

Memorandum

To: **Commerce Commission**

From: Vector

Re: Commerce Commission (the Commission) questions regarding Vector's 2016 asset management plan (AMP) for our Auckland gas distribution business (GDB)

- **An explanation for increases in Vector's non-network expenditure forecast as Vector's 2016 AMP does not fully explain these increases**
- **An explanation about why Vector's non-network capex is expected to increase despite the sale of the non-Auckland gas distribution network**

Our 2016 AMP does have explanations for both the increases in non-network capital expenditure (capex) and operating expenditure (opex).

With respect to opex, the 2016 AMP is in fact forecasting a decline in non-network opex from the previous forecast. The 2016 AMP is forecasting an approximate decline of \$6 million over the 9 years from the 2015 AMP forecast. This is an annual variance of \$0.66 million per annum lower than forecasted in the 2015 AMP.

At the cost category level for non-network operating expenditures, the 2016 AMP is forecasting a decline of \$4.6 million per annum for system operations and network support. At the same time the 2016 AMP is forecasting an increase of \$3.9 million per annum for business support costs. The differences between these categories of expenditures is largely due to the reclassification of expenditures from system operations and network support to business support expenditure. This reclassification does not affect the overall declining trend for non-network operating expenditure as forecasted by the 2016 AMP.

An explanation for the decline in Vector's non-network opex was provided in the 2016 AMP. The explanation noted:

On 20 April 2016 Vector sold 100% of Vector Gas, which owned the gas transmission network and GDB outside of Auckland. Approximately 130 staff responsible for operating these networks transferred with the business to the new owner, First Gas. As a result of the sale, Vector's corporate/shared services costs have reduced, particularly in relation to insurance, information technology and professional services costs that will no longer be incurred.

However, the 2016 AMP forecast also recognised there are a number of non-network operating expenditures that cannot scale down despite the sale of Vector gas transmission and non-Auckland gas distribution businesses.

Indeed parts of Vector's corporate shared service team are increasing in size such as our risk and health and safety functions given the increasing demands of *the Health and Safety at Work Act 2015*. Vector is also putting more emphasis on maintaining a high cyber security standard and investing in our capability to ensure our critical infrastructure is well protected against such vulnerability. In this respect, Vector is anticipating an increase in our non-network capital expenditure of approximately \$0.2 million per annum. This is driven by IT capital expenditure projects that would have previously been shared with Vector's gas transmission business and non-Auckland GDB.

- **An explanation for Vector's opex over-forecast variances with historical actual expenditure. We have noted that when 2013, 2014 and 2015 actual total opex expenditure is compared with what was forecast there is a significant difference. We are looking for re-assurance that there is no systematic over-forecasting occurring in this expenditure category.**

While there have been variances with actual opex when compared to AMP forecasts (schedule 11b) for the past three disclosure years, the reasons are distinct and not representative of a systematic bias for over estimating opex. As discussed below, the costs relating to corporate restructuring are the only common case across the 2014 and 2015 disclosure years for AMP forecast variances with actual disclosures. This is not an issue for the 2016 AMP forecast. The explanations below provide a clear explanation for the reasons why actual expenditure varied from forecast for each year.

The schedule 11b for 2014 and 2015 forecasted an increase in costs as a result of an anticipated corporate restructuring. This anticipated restructuring was foreshadowed in Vector's 2013 AMP in section 9.2 and also in Vector's 2015 AMP. The Vector 2013 AMP section 9.2 noted:

Vector is still considering moving to a more clearly defined asset manager and service provider structure. The forecasts of operational expenditure in this section take account of the forecast costs associated with the new business arrangements.

Accordingly, both the 2014 and 2015 schedule 11b forecasts included an estimate of cost post the corporate restructuring.

In both disclosure years Vector never ended up executing the required steps for corporate restructuring. This is acknowledged in box 12 of schedule 14 of Vector's 2014 gas information disclosures (GID).

The forecast for the 2013 year was provided as part of a section 53ZD request instead of via an AMP or AMP update so the explanations for the forecast are less apparent than for the 2014 and 2015 disclosure years.

Nonetheless, the key reason for the 2013 forecast variance with actual expenditure was the alignment of maintenance standards across the Auckland and non-Auckland gas network businesses. This assisted in reducing the volume of planned activity on the networks over the period – such as similar asset inspection cycles being performed on a uniform basis across the country. During this year Vector also achieved higher than forecast third party recovery for costs of damaging network assets. A review of debtors also allowed Vector to release doubtful debt provisions accrued for the period.

The forecast variance with actual opex for the 2014 disclosure year of \$4.7 million was based on a number of reasons. In this year Vector was able to realise \$0.5 million efficiency from a change in process reducing the number of mark-outs and stand-over tasks performed. The AMP also included an anticipated \$1.5 million cost from corporate restructuring as discussed above.

The 2015 AMP was accurate with forecasting operational maintenance expenditure for the year. The chief reason for variance between the forecast and actual opex was the anticipated corporate restructuring not proceeding, as discussed above.

- **An explanation for why there is an absence of expenditure in the replacement and renewal opex category for Vector forecast information**

Vector has determined all planned inspections and associated corrective actions should be allocated against the 'routine and corrective maintenance and inspection' category and not in the replacement and renewal category. The reason for this classification is that the primary driver for the classification for routine and corrective maintenance and inspection is the 'activities specified in planned or programmed inspection, testing and maintenance work schedules activities'. In Vector's opinion, this includes all planned and corrective works.

- **An explanation for Vector's capex over-forecast variance with historical actual expenditure. We have noted that when 2015 actual total capex expenditure is compared with what was forecast there is a significant difference.**

Given Vector's capex forecasts have generally been provided on an integrated basis (across both Auckland and North Island networks) i.e. in schedule 11a, we are providing this response on the basis of the previous combined view of Vector's GDB forecasting performance using our schedule 11a capex forecast versus actual expenditure as disclosed in schedule 6a.

We do not believe our "actual capex versus forecast" illuminates a systematic trend with our capex forecasts. Indeed, Vector's GID schedule 6a also shows capex has not remained flat over the

period but changed significantly year-to-year. Indeed, our schedule 6a shows capex of \$20.9 million for the 2013 disclosure year, \$28.4 million for the 2014 disclosure year and \$21.5 million for the 2015 disclosure year. More importantly, the reasons for variation from forecasts have been provided in Box 12 of Schedule 14 of our GID. The explanations provided in schedule 14 for the variance between AMP capex forecasts are based on expenditure without the impact of financing and capital contributions. Nonetheless, the reasons for the differences are equally valid when accounting for capital contributions and financing.

For the 2013 disclosure year, a key driver for the difference in anticipated capex was driven by lower than expected third-party relocation activity. This is an inherently difficult category to forecast for as third-party relocations are dictated by the third-party.

For the 2014 disclosure year, a number of categories of expenditure exceeded forecast by a considerable extent such as consumer connections which was \$6 million higher than forecast. The increase in the category of expenditure was also driven by the connection of a large customer (a dairy factory in Pokeno, South Auckland). However, system growth expenditure was not as high as forecasted for the year (\$2.25 million less than forecast). This decline in expenditure was due to the cancellation of a project to link Waikumete and Bruce McLaren gas stations.

The 2014 AMP update provided for a \$35 million increase (over nine years) in consumer connection expenditure (from the 2013 AMP) with an anticipated increase in Auckland development. Vector also forecasted an increase of \$15 million (over nine years) in asset replacement expenditure to replace parts of the pre-1985 polyethylene network. The 2014 AMP also included a \$12 million increase (over nine years) in asset relocation expenditure for anticipated civil works for relocations. The 2015 AMP also included a \$2 million decrease in system growth from the AMP update following the cancellation of the project to link the Waikumete and Bruce McLaren gas stations.

For the 2015 disclosure year actual expenditure was within \$7.5 million of forecast capex (before the impact of contributions) for the year. The key drivers for the variance were:

- 1) System growth expenditure coming in at \$2.8 million less than forecast. This was mainly driven by the deferment of three growth projects in Hamilton, Waitoa and Paraparaumu.
- 2) Asset relocation expenditure decreasing by \$2.2 million due to the New Zealand Transport Authority and Auckland Transport changing their timeline for projects requiring gas asset relocations.
- 3) Consumer connection expenditure was also \$2 million less than forecast from lower than anticipated customer connection activity occurring over the period.