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John McLaren
Manager
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PO Box 2351
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Dear John

Re: Proposed approach to further amendments to incremental rolling incentive scheme (IRIS) for electricity distributors

This is Powerco Limited's submission on the Commerce Commission's 27 February 2015 discussion document *How we propose to implement further amendments to input methodologies for electricity distributors subject to price-quality regulation* and the accompanying *Draft Electricity Distribution Services (Incremental Rolling Incentive Scheme) Input Methodology Amendments Determination 2015*.

Introduction and summary

Powerco supports the implementation of an IRIS to ensure that incentives to achieve efficiencies are equal throughout a regulatory period. We believe that the best way to achieve this goal is via an objective mechanism that produces predictable outcomes. However, we demonstrate below that the Commission's suggested approach would not achieve this result.

We welcome the Commission's publication of a decision tree and table which improves the clarity of the proposed amendments to the IRIS input methodologies (IMs) and look forward to the release of templates tailored for each situation.

We have endeavoured to complete a full review of all the IRIS scenarios, but, due to the limited time available, we have focused on the situation where a distributor transitions from a DPP to a CPP. We note that this involves three possible scenarios covered by proposed IM clauses 3.3.4(3), 3.3.4(5) and 3.3.4(6). As we have identified fundamental problems with the baseline adjustment term that is used in each of these clauses we believe there was no need to consider the other terms in clauses 3.3.4(5)and 3.3.4(6).

Our submission can be summarised as follows:

- The suggested approach to assessing the baseline adjustment term should not be adopted by the Commission as it does not distinguish between temporary and permanent efficiencies, and therefore:
    - does not achieve the objective of deriving a retention factor that provides for the fair and predictable sharing of efficiencies between distributors and consumers;

  - potentially leads to an uncertain, swingeing and inequitable penalty for distributors, which would disincentivise investment, contrary to s.52A of the Commerce Act 1986 ("the Act") and would promote a lack of certainty, contrary to the purpose of input methodologies set out in s.52R of the Act;

- the Commission's suggested approach should not be adopted because it allows the Commission too much discretion to determine the baseline adjustment term for distributors transitioning from a DPP to a CPP and, consequently, tends to reduce certainty for suppliers and consumers contrary to the purpose of input methodologies in s.52R of the Act;
- Powerco's recommended approach to the baseline adjustment term is to define "non-recurrent differences in penultimate year" as the difference between the Commission's DPP forecast of operating expenditure and actual operating expenditure in the penultimate year of the preceding regulatory period. This approach would not achieve consistent retention factors but it is a pragmatic approach that would result in a high degree of certainty consistent with s.52R of the Act, promote an outcome such that suppliers of regulated goods and service have incentives to innovate and invest, consistent with the purpose of Part 4 set out in s.52A of the Act, and produce an equitable sharing of efficiencies between producers and consumers.

Detailed discussion

Assessment of the baseline adjustment term must be objective

We agree with the Commission that the appropriate value for the baseline adjustment term, if it is to give effect to the desired retention factors, is for it to be based on the temporary (or "non-recurrent") differences between the forecast and actual operating expenditure in the penultimate year of the preceding regulatory period[1].

However, we are concerned that the Commission is proposing an approach to determining the baseline adjustment value that involves a high degree of discretion[2]. In practice, we believe that determining this amount will be very difficult for distributors transitioning from a DPP to a CPP. This is because the allowance set under a DPP is a low cost forecast with very little detail.

The degree of discretion involved would make it very difficult for EDBs to predict outcomes with any degree of confidence and this would further increase the perceived risks a supplier faces when proposing a CPP. This situation, should it come into effect, would be directly contrary to the purpose of Part 4 of the Commerce Act (s.52A(1)), in particular, the requirement to promote outcomes such that suppliers of regulated goods or services have incentives to innovate and to invest, and also directly contrary to the purpose of input methodologies prescribed by s.52R of the Act, which is to "promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods and services under this Part".

We note that incorrectly determining the baseline adjustment term amount could have a material financial impact on a distributor due to the quite different treatment of permanent and temporary efficiencies. A $1 temporary efficiency results in a $0.34

[1] See paragraph 3.9 of the Commission's publication "How we propose to implement further amendments to input methodologies for electricity distributors subject to price-quality regulation", 27 February 2015.

[2] Paragraph 3.8 of the Commission's publication states: "This approach is necessary because some degree of judgement may be required to determine the amount required to give effect to the desired retention factor".

benefit to a distributor, whereas a $1 permanent efficiency results in a benefit of $5.08[3]. A temporary overspend that is incorrectly classified as permanent could therefore result in the distributor being penalised five times the overspend amount and facing a retention factor of -500%. This would promote a lack of certainty, contrary to s.52R of the Act. The penalty would also be swingeing and inequitable, which would disincentivise investment, contrary to s.52A of the Act.

We therefore support the Commission's attempt in paragraph 3.10 of the consultation paper to identify a mechanism that would be used in the assessment to increase the certainty of outcomes. However, the suggested approach is only described at a high level – it would have been useful to have been provided with a real life worked example. We have used our interpretation of the illustration in paragraph 3.10 in the examples we have modelled and included with our submission (see Appendix).

Based on our interpretation of the Commission's illustration, we demonstrate that the specific mechanism suggested would not result in the desired retention factors. The scenarios are explained in the appendix to this paper.

The suggested model could result in highly divergent and inappropriate retention factors depending on whether the efficiency is permanent or temporary

The suggested model relies on a function of the difference between actual observed opex in the penultimate year of the DPP and a CPP opex allowance in the following regulatory period, in order to calculate the baseline adjustment term.

We use the following simple calculation of the baseline adjustment term applying our interpretation of the Commission's approach:

	DPP		CPP					
	Y1	Y2	Y3	Y4	Y5	Y6	Y7	Y8
Opex Allowance	100	100	120	120	120	120	120	
Actual Opex	110	110	120	120	120	120	120	
Baseline adjustment term	10							
Cashflow benefit to supplier	-10	-10	0	0	0	0	10	10

We have identified that a number of different combinations of permanent and temporary savings can result in the same baseline adjustment term. The following table illustrates this point and the resulting range of retention factors:

	Scenario				
Scenario inputs	1	2	3	4	5
Savings/(Overspend)					
Permanent Year 1	-	-10	-15	10	5
Temporary Year 1	-10	-	5	-20	-15
Temporary Year 2	-10	-	5	-20	-15
Scenario outputs					
NPV of supplier benefits	-7	-7	-7	-7	-7
NPV of total efficencies	-19	-149	-214	110	46
Retention factor	34.1%	4.4%	3.1%	-6.0%	-14.5%

The table and accompanying models in the Appendix demonstrate that the suggested mechanism cannot distinguish between a temporary and a permanent efficiency or overspend and that the result will be unpredictable retention factors.

[3] Based on a 7.19% post-tax WACC.

We use the example of an overspend, because it is likely that a distributor seeking a CPP will be doing so because it considers its DPP allowance to be inadequate to provide a long-term efficient service to consumers. An overspend is therefore the most likely outcome during a CPP assessment period.

These errors are a result of the incorrect assumption that opex allowances between a DPP and a CPP are linked

We question the Commission's assertion that there is a link between the expenditure baseline established in a CPP and expenditure in the previous regulatory period.[4] This claim assumes that the core level of business remains unchanged as an EDB moves from a DPP to a CPP. However, it is more reasonable to assume that business activities will change significantly to justify the costs of applying for a CPP. We cite Orion as an example of where the business activities undertaken in the period prior to the Christchurch earthquakes and after the earthquakes were markedly different and continued to change throughout their CPP period.

Further, actual opex incurred under a DPP should not be considered inefficient if it is shown, *ex post*, to have been efficient as a result of the process employed to approve a CPP determination.

We believe that any efficiencies/overspend should be treated as temporary in order to provide certainty and lead to an outcome consistent with the purpose of Part 4 of the Act and the purpose of input methodologies

In our view, a formula that accurately quantifies temporary efficiencies in the penultimate year of a DPP is not possible, but we nevertheless believe that an objective formula is required to provide certainty. A pragmatic solution would be to define the "non-recurrent differences in penultimate year" in proposed IM clause 3.3.7(2) as the difference between the Commission's DPP forecast operating expenditure and the actual operating expenditure in the penultimate year of the preceding regulatory period. This would effectively treat all of the variance as if it were temporary and would therefore share the actual variance in that year 34% to the distributor and 66% to consumers (based on the current DPP WACC). Although this approach would not guarantee consistent retention factors it would provide distributors with an incentive that is simple, easy to understand and within their control.

We justify our approach on the following basis:

- Defining the adjustment term in an objective manner would help to provide certainty for suppliers and consumers, consistent with the purpose of input methodologies set out in s.52R of the Act. By contrast, maintaining the Commission's proposed approach would promote uncertainty, contrary to s.52R.
- Incorrectly classifying a temporary inefficiency as a permanent inefficiency has a multiplier effect and could result in a swingeing and inequitable penalty for distributors. Alternatively, the consequences of incorrectly treating a permanent efficiency as temporary are far less material, with recoverable costs limited to a fraction of the variance in the penultimate year of the DPP.
- Dissuading distributors from expending an efficient level of opex during a CPP assessment period due to the threat of significant penalties would be inconsistent with the objectives of Part 4 of the Commerce Act, particularly the requirement to promote outcomes such that suppliers of regulated goods and services have incentives to innovate and to invest.

[4] Paragraph 3.11 of the consultation document refers, viz.: "This approach relies on that fact that the difference between the forecast for the DPP, and the forecast for the CPP, is the result of a distortion introduced by any non-recurrent differences between forecast and actual expenditure …"

- Opex overspend during a CPP assessment period should be considered temporary until a CPP determines an efficient allowance for opex. Sharing this overspend with consumers would ensure the electricity network continued to be managed efficiently in the long term interests of consumers while the regulatory process progressed.
- It would not be practically possible to determine temporary inefficiencies in a particular year when the allowance is set by the DPP.

If you wish to discuss any element of this submission, please contact either Ross Weenink (ross.weenink@powerco.co.nz , tel. (04)978-0522) or Jason McCarty (jason.mccarty@powerco.co.nz . tel. (04)901-7550) in the first instance.

Yours sincerely

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Appendix – Illustrative scenarios for the baseline adjustment term

Approach

A1. We have used the Scenario 3(i) model published by the Commission on 27 February 2015 as the basis of our analysis to ensure a common point of reference. However, it has been necessary to make the following modifications in order to undertake calculations of the baseline adjustment term as suggested by the Commission and focus the model on the penultimate year of the DPP:

A1.1 The relative year for discounting and the discount factor in rows 23 and 24 have been changed to start at year 4,which is the penultimate year of the DPP period. The change focuses attention on the efficiencies in this year which is the basis of the proposed baseline adjustment term.

A1.2 Calculations have been added to rows 118 to 135 which represent the calculations suggested by the Commission in paragraph 3.10. Note that cell L128 is the amount that the Commission suggests is representative of non-recurrent differences in the penultimate year.

A2. Six worksheets are provided to support our conclusions. The worksheets are:

Worksheet	Format	Description	Baseline adjustment term
Scenario1	Compact	Shows the impact of two temporary overspends in years 4 and 5	Commission's suggested approach
Scenario1(i)	Expanded	Shows the impact of two temporary overspends in years 4 and 5 using the Commission's suggested approach	Commission's suggested approach
Scenario2(i)	Expanded	Shows the impact of one permanent overspend in year 4 using the Commission's suggested approach	Commission's suggested approach
Scenario1(ii)	Expanded	Shows the impact of two temporary overspends in years 4 and 5 using Powerco's proposed approach	Powerco's proposed approach
Scenario2(ii)	Expanded	Shows the impact of one permanent overspend in year 4 using Powerco's proposed approach	Powerco's proposed approach
Simple scenario table	Expanded	Shows multiple combinations of temporary and permanent savings and overspends that result in the same baseline adjustment term but different retention factors	Commission's suggested approach

Format

A3. The format is consistent with the way in which the Commission has presented its models, with the compact format illustrating the IRIS IM where adjustment terms are all collapsed into year 2 of a regulatory period and the expanded format demonstrating each term as a series of adjustments over several years. The two formats produce the same results.

A4. The expanded version is favoured in this illustration, as "Benefit to supplier (higher cashflow)" in row 115 better demonstrates the cashflow pattern for a single efficiency.

Analysis

A5. Scenario 1(i) shows how a temporary overspend of $10 in year 4 and again in year 5 results in an NPV loss of -$30 to the distributor which is a 153% retention factor. This perverse outcome is due to the under-estimation of the baseline adjustment term ($5 derived from cell L128 compared to $10 of actual temporary inefficiencies in cell L14). The cashflows are demonstrated in line 115, where the impact of the incorrect baseline adjustment term is compounded over 6 years.

A6. It is an important aspect of the proposed IRIS IMs that it is a combination of the standard IRIS term in row 51 (clause 3.3.3(3) in this example) and the baseline adjustment term that results in the net impact on a distributor's recoverable costs. Both of these terms are rolled forward over six years and offset each other to some extent. To be effective, the two terms should be calculated on the same basis – otherwise the difference will be magnified by six years. The Commission's suggested calculation of the baseline term does not use the same inputs as the standard IRIS term, which increases the risk of a mismatch. The magnified consequences of a mismatch are illustrated in Scenario 1(i) row 115.

A7. Scenario 2(i) demonstrates how a permanent overspend in year 4 also results in a net present value loss of -$30 to the distributor. This is because the Commission's suggested formula is indifferent to whether the efficiency is a permanent or temporary difference, so the baseline adjustment trend remains $5 as in Scenario 1(i).

A8. The Simple scenario table illustrates further how several different combinations of permanent and temporary savings and overspends in the penultimate and final years of a DPP can result in the same baseline adjustment term regardless of a fluctuating temporary efficiency in the penultimate year.

Conclusions

A9. Incorrectly assessing the baseline adjustment amount can have a wide range of consequences for the retention factor, which generates uncertainty contrary to the purpose of input methodologies in s.52R of the Act.

Alternative approach

A10. Scenario 1(ii) again demonstrates the impact of an overspend of $10 in years 4 and 5, but this time uses Powerco's proposed approach to calculating the baseline adjustment as the difference between actual opex and the Commission's forecast opex in the penultimate year of the preceding regulatory period (refer to the formulas in cells M55 and N55). In this case, the baseline adjustment term is $10, resulting in an NPV to the distributor of -$7, which is a retention factor of 34%. This is the correct result for a temporary overspend.

A11. Scenario 2(ii) restates the example where there is a $10 permanent overspend in year 4 using Powerco's proposed baseline adjustment term. In this case the NPV to the distributor remains -$7 but, as the permanent overspend is deemed to have an NPV over its life of -$149, the retention factor is 4%. In this case the permanent overspend is shared with consumers only until the end of the DPP regulatory period, when a new level of efficient opex is determined via a reset DPP (or a CPP).

A12. While the retention factors will not be consistent across all scenarios, the impact of recoverable costs will be limited to a fraction of the variance in the penultimate year. In the absence of a technically pure solution this is a pragmatic mechanism for distributors, which is consistent with the statutory requirements.