welectricity.co.nz) .

Yours sincerely



Greg Skelton

**Chief Executive Officer**