Submission

Invitation to comment on Powerco's CPP proposal: "Issues to explore and consider"

22 September 2017

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1 Introduction

Aurora Energy welcomes this opportunity to comment on the Commerce Commission's "*Invitation to have your say on Powerco's proposal to change its prices and quality standards: Issues to explore and consider*" (the Issues Paper) dated 18 August 2017.

No part of our submission is confidential and we are happy for it to be publicly released.

If the Commission has any queries regarding our submission, please do not hesitate to contact:

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2 The process so far

It is positive that the Commission was able to provide Powerco some flexibility around the timing of its CPP application. It is clear that a lot of work went into delivering a robust application within what are very narrow application windows.

Aurora Energy supports the Commission engaging with stakeholders a short time after receiving the application. Consultation has an important role in helping the Commission form views prior to making its draft decisions[1]. The Commission has successfully applied this type of approach in a number of its review and determination processes.

We are encouraged that the Commission and Powerco have worked constructively in the build-up to the formal application. We don't think that a CPP determination process can be successfully undertaken on a pure propose/respond basis. A robust CPP requires goodwill and co-operation on the part of the applicant and the Commission.

It is important, for example, that both parties have confidence in the independent verifier and the verification stage of the process.

One of the criticisms the Commission received about the Orion CPP process was duplication of the work of the independent verifier, so it is pleasing that the Commission has indicated it will take the verification recommendations into consideration.

This should help provide regulated suppliers with improved certainty and confidence about the outcome of any future potential CPP applications, as well as reducing the risk from making an application[2].

For the avoidance of doubt, we support the Commission's proposal to rely on the verifier's opinion and focus on the issues identified in the verification report[3].

3 The Powerco CPP will set an important precedent

The Powerco CPP process and decision will provide an important precedent. This will have implications for potential future CPP applications, and other aspects of the operation of Part 4.

The way the Commission goes about the Powerco CPP determination process, as much as its final decision, is important for the successful achievement of the Part 4 purposes (s52A(1)) to promote the

[1] Albeit recognising that the Commission has undertaken a significant amount of work reviewing the verifier's report, etc., prior to releasing the Issues Paper.

[2] At the extreme, this includes the risk that the Commission will make a CPP determination that is less favourable than the DPP the regulated supplier would otherwise have been on.

[3] Commerce Commission. (2017). Invitation to have your say on Powerco's proposal to change its prices and quality standards: Issues to explore and consider, paragraph 180.

long-term benefit of consumers, and (s53K) "*to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances*".

While the Commission has gone through two sets of DPP determinations, for both EDBs and GPBs, and this has helped provide clarity about how the DPP regime operates, and is evolving, CPP precedent is strictly limited.

The Orion CPP was made under what will hopefully remain a unique set of circumstances (the catastrophic impact of the Christchurch earthquakes), which narrows its precedent value.

The context for the Powerco CPP proposal, where the DPP determination it currently operates under is insufficient to enable the level of opex and capex needed to ensure an appropriate level of security of supply, is much more likely to be directly relevant to other regulated suppliers considering CPPs[4].

4 Scrutiny of CPP proposals needs to be proportionate

Aurora Energy is pleased that the Commission has acknowledged that the level of information required to support a CPP application depends on the size of the regulated supplier. PwC previously submitted that the Commission could "usefully take account of the size of the regulated supplier when determining how much scrutiny is proportionate"[5].

Exactly what constitutes a proportionate level of scrutiny and evidence in support of a CPP proposal, depends on the nature of the application (if the application is for a specific investment, then business-as-usual expenditure should not need a high level of scrutiny) and the impact the proposal would have on consumers.

The Commission should avoid setting unduly high hurdles or tests for determining whether expenditure is justified. There is a difficult balancing act between ensuring consumers receive the service quality they want, at a price that is not excessive, while ensuring CPP applications receive proportionate scrutiny.

Consumers face potential asymmetric costs that should be taken into account. Consumers could be worse off if expenditure levels are too low, and undermine service quality, than if the Commission sets prices too high[6].

Powerco appears to have undertaken an extremely robust and rigorous consumer engagement process, but we wonder whether this went beyond what the Commission should expect or require of CPP applicants, given the cost involved in this stage of the process.

It should also be recognised the DPP/CPP regime has an inbuilt incentive mechanism. The Commission is not bound to set a CPP more favourable to the regulated supplier than the DPP and once a CPP application is made it cannot be withdrawn. This provides a strong discipline on regulated suppliers to only apply for a CPP if their circumstances clearly and genuinely warrant it.

[4] The fact that the DPP is a relatively low cost, one-size-fits-all (albeit with some tailoring) instrument will inevitably result in the prudent and efficient costs of some regulated suppliers being under-estimated. The Commerce Commission has acknowledged this, for example, in its consideration of whether the DPP should provide an uplift to reduce the likelihood of regulated suppliers needing to apply for a CPP.

[5] PwC. (2016), Submission to the Commerce Commission on Input methodologies review: emerging views papers. 24 March 2016, paragraph 10, p 4.

[6] The Commission is familiar with asymmetric risk/cost, so we do not repeat the arguments in support of this position here.

5 Suppliers should be rewarded for improving efficiency

The Commission is "*specifically interested in views on ... whether Powerco's forecast capex and opex efficiencies are appropriate*"[7], and has noted:

> *"It is also important to note that the verifier identified that Powerco did not appear to be proposing any opex reduction initiatives, but that it would be reasonable to expect some of the opex and capex forecast expenditure to result in opex reductions over the CPP period. However, Powerco has indicated in its proposal that internal improvements resulting from additional opex in the CPP period should result in capex efficiencies of $6 million per annum and opex efficiencies of $2 million per annum by the financial year 2023"*

and has invited "views as to whether such savings are appropriate over the CPP period."[8]

Consistent with the Commission's stated position, Farrier Swier commented:

> *"Powerco has ... moderated the forecasts to reflect forecast efficiencies…"*[9]

> *"while Powerco intends to implement good asset management practices, in the immediate term its expenditure forecasts reflect, at least in part, current practices and information"*[10]

> *"Based on our assessment of the documents and models provided, we are not aware of any specific opex reduction initiatives undertaken or planned during the current period or the proposed CPP period. We are, therefore, unable to provide a view at this stage.*

> *However, as noted above, we would expect some of the opex and capex initiatives proposed by Powerco for the CPP period to result in opex reductions over that period. We have seen some evidence of this being incorporated into the CPP proposal, e.g. efficiency reductions in capex and opex forecasts attributed to the asset management and future network initiatives."*[11]

The Powerco CPP application reduces the proposed CPP expenditure by $19.5 million for assumed future capex efficiency improvements (a reduction equivalent to 7.2% at FY23), and $5.1 million for assumed future opex efficiency improvements (a reduction equivalent to 3.5% at FY23). This is reflected in the table below extracted from Powerco's Main Proposal[12].

Efficiency allowances built into the CPP forecasts

	FY22	FY23
Capex		
Efficiency adjustment	$6.5m	$13.0m
Percentage reduction	3.6%	7.2%
Opex		
Efficiency adjustment	$1.8m	$3.3m
Percentage reduction	2.0%	3.5%

[7] Commerce Commission. (2017). Invitation to have your say on Powerco's proposal to change its prices and quality standards: Issues to explore and consider. 18 August 2018, paragraph 166.1, p 36.

[8] Commerce Commission. (2017). Invitation to have your say on Powerco's proposal to change its prices and quality standards: Issues to explore and consider. 18 August 2018, paragraph 155, p 35.

[9] Farrier Swier Consulting. (2017). Powerco's Customised Price Path Application: Final verification report for Powerco. 7 June 2017, section 1.6, p 11.

[10] Farrier Swier Consulting. (2017). Powerco's Customised Price Path Application: Final verification report for Powerco. 7 June 2017, section 1.7.1, p 13.

[11] Farrier Swier Consulting. (2017), Powerco's Customised Price Path Application: Final verification report for Powerco. 7 June 2017, paragraph 4.6.3, p 80.

[12] Powerco. (2017). Customised price-quality path (CPP): Main Proposal. 7 June 2017, p xiv.

Powerco has commented "*These reductions recognise improvement opportunities we identified, and were also in response to verifier feedback on likely efficiencies that should flow from business improvements planned over the CPP period*"[13] [emphasis added].

The Commission's question regarding forecast capex and opex efficiencies should be considered in the context of its own acknowledgement that[14]:

> *"The Electricity Networks Association (**ENA**) and Aurora were correct when they pointed out in their submissions on our policy paper that our forecasts should not represent 'stretch targets' that build in an expectation of efficiency gains before they have been made.*".

The Commission's GBP DPP reset position would enable regulated suppliers to receive benefit (reward) for making efficiency gains (consistent with s 52A(1)(b)), before they are shared with consumers (consistent with s 52A(1)(c)).

If efficiency gains are built into expenditure forecasts the outcome could be that 100% of any efficiency gains are passed through to consumers, or more than 100% if the efficiency gains fail to fully materialise. We prefer that incentives to improve efficiency resemble a carrot rather than a stick.

Given the importance of efficiency incentives to the achievement of the Part 4 objectives, it would be useful for the Commission to be clear about how it sees its GPB DPP reset stance applying more generally, including in relation to CPP applications and expectations about how regulated suppliers should determine their expenditure forecasts.

We think it could be worthwhile to provide guidance to verifiers about where the line is between testing whether proposed expenditure is justified and prudent, and making judgements about additional efficiency improvements which could be made during the regulatory period. To be clear, our view is that the verifier is required to scrutinise the proposed expenditure to ensure that it is efficient (in base-year terms), but should not be looking to 'bank' contingent process efficiencies - recognition of which, if achieved, is more properly handled by the IRIS mechanism.

Clear guidance from the Commission on this matter, consistent with its GPB DPP final determination position, would be useful for future CPP applications, verifier reports and providing certainty about the benefits (rewards) to regulated suppliers for improving efficiency.

6 Setting minimum service quality requirements

The Commission has raised questions about whether it would be appropriate to exclude planned outages from service quality during the CPP, and whether the service quality standards for unplanned outages should reflect that the CPP is expected to result in improved service quality.

Some factors we think the Commission should take into account when considering matters of service quality are:

- Service quality, both planned and unplanned, will be affected by the extent to which proposed expenditure is recognised in the Commission's determination.
- Reliability forecasts will be sensitive to expenditure timing and, if too stringently applied, may unduly restrict expenditure flexibility and hamper the ability to reschedule expenditure to manage unforeseen events.
- Quality standards should be considered in light of the rationale for the proposal. A proposal based on the need to arrest a forecast decline in reliability performance should not automatically drive the conclusion that a tighter reliability limit should be imposed at the conclusion of the CPP period.
- If seriously considering a de-weighting approach for planned interruptions, the Commission should be mindful of how the weighting is applied from a limit and performance perspective. If

[13] Powerco. (2017). Customised price-quality path (CPP): Main Proposal. 12 June 2017, section 10.5.1, p 78.

[14] Commerce Commission. (2017). Default price-quality paths for gas pipeline businesses from 1 October 2017: Final Reasons Paper. 31 May 2017, paragraph 4.121, p 68.

de-weighting is applied to both sides of the equation (reference set and reported performance), as occurred in the 2015 DPP reset, then nothing changes.

- In our view, temporary modification of quality standards to neglect the effect of planned outages is appropriate. However, if the Commission remains concerned that incentives to minimise the impact of planned outages are too weak, then it may be appropriate to consider some form of information disclosure around outage planning and mitigation criteria, or measuring performance over the entirety of the CPP period (rather than year-on-year), or basing the minimum requirement on the highest annual level of projected planned outages over the CPP period.

7 CPP proposal consultation requirements

The current CPP proposal requirements include consultation with consumers on the pricing impact of the proposal in the proposed CPP period, but not subsequent periods.

The proposed MAR increase for the CPP period is 5.7%, but the Commission has noted that the additional capital expenditure could feed through into an additional 10% MAR increase in the subsequent (DPP) 2023 period[15]. This is due to the fact that the majority of Powerco's capex will be recovered over subsequent regulatory periods.

The 10% MAR increase for 2023 is only an estimate, with a number of qualifications that limit the extent it can, or should, be relied on. Powerco's consumer engagement met or exceeded the CPP proposal requirements.

The Commission received critical feedback in relation to Orion's CPP proposal consultation given the Commission's stance that the consultation was inadequate, even though it meet the proposal requirements. It would be regrettable if there was a reoccurrence of this type of situation.

8 Proposed variation to the WACC IM

Aurora Energy supports Powerco's proposed variation to the WACC IM.

The IMs require the Commission to assume, when evaluating the CPP proposal and calculating the initial price path, that the current DPP WACC will prevail for the entirety of the five-year CPP regulatory period even if it is likely the DPP WACC will decrease or increase at the DPP reset.

A problem this creates, given the DPP WACC in 2020 is expected to be lower than present, is that if the Commission applies the IM as it stands, and tries to smooth the price increase over the CPP period, the initial price increase would be bigger than needed if the Commission took into account the expected reduction in WACC.

While we support Powerco's proposed variation to the WACC IM to deal with this[16], it ultimately highlights why we opposed the approach the Commission has adopted to DPP versus CPP WACC in the IMs.

We noted that this could create problems, where interest rates have risen, such as that if the CPP WACC equals the DPP WACC it could be less than the actual cost of capital for any additional CPP investment and this could act as a barrier to CPP applications. The corollary to this is that if interest rates decline after the DPP WACC is set it could result in temporary over-compensation of the regulated supplier.

Our view remains that an enduring solution to this issue would be to fully adopt a trailing average cost of debt (TACD) WACC in the IMs. The best long-term solution may be to permanently amend the IMs.

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[15] Commerce Commission. (2017). Invitation to have your say on Powerco's proposal to change its prices and quality standards: Issues to explore and consider. 18 August 2017, paragraph 96, p 23.

[16] Powerco. (2017). Customised price-quality path (CPP): Application. 12 June 2017, section 8.1.2, p26.

9 Proposed variation to the IMs for treatment of ACOT payments

Aurora Energy supports the proposed variation to the IMs sought by Powerco in relation to Avoided Cost of Transmission (ACOT) payments.

It doesn't appear that the interaction between existing contractual arrangements between EDBs and Distributed Generators and Part 4 arrangements, including the IMs, were adequately worked through by the Electricity Authority before it made its changes to the Distributed Generation Pricing Principles (DGPP) in Part 6 of the Electricity Industry Participation Code (Code) in December 2016.

As a result, the Electricity Authority created a situation where the combined effect of changes to the Code, and application of the IMs, means that all else being equal, a number of EDBs will be required to continue pay ACOT to distributed generators connected under commercial terms, but will be unable to recover those payments in prices. This is a perverse situation where EDBs that never gained any benefit from ACOT are now burdened with the obligation. We consider that the Commission should consider this matter in the context of the NPV=0 principle.

The amendments to the IMs to resolve this matter would be straightforward.

We support Powerco's recommendation that IM clause 3.1.3(1)(f), defining the distributed generation allowance as a recoverable cost, be amended to link the ACOT payment to the Schedule 6.4 requirements at the time the contracts were entered into[17].

Alternatively, the Commission could simply delete references to Schedule 6.4 of Part 6 of the Electricity Industry Participation Code and to the Electricity Industry Act (subparts (a) and (b), respectively) from the definition of distributed generation allowance in clause 1.1.4(2) of the IMs.

10 Concluding remarks

The Powerco CPP has important precedent value.

Aurora Energy anticipates that the Powerco CPP precedent will have broader application than Orion's CPP.

The Orion CPP was made under what hopefully will remain a unique set of circumstances; a catastrophic (high impact, low probability) event. The circumstances Powerco finds itself in are somewhat more prosaic. Greater expenditure is needed to maintain service quality than provided for under the existing DPP.

The fact that Powerco, even as one of New Zealand's largest regulated suppliers, felt the pre-2016 CPP settings meant there were "*significant uncertainties that made it impractical ... to pursue a CPP*"[18] highlights that if a regulated supplier is operating under an inadequate DPP applying for a CPP is not the only option available to it[19].

As the Commission works through the CPP determination process, it will be important to:

- ***Ensure confidence in CPPs as an alternative to DPPs that do not adequate reflect individual circumstances:*** The Powerco CPP determination will impact on the confidence that other regulated suppliers have to apply for a CPP to better meet their individual circumstances. The risk, if the Commission gets the CPP determination process wrong, is that regulated suppliers consign CPPs to the 'too hard' basket.

[17] Powerco. (2017). Customised price-quality path (CPP): Application. 12 June 2017, section 8.3.2, p31.

[18] Powerco. (2017). Customised price-quality path (CPP): Main Proposal. 12 June 2017, pvii.

[19] The Commission has previously received submissions about alternative options to applying for a CPP (including in relation to whether the DPP should include an uplift), that may not be in the best interests of consumers, including deferral or avoidance of expenditure and investment. These submissions highlighted the risk that regulated suppliers might adopt alternative strategies to applying for a CPP, such as deferral of prudent and efficient expenditure and investment. A potential outcome could be a period of underinvestment until the need for a CPP/uplift in price compared to the DPP becomes so overwhelming that the regulated supplier has sufficient confidence that its application would be successful.

- ***Take account of the cost and risk to regulated suppliers from applying for a CPP***, including the possibility that they could end up worse off. The Commission should be mindful that, while the CPP process assumes a high standard of asset management maturity, the reality could be quite different for applicants.
- ***Satisfy 'reasonable investor expectations'***, including that regulated suppliers are able to recover the costs of prudent and efficient investment.
- ***Understand the asymmetric costs to consumers of the Commission's decisions***. Consumers could be worse off if expenditure levels are too low and undermine service quality, than if the Commission sets prices too high[20].

The Commission faces a difficult balancing act between ensuring the CPP proposal (expenditure and/or service quality) is reasonable and justified, while not imposing unduly onerous or costly burdens on the regulated supplier making the application.

We are heartened by the work so far on the Powerco CPP application. We welcome that the Commission has signalled that it is confident in the robustness of the work the independent verifier has undertaken prior to Powerco submitting its CPP proposal. This should help avoid or mitigate some of the risks regulated suppliers face in applying for a CPP.

There will inevitably be learnings that come out of the Powerco CPP for potential CPP applicants, the Commission, and the independent verifier. The Commission undertook a post-determination consultation for the Orion CPP. We consider that it would be useful for a similar exercise to be conducted following determination of Powerco's CPP.

[20] The Commission is familiar with asymmetric risk/cost, so we do not repeat the arguments in support of this position here.