



From the Electricity Networks Association

Submission on the further amendments to input methodologies for electricity distributors subject to price-quality regulation

Incremental Rolling Incentive Scheme

20 March 2015

The Electricity Networks Association makes this submission along with the explicit support of its members subject to price-quality regulation, listed below.

Alpine Energy Ltd
Aurora Energy Ltd
Centralines Ltd
Eastland Network Ltd
EA Networks Ltd
Electricity Invercargill Ltd
Horizon Energy Distribution Ltd
Nelson Electricity Ltd
Network Tasman Ltd
Orion New Zealand Ltd
OtagoNet Joint Venture
Powerco Ltd
The Lines Company Ltd
Top Energy Ltd
Unison Networks Ltd
Vector Ltd
Wellington Electricity Lines Ltd

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1. Introduction

1. This submission addresses the proposals set out in the Consultation Paper¹ and accompanying Draft IRIS IM Determination².
2. The Electricity Networks Association (ENA) appreciates the opportunity to submit to the Commerce Commission (the Commission) on these papers. The ENA represents the 29 electricity network businesses (ENBs) in New Zealand.
3. This submission is consistent with, and builds on, comments we made in our earlier submissions on the Incremental Rolling Incentive Scheme³ (IRIS) Input Methodology (IM) proposals. We appreciate the consideration that has been given to our previous submissions in this regard.
4. In this submission we firstly consider the proposed amendments to the opex IRIS scheme and in particular the specification of the ‘adjustment factors’ which are intended to give effect to the policy intent of the opex IRIS. We also consider and comment on the detailed drafting of the proposed amendments to the IRIS IM.
5. The ENA’s contact person for this submission is:

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¹ Commerce Commission, How we propose to implement further amendments to input methodologies for electricity distributors subject to price-quality regulation – Incremental Rolling Incentive Scheme, 27 February 2015

² Commerce Commission, Draft Electricity Distribution Services (Incremental Rolling Incentive Scheme) Input Methodology Amendments Determination 2015, 27 February 2015

³ Dated 15 September 2014 and 31 October 2015

2. Incremental Rolling Incentive Scheme

6. In our 2014 submissions on the IRIS IM we focussed on the capex and opex incentives to apply to ENBs subject to Default Price-Quality Paths (DPPs). At the time the DPP IRIS IM was finalised, we understood that the Commission was further developing the proposed opex incentive scheme to apply when ENBs are subject to Customised Price-Quality Paths (CPPs). The capex IRIS, which was introduced in November 2014 (alongside the DPP opex IRIS) applies under both circumstances.
7. Accordingly the Consultation Paper now proposes further amendments to the opex IRIS. These are intended to address situations where an ENB transitions between DPPs and CPPs.
8. The ENA supports the intent that the proposed amendments will not apply to Orion New Zealand under its current CPP.

2.1 Policy intent

9. We understand that the policy intent of the proposed opex IRIS scheme includes:
 - a) Incentives to control opex which are the same in each year of a regulatory period;
 - b) Symmetric incentives;
 - c) A recoverable cost which reflects the net incremental change in opex carried forward from earlier years when the opex savings/losses are made; and
 - d) A retention period of five years following the year of gain/loss, which is equivalent to a retention factor of approximately 35% for ENBs.
10. The ENA supports the introduction of incentives for opex efficiencies, and as previously stated, agrees that incentives to make cost efficiencies should be consistent over time. In this respect, and as previously submitted, the ENA supports a 5 year retention period after the year of a saving in opex and a shorter period for overspend. This asymmetry reflects the approximate nature of the Commission's DPP forecasting approach and strengthens the incentive to reveal where the true costs are lower than the forecast, but does not impose an equivalently strong penalty where the ENB's true costs are higher than the Commission's forecast.
11. The ENA also supports the intent for the opex incentive to be specified as an IM. As incentive schemes operate over more than one regulatory period, the IRIS must be predictable and stable in order for the appropriate incentives for opex efficiencies to exist and operate as intended. This is consistent with the purpose of IMs which is to provide regulatory certainty.

2.2 Inadequate DPP expenditure forecasts

12. One of the key reasons that an ENB may apply for a CPP is that the expenditure forecasts which underpin a DPP price path are inadequate. It is critical for the effective performance of Part 4 of the Commerce Act that the DPP/CPP framework operates as intended. There is inevitably a delay in an ENB obtaining a CPP to remedy inadequate expenditure forecasts in a DPP.
13. The proposed IRIS IM does not adequately accommodate these circumstances as, for the purpose of the IRIS, the Commission's DPP opex and capex forecasts provide the baseline against which the IRIS incentive is assessed, until a CPP comes into effect. Thus an ENB will be penalised for expenditure which exceeds the baseline, even when it has legitimate reasons for doing so, which are subsequently endorsed via a CPP Determination.
14. As we have previously submitted the IRIS baseline forecast opex should be adjusted in these circumstances, to reflect the expenditure required by the ENB prior to a CPP coming into effect, which was not reflected in the Commission's DPP forecasts for the regulatory period.

2.3 Regulatory framework

2.3.1 DPPs and CPPs

15. The DPP/CPP regulatory framework applying to non-exempt ENBs creates practical complexity which needs to be accommodated in the design of a multi period opex incentive. In particular, the features which must be addressed include:
 - a) The range of methods which can be employed to set opex allowances in price paths (including with reference to current and projected profitability via starting price adjustments (SPA), rolling over existing prices, by applying the CPP IMs, and at the end of a CPP by rolling over prices or using any other method the Commission may deem to be appropriate as per section 53X(2) of Part 4 of the Commerce Act;
 - b) Regulatory periods of different durations, including very short regulatory periods which arise due to transitions between CPPs and DPPs, and the option of electing 3, 4 or 5 year CPPs;
 - c) Information requirements at the time ENBs are finalising their prices prior to the beginning of a pricing year; and
 - d) Information constraints at the time prices are set at the beginning of a new regulatory period.
16. In order to address the final point, a nil carry forward amount is used in the final year of the regulatory period, with a subsequent 'adjustment' in year 2 of the next regulatory period to allow for the incremental change in opex which occurred in the final year of the preceding period. This is consistent with the Australian Energy Regulator's (AER's) approach.

17. As the consultation on the opex IRIS has proceeded it has become apparent that a number of adjustment terms are required in order to address the range of circumstances outlined in paragraph 12 above, while giving effect to the policy intent.

2.3.2 The adjustment terms

18. The Consultation Paper explains how the adjustment terms are dependent on the situation which applies, and six generic scenarios are presented in Table 2.1 of the Consultation Paper by way of illustration. Of these, three ‘standard’ scenarios are identified, and in addition, three ‘non-standard’ scenarios where a DPP or CPP period is less than two years duration. The ENA agrees that all of the scenarios presented are plausible.
19. In Table 2.2, the Consultation Paper maps 12 different adjustment terms to each of the six scenarios. This demonstrates which terms apply under which set of circumstances.
20. The most simple scenario is a continuing five yearly DPP, where prices are reset using a SPA. The ‘base year adjustment term’ is the only adjustment required in this instance. The alternative DPP reset scenario where prices are rolled over uses the ‘base year adjustment term’ plus a ‘roll over adjustment term’. Both of these terms were consulted on last year and introduced in the IRIS IM in November 2014.
21. The proposed IRIS IM amendments include additional opex adjustment terms for:
 - a) *Standard case CPP (Clause 3.3.4(3))* – which requires a new ‘baseline adjustment term’ in addition to the existing ‘base year adjustment term’;
 - b) *Special case DPP following a single starting price year (Clause 3.3.4(4))* – which requires three new adjustment terms in addition to the ‘base year’ and ‘roll-over’ adjustment terms which already exist;
 - c) *Special case CPP following a single starting price year (Clause 3.3.4(5))* – which requires three additional adjustment terms in addition to the ‘base year adjustment term’ which already exists and the new ‘baseline adjustment term’ to be introduced for standard case CPPs; and
 - d) *Special case CPP following two consecutive starting price years (Clause 3.3.4(6))* – which requires six additional adjustment terms in addition to the new ‘baseline adjustment term’ to be introduced for standard case CPPs.
22. The large number of terms reflects the fact that the adjustments have been unpacked into single steps. We support this approach because we consider that it is easier to understand than an alternative approach which combines individual steps into more complex, aggregated adjustment terms. We expect that each of these terms will be explained in detail in the decision papers which accompany any amended IRIS IM determination.
23. We also note and support the intention for the Commission to provide ENBs with spread sheet versions of the IRIS IM clauses which are relevant to their circumstances, including the formulae necessary to calculate the values of the applicable adjustment terms.

2.4 Baseline adjustment term

2.4.1 Commission to determine value

24. The Consultation Paper raises a specific matter for consultation. Chapter 3 of the Consultation Paper focuses on the arrangements when an ENB transitions from a DPP onto a CPP. In these circumstances the 'baseline adjustment term' is to be applied.
25. The purpose of this term is to re-establish the link between opex allowances under a DPP and a CPP. Previous versions of this formula have been proven to be unstable and therefore inconsistent with the objective of achieving a 35% retention factor (as described in paragraphs 3.4 to 3.6 of the Consultation Paper).
26. Accordingly it is now proposed that the Commission will determine the value of the baseline adjustment term on a case by case basis, after having regard to the views of interested persons. It is proposed that this will occur at the time a CPP is determined.
27. The objective of the adjustment is to identify the value of temporary or non-recurring opex variances (ie: differences between forecast and actual opex) in the penultimate year of the preceding regulatory period. The Consultation Paper suggests that some judgement will be required in this regard.
28. The ENA has serious concerns about this proposed approach because we consider it is inconsistent with the objective of IMs (which is to provide regulatory certainty). Without certainty, the incentive properties of the IRIS are undermined. We also note that this proposal increases the uncertainties facing ENBs when deciding whether to apply for a CPP. The section 52A purpose of Part 4 will not be met if ENBs are discouraged from applying for a CPP in situations where it may be in the long term interests of their consumers for alternative price or quality standards to apply to them.

2.4.2 Proposed method

29. The ENA is particularly concerned that the Consultation Paper proposes a method for assessing the value of the baseline adjustment term which does not appear to be able to distinguish between temporary and permanent opex variances in the penultimate year of the preceding regulatory period. For example, paragraph 3.11 of the Consultation Paper states that:

This approach relies on the fact that the difference between the forecast for the default price-quality path, and the forecast for the customised price-quality path, is the result of a distortion introduced by any non-recurrent differences between forecast and actual expenditure in the penultimate year of the preceding regulatory period.

30. We do not believe this is a reasonable assumption when an ENB moves from a DPP to a CPP. The driver for a CPP is most likely to be a change in circumstances which cannot be accommodated by a DPP. This can be expected to require a step change in expenditure to address business specific circumstances (as demonstrated by Orion New Zealand in applying for increased expenditure allowances via a CPP, to address the consequences of the Canterbury earthquakes). It is likely, as it was in Orion's case, that the step will occur (at least in part) prior to the CPP coming into effect. We consider

that it is more likely that variances between actual and forecast opex prior to a CPP are more likely to reflect temporary than permanent differences.

31. We also suggest that it is most likely that an opex variance will only be able to be assessed as temporary or permanent in due course ie: with the benefit of hindsight.
32. In addition we are also concerned that the proposed process requires this assessment to be made in the final year of the DPP - at the time the CPP is being determined. This will be in the period immediately following the penultimate year. We do not consider that there will be sufficient time to do this, given it is likely that actual opex for the penultimate year will not be known with certainty until partway through that year – and the CPP must be determined four months prior to it coming into effect (ie: by the end of November for a 1 April pricing year), after allowing for consultation.
33. We also note that the DPP opex allowance is determined using low cost forecasting methods which apply to all non-exempt ENBs, and which rely on industry and economy wide assumptions (when set with a SPA), or rolled over from previous periods. The DPP opex forecast is not granular, ie: it is generated at a total opex level, and therefore it is only at the total opex level that variances between actual and forecast opex can be calculated. This suggests that it may not be possible to break down the variance in the target year.
34. Further, the CPP opex allowance is determined using extremely disaggregated and ENB specific information (as specified in the CPP IM). Given the DPP price path setting options, we consider it may not be possible to establish a robust link between DPP and CPP opex allowances in practice.

2.4.3 Commission’s suggested approach

35. The Consultation Paper explains how the Commission may determine the baseline adjustment term (described in paragraph 3.10). In order to test the proposal we have attempted to model the suggested approach. A worked example is presented in Appendix 1. This shows that, using a plausible scenario⁴, the target 35% retention factor is not achieved.
36. Our example follows the standard case CPP scenario (Clause 3.3.4(3) of the draft IRIS IM Determination). Following the proposed method described in paragraph 3.10 of the Consultation Paper, we perform the following calculations:
 - a) First, we project the DPP opex forecast forward using the penultimate year of the first regulatory period as the base year, as per 3.10.1. (Refer row 3).
 - b) Second, we calculate the net present value (NPV) of the forecast opex described above as per 3.10.2. (Refer row 3).
 - c) Third, we calculate the NPV of a forecast of CPP opex for the second regulatory period, as per. 3.10.3. The CPP opex forecast exceeds the DPP opex forecast – which is a likely CPP scenario. (Refer row 2).

⁴ For simplicity we have assumed no input price escalation in the opex forecasts used in the worked example.

- d)* Fourth, we calculate the proposed baseline adjustment term by using Excel's goal seek function to equalise the NPV of the DPP and CPP opex forecasts, as per 3.10.4. (Refer rows 24 and 4).
- 37. Based on the calculations above the total savings for the first regulatory period are (\$3). The calculated benefit to the supplier is \$13 after the IRIS incentive impact is calculated through to the end of the second regulatory period, using the method proposed in paragraph 3.10. This outcome is not consistent with the target retention factor of 35%.
- 38. Accordingly we have concluded that the proposed method is not a suitable approach for determining the baseline adjustment term because it does not provide sufficient certainty, affords the Commission too much discretion, and may not always fulfil the policy intent.
- 39. Further, we do not support a 'Commission determined method' without firstly developing a proposed approach which can be applied consistent with the policy intent, with certainty. Given the short consultation period available, we have not been able to develop a suitable alternative proposal for the purpose of this submission.

2.5 Conclusions and recommendations

- 40. In conclusion the ENA supports:
 - a)* The introduction of incentives for opex efficiencies;
 - b)* The intent for the opex incentive to be specified as an IM which is consistent with the purpose of IMs which is to provide regulatory certainty;
 - c)* An approach to defining the adjustment terms as individual steps, which we consider is more usable than an alternative approach which combines individual steps into more complex, aggregated adjustment terms; and
 - d)* The intention for the Commission to provide ENBs with spread sheet versions of the IRIS IM clauses which are relevant to their circumstances, including the formulae necessary to calculate the values of the applicable adjustment terms.
- 41. The ENA however, recommends that the proposed amendments to the opex IRIS are deferred until a better solution for the adjustments required when transitioning from a DPP to a CPP can be developed. In particular:
 - a)* The ENA does not consider that the proposed method for assessing the baseline adjustment term described in paragraph 3.10 of the Consultation Paper will consistently generate outcomes which are consistent with the policy intent;
 - b)* We do not consider it is consistent with the intent of the IMs, or the intended operation of a CPP opex incentive, for the Commission to have complete discretion as to how it may determine the value of the baseline adjustment term;
 - c)* The ENA does not consider that the proposed consultation step adequately addresses this concern; and

- d)* As previously submitted, the ENA proposes that baseline forecasts are adjusted to reflect the expenditure required by the ENB prior to a CPP coming into effect, which was not reflected in the Commission's DPP forecasts for the regulatory period.
- 42. Accordingly we recommend that the proposed 'Commission determined method' is not implemented without firstly developing a method which can be applied consistent with the policy intent, with certainty.
- 43. Given the short consultation period available, we have not been able to develop a suitable alternative proposal for the purpose of this submission.

3. Determination Drafting

3.1 Technical review

44. We have reviewed the IM determination drafting and have confirmed that the drafting is consistent with the intent of the proposed amendments and the accompanying spread sheet, with one exception.

a) Clause 3.3.9(6) which defines the 'year 5 adjustment term' is defined as:

A 'year 5 forecast adjustment term' is calculated in accordance with the formula–

$$(\text{forecast opex}_{t-5} - \text{forecast opex}_{t-4})$$

×

$$((1/(1+WACC)^4) + 1/(1+WACC)^2 - 1/(1+WACC)^2)$$

b) The correct formula which is consistent with the spread sheet is:

$$(\text{forecast opex}_{t-5} - \text{forecast opex}_{t-4})$$

×

$$(1/(1+WACC)^4 + 1/(1+WACC)^2 - (1+WACC)^2)$$

45. In our 31 October 2014 submission we also highlighted issues with the previous version of the draft determination (refer Appendix 1). A number of our suggestions were responded to in the November 2014 determination however some of our suggestions appear to have been ignored. We continue to believe that improvements to the drafting could be made and encourage the Commission re-examine the draft determination in this respect.

3.2 Reducing complexity

46. In our 31 October 2014 submission we raised a number of observations about the complexity of the proposed IM and how this might be mitigated in the drafting. We appreciate the improvements that have been adopted by:

- a)* Ensuring all terms are labelled, and where possible using terms which reflect the purpose of the term;
- b)* Restructuring the IM by grouping related clauses together; and
- c)* Clarifying that irrespective of whether prices are adjusted (in accordance with section 53P(3)(b)) or rolled over at the start of a DPP (in accordance with section 53P(3)(a) or section 53X(2)), that it is expected that a baseline opex forecast will be determined by projecting forward an initial level of opex from a single year. We understand the intent is to replicate the SPA method for forecasting opex in non-SPA circumstances.

47. We note that section 53X(2) – which applies when a CPP comes to an end - also allows for starting prices to be reset any other way that the Commission may determine, after advising the supplier in question. It is therefore possible that at the end of a CPP, DPP price paths which are not set by rolling over CPP price paths may also not have an underlying opex forecast. We submit that the Commission will need to:
- a) Derive an opex forecast which underpins the price path so determined; or
 - b) Project forward an initial level of opex, where:
 - i. prices are rolled over; or
 - ii. determined using an alternative method which does not include an opex forecast.
48. We also consider that, as previously submitted, the draft IM could be further improved by:
- a) Ensuring consistent terminology throughout (eg: ‘opex’ or ‘operating expenditure’); and
 - b) Reviewing the use of the term ‘capex’ which in practice refers to ‘commissioned assets’ in the IRIS.
49. We also encourage the Commission to include in its final decision paper explanations for each component of the IRIS which are as descriptive as possible, ie: fully explain the purpose of each clause or term. There is little explanation in the Consultation Paper, but we expect more content will be included in the final decisions paper to assist interested persons to understand the methodology.

3.3 Conclusions and recommendations

50. The ENA:
- a) Acknowledges that a number of our previous suggestions for drafting improvements have been adopted in the IRIS IM;
 - b) Recommends that a formula error is corrected in Clause 3.3.9(6) which would align it with the spread sheet calculation;
 - c) Notes that there are non roll-over options for setting DPP prices at the end of a CPP, for which opex forecasts may need to be determined; and
 - d) Encourages the Commission to include in its final decision paper, explanations for each component of the IRIS which are as descriptive as possible, to aid understanding.

Appendix 1 - Baseline Adjustment Term Example

Scenario 3 (Standard case CPP, 3.3.4.(3) of the draft IRIS IM Determination)

Assumptions		DPP regulatory period					CPP regulatory period					PV
		P1	P2	P3	P4	P5	P6	P7	P8	P9	P10	
1	Period											
2	Forecast Opex - CPP	100	100	100	100	100	110	110	110	110	110	333
3	Forecast opex determined consistent with the approach used for setting default price-quality paths (3.10.1 & 3.10.2)				103	103	103	103	103	103	103	312
4	Forecast opex determined by adjusting an amount from the level of opex in the base year (3.10.3)				110	110	110	110	110	110	110	333
5	Actual Opex	100	100	100	103	100	110	110	110	110	110	
6	CPI	1.0%										
7	WACC	7.50%										

* PV represents the present value of the forecast opex in the CPP regulatory period.

8	Discount factor	1.0	0.9	0.9	0.8	0.7	0.7	0.6	0.6	0.6	0.5	
9	Actual Opex	100	100	100	103	100	110	110	110	110	110	
10	Forecast Opex	100	100	100	100	100	110	110	110	110	110	
11	Amount carried forward in the first disclosure year	-					-					
12	Amount carried forward in all but the first or last disclosure years		-	-	(3)			-	-	-		
13	Amount carried forward in the last disclosure year					-						-
14												
15	Amount carried forward from year 1		-	-	-	-	-	-	-	-		
16	Amount carried forward from year 2			-	-	-	-	-	-	-		
17	Amount carried forward from year 3				-	-	-	-	-	-		
18	Amount carried forward from year 4					(3)	(3)	(3)	(3)	(3)		
19	Amount carried forward from year 5						-	-	-	-	-	
	Amounts carried forward						(3)	(3)	(3)	(3)	(3)	-
	Adjustment to the opex incentive (cl 3.3.2(2)(b))											
20	Base year adjustment term (cl 3.3.5)											(2)
21	Baseline adjustment term (cl 3.3.7)											38
	Total adjustment terms											36
	Opex incentive amount						(3)	33	(3)	(3)	(3)	-
22	Total Saving	-	-	-	(3)	-						
23	Benefit for supplier	-	-	-	(3)	-	(3)	33	(3)	(3)	(3)	-
	Baseline adjustment term calculation											
24	Non recurrent difference (3.10 of the Consultation Paper)				(7)							

Summary			
25	Total Savings	(2)	(calculated as a function of row 22 and row 8)
26	Net benefit to suppliers (NPV as at 31 March 2020)	13	(calculated as a function of row 23 and row 8)
27	% of benefit retained	(547%)	