Feedback

Commerce Commission Part 4 Input Methodologies Review 2022

Feedback on the IRIS equivalence staff discussion paper

6 December 2022

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1. Introduction

1. Aurora Energy Limited (Aurora) welcomes the opportunity to submit its views on the Commerce Commission's (the Commission's) "IRIS equivalence staff discussion paper".

2. No part of our submission is confidential.

3. The Incremental Rolling Incentive Scheme (IRIS) mechanism is highly complicated and specialised, and is underpinned by complex financial modelling. For a variety of reasons, we have been unable to procure expert advice that would have been required to provide a more fulsome submission on the IRIS equivalence paper. Although we have confined our feedback to the high-level, we trust that it will still be useful.

4. We look forward to providing more detailed comments on expenditure incentives in future consultation opportunities as the input methodologies (IM) review progresses.

2. General Comments

2.1. Effective incentive mechanisms acknowledge dependencies

5. Recent workshops held by the Commission on '*Forecasting and incentivising efficient expenditure for EDBs*' and '*Price-quality path in-period adjustment mechanisms*' have highlighted the interrelated nature of expenditure forecasting, re-openers, and expenditure incentives. For expenditure incentives to work effectively, forecasts need to be appropriate and re-opener mechanisms need to adequately deal with uncertainties.

6. In Aurora's view, the integrity of the IRIS mechanism is heavily dependent on two factors:

   6.1. the expenditure allowances upon which the IRIS acts must be reflective of each EDB's reasonably anticipated needs (receiving rewards, or incurring penalties, based on forecast inadequacy doesn't inspire confidence that the mechanism acts as an expenditure efficiency incentive); and

   6.2. the IRIS mechanism must support equivalent opex/capex substitution, with the penalties and rewards from substitution neutralising each other. Even if the allowances are inadequate, substitution should leave the EDB no worse off.

7. Expenditure allowances have generally been set with an historic bias:

   7.1. Opex allowances have been set using an historic 'base', adjusted for anticipated 'steps' (which to-date have largely reflected the mechanical consequences of changes to the price-quality regime and accounting standards[1]) and, finally, adjusted for growth 'trends' that impact network operational costs[2] (base-step-trend approach);

   7.2. Capex allowances have been set using EDB forecasts, but constrained with reference to medium-term (7-year) historical average expenditure, both by expenditure category and overall expenditure.

8. Many submitters to the Commission's process & issues paper were of the view that historically-based constraints on expenditure allowances were unlikely to lead to EDBs supporting decarbonisation-driven electrification of the economy effectively. Decarbonisation is likely to require greater levels of expenditure than historically; albeit that there is uncertainty as to the timing of some of these investments.

9. Default price-quality (DPP) regulation is a 'relatively low-cost' regime[3] and, in the past, application of the 'relatively low-cost' principle has led to a 'one-size-fits-all' approach to expenditure forecasting whereby the specific needs of individual EDBs have not been considered. Historically, this appears to have worked reasonably well in practice, with most EDBs able to live with the expenditure allowances that were set for

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1 Commerce Commission. (2019). Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision: Reasons paper. Paragraph A56, p 163

2 Ibid. Paragraphs A96-A98, p175.

3 Commerce Act 1986, section 53K.

them and 'cutting their cloth to suit', with only a small number of EDBs needing to seek high-cost customised price-quality paths (CPPs).

10. However, in light of the (1) increased investment requirements and (2) timing uncertainty that appears to characterise the decarbonisation journey over the next couple of regulatory periods, it's probable that relying on CPPs will be unworkable, not the least from a resourcing perspective.

11. In Aurora's view, there needs to be a recalibration of what 'relatively low-cost' means for expenditure setting. We acknowledge that the Commission has already commenced a workstream looking at improving forecasting adequacy, and intends commencing the DPP4 reset earlier than would otherwise occur, so that relevant issues can be considered in tandem with the IM review. Both of these actions will help with recalibration.

2.2. IRIS EQUIVALENCE SCENARIOS

12. We appreciate the effort that the Commission has taken to try and demonstrate the equivalence of the capex and opex IRIS.

13. As we noted earlier, however, the IRIS mechanism is very complex and, in our view, the unlikely nature of the explanatory scenarios offered is a barrier to better understanding. For example:

    13.1. In scenario 1, it's virtually impossible to visualise a situation where capex can be avoided (permanently deferred) by temporary (one-off) opex of equal value; and

    13.2. In scenario 2, where a deferral decision appears to be demonstrated, It's unlikely that the opex solution would have a finite 10-year life, without some other solution replacing it after that period.

14. Scenarios need to be realistic if IRIS equivalence is to be demonstrated effectively. Equivalence needs to demonstrate that the rewards from expenditure savings neutralise the penalties from expenditure overspend, over the foreseeable lifetime of the expenditure driver. For example, if demand growth is the most common driver where opex/capex trade-offs will be considered then:

    14.1. an opex solution may defer the need for capex for a period;

    14.2. a capex solution is still likely to be needed at some future time, owing to diminishing returns of the opex solution (e.g., the rate of demand growth overtaking the availability of flexibility resources); and

    14.3. equivalence needs to demonstrate that rewards from a capex underspend are neutralised by the penalties incurred by opex overspend, up to the point that the capex solution is finally required.

2.3. SIMPLICITY IS KEY

15. Aurora considers that the IRIS mechanism needs to be overhauled so that it is simpler to understand, and is able to inform network decision-making.

16. Ultimately, EDBs need 'real world' tools that allow them to determine and compare the IRIS impact of differing investment options and timings, without having to develop bespoke modelling each time. The IRIS mechanism should be simplified to support development of those tools.

17. An example of where we think the current IRIS mechanism is unclear, or at least counter-intuitive in the equivalence scenario analysis, is in the capex IRIS where the investment (commissioned assets) value is used as an input. In deciding between competing capex and opex solutions (all else being equal and absent the IRIS) an EDB that considers the interests of its consumers would select the solution (opex or capex) that best meets the engineering requirements and delivers the lowest impact on consumer prices (i.e., annual opex cost versus annual capex cost (ROI, depreciation of capex solution, etc)). It isn't clear to us that the IRIS replicates this consideration in its approach.

18. Suggestions for making improvements to opex/capex equivalence have included moving to a total expenditure (totex) allowance-setting approach. Aurora currently has no specific views on a potential totex approach, but would likely consider this favourably if it facilitated a simpler, more readily understood expenditure efficiency incentive framework (against a foundation of realistic allowance-settings, of course).