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John McLaren
Chief Advisor
Regulation Branch
Commerce Commission

By email: regulation.branch@comcom.govt.nz

Dear John

Submission on the Default Price-Quality Paths from 1 April 2015 for 17 Electricity Distributors: Process and Issues Paper

1. Introduction

1. Horizon Energy Distribution Limited ("Horizon Energy") welcomes the opportunity to provide feedback to the Commerce Commission ("Commission") on the default price-quality paths from 1 April 2015 for 17 electricity distributors: process and issues paper ("process and issues paper").

2. We support the submission provided by the Electricity Networks Association ("ENA").

3. We acknowledge the Commission can either roll over prices that previously applied, or adjust starting prices based on the current and projected profitability of each non-exempt Electricity Distribution Business ("EDB") under s53P(3)(a) and (b) of the Commerce Act 1986 ("the Act") respectively.

4. We support the Commission's undertaking that a decision on the approach to use for setting starting prices at 1 April 2015 is dependent upon the outcome of the calculations of current and project profitability for EDBs.

5. We acknowledge the Commission's proposal to calculate starting prices based on current and projected profitability for EDBs is similar to the approach applied in November 2012.

6. In general we support the Commission's proposal to use a similar approach to that used in November 2012, however submit that there are a number of issues for the Commission to consider for refining this approach, due to this being a low-cost 'one size fits all' approach to setting price paths.

2. Forecasting Operating Expenditure

7. The approach to forecasting consistent with November 2012 is to update an initial level of operating expenditure for the impact of expected changes in network scale, partial productivity and input prices.

8. In considering whether to use one or more years of data to determine the initial level, we submit for the Commission to use 2013/14 actual data only. 2013/14 actual data will be the most recently available at the time of the final decision and therefore best reflects an EDBs current operating expenditure levels.

9. We note the Commission's concern on the use of 2013/14 forecast data for operating expenditure, and suggest that while forecast data may be of use for the draft determination in June 2014, the final determination in November 2014 will have the benefit of using the actual 2013/14 information disclosed at the end of August 2014.

10. We note and support the Commission's comment on the ability for EDBs to provide actual 2013/14 data prior to August 2014 to enable use in the draft determination in June 2014.

11. We do not support the use of an average of 2012/13 and 2013/14 data to set initial level of operating expenditure, for reasons such as 2012/13 was the first year of disclosure under the Electricity Distribution Information Disclosure Determination 2012. Some recognition of inconsistencies in the initial application of the Electricity Distribution Information Disclosure Determination 2012 needs to be provided for, thereby 2012/13 data may not be the most suitable for use.

12. We do not support the use of an average of a longer time series, such as from 2009/10 to 2013/14 as this would require further s53ZD information requests for EDBs to restate 2010/11 operating expenditure under the Electricity Distribution Information Disclosure Determination 2012.

13. When considering expected step changes we acknowledge the criteria established under para A35 of the process and issues paper and accept Horizon Energy does not meet this criteria in its entirety due to changes being required to be largely out of the control of the EDB (para A35.4). However we are expecting a 13% increase from 2013/14 to 2014/15 in Systems Operations and Network Support expenditure due to long standing staff vacancies filled during March 2014. The requirement to fill these vacancies is a result of our existing staff being fully utilised in responding to increased levels of health and safety requirements, increased price-quality/information disclosure regulation requirements and to develop the relevant skills set within the business to provide succession planning in key engineering roles.

14. It would be helpful for the Commission to remain mindful of step changes that EDBs may be indicating prior to 1 April 2015, and to enable EDBs to submit anticipated step changes within the 2014/15 year under a Director certification process.

15. We acknowledge the comments made by Frontier Economics in working with the ENA forecasting working group on the appropriateness of using network length and number of users as proxies for network scale.

16. The Commission has noted the partial productivity component for calculating operating expenditure will be the subject of Economics Insights analysis, and that further consultation will be held.

17. For the November 2012 reset changes in input prices were derived using weighted average forecasts of changes in all industries labour cost index and all industries producer price index.

18. We note and support the comments made by the ENA and Frontier Economics of the merits of exploring other options for changes in input prices, including the use of sub-indices more closely linked with the electricity distribution sector. And that the use of forecasts from different sources may reduce forecasting errors.

3. Forecasting Capital Expenditure

19. The Commission noted in November 2012 of the potential incentive for EDBs to inflate capital expenditure forecasts to position a more favourable starting price outcome. While we accept there is the ability for EDBs to inflate forecasts, it is not in the EDB's interests to inflate forecasts simply to improve returns as in almost all cases the very consumers who are asked to pay for investments on the network are the ultimate beneficiaries of any dividends and or rebates.

20. As the Commission is aware EDB's know their respective businesses well, with published forecasts being the outcome of careful planning with the benefit of applied local knowledge, these bottom up characteristics to forecasting are at risk of being dismissed in favour of a top down approach to forecasting.

21. We submit that the Commission could look to adopt a mechanism that reviews EDBs forecasts in comparison to actuals over a period of time. This could then provide the requisite comfort that EDB forecasts are being reasonably stated and therefore use of these forecasts for modelling current and project profitability will not be quite as problematic. This approach will need to gestate during this upcoming reset process due to the lack of historical disclosures under the Electricity Distribution Information Disclosure Determination 2012, but could be considered by the Commission for future price resets.

22. We do not support the Commission's mention in the use of average historic expenditure inflated on a percentage allowance for categories such as asset replacement and renewal, system growth, and reliability, safety and environment categories. In many cases the expenditure historical profile will not necessarily reflect the required future profile.

23. We support the Commission's mention of the use of detailed category specific models to forecast asset replacement and renewal, system growth, and reliability, safety and environment capital expenditure. These models could be used for a reasonableness check of EDB forecasts, and again provide the Commission with comfort on the use of EDB forecasts in the longer term. For other categories of capital expenditure, including non-network, we suggest the Commission could use EDB forecasts with a cap of 45% above historic expenditure.

24. We support the ENA submission that depreciation rates for non-network assets should be less than the 45 year period stated in the Default Price-Quality Path Input Methodology. We suggest a period of 5 years for non-network assets is consistent with the shorter life of these asset categories such as IT hardware/software, motor vehicles, and fixture and fittings.

25. In terms of availability of data for the detailed category specific models, it is recognised that while EDBs are continuing with improvements to systems for disclosure under the Electricity Distribution Information Disclosure Determination 2012, the robustness of asset age information may be problematic, as evidenced within the 2012/13 disclosures by the percentage of assets with ages unknown.

26. In the absence of reliable asset age information, condition based assessment could be used, where available, however standardisation would be required across all EDBs to enable consistent use of assessment information. This will happen over time and as such reinforces the need to keep EDB's forecasts in focus for modelling of current and projected profitability for this upcoming price reset, whilst concurrently developing the appropriate models that could be used in future resets.

27. In terms of the expected life of network assets, the Weibull distribution was developed in use of fatigue testing, and is generally considered to better represent remaining asset life than the normal distribution, which may under-estimate failure rates.

28. We believe the use of overseas data should be approached with caution, requiring interpretation within the context of a relatively small New Zealand sector, and the further attributing of specific factors such as location and micro cost drivers.

29. The risk of using inflation-adjusted unit cost from the optimised deprival value handbook is that these values will significantly under-estimate replacement cost.

30. We suggest the Commission's comment on the application of an age-based survivor model in the absence of unit cost data should be approached with caution, with EDB's existing asset management policies not entirely governed by age-only based decision making framework.

31. We support the Commission's investigation into the use of age-based survivor modelling, with the noted concerns as mentioned above regarding availability of suitable data and the necessary time to develop robust models.

4. Incentives for service quality

32. We acknowledge the ENA quality working group and the Commission's attendance and involvement in the process to assess the current quality regime in keeping with the purpose of Part 4 being; to provide incentives to improve efficiency and provide services at a quality that reflects consumer demands.

33. We understand the Commission is considering potential changes to the quality regime such as adopting an incentive scheme under s53M(2) of the Act.

34. We support the Commission's introduction of a revenue-linked quality incentive scheme, however suggest the Commission consider a band around the target where rewards or penalties are available, or alternatively a mechanism that allows for setting off rewards and penalties over the regulatory period. This would provide further certainty in that EDBs could evaluate the potential ability to maintain quality standards within a set band, and therefore have further certainty around revenue and returns.

35. When looking to set reliability targets for the upcoming regulatory period, we submit at this early stage the reward/penalty mechanism should be split 50/50 across the SAIDI and SAIFI measures, with five year historical data being used to calculate limits for the band. In addition we advocate for the use of planned and unplanned interruptions, with planned interruptions gaining a lower rating.

36. We suggest an introduction of revenue at symmetrical risk/reward be phased in to enable EDBs a period of time to adjust, starting at a capped 1% of revenue in year 1 with a possible movement to a capped 2% of revenue in year 5.

37. Due to the above mechanism, there should not be need for further enforcement action if reliability performance is consistently low, due to the penalties that will be borne by the EDB.

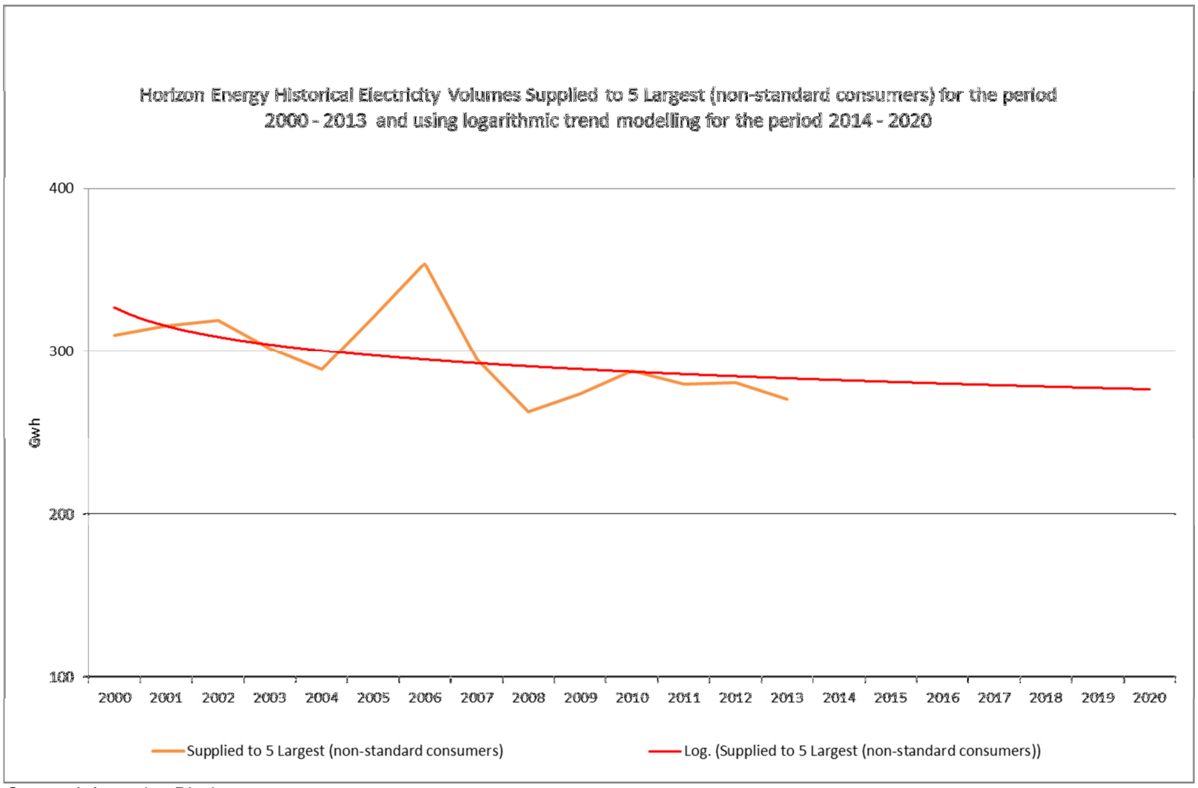
5. Forecasting Revenue Growth

38. The process and issues paper has mention of the Commission's intention to retain the November 2012 approach to forecast revenue growth, and invites views of any issues with the approach used previously.

39. We support the previous approach but advocate for a separation in the use of real GDP forecasts as a driver in constant price revenue for commercial and industrial users.

40. We submit that the constant price revenue in electricity supplied to industrial users does not correlate to real GDP forecasts. An example of this was the 2012 announcement from Norske Skog that the Kawerau mill halved newsprint production. This despite the Commission's real regional GDP forecasts for the Bay of Plenty of 1.6%, 1.8%, and 2% for 2013, 2014, and 2015 respectively. Industrial users present a different consumption profile, uncorrelated with real GDP forecasts, and should therefore be treated separately from commercial users.

41. In terms of an approach for calculating the change in constant price revenue for industrial users applicable to all EDBs. The use of disclosed non-standard consumers billed quantities under the Electricity Distribution Information Disclosure Determination 2012 and the 5 largest connection points based on electricity supplied under the Electricity Distribution (Information Disclosure) Requirements 2008 would enable an extrapolation of historical quantities to be completed, as shown below.



Source: Information Disclosure

6. Treatment of Uncertainty and Risk

42. In terms of uncertainty created within the price reset process, while it is acknowledged the Commission has set about providing increased transparency as part of the consultation process for resetting prices at 1 April 2015, there remains significant uncertainty for EDBs to contend with.

43. Fundamentally uncertainty rests with the setting of starting prices under s53P(3)(a) and (b) of the Act, with the outcome resting only on the Commission's final determination.

44. We submit for the Commission to provide guidance of the outcome within the draft determination in June 2014 to make EDBs aware of the potential that despite the ongoing consultation process and modelling of EDB's current and project profitability, prices may simply be rolled over.

45. The Commission is seeking views on uncertainty associated with forecasts of revenue and expenditure, where we suggest uncertainty is two-fold. Firstly due to the ongoing refinement in approach the Commission is proposing to apply for modelling of EDB's current and project profitability, and secondly with the variability in the forecast drivers. Further uncertainty has been introduced with the consultation on the Cost of Capital Input Methodology, for which we reiterate again that we are strongly opposed to a review of the Cost of Capital Input Methodology at this time.

46. To mitigate some of the uncertainty we encourage the Commission to publish the constant price revenue and projections models to enable EDBs to get familiar with the mechanics of the models, similar to the release of the reset model. Further workshops would be useful to facilitate a questions and answers discussion on these models.

47. Overall we are supportive of the comments within section 6 of the ENA submission proposing solutions to forecasting and compliance risk. Specifically we agree with the comments that EDBs, in an effort to avoid breaching the price path, are intentionally pricing below allowable notional revenue when setting prices, thereby not earning a normal return along the price path.

48. We support the ENA view to share risk with consumers, where the mitigation of the risk is largely outside of the EDBs control, and in the case of catastrophic events support the reopening of the DPP for this purpose.

49. We note it will be helpful when the Commission develops enforcement guidelines specific to Part 4 as this will provide further certainty for EDBs.

50. Thank you for considering this submission. Please find contact details below to discuss any of these matters further.

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