Date:

28 September 2016

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Industry/area of interest:

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Default price-quality paths for gas pipeline services from 1 October 2017

Final

Submission to the Commerce Commission

From the Electricity Networks Association

Contents

1. Introduction

1. The Electricity Networks Association (**ENA**) appreciates the opportunity to make a submission to the Commerce Commission (**Commission**) in respect of the *'Policy for setting price paths and quality standards for Default price-quality paths for gas pipeline services from 1 October 2017'* **(policy paper),** published by the Commission on 30 August 2016. This submission responds to the proposed approach to setting opex and capex forecasts, as set out in the policy paper, and further described in the accompanying papers:

    - Strata Energy Consulting, *Low cost review framework for gas pipeline expenditure – Proposed Framework and Methodology*, 29 August 2016, (**Strata methodology paper)**
    - Strata Energy Consulting, *Low cost review framework for gas pipeline expenditure – Pilot Study Report,* 29 August 2016 (**Strata pilot study)**.

2. The ENA represents all of New Zealand's 29 electricity distribution businesses (**EDBs**) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB's network) electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

3. The policy paper indicates that the Commission's work on setting opex and capex forecasts for the gas Default Price-Quality Path (**DPP**) may form part of its considerations for the 2019 EDB DPP reset. Accordingly, this submission primarily considers the proposed approach to setting opex and capex forecasts for DPPs in the context of the 2019 reset for non-exempt EDBs.

2. Submission summary

4. The ENA supports in principle the use of suppliers' own expenditure forecasts when setting DPP capex and opex allowances. At this time, ENA members have not considered in detail how such an approach could be applied at the next EDB DPP reset.

5. We make the following initial observations about the proposals:

    - the ENA supports the application of the proportionate scrutiny objective, and the development of specific criteria against which supplier expenditure forecasts are assessed
    - we are concerned that the proposed approach does not adequately reflect the default or low cost nature of the DPP, as it introduces features which are more appropriate for customised price-quality paths (**CPPs**)

- it is suggested that expenditure allowances may be set as ‘stretch targets’ in order to drive efficiencies into DPP price paths. We do not consider that this is consistent with the Part 4 purpose statement, or the expenditure objective which has been proposed
- a major concern is the scope for significant judgement to be applied by the Commission in its assessments of each supplier’s forecast expenditure and we recommend that further consideration is given to reducing discretion in determining Business as Usual (**BAU**) allowances and introducing default allowances
- it is implied that the assessment framework may become embedded into the broader regulatory regime via Asset Management Plans (**AMPs**). It is our initial view that this would not be appropriate for EDBs, without substantial refinements to the proposed framework.

6. The ENA looks forward to working further with the Commission as it turns its attention to developing an approach for determining EDB capex and opex allowances for the next regulatory period.

3. Proposed approach

7. The policy paper proposes greater use of supplier forecasts of capex and opex for setting expenditure allowances than has been applied in previous DPP Decisions. This approach involves:

   - Specifying an expenditure objective – to be based on the CPP expenditure objective which is specified in the Input Methodologies (**IMs**); and
   - Implementing an assessment framework which leverages existing information disclosures (**IDs**), and applies a proportionate level of scrutiny to aspects of suppliers’ expenditure forecasts, using an escalating quantitative and qualitative assessment process.[1]

Assessment framework

8. A core component of the proposal is the assessment framework, which is expected to comprise five stages as follows:

   i. Compliance – checking that the ID capex and opex forecast information for each supplier fully complies with the requirements of the ID Determination
   ii. BAU variance check – quantitative estimates of BAU and non-BAU expenditure forecasts, to be derived from metrics and ratios which focus on supplier forecasting accuracy and cost drivers; and supplemented by step and trend analysis of opex
   iii. AMP scrutiny – qualitative assessment of supplier AMPs to determine whether there is sufficient support for non-BAU expenditure, with reference to the expenditure objective

[1] Policy paper, paragraphs 3.14 – 3.16

iv. Supplier scrutiny – suppliers provide additional information in support for non-BAU expenditure forecasts where AMP information is deemed to be insufficient; this additional information is then qualitatively assessed with reference to the expenditure objective

v. Decision – this stage has three possible outcomes:

- Allowable expenditure – forecast expenditure meets the expenditure objective and is included in the DPP expenditure allowances
- Excluded expenditure – forecast expenditure is deemed insufficiently prudent following scrutiny, and a fall-back option is applied in determining the DPP expenditure allowances. We note that fall-back options have not yet been developed, however it is intended they will fall at the lower end of the range of possible outcomes which align with the expenditure objective[2]
- CPP recommendation – forecast expenditure is excluded and the Commission recommends that the supplier makes a CPP application.

Legislative objectives

9. The policy paper explains that this proposal is consistent with the Commerce Act, Part 4 legislative framework because:

- The DPP is not intended to be mechanistic, ie: it is not required to be a 'one size fits all' approach and therefore the Commission is able to be flexible, and tailor its approach to individual suppliers
- It is a 'relatively low cost' approach, consistent with the level of cost and scrutiny proportionate and commensurate with the intent of the regime, with reference to the higher cost CPP alternative
- Applying additional scrutiny to BAU expenditure, is consistent with the proportionate scrutiny principle
- It incentivises suppliers to improve efficiency, by placing downward pressure on supplier forecasts
- It is able to be applied to all GPBs
- Is transparent, as it is intended that the Commission's assessments of supplier forecasts will be published.

10. In the remainder of this submission we comment on the proposed approach and the assessment framework, from the viewpoint of the next EDB DPP reset.

[2] Policy paper, paragraph 3.119

4. Application to EDB DPPs

11. In principle, the ENA supports the use of suppliers' own expenditure forecasts when setting DPP capex and opex allowances. The ENA has previously advocated for more use of AMP forecasts when developing regulatory price paths.[3]

12. At this time, ENA members have not considered in detail how such an approach could be applied at the next EDB DPP reset. However, we support further investigation of it prior to 1 April 2019, when the next DPP comes into effect. In principle the ENA supports an approach which involves less scrutiny on expenditure forecasts which are in line with historical levels and trends, and more scrutiny where expenditure forecasts deviate from expected trends. This is consistent with the proportionate scrutiny objective.

13. We note that there are differences between EDBs and GPBs that need to be considered, including the number of regulated suppliers, the scale of regulated services, the nature of the markets in which they operate, and the design of the regulatory framework, for example the Incremental Rolling Incentive Scheme (**IRIS**) which applies to non-exempt EDBs.

Expenditure objective

14. The ENA supports the development of specific criteria against which supplier expenditure forecasts are assessed. We question however, whether it is appropriate to adopt the CPP expenditure objective for DPPs as proposed, given the more extensive assessment of expenditure forecasts to be undertaken for CPPs. We suggest that it may be more appropriate to develop a DPP objective or criteria, which better reflect the low cost, 'default' characteristics of the DPP.

Incentives and low expenditure allowances

15. We note that in order for the incentive objectives of the regime to operate effectively, EDBs must have sufficient incentives to seek out efficiencies within and between regulatory periods, and sufficient expenditure allowances to enable them to meet their quality standards and other legislative and regulatory obligations.

16. The proposed expenditure objective appropriately recognises the need for suppliers to meet their obligations. However, we note that the commentary in the policy paper, and the examples provided in the Strata papers suggest that in practice the proposed approach may establish 'low' expenditure allowances, and these will create efficiency incentives. For example:

> *'If potentially systematic issues in the forecast are found, then it may be necessary to reject the entire expenditure forecast. In this case the Commission wold need to establish an alternative method for calculating the DPP (e.g. consider the lowest actual year to represent efficient costs and use this value for future years)'*[4]

[3] For example: ENA, Submission on default price-quality paths from 1 April 2015 for 17 electricity distributors: process and issues paper, 30 April 2014, para 32

[4] Strata methodology paper, para 30

'We think the framework should create downward pressure on suppliers' forecasts, incentivising accurate, well supported forecasting earlier in the process'[5]

'However, due to the contingent nature of growth capital expenditure, we expect that this may be an area of a supplier's forecast that is harder to justify, and therefore may experience exclusion of a proportionately higher level of its forecast expenditure'[6]

17. While we acknowledge the GPB IMs do not include a DPP IRIS, we are concerned at the suggestions that expenditure allowances may in fact be set as 'stretch targets' in order to drive efficiencies into DPP price paths. We do not consider that this is consistent with the Part 4 purpose statement, or the expenditure objective which has been proposed.

18. Using the lowest actual year to represent efficient costs is likely to under represent expenditure requirements – there will always be years of unusually high or low expenditure requirements and these extremes are generally not good guides to a reasonable level of expenditure.

19. We also note that the DPP quality standards and price path decisions must be aligned. For example, it is not appropriate for quality standards to reflect historical averages, and expenditure allowances to reflect 'low' expenditure years.

DPPs and CPPs

20. The ENA is also concerned that the proposed approach has the potential to become more like a CPP assessment of expenditure than is intended by the regulatory framework. As a consequence, the method would not be consistent with the 'low cost' intent of a DPP. We question whether the cost of the CPP alternative is the correct benchmark against which to determine low cost (as proposed), as this is by definition a very high cost threshold. We suggest that a more appropriate benchmark is the status quo approach.

21. We note that the proposed assessment method places some weight on methods employed in other jurisdictions where regulators undertake detailed supplier specific expenditure evaluations.[7] However, these regulatory models are more aligned with CPPs, not DPPs and therefore should not form the basis of the assessment approach for the DPP.

22. A major concern is the scope for significant judgement to be applied by the Commission in its assessments of each supplier's forecast expenditure. For example, the policy paper indicates that the Commission plans to retain discretion to scrutinise expenditure regardless of the materiality bounds set to determine BAU expenditure. (i.e. even where expenditure is below the BAU variance threshold, the Commission proposes that it will further scrutinise that expenditure)[8] We submit that this proposal may be suitable for CPPs, but it is not suitable for DPPs.

23. Accordingly, if an approach of this nature is applied when forecasting expenditures for the EDB DPP (which we do not have a view on at this stage), we submit that any assessment framework that is applied should be more mechanised than that which is currently proposed for GPBs, partly

[5] Policy paper, para 3.59

[6] Policy paper, para 3.61

[7] Strata methodology paper, para 51-52

[8] Policy paper, footnote 36

to accommodate the larger number of suppliers subject to the EDB DPP, but also to ensure that the costs and complexity of EDB DPPs are materially less than CPPs.

24. In this respect, the ENA recommends that:

- Opportunities for judgement are minimised and the proposed assessment process is simplified, and based on ID metrics and information which are familiar to EDBs
- Transparent and unbiased criteria are developed for establishing BAU and non-BAU expenditure. These are to be fit-for-purpose (ie: low cost) and preclude 'cherry picking' to achieve certain outcomes, including additional scrutiny.[9]
- Expenditure that is within the BAU boundaries should be accepted, without further scrutiny, and that this assessment is undertaken at the total opex and total capex level
- The Commission's expectations of information required to support non BAU expenditure are well articulated in advance (we include further comments on AMPs below), and alternative assessment methods are considered, for example compliance with ISO 55000
- Reasonable default options are specified in advance; these would be available should suppliers not wish to participate further during the scrutiny phases
- The recommendation for a CPP outcome is removed as it is not required for specifying DPP price-quality paths and it is not appropriate for the Commission to formally recommend suppliers make a CPP application.

AMPs

25. It is suggested on the one hand that AMPs will need to include additional information in them[10], and elsewhere that there will be sufficient qualitative information in AMPs to support expenditure forecasts.[11]

26. We note that AMPs are forward looking, however the proposed assessment framework is heavily influenced by historical expenditure levels. To date this has not been a significant focus of EDB AMPs. Accordingly, we suggest that existing EDB AMPs may not adequately justify forecast expenditure with reference to BAU thresholds. Also, this may be difficult to achieve in practice as the proposed method to determine the BAU thresholds is subjective.

27. The proposal may therefore impose additional compliance cost on all EDBs as they seek to provide more information in their AMPs to answer potential questions about their expenditure forecasts. It also implies the assessment framework may become embedded into the broader regulatory regime. It is our initial view that this would not be appropriate for EDBs, without substantial refinements to the framework.

28. The suggestion that further information will be required in AMPs also introduces some regulatory ambiguity, because the consultation papers do not address how it aligns with the existing ID

[9] For example, by defaulting to the lowest historical expenditure year for each expenditure category.

[10] Strata methodology paper (paras 46-47)

[11] Policy paper, para 3.104

requirements for AMPs, and whether and how AMP Updates will be assessed as part of the proposed framework. In addition, the papers do not address how this potential change to AMP requirements may influence the compliance review to be undertaken during the first phase of the assessment.

29. Finally, the consultation papers suggest that suppliers will have business cases and board papers to support their AMP expenditure forecasts, and that these would be expected to be available for the supplier scrutiny stage[12]. We note that AMPs are planning documents which are updated regularly, and, as acknowledged in the ID Determination, the plans are expected to be more comprehensive for the beginning of the planning period, than the later years.[13] This feature of the AMPs disclosed under Part 4 requirements does not appear to have been adequately recognised in this proposal.

[12] Policy paper, para 3.110

[13] Electricity Distribution Information Disclosure Determination 2012, Attachment A, refer for example: para 11.9 (for development plans) and para 12.3 (for asset replacement and renewal plans)

5. Appendix

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

Alpine Energy

Aurora Energy

Buller Electricity

Counties Power

Eastland Network

Electra

EA Networks

Horizon Energy Distribution

Mainpower NZ

Marlborough Lines

Nelson Electricity

Network Tasman

Network Waitaki

Northpower

Orion New Zealand

Powerco

PowerNet

Scanpower

The Lines Company

Top Energy

Unison Networks

Vector

Waipa Networks

WEL Networks

Wellington Electricity Lines

Westpower