Aurora ENERGY

Submission

Priorities for the electricity distribution sector and proposed focus areas for the 2020 reset

28 December 2017

Table of Contents

1 Introduction

Aurora Energy welcomes this opportunity to comment on the Commerce Commission's open letter on *"Our priorities for the electricity distribution sector for 2017/18 and beyond"* and *"Proposed focus areas for the 2020 reset of the default price quality path"* (Open letter consultation), dated 9 November 2017.

Please also treat our submission (attached) on the Electricity Authority's consultation paper *"2018/19 Levy-funded appropriations and work programme focus areas"*, dated 21 November 2017, as part of this submission. It deals with matters of overlap between the Commission and the Electricity Authority.

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 Part 4 operational improvement

Aurora Energy welcomes the approach the Commission has taken to improving and evolving the operation of Part 4 of the Commerce Act 1986.

The current version of Part 4 has been in place for a relatively short period, with the Commission only having undertaking two DPP resets for the electricity and gas sectors, respectively, and only now undertaking its second[1] CPP determination.

We have previously commented on the challenges that the Commission faced in first getting the new Part 4 regime up and running, and the improvements that the Commission has been able to make between each of the resets.

It is inevitable that the Part 4 regime will develop and evolve over time. This can be seen vividly, for example, with introduction of IRIS (which was initially only in place for Transpower), wash-up provisions, and the introduction of a service quality-revenue linkage in the second EDB DPP reset.

We see the Commission's proactive and advanced engagement with stakeholders on priorities and reset focus areas as a valuable component of its efforts to continually improve the way Part 4 is operated; particularly as the Commission has now largely completed the Input Methodologies (IMs) review, and can focus on other priorities.

We also support the Commission's ex-post reviews of its determinations, and the indication it will undertake such a review after the Powerco CPP determination.

3 Cross-sector precedent

The decisions that the Commission makes in relation to airports, electricity, gas and telecommunications (under the Telecommunications Act) have, or should have, precedent value for each of the other sectors.

The Government Bill to move Chorus' price control to a Part 4/IPP type regime will only serve to strengthen the precedent value of decisions under both Part 4 of the Commerce Act and the Telecommunications Act.

[1] Wellington Electricity Lines Ltd's 'single-issue' CPP proposal notwithstanding.

We have observed the cross-sector precedent value of the Commission's decisions. For example, decisions that the Commission made about how to set WACC in relation to telecommunications influenced how WACC was then set in electricity and, most recently, with the Commission essentially applying the WACC IM in the Chorus FPP determination. There has also been an observable flow-through from the respective electricity and gas DPP resets[2].

We are not sure that the Commission always details the linkages between sectors as clearly as it could. We think there is potential for improvement, which could be helpful for the Commission's work programme leading into the 2020 DPP reset and beyond.

Some areas where we would be interested in getting clearer understandings include:

- **Reasonable investor expectations:** We have mentioned a number of times that the Commission explicitly applied the principle of *"reasonable investor expectations"* in the context of the Chorus' FPP determination, but has remained silent on its relevance or implications under Part 4 Commerce Act[3].
- **Implications of the 2017 Gas DPP reset:** What are the potential precedents/decisions in the gas DPP reset that the Commission considers could be relevant to, or impact on, future electricity DPP resets? It is clear, for example, looking at the way the DPP resets have evolved from the first electricity reset (2010), followed by the subsequent gas (2012), electricity (2015) and gas (2017) resets that Asset Management Plans are playing an increasingly critical role in the Commission's reset decisions.
- **Implications of the Commission's views on Airport pricing methodologies:** To what extent are the Commission's comments about Auckland Airport's pricing relevant to its views on efficient operation by EDBs? We are particularly interested in the Commission's observation that *"Auckland Airport's pricing structure does not currently incentivise any change in peak demand"*, even though *"Peak demand is a key contributor to the need and timing of the second runway"* and *"Changes in peak demand could allow Auckland Airport to delay the need for a second runway"*[4]. The Commission's pricing principles for airports suggests that peak or congestion pricing should be adopted where a regulated supplier faces investment expenditure requirements driven by demand growth (the fact that pricing comes under the ambit of the electricity Authority notwithstanding).
- **Implications of the determination of 'Chorus' IMs for Part 4:** The Commission would have to develop IMs for Chorus under the Telecommunications (New Regulatory Framework) Amendment Bill. Based on precedent from the Chorus FPP determination, we would expect the existing Part 4 IMs to serve as the basis for the 'Chorus' IMs. It may well be the case that issues are identified in the development of the 'Chorus' IMs that aren't industry-specific, and that have potential implications for the existing Part 4 IMs.

We appreciate that the Commission will not necessarily be able to make clear all of the implications of these matters now, but we think that the Commission should bear them in mind as it progresses its work.

4 Focus areas for the 2020 DPP reset

We support the Commission's proposed focus areas, and the intention to include the approach to forecasting of capex and opex as a focus area. Forecasting of capex and opex was an area that attracted significant commentary within submissions, during the 2015 DPP reset process. We are not sure that the matter was resolved to anyone's complete satisfaction.

One element we would like to see investigated is ex-post testing of the extent to which the Commission's forecast assumptions in each of its resets has proved to be accurate. We consider that

[2] The Commission, for example, alludes to this within its discussion on the relevance of the approach it took to setting expenditure in the latest gas DPP reset to Wellington Electricity's resilience CPP proposal. We infer that this would also be relevant to the 2020 DPP reset, although the Commission does not explicitly state this.
[3] For example; Aurora Energy Ltd. (2015). Submission in response to the Commerce Commission's request for feedback on the process for resetting default price-quality paths for electricity distributors, and Aurora Energy Ltd. (2015). Submission in response to the Commerce Commission's Open letter on our proposed scope, timing and focus for the review of input methodologies.
[4] Commerce Commission. (2017). Have your say on the review of Auckland and Christchurch Airports' third price setting events (July 2017 – June 2022), paragraph 78.

this would be a good starting point for determining the extent to which changes may be needed to better improve the accuracy of forecasts.

To a certain extent, Aurora Energy anticipated the consultation on the Commission's focus areas. We refer the Commission to the *"Post-reset priority work areas"* section of our submission on the 2015 EDB DPP draft reset. The views expressed in the DPP draft reset submission should be treated as part of the submission on the Open Letter consultation[5]. A focus of our DPP draft reset submission was around efficiency incentives. We consider that ensuring there are strong incentives to improve efficiency is a critical element to the success of operating the Part 4 regime.

The Commission has suggested that *"'Shining a light' in a way that makes distributor performance more easily understandable, will likely bring more stakeholders into these conversations and create increased incentives for performance improvement"*[6].

We are of the view that rewarding regulated suppliers for improving efficiency is a far more effective way of promoting incentives to improve efficiency than increasing Information Disclosure obligations. We share the sentiment expressed by Transpwer that *"As regulatory arrangements mature, the Commission can increasingly rely on the operation of incentives to drive continuous efficiency gains and reduce the extent to which regulatory scrutiny is expected to be a driver. The incentives are both more effective and require less administrative effort from the Commission"*[7].

We think that the level of reward that regulated suppliers receive as a consequence of improving efficiency warrants a similar level of attention as the review of the WACC percentile.

The Commission's Part 4 IM WACC percentile decision provides a useful benchmark for providing quantified evidence, limiting, to the extent practicable, the degree to which judgement needs to be relied upon.

The longer a regulated supplier is able to retain its cost savings, the stronger the incentive it will have to improve efficiency and, by corollary, the cost savings that are ultimately available for sharing with consumers will be maximised. There are some clear trade-offs, however. If regulated suppliers were able to retain 100% of any cost savings, their incentives to improve efficiency would be maximised, but consumers would not receive any of the benefits of the efficiency gains.

Vector has previously provided a useful framework for making explicit what the retention factor or efficiency sharing rate is (what they label *"incentive rate"*) and how it could be enhanced, or changed, through different levers[8]. We think this would be a useful starting point for a quantified and evidence-based exercise to determine whether the current retention factor is optimal.

Comments made by both the Commission and the Electricity Authority, cited above, indicate that incentives to improve efficiency may be too weak, and that the retention factor should be changed to provide regulated suppliers with a greater share of efficiency gains. One way to strengthen the retention factor would be to delay the sharing of efficiency gains[9].

However, for incentives to work appropriately, it is essential that the Commission's expenditure forecasts reasonably reflect the needs of the regulated supplier. That requirement ties in well with the Commission's 2017/18 priorities, which are predicated, in part at least, on the Commission gaining a better understanding of regulated suppliers performance.

5 Concluding Remarks

Aurora appreciates the Commission's approach to forward planning and consultation, in preparation for the 2020 DPP reset.

[5] The "Post-reset priority work areas" section of our submission on the 2015 EDB DPP draft reset is provided in the Appendix.
[6] Commerce Commission. (2017), Our priorities for the electricity distribution sector for 2017/18 and beyond, paragraph 25.
[7] Transpower Ltd. (2017). Capex IM review: issue identification via focus areas.
[8] Vector Ltd. (2013). Submission to the Commerce Commission on Incentives for Suppliers to Control Expenditure During a Regulatory Period, and Vector Ltd. (2013). Efficiency impacts of operation of Part 4 – Stylised Example Mark II.
[9] Refer, for example, to Aurora Energy Ltd. (2014). Submission: Proposed Default Price-Quality Paths for Electricity Distributors from 1 April 2015 and Low Cost Forecasting Approaches for Default Price-Quality Paths, section 14 Post-reset prioritise work areas, and Vector Ltd (2013). Submission to the Commerce Commission on Incentives for Suppliers to Control Expenditure During a Regulatory Period.

The Open Letter helpfully provides a degree of prescription about the importance the Commission places on asset management planning, and what may be considered good or best practice.

We think illustrating what the Commission views as good or best practice in the sector, as well as examples of poor performance, will help encourage endeavours by regulated suppliers to improve asset management practices. This is an evolving area, particularly given the impact of new technologies.

While the Commission also intends to 'shine a light' on the efficiency performance of electricity distributors, we feel this should be refocused to prioritise ensuring electricity distributors have strong incentives to improve efficiency, thereby maximising the cost savings available to be shared between suppliers and consumers over the long-term. We would like to see the Commission consider the determination of optimal retention factors with the same focus on evidence-based decision making as the review of the WACC percentile.

14 POST-RESET PRIORITY WORK AREAS

Aurora is pleased that the Commission's operation of the Part 4 regime is evolving, even with the short period between the initial and second EDB DPP resets. We look forward to the Commission advancing the regime further for the 2020 reset, and beyond. Aurora fully expects that the operation of the Part 4 regime will evolve, and will become increasingly more sophisticated. This is typical with more mature regulatory regimes in overseas jurisdictions that have been in existence a lot longer than the current Part 4.

The Commission, for example, has noted "Regulators in other jurisdictions have also made incremental improvements to incentive mechanisms as their regulatory regime matures. In the United Kingdom, for example, Ofgem first introduced an equalised incentive on in 2009. More recently, the Australian Energy Regulator has introduced an incentive mechanism similar to the EBSS for capital expenditure in order to strengthen incentives for suppliers to deliver capital projects efficiently. The Capital Expenditure Sharing Scheme results in suppliers retaining 30% of any underspend or overspend".[158]

As the proverb says "Rome wasn't built in a day".

More attention should be given to s53P(3)

Aurora would also like to see greater attention given to the choice between reset and roll-over of existing prices when the Commission undertakes its future DPP resets.

The current basis for such a review seems relatively one-dimensional, and comes down simply to whether the Commission estimates regulated suppliers would earn supranormal profits in the next regulatory period if it does not reset prices. The DPP regime may be CPI-X but the Commission's Starting Price Adjustment methodology is based on rate of return regulation.

We preferred the approach, adopted by the Commission in the previous Part 4A regime, of removing supranormal profits/sharing efficiency gains over time (the Commission rejected adoption of a Starting Price Adjustment under Part 4A).

Aurora does not believe the Commission should take an all or nothing approach to price resets, or that 100% of efficiency gains from the previous regulatory period should be removed at the time of the next reset.

The choice between roll-over (no removal of supranormal profits) versus reset (based on the current full removal of projected supranormal returns) need not be seen as discreet, either-or options. The Commission should, for example, consider adoption of Vector's Staggered Sharing Mechanism proposal as a middle ground option; i.e., the Staggered Sharing Mechanism would remove part/most projected supranormal profits arising from efficiency gains in the previous price control period but not all, increasing the reward for efficiency gains and, over the medium to long-term, ensuring greater efficiency gains are available to be shared.[159]

We consider this warrants further attention, subject to the Commission's statement, made at the last reset, that "We have not applied a staggered sharing mechanism at this reset because incentive mechanisms only provide benefits to consumers when they have been signalled to suppliers up front. That is not the case for any efficiency gains that were achieved prior to the start

[158] Commerce Commission, Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme, 18 July 2014, footnote 21.

[159] We recognise there is scope for a Staggered Sharing Mechanism to both complement and substitute for aspects of IRIS e.g. IRIS could mimic the Staggered Sharing Mechanism by extending the period that regulated suppliers are able to hold onto efficiency gains beyond 5 years. They are not perfect substitutes, however, as the Stagger allows for more graduated sharing (rather than all or nothing) and is less complex than an IRIS.

of this regulatory period".[160] This would suggest that if a stagger was to be introduced, it should be done so, in advance, to take effect at the 2020 reset.

Efficiency incentives will be an ongoing area for improvement

While we acknowledge that the Commission is proposing material improvements for the 2015 reset, we do not believe the Commission has yet done enough to get the balance between short-term pass-through of efficiency gains, and maximising the level of future efficiency gains available to be shared with consumers.

We also consider, consistent with the High Court commentary on the WACC percentile and the need for Part 4 decisions to be evidence-based generally, that the Commission should investigate what the optimal retention factor should be.[161] We do not consider the observation that a retention factor of 35% is "Comparable to strength of the incentive that occurs naturally in the first year of a 5 year regulatory period" or "Consistent with the strength of the incentive that is favoured by the Australian Energy Regulator"[162] to be sufficient.

We agree with Vector that "There will be opportunities to evolve the operation of Part 4, including in relation to efficiency incentives, and to leverage off the experience and operation of economic regulation in other jurisdictions"[163] and "There is no single "silver bullet"[164] solution to efficiency incentives. Aurora agrees with Vector that "a package of complementary incentive mechanisms would be desirable, for example: IRIS, staggered pricing mechanism and an S-factor".[165] We think the Commission should prioritise consideration of optimal retention factors for sharing efficiency gains between regulated suppliers and consumers, and what analysis and empirical evidence could be obtained to support a decision on the matter.

Aurora considers that menu regulation, and Vector's Stagger, are options worth considering for the 2020 reset. Menu regulation has the potential to significantly address the Commission's concerns about regulated suppliers gaming their capex forecasts, and could also help ensure efficient trade-offs are made between opex and capex. We fully acknowledge that while Castalia, in particular, has presented strong arguments in favour of menu regulation it is a complex matter and may not be realistic for the 2015 reset.

Revenue-linked service quality scheme

It is evident from the Commission's 2015 DPP reset proposals, that it is only taking tentative steps towards introduction of a price-service quality link. It probably makes sense to take a cautious approach the first time round, particularly as there are only two years between the initial and 2015 DPP resets, which limits the time and resources the Commission has for considering such a mechanism. We would welcome a more comprehensive review of such mechanisms for the 2020 reset, with the added advantage of experience with the initial basic version the Commission is proposing.

It would be desirable if the Commission could complete this exercise well before the determination of the 2020 reset, so that EDBs have time to review the implications of the enhanced service reliability incentive scheme for how they should operate their businesses. The more complex or sophisticated the scheme the more time that would be desirable.

[160] Commerce Commission, Revised Draft Reset of the 2010-15 Default Price-Quality Paths, 21 August 2012, paragraph 156.

[161] The Kiwi Share Obligation includes a 100% retention factor, with CPI-0% set for perpetuity so Chorus/Telecom retain all efficiency gains, and there are zero benefits to consumers.

[162] Commerce Commission, Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme, 18 July 2014, paragraph 67.

[163] Vector, Submission to the Commerce Commission on Incentives for Suppliers to Control Expenditure During a Regulatory Period, 21 October 2013, paragraph 9.

[164] Vector, Submission to the Commerce Commission on Incentives for Suppliers to Control Expenditure During a Regulatory Period, 21 October 2013, paragraph 15b.

[165] ibid

We would like to emphasise that while the Commission's proposal adopts a "cautious" approach, it needs to start somewhere. Pursuit of the perfect should not be the enemy of the good.[166]

Consumer willingness to pay/VoLL

We agree with the Commission's arguments that "in principle, the incentive rate should reflect consumers' willingness to pay for changes in service reliability, as suggested by Vector. However, given that revenue at risk is set at 1%, applying an incentive rate comparable to a type of value of lost load measure would result in a very narrow band between cap and collar for many distributors".[167]

This is a matter that the Commission should revisit for future (2020 and beyond) resets, in conjunction with the percentage revenue at risk; e.g., 5% revenue at risk, based on VoLL, may make sense if the revenue-linked quality incentive scheme is successful.

We suggest that the Commission liaise with the Electricity Authority on the establishment of an appropriate VoLL that could potentially be used for future resets. The Authority has established a VoLL of $20,000/MWh, and this is incorporated in the Electricity Industry Participation Code.[168] The Commission proposes to use this VoLL value for setting the quality incentive rate in Transpower's IPP.

Last year, the Authority completed a study on VoLL, which produced a national VoLL estimate of $50,031/MWh.[169] This brings into question whether the $20,000/MWh VoLL should be relied on, though the Authority has not formed a public view on the merit of the alternative VoLL calculation, and has not consulted on this. Care needs to be taken to ensure that the benefit to consumers of service quality improvements are not overstated, as this could result in over-investment/expenditure. This is not a matter that we would expect the Commission and Electricity Authority to be able to resolve with the timeframe of the 2015 EDB DPP reset, even if the Commission was planning on applying VoLL to the revenue-linked service scheme.

[166] The section of this submission "Revenue-linked service quality scheme" discusses some potential areas for future development.

[167] Commerce Commission, Proposed Quality Targets and Incentives for Default Price-Quality Paths from 1 April 2015, 18 July 2014, paragraph 6.9.

[168] Clause 4 of Schedule 12.2 of the Electricity Industry Participation Code 2010.

[169] Electricity Authority, Investigation into the Value of Lost Load in New Zealand: Report on methodology and key findings, 23 July 2013, paragraph C.39.