

Commerce Commission
P O Box 2351
Wellington 6140

For the Attention of: Dr Simon Todd

29 November 2016

Dear Simon

Report on Vector distribution supplier evidence assessment responses

1. I am pleased to provide this report setting out Strata Energy Consulting Limited's (Strata) recommendations to the Commerce Commission on the explanations and evidence supplied by Vector dated 25 November 2016, provided in response to the questions posed to Vector by the Commission.
2. Five questions were put to Vector following AMP evidence assessment of the 2016 gas distribution asset management plan (AMP), certified by directors on 23 August 2016.¹
3. The following table provides Strata's recommendations and reasons relevant to each of the questions posed by the Commerce Commission to Vector.
4. Questions 1 and 2 have a combined recommendation and rationale for the two questions posed by the Commission as they both relate to the same topic of non-network opex forecasts. Vector explained its rationale for non-network opex by providing a combined response to questions 1 and 2.

¹ Two additional questions not directly related to the supplier evidence assessment process were also posed to Vector. The questions are responded to at pages 5 to 6 of Vector's memorandum. They are outside the scope of Strata Energy Consulting's assignment and are not reported on.

Question	Question posed	Strata recommendation	Rationale
1.	An explanation for the increases in Vector's non-network expenditure forecast as the AMP does not fully explain these increases	Strata recommends that the explanations provided for the increases in non-network opex not be accepted and that the non-network expenditure forecasts be limited to the upper bound of the non-network opex variation boundary for the assessment period 2018 to 2022	Key point made by Vector is that their non-network opex is declining when the 2016 forecast is compared to the 2015 AMP forecast. Strata do not consider this is a valid comparison, as forecasts should be compared to actual historical expenditure, as the Commission does.
2.	An explanation of why Vector's non-network capex is expected to increase despite the sale of the non-Auckland gas distribution network		<p>Vector in their response repeat key outcomes from their table produced in the 2016 AMP to demonstrate differences between 2015 and 2016 opex forecasts (see: 2016 AMP, section 9, p.7 of 9). The differences described in the 2016 AMP are based on Vector's projections of real NZ\$ forecasts using forecast PPI for 2017 of 1.8%. Vector suggests in its memorandum that rather than increase, non-network opex, actually declines by approx.\$6m over a 9-year period to 2025. Strata however, demonstrates in the dashboard that compared to the materiality boundaries for non-network opex attributable to the Auckland gas distribution business, non-network opex is forecast to increase above the materiality boundary, based on the "back cast" 2013-to-2015 actuals for the Auckland-only distribution business, year-on-year over the assessment period to 2022.</p> <p>Non-network opex base materiality is \$6407m p.a. This is broken down into: (a) \$2663m p.a. - system operations and network support opex, (b) \$3744m p.a. - business support opex. For every year of the assessment period to 2022, non-network opex is forecast to be \$950k above the base materiality for non-network opex.</p> <p>Vector repeat their explanation from the AMP itself by quoting a paragraph from section 9.2.1 of their AMP (see: 2016 AMP, section 9, p.8 of 9) that effectively states that corporate and shared services costs have reduced. 130 staff are transferred and insurance, IT and professional services costs have reduced. However, despite this, Vector then argue that there</p>

Question	Question posed	Strata recommendation	Rationale
			<p>is a proportion of non-network opex that will not scale including increasing demand for management of health and safety risk due to the 2015 Act and an increase in IT due to Vector maintaining a high cyber security standard and investing in capability to ensure critical infrastructure is not vulnerable (these reasons were also set out in section 9.2.1, last paragraph). The matters described above are forecast to increase non-network opex by only \$0.2m p.a. Vector also states that in previous years such projects would have been shared across the GTB and non-Akld gas distribution businesses and that the Auckland GDB is therefore shouldering a comparatively higher share of these costs post-sale (see: Memorandum at p.2). The AMP at section 9.2.1 said something similar: <i>“The quantum of cost allocated to Vector’s gas network has increased directly as a result of the sale. This is due to loss of significant economies of scale that Vector enjoyed managing multiple networks.”</i> In the AMP, Vector conclude: “as a result, any corporate cost savings, as a result of the sale of Vector Gas are unlikely to be sustained in the long term.” (2016 AMP, section 9, p.8 of 9)</p> <p>Strata observes that there are no corporate cost savings from the sale even in the short-term and that effectively non-network costs are forecast to increase by close to \$1m per annum higher than the “back cast” average of actual non-network costs attributable to the Auckland GDB.</p>
3.	<p>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</p>	<p>Strata recommends that the explanation provided for the over-forecasts of opex compared to actuals for 2013, 2014 and 2015 years be accepted as satisfactory to explain the major variations between the opex forecasts and historic actual</p>	<p>Vector states that there are multiple reasons for the over-forecasting of opex compared to actuals. Prior AMPs are quoted and Vector emphasises its contemplation of corporate restructuring in 2013 for 2014 and subsequently 2015, including a 17.2% forecast mark-up intended to be applied to gas contracting services were the restructuring to go ahead. The restructuring did not go ahead. Vector indicates that this was acknowledged in the 2014 Information Disclosures (Schedule 14, box 12) – Strata confirms this. Vector state that</p>

Question	Question posed	Strata recommendation	Rationale
	systematic over-forecasting occurring in this expenditure category	opex.	restructuring has not been forecast in the 2016 AMP and Vector <i>“is not presently considering the corporate restructuring”</i> (Memorandum, p.3). The 2013 forecast variance from actual, Vector indicates, was fully explained as part of a s.53ZD request. Vector state that the key reason for the variance was the alignment of maintenance standards between the Akld and non-Akld gas distribution businesses. 2014 AMP variance, in addition to the \$1.5m corporate restructuring not going ahead, includes a \$0.5m improvement in process due to reduced mark-outs and stand-over tasks performed. The 2015 AMP key variance was the \$1.5m corporate restructuring not proceeding.
4.	An explanation for why there is an absence of expenditure in the replacement and renewal opex category	Strata recommends that the explanation provided by Vector be accepted as satisfactory.	Vector considers the primary driver for opex expenditure is routine and corrective maintenance and inspection and that there is no driver for allocating any opex forecast to AR&R.
5.	An explanation of 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	Strata recommends that the explanation provided for the over-forecasting variance between forecast and actual historic capex expenditure be accepted as satisfactorily explaining the major variances between forecast and actual capex expenditure during the period 2013-to-2015.	Vector explained that the response is that capex investment is lumping and variances are explained each year in box 12 of Schedule 14 of their annual Information Disclosures. The biggest driver between actual and forecast capex in 2013 was the significant difference in asset reallocation capex driven by delays in 3 rd party reallocation projects. The primary 2014-year difference is attributed to Vector identifying a more efficient solution to improve gas reliability by upgrading the gas transmission system rather than installing a \$4m distribution link pipeline. This meant \$2.25m of system growth forecast expenditure was not spent in 2014 and a further \$2m forecast for the project in 2015 was not required. In 2015, the forecast difference is described as attributed to an over-forecast of system growth expenditure of \$2.8m due to the deferment of 3 growth projects on the non-Auckland gas network; \$2.2m difference in asset relocations due to NZTA timetable delays; and Vector’s consumer connection forecasts being \$2m higher than actual.

Summary of recommendations

5. Strata recommends that the explanations provided to questions 1 and 2 not be accepted and the resultant non-network opex forecast, it is recommended should be held to the upper variation boundary for each year 2018 to 2022.
6. Strata recommends that the explanation provided for questions 3-to-5 be accepted as providing sufficient justification for the forecasting variances between opex and capex forecast, as compared to actuals; and the explanation for not using the forecast category of asset replacement and renewal in its opex forecasting.

Regards

A handwritten signature in black ink, appearing to read 'Bill Heaps', with a stylized flourish at the end.

Bill Heaps
Managing Director
Strata Energy Consulting Limited