Strata
ENERGY CONSULTING

Simon Todd
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Commerce Commission
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For the Attention of: Simon Todd

30 March 2017

Dear Simon

Assessment of Vector's cross-submission additional evidence on non-network expenditure attributed to the Vector gas distribution business

1. On 24 March 2017, Vector provided a cross-submission to the draft reasons paper for the default price-quality paths for gas pipeline businesses. In its cross-submission, Vector included a section discussing further its non-network expenditures, both capex and opex, with respect to Vector's gas distribution business (GDB).

2. On Monday 27 March, the Commerce Commission requested that the information supplied by Vector in its cross submission regarding non-network forecast expenditure, be reviewed by Strata and our previous recommendations updated in the light of the new information.

3. The relevant part of Vector's cross submission is set out at paragraphs 8 to 17.

4. The cross submission covers non-network capital expenditure (capex) and non-network operating expenditure (opex) split between systems operations and network support (system support opex) and business support opex.

Strata's assessment

Non-network capex (paragraphs 8 – 10)

5. Vector advises the Commission that, due to the sale and purchase transition, many of the capital IT projects affecting its gas distribution business were deferred until the sale was complete. This deferral resulted in IT capital expenditure being "artificially depressed" in 2016. Whilst the 2016 capital expenditure figures are lower than prior years, the forecast years 2017-2022 compared to 2013-2015 actual expenditure are at similar levels. This

indicates that no scaling adjustment for the reduced size of Vector's gas distribution business post-sale is taking place.

6. Vector's cross submission on non-network capital cost lists several IT initiatives it intends to undertake during the forecast period from 1 October 2017 to 30 September 2022. Paragraph 9 of Vector's cross submission describes the initiatives in the form of non-network capex projects. The list of five IT projects are described at sub-paras 9(a) to 9(e).

7. Three of the five projects have forecasted financial years indicating when Vector intends to deliver them. Each of the brief project descriptions provided a reasonable overview of the proposed IT projects. However, financial forecasts have not been provided for any of the projects listed at paragraph 9. The absence of financial forecasts means that Strata is unable to consider that the additional non-network capex is fully justified.

8. Without a clear linkage between the forecast capex itself and each proposed initiative, Strata is unable to conclude that the forecast capex expenditure is justified. In addition, the information provided by Vector does not explain why its forecast is higher than was historically spent on a much larger network.

9. Strata recommends that the information supplied by Vector in its cross submission is still insufficient to justify the forecast capex expenditure.

Non-network opex – system operations and network support (systems support) (paragraphs 12 – 16 of Vector's cross submission)

10. Vector states that in response to Auckland's growth, the company has employed 2 new community liaison staff that work across Vector's network and non-network businesses. Vector states that these personnel are not dedicated to Vector's gas distribution network but work across Vector's total network businesses, including by assisting engagement with local communities to ensure new infrastructure project deployment occurs, to the extent possible, with community support.

11. Vector has also increased its team working on customer-initiated developments and new customer connections by 10 FTE's since 2013. This team also assists customers where they need other non-network solutions. The cross submission indicates that these personnel are also shared across all Vector's network businesses and not dedicated to the GDB.

12. The sharing of resources across the total business seems to be an efficient approach. However, because Vector has not provided a breakdown of how the costs of its employees are allocated to the various businesses, Strata cannot conclude that the system support opex forecasts are reasonable. Accordingly, Strata's advice is that the information supplied by Vector in its cross submission is insufficient to justify the forecast opex expenditure.

Non-network opex – non-network support costs (paragraph 17 of Vector's cross submission)

Vector attributes the costs to two key drivers:

a. health and safety capability; and
b. cyber security capability.

13. Vector provides aggregate cost evidence indicating that the opex invested in the above two areas cannot be scaled and that their costs have increased from $86k in FY2013 to a forecast $260k in FY2017.

14. The explanation of the extent of the cost increases and their attribution provide sufficient support, in a DPP context, for the forecast to be allowed. Accordingly, Strata recommends that the Commission consider increasing the non-network support costs (opex) allowance to accommodate Vector's forecasts for the next DPP period 2017 to 2022.

Summary of Strata's opinion

15. The information and response from Vector required to address the Commission's concerns regarding non-network capex is insufficient to justify any increased expenditure allowance.

16. The additional information provided by Vector to address the Commission's concerns regarding the system operations and network support categories of non-network opex is insufficient to justify any increased expenditure allowance.

17. The information and response provided by Vector with respect to non-network operational costs is sufficient to address the Commission's concerns and Strata recommends that non-network opex forecasts provided by Vector for its gas distribution business be accepted.

Regards

Bill Heaps
Managing Director
Strata Energy Consulting Limited