

20 December 2018

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Commerce Commission  
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Dear Dane

### **EDB DPP3 reset**

1. This is a submission by the Major Electricity Users' Group (MEUG) on The Commerce Commission Issues Paper Default price-quality paths for electricity distribution businesses from 1 April 2020 published 15 November 2018 (CC EDB DPP3 reset) and associated materials.<sup>1</sup>
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. Attached and to be read as part of MEUG submissions is a report by Mike Hensen of NZIER, EDB DPP reset issues paper, Comment on Commerce Commission Issues Paper, 14 December 2018.

### **Context**

4. The DPP3 reset is a once every 5-year review of price-quality paths for the 17 EDB governed by DPP/CPD regulation. Aggregate DPP/CPD regulated revenues is approximately \$2 billion per year. The DPP reset influences how the 12 EDB not governed by DPP regulation set tariffs of approximately \$500 million per annum. Consumers pay around \$7 billion per year for total delivered electricity services. Hence, the importance of getting the DPP3 setting right for all EDB revenues of \$2.5 billion or 35% of total charges.
5. Emerging technologies will provide consumers more choices on when and how to use EDB line services. What technologies and when they will prove economic is uncertain. The DPP framework needs to evolve and be adaptable for this uncertain future. There are multiple and related factors to consider including changing quality issues with, when and where uptake of emerging technologies occurs and alignment with Electricity Authority work to assist EDB adopt improved pricing practices and default contract terms and conditions.
6. As New Zealand is expected to be an adopter and importer of new technologies, we can learn from the behaviour of consumers in other countries. Caution is needed when considering using overseas regulatory practices given our unique low-cost DPP approach.

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<sup>1</sup> Document URL [https://comcom.govt.nz/data/assets/pdf\\_file/0022/106078/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Issues-paper-15-November-2018.PDF](https://comcom.govt.nz/data/assets/pdf_file/0022/106078/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Issues-paper-15-November-2018.PDF), financial model, Brattle Group report for Electricity Networks Association and ENA Quality of Supply Working Group interim report at <https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-default-price-quality-path/2020-2025-default-price-quality-path?target=documents&root=97131>

## Key submissions on reliability standards and incentives, other service quality metrics and incentives for efficiency

7. MEUG asked NZIER to consider the issues of reliability standards and incentives, other service quality metrics, incentives for efficiency and reduction of losses.<sup>2</sup> The Key points section of the NZIER report follows:

### Key points

The DPP process applies simple metrics to the measurement of reliability and the Issues paper proposes to continue this approach with incremental change. This simple approach hinders discussion of the following issues:

- reasons for the wide variation in the quality of service provided by EDB serving similar customer groups
- actual distribution of the inconvenience and cost of outages across customers which is masked by measures of service quality based on averages
- the capacity of EDB to materially alter the incidence and duration of outages over both the medium term and the relative effectiveness of operational and capital expenditure in changing the pattern of outages

The cost to customers of incentives for EDB to improve service quality are driven by the history of individual EDB networks but do not align well with the estimated benefit to customers of the reduction in the length of outages. The option to increase the proportion of revenue at risk from 1 percent to 5 percent or an intermediate figure does not address this mismatch. (An increase in the revenue at risk without an increase in the cap/collar range around the target SAIDI/SAIFI simply increases the cost of the incentive.)

Instead, the revenue at risk percentage set as an incentive to improve reliability and the cap/collar should be set for individual EDB so that the match the benefit to customers indicated by VoLL.

The Issues Paper includes a suggestion for incentives to EDB to reduce line losses. An assessment of the costs and benefits of this proposal would be a good opportunity to compare designs of incentive schemes.

### Other issues

8. As noted in paragraph 6, caution is needed when considering using overseas regulatory practices given our unique low-cost DPP approach.

<sup>2</sup> Refer Issues paper, Attachments C to F.

9. The discussion on Real Financial Capital Maintenance (FCM), Allocation of risk and Asymmetric consequences of over- and under-investment is a useful reminder of the economic regulatory principles underpinning New Zealand’s regulatory framework.<sup>3</sup> The Commission’s role as a “pure” politically independent economic regulator is an important factor in giving suppliers and consumers certainty compared to the more complicated practices overseas of having licensed regional monopolies with more intrusive regulation often with other conflicting social and or environmental objectives.

10. It’s worth recalling the December 2016 decision paper on the IM Framework noted:<sup>4</sup>

- The economic principles are guidelines not a regulatory compact. Refer paragraph 147 of the December 2016 decision:

“We do not agree with submitters that the economic principles discussed in this chapter (or any economic principles) amount to a regulatory compact. Rather, the three key economic principles listed at paragraph 117 provide useful guidance to us in giving effect to s 52A when making decisions in the IM review. These economic principles are subordinate to s 52A and we can only apply them in so far as they assist us to give effect to s 52A. That is, the principles are not an outcome we seek to give effect to in and of themselves; rather, they are a means to an outcome—that outcome being promotion of the long-term benefit of consumers in accordance with s 52A.”

In using the economic principles as guidelines MEUG notes the observed behaviour of participants and actual market outcomes are relevant in what weight to give each of the principles and in the overall design of the Part 4 regime.

For example, the recent High Court agreement with Vector’s judicial review claim of the Utility Disputes Ltd decision on compensation claims related to the Penrose sub-station fire in October 2014 that EDB do not have a duty of care for line services provided to end consumers. This has affirmed our view EDB bear no risk apart from stranding risk in the long-term (in particular scenarios discussed in the next bullet point) provided they incrementally improve on the status quo.

- Emerging technologies may fundamentally change the sector so that the principles may be tested. Refer paragraph 152 of the December 2016 decision:

“Specifically, we acknowledge that there may come a time when, due to the development of emerging technologies or other circumstances, the key economic principles no longer assist us in promoting the s 52A purpose and application of these principles is no longer sustainable. Over the longer term, this could be one possible outcome (although not a probable outcome, under currently available information) of the continued uptake of some emerging technologies that may act as substitutes to the regulated service. The market risk, in that context, is that if enough consumers disconnect from the network, the remaining consumers will not be willing or able to pay the prices that would be required for suppliers to achieve FCM, even if our price path remains consistent with FCM. There may also be a political risk in that if circumstances change to a sufficient extent, the government may intervene and amend or repeal Part 4. If such a ‘tipping point’ occurs, regardless of any action we might take, suppliers may not be able to achieve FCM.”

<sup>3</sup> Refer Issues Paper, paragraph 2.17.

<sup>4</sup> Commerce Commission, IM review decisions – Framework for the IM review, 20 December 2016, [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0016/60532/Input-methodologies-review-decisions-Framework-for-the-IM-review-20-December-2016.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0016/60532/Input-methodologies-review-decisions-Framework-for-the-IM-review-20-December-2016.pdf)

Further, “under currently available information” emerging technologies would not lead to the phenomenon termed the “utility death spiral” whereby consumers decreasing use of regulated network services would lead to an unsustainable scenario of remaining consumers paying spiralling higher tariffs for sunk costs. The prospect of a “utility death spiral” scenario has become less fashionable or at least considered less likely than other scenarios. Nevertheless, it is still considered a feasible scenario by EDB and therefore regulators should also have a plan if the “utility death spiral” or “off-grid” scenario eventuates.<sup>5</sup>

11. Missing from the DPP reset is consideration of changes in “fixed” parameters, asset beta and market risk premium, in the calculation of the Weighted Average Cost of Capital (WACC). While setting WACC is a matter for Input Methodologies (IM) we raise it now because it is an integral and important factor in the cost consumers will pay in the 5-year price path starting 1 April 2020. WACC does change from time to time and those changes may not align with the statutory not to be exceeded 7-year review cycle of IM. MEUG notes that the just announced decision by the Australian Energy Regulator on WACC on 17<sup>th</sup> December 2018 has material changes in the value of key assumptions, namely beta and market risk premium.<sup>6</sup> If the direction and scale of those changes also applied to the current New Zealand WACC for EDB, then the change in consumer line charges for regulated electricity line services would be in the order of tens of millions of dollars per year and potentially in excess of \$100 million per year.
12. A major flaw with DPP is that consumers have no idea if the service we receive from EDB is at, near or far from world’s best practice. That must also be frustrating for EDB striving to be the best when under DPP even the worst performing EDB can with minimal incremental improvements between resets still earn full WACC. These issues are not part of the DPP3 reset process but are worth remembering when fine tuning settings and incentives.
13. MEUG comments on forecasting operating expenditure issues follows:<sup>7</sup>
  - In addition to the existing econometric forecasts of population growth, Asset Management Plan (AMP) forecasts and direct requests for information from EDB for predicting network growth and scale, another factor to consider is forecast household income for local areas to assist where emerging technologies are likely to be deployed earlier in wealthier areas.
  - Using an operating partial productivity factor of 0% because that is the historic trend for New Zealand EDB’s is not supported by MEUG. Unless there is a fundamental flaw in using best practice observed offshore, then MEUG suggests the Commission propose to use 1.5% observed for US distributors discussed in paragraph A24.3. The incentive is then on EDB to prove why 1.5% should not apply to New Zealand EDB.
  - We look forward to further consultation on the treatment of operating leases (paragraphs E29 to E31).

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<sup>5</sup> For example, see Electricity Networks Association, Network Transformation Roadmap presentation 11 December 2018, slide 8 includes an “off Grid” scenario, <https://www.ena.org.nz/dmsdocument/467>

<sup>6</sup> Refer <https://www.aer.gov.au/news-release/aer-releases-final-decision-on-rate-of-return-for-regulated-energy-networks>

<sup>7</sup> Refer Issues Paper, Attachment A.

14. MEUG comments on forecasting capital expenditure issues follows:<sup>8</sup>
- The Issues paper discusses the world-wide problem faced by regulators of EDB over-forecasting capital requirements. The same applies to New Zealand. There should be consequences for this systemic problem. One option might be that EDB should be held accountable to report on variances compared to their AMP forecasts and to set out what mitigating actions they have taken to reduce forecasting bias.
  - The Issues paper proposes the status quo use of AMP for forecasting capital expenditure with alternative approaches left for consideration at some future reset. The alternatives include using a historical trend and step approach like opex or the Commission developing models. MEUG suggests the best approach for DPP3 should be decided after costs and benefits of the status quo and alternatives are compared, particularly as there is a problem with the status quo of persistent bias.
15. MEUG comment on energy efficiency, demand-side management and reduction of losses issues follows:<sup>9</sup>
- Paragraph F23 of the Issues paper asks “We are interested in views on whether the incentives for EDBs to promote energy efficiency and demand-side management initiatives should be further strengthened beyond our reconsideration of retention factors.” The paper invited comments on moving to a “cap and collar” incentive to reduce line losses or some other new mechanism (paragraphs F29 to F31).
- MEUG is cautious about using special uplifts or incentives to promote energy efficiency, demand-side management or best practice to have an optimal (not necessarily the lowest technically possible) level of losses such as those used overseas.
- We don’t think the incentive effect of information disclosure and publication of information comparing the performance of EDB on these issues has been sufficiently developed. Compared to improving forecasts of capital and operating expenditure and developing incentives for efficiency and price-reliability trade-offs, we think energy efficiency and managing energy losses are second order issues. Section 3.2 of the NZIER report supports our view the potential benefits of reduced line losses are probably less than 10% of the estimate of total losses of about \$140 million per year.
- Demand-side management we think is best considered as part of the challenges forecasting future consumer demands, including new uses for, local networks.

### Next steps

16. MEUG looks forward to the response by other parties to this submission and an opportunity for MEUG to provide input in the cross-submission phase.

Yours sincerely



Ralph Matthes  
Executive Director

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<sup>8</sup> Ibid, Attachment B.

<sup>9</sup> Ibid, Attachment F.