Feedback on

Input methodologies review:

Gas pipeline default price-quality path reset 2017

28 January 2016

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1. Introduction

1. This is Powerco Limited's (Powerco) feedback on the Commerce Commission's (Commission's) request for comment on matters relating to the gas pipeline default price-quality path reset 2017 (DPP reset) and Input Methodology review (IM review).

2. The focus of this submission is on the items raised at the gas sector stakeholder meeting on 8 December 2015. It also responds to the Commission's request to provide written comments highlighting any further gas industry specific issues or perspectives in relation to the IM review or the resetting of the default price-quality path in 2017.

3. This submission considers gas-specific IM issues in addition to price-quality path matters, but does not provide detailed views on cross-sectoral IM topics. These will be commented on as part of the relevant IM consultations, including our submission on the Commission's cost of capital update paper published on 30 November 2015.

4. Submission format:

   Part A: Gas industry environmental overview.

   Part B: Feedback on topics raised and discussed at the Commission's gas sector stakeholder meeting.

   Part C: Gas DPP reset matters requiring future consideration.

   Supporting document: Concept Consulting, "Relative long-term demand risk between electricity and gas networks" 27 January 2016.

2. Summary of Powerco's views

5. The following table summarises Powerco's views and provides recommendations for consideration.

Form of control	Powerco view	Recommendation
The Commission has asked if the appropriate form of control is being applied to gas pipeline businesses.	Powerco supports the continued application of a WAPC as it incentivises distribution companies to promote gas consumption between resets. This is likely to benefit consumers and the nation as a whole by increasing the uptake of an energy source where it is expected to be more cost effective than electricity, particularly for space heating and water heating.	The benefits of gas as a fuel, and its discretionary character, make a WAPC is the most appropriate form of control for gas. However, in order to reduce the volume risk to gas distribution businesses (GDBs) associated with a WAPC, we recommend that Commission investigate possible ways of refining its constant price revenue growth (CPRG) forecasts – we have suggested a workshop to progress this.
Expenditure Incentive	**Powerco view**	**Recommendation**
The Commission has asked for comment on the introduction of an opex and/or capex IRIS for gas.	Any incremental rolling incentive scheme (IRIS) mechanism needs to be carefully assessed to ensure that that it results in net benefits. This is particularly relevant to a capex incentive, because of the need to ring fence customer-driven capex associated with new connections, which would increase the complexity of any gas capex incentive mechanism.	The Commission should use this forthcoming reset period to further develop its low cost forecasting approach for gas and defer consideration of financial incentives until the next reset. Any IRIS mechanism should be limited to opex in the first instance, and then only if it can be shown to produce a net national benefit.
Quality of service and security of supply	**Powerco view**	**Recommendation**
The Commission have asked if any changes need to be made to the quality standards to provide the right incentives.	The current response times to emergencies (RTEs) measure works well to incentivise good safety performance at a consumer level. Any new metrics should be subject to thoroughgoing working group assessment which may extend beyond the current IM/ DPP reset process.	The current RTE measure is an appropriate method of encouraging GDBs to meet the expected quality of service and security of supply levels. Any new metrics should be subject to thoroughgoing working group assessment which may extend beyond the current IM/ DPP reset process.

Opportunities for future engagement with sector stakeholders	Powerco view	Recommendation
The Commission has asked for the identification of opportunities for future engagement with industry.	Strong stakeholder engagement is essential to develop a robust and fit for purpose framework. Industry-led working groups have proved to be an effective way of exploring issues and developing practicable recommendations.	Working groups should be established on key matters where a range of options exist. As an industry leader the Gas Industry Body (GIC) should be engaged to support the establishment and functions of any working groups. The work of the groups may continue beyond the current IM review/ DPP rest process.
The treatment of major capital projects	**Powerco view**	**Recommendation**
The Commission has asked for comments on the treatment of major capital projects.	The differences between the asset types managed by GDBs and gas transmission businesses (GTBs) mean the impact of major projects on expenditure profiles can be significantly different.	Powerco currently has no major investment needs that require special consideration. However, we agree that the regulatory framework should be sufficiently flexible to facilitate major projects which are in the long-term interests of consumers but believe that the Commission has sufficient discretion within the current DPP/CPP structure to create a process which will accommodate major investment without requiring a fundamental change to the regulatory settings.
Gas DPP reset matters requiring future consideration	**Powerco view**	**Recommendation**
Comments on matters requiring further consideration when setting the 2017 DPP.	Broadly speaking the methodology used to set the initial gas DPP in 2013 has proven to be fit for purpose. However, the 2017 resetting of the gas DPP provides an opportunity to make incremental improvements to the input methodologies and data used to support forecasts.	In addition to updating the economic indicators, and the work areas discussed above, we recommend that the Commission consult further with the industry on the following DPP inputs: • Capital/operating expenditure forecasts • Constant price revenue growth forecasts.

3. **Part A:** Gas industry environmental overview

6. Powerco considers that the current rules and requirements developed progressively since 2010 and specified in either the IMs, DPP determinations and / or the information disclosure regime generally provide a fit for purpose framework that is achieving the regulatory objectives and broadly meeting customer expectations while allowing businesses to operate effectively and efficiently.

7. We do not consider that there are any significant IM or DPP issues that are currently impacting on the effectiveness of the regulatory framework for gas; this does not mean that there are not opportunities for refinement and continuous improvement (as we note in this paper). Those issues that have been raised as part of the wider IM review, some of which are material in nature and should be addressed, also do not point to a framework that is broken rather one that is maturing and open to refinement.

8. While we encourage the Commission to continue to develop the IMs and price-quality path mechanisms based on cross sector experience, we urge caution when considering blanket approaches to electricity and gas, and transmission and distribution services. What may work in one setting will not necessary work in another due to structural, product and competitive differences between the respective markets.

9. Industry participants at the gas stakeholder meeting held by the Commission on 8 December appeared to agree that a one size fits all model of regulation does not necessarily work as the default for the gas distribution and gas transmission sectors. We consider that the benefits of customising frameworks to the specifics of an industry or industry sub-sector considerably outweigh the additional costs of any upfront developmental work that may be needed.

10. The measure of quality of service and security of supply for distribution and transmission is an example of where differentiation between gas distribution and gas transmission is required. While the RTE measure drives the right incentive for GDBs, and is an appropriate quality measure for regulatory purposes under Part 4, it is a measure of little value in the GTB sector due to the nature of the transmission assets. There are a number of other examples where different approaches might be considered for distribution and transmission, for example, the treatment of major capital projects, the nature and scope of expenditure incentive mechanisms and the form of control. We therefore strongly recommend that the Commission consider gas sub-sectors individually as the IM review and DPP reset processes progress.

11. Where it makes sense to align regulatory rules across sectors Powerco will support this, for example approaches to asset valuation, taxation and cost allocation as specified in the core IMs.

12. In the NZ gas sector there are only four distribution service providers and, in Powerco's view, this provides the opportunity for the Commission to refine its approach to certain areas of the DPP reset process and take a more company-specific approach. Aligning its low-cost forecasting methodologies more closely to suppliers' own forecasts (assuming a supplier's underlying processes are considered sound) is a feasible objective for the next DPP reset.

13. Gas is a discretionary fuel for most residential and commercial customers, whereas electricity is generally considered to be an essential service. It is important to recognise this difference when considering how to regulate gas distribution and when deciding where the incentives and risks should be allocated. Being suppliers of a fuel of choice, gas pipeline businesses are subject to greater demand volatility compared to electricity networks. Customers can more easily decide to disconnect from their gas supply in times of financial hardship, for example, or reduce consumption of gas if new electricity-based technologies come on the market (e.g. heatpumps, solar hot water and hot water heatpumps). Gas distribution is arguably more exposed to a higher level of externally

driven risk than would be the case for a supplier of an essential service. We will elaborate further on this point as part of our response to the Commission's consultation in the risk adjusted cost of capital.

14. Suffice to say that, because gas is a discretionary fuel source, a customer will only choose gas as a supplement to their electricity supply if it provides a net benefit to them, however the customer determines this benefit (which may include intangibles). It is important that the regulatory framework reflects this fact and does not inadvertently constrain a supplier's ability to maintain this choice.

15. Accompanying this submission is short paper, prepared for Powerco, by Concept Consulting which aims to draw out some of the differences between gas and electricity businesses which are relevant when considering the regulatory settings that should apply in each case. The Concept Consulting paper should be read in conjunction with Powerco's submission. We hope that this report will assist the Commission's consideration of the appropriate degree of regulation for gas distribution at the next DPP reset in 2017.

16. Parts B of this submission focuses on IM matters raised at the Commission's gas stakeholder meeting and Part C discusses price-quality path reset matters. We will be providing comment on gas-related cost of capital issues in our submission to be submitted on 5 February 2016. The content of this submission and the Concept report should be referred to when considering our cost of capital submission.

4. **Part B:** Feedback on topics raised and discussed at the Commission's gas sector stakeholder meeting.

17. As documented in the Commission's *Summary of views* paper (Summary paper), published on 22 December 2015, the topics covered at the gas stakeholder meeting were:

1. Opportunities for future engagement with sector stakeholders;
2. Quality of service and security of supply;
3. The treatment of major capital projects;
4. Form of control, pricing and risk sharing; and
5. The incremental rolling incentive scheme (IRIS).

4.1. Opportunities for future engagement with sector stakeholders

18. Powerco supports the Commission's drive to facilitate and encourage structured and sustained consumer engagement with the development of the regulatory framework. Ultimately, achieving robust decisions will require appropriate stakeholder engagement at the right time.

19. As noted by the Commission in the Summary paper, the industry working groups (with wider stakeholder engagement) that were established as part of the 2015 electricity DPP reset process were used to good effect and resulted in industry-led recommendations being made in an efficient and timely manner.

20. At the gas stakeholder meeting the Commission posed four questions relating to opportunities for future engagement with sector stakeholders. We respond to each of these questions in the table below:

Commission Question	Powerco Response
Pipeline of engagement?	We support the Commission introducing a structured stakeholder engagement plan that includes industry working groups.

Working Groups?	We strongly support the use of working groups to focus on specific issues. We recommend that the Gas Industry Company be considered as an independent facilitator for particular workshops due to its sector knowledge, experience and contacts. Matters that could benefit from working groups include: • Quality of service and security of supply (distribution and transmission) • Constant price revenue growth modelling for the next DPP (distribution) • Low cost forecasting approaches for establishing opex and capex allowances (distribution and transmission) • Pricing methodologies and Form of Control alignment for gas transmission
Frequency?	The meeting frequency for working groups should be tailored to the requirements of the particular issue being considered We note that the Commission is aiming to publish a draft decision on any proposed IM changes mid-way through 2016 – this will limit the feasible number of working group meetings when the aim is to feed into the Commission's IM process. However, it may also make sense for some working groups to continue beyond the IM review.
Representation?	Participation in working groups should be open to all stakeholders, but, because of the technical nature of some of the issues that will be discussed, it may be appropriate for some participants to be granted observer status only.

4.2. Quality of service and security of supply

21. While we agree with the Commission's assessment at the gas stakeholder meeting that the current response time to emergencies (RTE) quality measure is somewhat crude, it works well for the distribution sector as a measure of safety at a consumer level.

22. Quality of service and security of supply measures are a good example of where the gas distribution and transmission sectors differ materially and should therefore be subject to different measures. The remainder of this section focuses on the issue of quality of service and the security of supply measures for the distribution sector.

23. We believe a working group to consider the broad area of "gas quality of service" should be established and its brief should include gaining some insight into customer value preferences and appropriate metrics that could provide appropriate information on network quality performance and customer service trends. The next step should be to consider the practicality and net benefit (if any) of an extended suite of metrics. If any new measures are justified, the question will then be whether they should be reported on as part of information disclosure only or be included as part of the price-quality assessment framework. A thoroughgoing assessment of any new measure may extend beyond the timeframe of the current IM / DPP reset process.

24. Powerco would welcome discussions with the Commission on how to initiate an industry working group to progress this work area with the aim of providing recommendations for the 2022 gas DPP reset.

4.3. The treatment of major capital projects

25. The expenditure profiles of transmission businesses are inherently more "lumpy" than those of gas distribution businesses and we understand that there is an immediate need for the regulatory framework to accommodate the specific needs of the transmission businesses.

26. Powerco's gas business forecasts incremental growth across most parts of its network, but there are no significant "lumpy" investments on the horizon or a need to "step change" away from broadly average levels of current network expenditure. As such, we have no immediate requirement for either a CPP or a DPP mechanism to specifically address major capital projects.

27. That said, we support the principle that either the DPP or the CPP mechanisms should be sufficiently flexible to allow suppliers (both distribution and transmission) to make an individual case for the Commission to consider and approve separate allowances for "single issue" investment drivers (e.g. major project allowances).

4.4. Form of control

28. Powerco welcomes discussion on the appropriate form of control for gas distribution businesses, as part of the general IM review, but considers that the current weighted average price cap (WAPC) method is very likely to remain the preferred approach for gas even if a revenue cap is preferred for electricity.

29. In our view, different approaches to the form of control may be justified, because gas is a discretionary fuel, while electricity is essential. Electricity will continue to be supplied and used regardless of whether or not there is any incentive to promote it and market it. This is not the case for gas. Particularly in the residential sector, if gas is not actively promoted, its use tends to decline over time, often because consumers simply lack information about its availability and advantages. Its discretionary character also means that gas has a higher price elasticity of demand than electricity. Gas is often a more cost-effective energy source than electricity, particularly for space heating and water heating. Consequently, a failure to use gas for these purposes when it is available is not only contrary to consumers' best interests, but not in the interests of the nation as a whole. Hence, the best form of control for gas is one that provides an incentive to promote its use.

30. The WAPC method incentivises distributors to out-perform the Commission's constant price revenue growth (CPRG) forecasts between price re-sets by promoting gas use to achieve a higher level of gas sales than the Commission forecast. If the outcome is a greater use of gas where it is the most efficient fuel, this advantages not only the gas distributor, but also consumers and the nation as a whole. Because of this volume incentive, the WAPC also incentivises distributors to price to promote gas where it is efficient to do so.

31. Under the WAPC method, volume risk is borne by distributors rather than consumers, but, in our view, this is appropriate, as distributors are better able to manage day to day volume risk under normal operating circumstance by promoting gas. (However, we also note that being subject to a single point of supply from gas transmission arguably makes gas distribution more exposed to major event / catastrophic volume risks). Under a revenue cap, per unit distribution costs increase as volume falls, but consumers can do little to manage this risk other than to disconnect from their gas supply.

32. On balance, therefore, we believe a WAPC is the best form of control for gas distribution. Nevertheless, the case for it would be even stronger if the Commission could improve its CPRG forecasting to reduce the risk of unreasonably optimistic forecasts.

4.5. The incremental rolling incentive scheme (IRIS)

33. Powerco has actively engaged with the industry and the Commission to develop the current suite of expenditure incentives which apply to the electricity sector. We do not

intend to reproduce the full detail of our prior submissions here but would like the Commission to take account of our response[1] to the Commission's *Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme* paper, published on 18 July 2014, when considering expenditure incentive mechanisms for the gas sector.

34. The introduction of an IRIS to the gas sector should not occur as a result of a scheme being deemed appropriate to apply to the electricity sector. (In this context we use the term IRIS to refer to both the opex and capex incentive mechanisms). Any justification for new incentive arrangements for gas should demonstrate clearly what the problem is that the incentive is trying to address and how a chosen solution would take account of the unique characteristics of the gas market. While simple in theory, the introduction of an IRIS in practice is highly complex and potentially very costly to the industry and the nation as a whole.

35. While we agree that unequal incentives to pursue efficiency gains over the regulatory period may exist in theory, and there is some opportunity for suppliers to influence profits by incurring costs (or not) in a particular year, there is no evidence of this sort of behaviour actually occurring in the gas distribution sector. Consequently, we encourage the Commission to consider these issues thoroughly in a gas context before introducing complex and potentially costly additional regulation.

36. The very nature of price-quality path regulation creates an incentive to economise on expenditure, as a limit is placed on the average price charged for distribution services before the price is reset at the end of the regulatory period. If the Commission considers that this natural incentive does not adequately address the timing issues it has identified, then exploring the use of an IRIS mechanism may be valid. When considering an IRIS mechanism for gas distribution it will be important to demonstrate that the benefits outweigh the costs. We think the case for introducing capex incentives at this stage is less compelling than the case for an opex incentive, which has been proven effective in other jurisdictions. As we noted at the Commission's Forum, a component of annual distribution capex is associated with customer-driven new connections. Such investment would need to be excluded from any incentive mechanism, as not to do so would unduly penalise a supplier for simply meeting the requirements of its customers. The need to ring fence any such expenditure would necessarily mean that any capex incentive mechanism for gas would be complex.

37. In the Commission's 2010 IM Reasons Paper[2] the Commission recognised that the operation of a rolling incentive scheme is contingent on having reliable cost forecasts for the regulatory period. Powerco's position is that the Commission should use this forthcoming reset period to further develop its low cost forecasting approach for gas and defer consideration of financial incentives until the next reset.

5. **Part C:** Gas DPP reset matters requiring future consideration

38. As a general point, we consider the methodology used to set the initial gas DPP has generally achieved its objectives and does not require wholesale change. Improvement opportunities exist that could advance the efficiency and effectiveness of the current framework but these can be achieved through targeted incremental amendments.

39. The discussion below identifies areas that we believe merit further investigation as part of the Commission's gas DPP reset process.

[1] Powerco submission on *Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme* 29 August 2014.

[2] Commerce Commission, *Input Methodologies (EDBs and GPBs) Reasons Paper*, 22 December 2010, p.210.

5.1. Capital Expenditure Forecasts

40. To date, the Commission has based its forecast capex allowances for a DPP on a company's own capex projections, but limited to a maximum future increase (or cap) based on a company's actual annual average growth rate in the years prior to the new regulatory period.

41. Whilst we have stated our preference for projecting DPP allowances based on a company's actual AMP forecasts (subject to the Commission seeking some form of process / forecast quality assurance) we accept the rationale supporting the "threshold" approach, particularly for electricity, as it achieves the low-cost forecasting objective of a DPP. (For electricity, the Commission would need to review 17 AMPs.)

42. However, we think the Commission recognised at the gas stakeholder meeting that the small number of regulated gas suppliers offers the potential to provide a more flexible and tailored approach for gas, which could place greater emphasis on a gas supplier's actual AMP forecasts. How the Commission might achieve the assurance it requires that individual AMPs will be delivered could be considered by a working group.

5.2. Operating expenditure forecasts

43. Powerco supports the general approach developed by the Commission to forecast opex allowances during the setting of the initial gas DPP. The methodology used a number of drivers to project forward from an initial opex amount (single base year). However, as with capital expenditure forecasting, we believe that alternatives should be considered, such as using GDBs' own forecasts – subject, if necessary, to some form of assurance review.

5.3. Forecast of revenue growth in constant prices

44. When setting the initial DPP for gas distributors, the Commission made an assessment of constant price revenue growth (CPRG) using the historical ICP growth rate and gas quantities modelled in a gas demand study by Concept Consulting. Powerco recognises the challenges associated with developing a methodology that accurately forecasts CPRG. However, given the sensitivity of the P_0 model to CPRG, it is vital that a robust and realistic methodology be applied and continually refined based on the latest data and analysis. As such, we recommend that a working group should be formed to support the Commission to review the current approach and consider alternatives.