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[By email]

Dear Tricia

## **Submission on Gas Pipeline Services 2017 DPP policy paper**

### **Section One: Introduction**

1. This submission responds to the Commerce Commission's (Commission) consultation paper "Default price-quality paths for gas pipeline services from 1 October 2017: Policy for setting price paths and quality standards" (consultation paper), dated 30 August 2016. It also responds as required to the supporting documents to the consultation paper:
  - Concept Consulting, "Approach to developing distribution network demand projections", 4 July 2016 (Concept report).
  - Two reports by Strata Energy Consulting dated 29 August 2016, "Low cost review framework for gas pipeline expenditure: Proposed Framework and Methodology" and "Low cost review framework for gas pipeline expenditure: Pilot Study Report" (Strata reports).
2. In addition, on 16 September 2016 GasNet received a letter from the Commission advising that the Commission had already carried out BAU variance and AMP scrutiny

checks<sup>1</sup> on GasNet’s forecasts and providing details of the analysis carried out. We wrote to the Commission on 26 September raising some procedural concerns with the letter. We are pleased the Commission has now withdrawn the letter and will consider submissions before deciding how to move forward with assessing the expenditure forecasts of GasNet and other gas businesses.

3. Because the information provided with the 16 September letter described the results of the BAU variance and AMP scrutiny checks on GasNet’s forecasts we focus our comments on the expenditure forecasting methodology on these checks of the GasNet-specific material and we place less focus on the more generic material contained in the Strata reports. This submission therefore primarily responds to the analysis contained in the “GasNet dashboard”.<sup>2</sup> However, the comments on how the methodology has been applied to GasNet should also be read as comments on the general methodology.

## Section Two: Executive Summary

### *Forecasting expenditure*

Commission proposal	GasNet comment or recommendation
The approach is to use supplier forecasts to set DPP expenditure allowances, subject to some level of Commission scrutiny	Support in principle
Base year for BAU variance checks is set at the year of lowest recorded expenditure	Do not support. An average over recent years should be used to avoid picking an unusual year
A materiality range is applied when assessing whether total opex or total capex forecasts are “BAU”	Support a materiality range, but this should also be applied when assessing expenditure forecasts of opex and capex categories
BAU variance checks assess a range of metrics across totals and categories of expenditure	Where total opex and/or total capex come within the BAU variance thresholds, there should be no further scrutiny of that forecast (this promotes the low-cost approach)  Where total capex and/or total opex exceed the BAU variance thresholds, the scrutiny should focus on the categories that are driving the increase in expenditure
The AMP and other information provided by the supplier are scrutinised by the Commission	Accept this is necessary but this scrutiny should be directed by criteria, which are developed by the Commission with stakeholders and are specified up front

<sup>1</sup> These terms are explained in Section Three of this submission.

<sup>2</sup> The spreadsheet “2613554\_GPB Dashboard – Released to Commerce Commission (13 Sept 2016) – (GasNet)” that was provided to GasNet on 16 September 2016.

Commission proposal	GasNet comment or recommendation
No clear default option is specified	<p>If the Commission decides forecasts do not meet “AMP scrutiny” the supplier should have the option to choose whether to provide additional information</p> <p>If they do not provide additional information or the additional information is not considered sufficient by the Commission, a default option should apply</p> <p>The default option should be set out up front so all parties know what it is</p> <p>The default option should be to apply the same approach as at the 2013 DPP reset; i.e. for opex use the step and trend approach and for capex use supplier forecasts but limit them to a percentage of the historical average</p>

### **Forecasting revenue growth**

Commission proposal	GasNet comment or recommendation
Concept Consulting has developed revenue growth forecasts for each GDB	<p>The Concept forecasts for GasNet’s Whanganui network are reasonable</p> <p>Concept has not developed a forecast for our Bay of Plenty investment</p> <p>We would be happy to work with the Commission to develop reasonable forecasts for the Bay of Plenty</p>
No wash-up for revenue growth has been proposed	<p>We support a revenue growth wash-up where the forecast turns out to be materially wrong (e.g. more than 1% of allowable revenue)</p> <p>This would be especially useful in the Bay of Plenty region where demand growth is most uncertain</p>

### **GasNet investment in the Bay of Plenty**

Commission proposal	GasNet comment or recommendation
Agree to accommodate the Bay of Plenty investment in the DPP; consider that it is likely to benefit consumers by promoting competition	We welcome this and look forward to working with the Commission on the methodology
There is no discussion in the paper of <i>how</i> the Bay of Plenty will be accommodated	We are concerned the Commission may require disclosure of confidential information in order to set the price path

Commission proposal	GasNet comment or recommendation
	We suggest that any forecasts we provide are clearly indicative with a wash-up for material deviations from forecast should they occur

### Quality standards

Commission proposal	GasNet comment or recommendation
Retain the Response Times to Emergencies quality standard	Agree
Create a new 'major interruptions' standard	We do not support this proposal; GDBs already have strong incentives to avoid interruptions  It is not clear a new standard is desired by consumers or would improve outcomes

## Section Three: Forecasting expenditure

### Summary of consultation paper

4. The consultation paper proposes to place reliance on suppliers' own forecasts to set the capex and opex allowances, subject to scrutiny of the forecasts. This is termed the "supplier-based scrutiny approach".
5. The proposed supplier-based scrutiny approach involves three steps:
  - **Step 1 – BAU variance check:** The Commission compares expenditure forecasts against materiality thresholds that are based on historical expenditures to determine if forecasts appear to be at, below or above a 'business as usual' expenditure level. Anything that is above the BAU materiality threshold would require further scrutiny.
  - **Step 2 – AMP scrutiny:** This stage involves the Commission reviewing the asset management plan (AMP) produced by the business to determine whether forecast expenditures above the BAU materiality threshold are justified by the AMP. If they are deemed to be justified they are included within the DPP expenditure allowances. If they are not deemed to be justified, further scrutiny is required.
  - **Step 3 – supplier scrutiny:** This stage involves the Commission requesting additional information from the business to justify those expenditure forecasts that

are not, in the Commission's view, adequately justified in the AMP. If the information provided by the supplier justifies the forecasts to the Commission's satisfaction, the information will be included in the AMP. If the information does not, the Commission may exclude the expenditure from the DPP allowances and can also recommend the business apply for a CPP.

***The principle of using suppliers' forecasts remains valid***

6. GasNet has previously been supportive of the Commission utilising suppliers' expenditure forecasts as inputs to their DPP allowances and acknowledged that the Commission will want to scrutinise these forecasts to some degree.<sup>3</sup> We continue to support the principle of basing DPP expenditure allowances on suppliers' forecasts and agree the Commission will need to obtain some assurance that the forecasts are reasonable.
7. Despite our support for the principle, the proposed supplier-based forecasting approach (i.e. the approach that is proposed in the consultation paper and Strata reports and which was applied to GasNet as described in the letter of 16 September) is in need of improvement before it can be robustly applied in a DPP context.
8. In this section we discuss our concerns with the proposed approach and then outline a recommended way forward.

***Proposed methodology is too costly and inconsistent with the DPP framework***

9. Section 53K of the Commerce Act specifies that DPPs should be relatively low-cost. The consultation paper suggests that this means DPPs should be low cost relative to a CPP. We do not accept that this means any method of setting the DPP would meet the relatively low-cost standard provided it is at least slightly cheaper than a (very expensive) CPP. A DPP methodology should be orders of magnitude lower cost than a CPP, as the method used at the last DPP reset was. We would not support a DPP method that is notably more expensive than the previous DPP method.

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<sup>3</sup> GasNet, "Submission on DPP from 2017 for gas pipeline services, process and issues paper", 24 March 2016, paragraphs 14-15.

10. We agree that BAU variance checks (or something similar) provided they are done in the right way can be a relatively low-cost method. We are not convinced that the AMP scrutiny and supplier scrutiny steps will be relatively low-cost.
11. This is because, firstly, the information the Commission has indicated will be required goes beyond what is normally contained in AMPs. For example, the commentary made on GasNet's expenditure in the material supporting the 16 September letter indicated an expectation that the AMP would explain previous shifts in expenditure and demand. As AMPs are forward-looking documents, this should not be expected. It would be possible to expand AMPs to include this information, and this is what we may do now we have seen the Commission's approach, but this will create additional costs.
12. Secondly, for the supplier scrutiny stage the consultation paper states this is expected to be low cost because suppliers will already have Board Paper or business case or other documentation supporting the AMP forecasts, which can simply be provided to the Commission. This is not correct and indicates some misunderstanding regarding how businesses actually operate. No prudent business would prepare detailed business cases many years before the investment takes place. GasNet develops annual plans which are approved by the board each year. Any plans beyond the first year are subject to revision in the following year's annual plan. As such, GasNet does not produce detailed business cases or board papers for future projects that are uncertain. GasNet might prepare these plans if DPP expenditure allowances depended on it, but this would be an additional cost incurred entirely to meet regulatory requirements and would not be consistent with a low-cost approach.
13. Overall the proposed approach seems to place a substantial onus and cost onto suppliers to justify their expenditure forecasts. This is what would be expected in a CPP context, but does not seem appropriate for a DPP.

***BAU variance checks are not all robust***

14. The Commission, with assistance from Strata, has developed metrics against which to assess whether the expenditure forecasts are consistent with BAU expenditure levels. Having seen how these metrics have been applied to GasNet (through the 16 September letter and attached GasNet dashboard) we do not consider that they are all

robust and/or able to inform the Commission about whether expenditure trends are reasonable.

15. Our reasons for this view, and comments on the metrics, are detailed and so we have made these comments in Appendix A.
16. In principle, however, we note the approach involves the creation of new metrics which are not familiar to suppliers or consumers and which differ from the performance metrics published in information disclosure. The information disclosure framework is designed to provide information about the performance of suppliers in relation to the purpose statement. We consider more reliance should be placed on metrics that are consistent with those applied through information disclosure. This would also help to deliver a low-cost methodology.

### ***Discretion and judgement***

17. We are comfortable in principle with the Commission reviewing our AMP (and other information if required and available) to assess the justifications for our expenditure forecasts. However, it is important that everyone involved understands how these reviews will be undertaken.
18. In our view, the Commission is reserving too much discretion for itself in this process and providing too little information for suppliers and consumers to understand how the forecasts are being assessed. We support the Commission developing criteria for assessing the expenditure forecasts, with input from stakeholders.

### ***Proportionate scrutiny and GasNet's transitional AMP***

19. As the Commission is aware, GasNet's AMP is a transitional AMP, as is permitted by 2.13.9 of the GDB ID determination. The introduction to GasNet's AMP explains that:<sup>4</sup>

*"This AMP, being the forth produced by GasNet and prepared under transitional provisions, has been prepared to satisfy the new regulatory requirements as a minimum, and as such does not necessarily provide the comprehensive information typically found in mature Asset Management Plans. Following the approval and*

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<sup>4</sup> GasNet, "Transitional Asset Management Plan 2016-2026", section 1.1.

*publication of this AMP GasNet will continue to build on this platform until ultimately meeting the requirements of a fully compliant Asset Management Plan by 30 June 2017 prior to the end of the first regulatory period.”*

20. It should therefore be expected that GasNet’s AMP is less detailed than some others the Commission may have reviewed and GasNet’s AMP may be less likely to contain some detail that is sought.
21. We consider that the proportionate scrutiny principle is relevant here. The Commission should apply scrutiny having regard to the relative size of the business being scrutinised and also having regard to the level of disclosure obligations that currently apply to the business. This would mean being open to accepting a lesser degree of justification within GasNet’s AMP compared to the better developed AMPs of the larger gas pipeline businesses and requiring less information from smaller suppliers than from larger suppliers.

### ***Conflation of efficiency incentives and expenditure forecasting objectives***

22. The purpose of utilising suppliers own forecasts is to improve expenditure forecasting within the DPP. We support this objective. However, the consultation material and information about the scrutiny being applied to GasNet implies the Commission and Strata are trying to use this method to set lower expenditure allowances to drive efficiencies. As we explain below, this is inconsistent with incentive-based regulation.
23. In its report on the Pilot, as applied to Powerco, Strata argued that any increase in expenditure during the previous regulatory period should be scrutinised. This was the reasoning for selecting 2013 as the base year as it enabled expenditure increases in 2014 and 2015 to be scrutinised.<sup>5</sup>
24. Similarly, the GasNet dashboard states that:<sup>6</sup>

*“Total forecast opex sits within the materiality boundaries but has a relatively flat trajectory. The flat forecast suggests that GasNet has made no consideration in its forecasts for the impact of potential efficiency gains on opex. It is recommended that*

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<sup>5</sup> Strata Pilot Study report, paragraphs 28-29. Similar comments are made in the GasNet dashboard (e.g. Reporting tab, cell B7).

<sup>6</sup> GasNet dashboard, Reporting tab, cell B8.



*the Commission signals that this is likely to require explanation should this forecasting approach persist at the next DPP reset.”*

25. These views are inconsistent with the intent of incentive-based regulation. Incentive-based regulation partly decouples costs and revenues such that the regulated firms can retain the benefits of efficiency savings (or the costs of inefficiencies) for a time before sharing those efficiencies with consumers.
26. If GasNet was to include efficiency gains in its forecasts and the Commission was to use those forecasts to set prices, GasNet would not receive any benefits from their efficiencies and thus would have no incentive to make them. Over time this would lead to higher prices and thus not promote the long-term benefit of consumers.

***What happens if expenditure forecasts are not accepted?***

27. The information provided by the Commission does not fully explain what will occur if the Commission decides that certain expenditure forecasts are not justified by the material provided by the supplier.
28. It is important that all parties are clear about the consequences of the Commission deciding that expenditures are not justified. This is important for natural justice purposes – so parties understand the consequences of regulation – and will also inform the effort parties make to justify their forecasts.

***Implications for GasNet’s Bay of Plenty investments***

29. Our impression is that the Commission would decide that none of the Bay of Plenty investment would meet the BAU variance thresholds as this investment is not reflected in the historical expenditures. Thus GasNet would only get the necessary expenditure allowances if it has sufficient evidence supporting the investments. We discuss this further in the Bay of Plenty section of this submission.

***Recommended approach***

30. As noted above, we support the principle behind the supplier-based forecasting approach but do not fully agree with the way the Commission has proposed to apply it. We recommend the Commission make improvements to its approach to make the

process more cost-effective, less subjective and more likely to succeed. It would also be more consistent with the legislative intent and the long-term interests of consumers.

31. The BAU variance assessment would be improved by:
  - Setting the 'base year' as the average of expenditures in constant price terms over the 2013-2016 years, because this will provide a more reliable 'BAU' estimate than picking a single historical year.
  - Applying a range to the base year values for total capex and opex and to the capex and opex categories, because this will allow for some variation in BAU expenditure over time.
  - Assessing total capex and total opex forecasts against the total capex and total opex materiality thresholds first. Where they come within the thresholds, these expenditures are not further assessed, consistent with the low-cost DPP.
  - Where total capex or total opex exceed the materiality thresholds, expenditure forecast in each capex and/or opex (as required) category should be assessed against their materiality threshold, as this directs the scrutiny to the right place.
  - For those expenditure categories where forecast expenditure is below their threshold, no further investigation should be carried out, consistent with the low-cost DPP.
  - For those expenditure categories where forecast expenditure is above the threshold, these categories (and only these categories) should be examined through AMP and, if needed, supplier scrutiny.
32. AMP and supplier scrutiny should be applied in a manner that is consistent with the proportionate scrutiny principle – i.e. it should take account of the relative size of the business and expect that smaller businesses may have a lesser degree of explanation available (particularly where AMPs are still transitional).
33. AMP and supplier scrutiny checks should be undertaken on the basis of specified criteria. We suggest the Commission work with stakeholders to develop criteria that would be suitable in the DPP context.
34. Where, after the BAU variance checks and AMP scrutiny checks, the Commission does not think a forecast is justified, the supplier has a choice whether to provide further

information or go to a default method. We suggest the following should be the default method:

- For opex, the allowance should be determined by the step and trend approach as applied in 2013
- For capex, the allowance should be set at a percentage of the historical average capex of the supplier, for example at 120% as applied in 2013 and to electricity distributors in 2015.

#### **Section Four: Forecasting revenue growth**

35. The Commission has engaged Concept Consulting to develop demand forecasts for each GDB. Concept has developed a forecast for GasNet in Whanganui only, which is for demand to stay flat for most of the 2017-2019 regulatory period.
36. Forecasting revenue growth for gas distribution businesses is challenging. The Concept report has made a reasonable attempt at this task. It has had to make a series of assumptions, but we consider the resulting forecast for our Whanganui network is reasonable. That said, the probability that the forecast will be wrong remains relatively high.
37. We support a constant price revenue growth wash-up that would apply where the forecast turns out to be materially wrong (more than 1% of allowable revenue in any one year of a regulatory period).
38. For the Bay of Plenty, we can provide the Commission with information regarding our expected rate of uptake and this could deliver a useable demand forecast. As the rate of uptake in new developments is always particularly uncertain, a wash-up would be particularly useful for GasNet in this region. We discuss forecasting for the Bay of Plenty in more detail in the Bay of Plenty section of this submission.

## **Section Five: GasNet investment in the Bay of Plenty**

### ***Summary of consultation paper and letter***

39. The consultation paper proposes to “accommodate the expansion under the DPP. This would involve incorporating an increase in capex and opex to allow for the Bay of Plenty expansion.”<sup>7</sup>
40. The consultation paper discusses some analysis that shows this is a low-risk approach. However, it does not explain how it would incorporate increased expenditures in the Bay of Plenty into the GasNet DPP.
41. The letter of 16 September requests that GasNet provides expenditure forecasts for the Bay of Plenty investment and supporting information to justify the forecasts, for scrutiny.

### ***The proposal is welcome but more detail would be helpful***

42. We appreciate the Commission’s willingness to accommodate GasNet’s growth opportunity in the DPP. We agree this investment is likely to benefit consumers over time by improving competition for gas pipeline services in the Bay of Plenty region.
43. There is no discussion in the paper of *how* the Bay of Plenty revenue or expenditure forecasts for GasNet will be developed, just a statement that they will be. Also, revenue growth for GasNet in the Bay of Plenty is not covered at all in the Concept report and we are not clear how the revenue forecast for our Bay of Plenty investment will be developed. There seems to be a disconnect between what the Commission says in Attachment C of the consultation paper (that it will accommodate the Bay of Plenty expansion in GasNet’s forecasts) and the revenue growth and expenditure forecasting sections of the consultation paper – which focus on current network footprints only.
44. For expenditure, it seems the assumption is that every dollar that is forecast to be spent in the Bay of Plenty will be subject to scrutiny (because it is all different from BAU). We think this is excessive and a better approach would be to scrutinise forecasts where they imply a higher expenditure per customer or per unit supplied than GasNet’s Whanganui network.

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<sup>7</sup> Consultation paper, paragraph C5.

***We suggest an alternative forecasting approach for the Bay of Plenty investments***

45. As the Commission acknowledges, certain growth opportunities in the Bay of Plenty are competitive and this should deliver a good deal for consumers. This means there should be less concern about non-competitive market outcomes in the forthcoming regulatory period and the Commission should be careful not to act in a way that distorts competitive activity. For example, there is currently some pricing competition and competing pipelines in the region.
46. If GasNet was required to provide detailed forecasts of its costs in the Bay of Plenty, this could compromise our ability to compete in this and future growth opportunities. As the Bay of Plenty expansion is a growth project in a new region we have not previously operated in, any forecasts of expenditure, revenues or demand in that region also have a higher than usual chance of being wrong.
47. GasNet can provide expenditure and revenue forecasts for the Bay of Plenty expansion. However, it would be better for these to be clearly indicative, perhaps based on averages from our Whanganui network, with a wash-up for material deviations from forecast should they occur.
48. This would retain commercial confidentiality while ensuring consumers only pay the reasonable cost of the investments.

***Alternative options discussed in the consultation paper***

49. The consultation paper notes that two other options relating to GasNet's Bay of Plenty opportunity were considered – to set separate price paths for Whanganui and the Bay of Plenty; and for GasNet to apply for a CPP. Both of these options have been rejected by the Commission.<sup>8</sup>
50. We agree separate price paths should not be set for the Whanganui and Bay of Plenty networks. We do not believe this would be consistent with the Act, which anticipates regulating suppliers as single entities. Also it is not how other regulated suppliers with

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<sup>8</sup> Consultation paper, paragraphs C19-C25.

geographically non-contiguous networks are regulated and we see no reason to treat GasNet differently.

51. We also agree a CPP is not the right solution. Even with the Bay of Plenty opportunity, GasNet is not a large enough business to afford a CPP. If a CPP was the only way we could undertake the Bay of Plenty opportunity, the cost of the CPP would be so large as to make the investment uneconomic.

## **Section Six: Standards for quality of service**

### ***Summary of consultation paper***

52. The Commission proposes to keep the current quality standard – Response Times to Emergencies.
53. The Commission also proposes establishing an additional quality standard related to major interruptions. This standard is that any interruption above a specified limit (e.g. length of outage or number of customers affected) would be a 'major interruption' and a breach of the quality standard. If a major interruption occurred, there would be a detailed reporting obligation on GasNet. The Commission would review GasNet's report and then have discretion about how to deal with the breach (e.g. the Commission could take no action, or issue a warning letter, or seek to prosecute the breach under the Commerce Act).
54. The Commission has not put forward any suggestion on what the 'major interruption' limit should be for distribution but has sought submitters' views on this.

### ***GasNet response to the consultation paper***

55. We support the continued use of the Response Times to Emergencies standard. This standard is in place and we have developed the necessary systems and processes to record information and report against this standard.
56. We do not support the proposal of also having a 'major interruptions' standard at this time. We agree that avoiding major interruptions is important for consumers. However, GDBs already strive to avoid interruptions and we have strong financial, reputational and health and safety incentives to seek to maintain supply. It is not clear a new regulatory

target would improve the quality of service we provide or that it is demanded by gas distribution consumers.

57. If this new standard is implemented, the definition of interruption should be consistent with the information disclosure definition. We want to avoid the costs of having to work with multiple definitions across different regulations.

### **Section Seven: Compliance issues**

58. The consultation paper suggests aligning the price restructure and transaction provisions in the gas DPP to the current electricity DPP.
59. We support any reforms that reduce cost or ambiguity but we would not support change just to align gas with electricity. There needs to be a clear cost or efficiency benefit for suppliers for any changes that are made to compliance requirements. Our systems and processes affect the existing DPP requirements and we would be concerned if we had to incur costs to accommodate the new DPP compliance provisions.

### **Contact details**

Thank-you for considering this submission. If you have any questions please contact me on 06 349 0131.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Geoff Evans', written in a cursive style.

**Geoff Evans**

General Manager

## **Appendix A: Comments on the detail of the BAU variance and AMP scrutiny**

### **Introduction**

60. As noted, on 16 September the Commission issued GasNet with the results of the BAU variance and AMP scrutiny checks that it had applied in relation to GasNet's 2016 AMP forecasts. Having reviewed those we have a number of concerns with the checks and suggestions to improve them (although we acknowledge that some of the checks appear reasonable). These concerns and suggestions are discussed in this Appendix.
61. These comments should also be seen as comments on the BAU variance methodology in principle, as described in the Strata reports.

### **GasNet's forecasts are reliable**

62. We agree that GasNet's actual and forecast operating expenditure have been closely matched in disclosures so far and that this would seem to indicate a good degree of forecasting accuracy by GasNet.<sup>9</sup> This should give the Commission comfort that our current AMP forecasts are reasonable.

### **Checks for data errors**

63. A check of the input values in the GasNet dashboard tool against GasNet's disclosures indicates that some of the dashboard values (in particular the 2013-2015 expenditure values) differ from disclosures. These appear to be adjustments to convert values into constant prices but this is not clear. Given the materiality and importance of the BAU variance model, we recommend the Commission obtains an independent review of the accuracy of the inputs and calculations before applying the results. The Commission should also document any adjustments made to disclosure data and seek sign-off for those changes from the affected businesses.

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<sup>9</sup> GasNet dashboard, Reporting tab, cell K8.



## **Base year**

64. The BAU variance checks begin by assessing forecast expenditure against a ‘base year’. The base year has been chosen as the year of lowest expenditure in 2013 – 2015. For capex the base year is 2013, while for opex the base year is 2015. We disagree with this “cherry picking” method of choosing the base year, which will fail to identify a reasonable BAU level of expenditure.
65. We see no evidence that the Commission has sought to identify any unusual circumstances in 2013 or 2015 to explain the relatively low levels of expenditure, or that the Commission has sought to confirm whether these are ‘normal’ years against which it is appropriate to assess future expenditure. Using different years for capex and opex is also poor practice as it ignores the trade-offs that can be made between expenditure types in each year (i.e. capex may have been low in 2013 because more was spent on opex in that year and the 2013 capex level may not be sustainable alongside the 2015 opex level).
66. A materially better method would be to take an average of historical expenditure (in constant price terms) for the years 2013-2016<sup>10</sup> as the ‘base year’ as this will average out any unusually high or low-cost years and give a more robust base against which to assess expenditure. This is a low-cost forecasting method that is suitable for a default price-path; reduces discretion and improves certainty and businesses will be able to predict and respond to it.

## **Range**

67. In assessing total capex and total opex the methodology applies a range around the boundary value and expenditure is only deemed to have failed the BAU variance check if it exceeds the top of the range. However, when assessing capex and opex categories, no range is applied. We recommend applying a range around the boundary value at a category level as well as a total expenditure level (but only where total forecast expenditures exceed BAU materiality thresholds; as only in these circumstances should expenditure categories be assessed).

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<sup>10</sup> 2016 actual expenditure data will be available following publication of 2016 disclosures in advance of the final Gas DPP reset decision.

### **Analysis includes years beyond the current regulatory period**

68. The data analysis extends to 2025. This is inappropriate as the regulatory period ends in 2022. It is appropriate for the Commission to scrutinise data out to 2023 (as GasNet's 2023 disclosure year includes three months of the 2022 pricing year) but it should not consider data beyond that year. There is no need to incur costs considering expenditure forecasts that relate to a subsequent regulatory period and incurring these unnecessary costs moves the approach further away from a low-cost DPP benchmark.

### **Inconsistent timeframes of inputs**

69. The analysis compares variables that are not forecast over the same timeframe. In accordance with the information disclosure requirements, GasNet has forecast opex and capex out to 2026, but has only forecast ICPs and GJ supplied to 2021. The Commission has assumed ICP and GJ values for 2022 and subsequent years are equal to 2021 values. This makes the assessment of expenditure per ICP and per unit supplied for 2022 and later years unreliable. We recommend this analysis is not applied to any years after 2021. If the Commission does forecast beyond the end of the data series it should at least carry forward the trend, rather than assume the final year value remains unchanged.

### **Analysis should consider aggregate expenditure, not annual expenditures**

70. The analysis takes no account of aggregate expenditure over the regulatory period. As we understand it, the analysis considers that any year in which expenditure exceeds the BAU variance boundary requires AMP scrutiny.<sup>11</sup> However, if for example in one year the forecast expenditure exceeds the boundary by \$1m and in the next year the forecast is \$1.5m below the boundary, this should be seen as acceptable as it is within the BAU boundary in aggregate. There will always be year-on-year variances in expenditure, particularly in capex, and the application of the boundary should recognise this.

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<sup>11</sup> The assessment of Asset Replacement and Renewal capex in the GasNet dashboard, Capex dashboard tab, is a good example of this.

## **Some of the analysis is not meaningful**

71. We have concerns that some of the metrics are not well conceived and do not provide useful insights. The Commission appears to be interpreting data in a particular way when other plausible interpretations are available. In this section we discuss three examples – the opex to output analysis, the relationship between expenditure and gas conveyed and the cost of interruptions analysis.

### ***Opex to output***

72. In the “opex to output” radar diagram, the Commission considers the relationship between GJ supplied/ICP and network opex/ICP.<sup>12</sup> The Commission considers that any change in the ratio of these two metrics indicates a change in underlying efficiency. We suggest this is reading too much into the data. If you examine the underlying forecasts, they show some movement in ICP numbers and GJs in the first three forecast years, with GJ supplied then forecast to remain flat while ICPs are forecast to grow at a steady and low rate. This doesn’t indicate a change in efficiency. It indicates that there are some expected changes in terms of demand and customer numbers in the near term, with less information for the later years. Significant weight should not be placed on this analysis.
73. More generally, a change in the ICP/GJ ratio without a change in operating expenditure does not necessarily imply a change in efficiency. It can just as easily indicate that a certain level of change in supply can be handled without changing costs. For example, where a major user increases or decreases its demand, it is not very likely that operating costs would change as a result as the fixed cost of dealing with the consumer would remain unchanged.
74. Further, we do not see why it should be expected that a change in opex and a change in GJ supplied would have a 1:1 relationship, which is what seems to be assumed. If the Commission wishes to progress with metrics such as ICP and GJ per \$ of opex, these metrics would be more robust if they were based on an econometric assessment of the relationship between these terms (as the Commission has done in its development of the step and trend opex forecasting approach for electricity distribution businesses, for example).

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<sup>12</sup> GasNet dashboard, Reporting tab, column E.

### ***Relationship between expenditure and gas conveyed***

75. The GasNet dashboard implies the relationship between total expenditure and gas conveyed is indicative of efficiencies or dis-efficiencies and does not consider any other possible explanations.<sup>13</sup> But if the expenditure is focused on replacing or maintaining existing assets, then it could conceivably have no impact on throughput at all. This should be recognised in the analysis.

### ***Cost of interruptions***

76. The cost of interruptions analysis suggests that in all years the service interruptions, incidents and emergencies opex \$ per interruption exceeds the 'interruption opex boundary' that has been set.<sup>14</sup> This analysis is flawed and is a good example of the problems with this type of analysis. The problems are:

- As a first point, this should not have been considered at all as forecast opex was within the BAU variance range.
- The number of interruptions for a GPB are generally very low and thus much of the opex in the category service interruptions, incidents and emergencies category will be spent responding to incidents and emergencies, rather than interruptions. As such, fluctuations in the ratio of opex in this category to interruptions is likely to reflect the ratio of interruptions to incidents and emergencies, which may vary over time. Also, for GasNet as a small GDB, the complexity of incidents and emergencies experienced is also likely to fluctuate between years.
- The forecast interruptions value has not been set in a robust manner. Actual reported total interruptions were: 278 in 2013, 267 in 2014 and 115 in 2015. GasNet does not forecast future interruptions as this is not required through information disclosure. The Commission therefore did not have any forecast of interruptions to use to assess the interruptions expenditure forecast. However, the Commission assumed that the 2015 level of interruptions (by far the lowest of the three years'

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<sup>13</sup> GasNet dashboard, Reporting tab, cell E6.

<sup>14</sup> GasNet dashboard, Opex dashboard tab, cell H4.

data available, so it appears to be an outlier) will continue over time. This is not a credible forecast.

77. In our view, excluding this analysis from the BAU checks (due to lack of data) is a better approach than including it in the analysis.

### ***Additional observations***

78. In addition to the points raised above, there are a number of calculations and charts in the BAU variance spreadsheet that are not very clear. We note these below.

- It is not clear how the low, mid and high opex step and trend rates are set.<sup>15</sup>
- It is not clear what the “Estimated asset base and network opex” analysis is seeking to explain.<sup>16</sup> It is not clear why the estimated asset base is calculated as, for each year, the 2015 closing RAB adjusted by 0.5% plus forecast system growth capex only and then this value is then compared to the total network opex forecast. The assumption that replacement and renewal capex will equal depreciation is confusing given that actual replacement and renewal capex forecasts are available. It is also not clear why other capex categories are excluded from the analysis.
- Also, in the same “Estimated asset base and network opex” analysis, it is not clear what the “adjusted opex boundary” is intended to show. This seems different from the materiality boundaries as it increases and increasingly diverges from the forecasts over time.
- It is not clear why the cost per connection capex boundary<sup>17</sup> is generally below the level of actual expenditure recorded in every year for which data is available.

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<sup>15</sup> GasNet dashboard, Reporting tab, column C.

<sup>16</sup> GasNet dashboard, Reporting tab, column D.

<sup>17</sup> GasNet dashboard, Capex dashboard tab, cell K3.