



From the Electricity Networks Association

Feedback on the process for resetting default price-quality paths for electricity distributors

Final Response

10 April 2015

The Electricity Networks Association makes this submission along with the explicit support of its members which are 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 responds to the Commerce Commission's (the Commission's) request for feedback on the process for resetting default price-quality paths (DPPs) for electricity distributors (the Request for Feedback).¹
2. The Electricity Networks Association (ENA) appreciates the opportunity to comment on the DPP reset process. The ENA represents the 29 electricity network businesses (ENBs) in New Zealand.
3. The remainder of this submission addresses the key features of the DPP reset process, including the reset timetable, consultation papers, Input Methodology (IM) amendments and determination drafting. We also provide feedback on the supporting models and associated data requests which formed a critical component of the reset process.
4. The ENA's contact person for this submission is:

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1.1 Summary

5. In considering the key components of the DPP reset, the ENA makes the following key observations.:
 - a) The DPP reset consultations converged with the IM consultations, which in our view, when combined with the large volume of material to be considered, compromised the consultation processes. We encourage the Commission to consider how it might sequence its future work streams to smooth out the work load for submitters.
 - b) We suggest that it may be possible to assist submitters in the future by ensuring the consultation papers include sufficiently detailed explanations of the proposals; the options considered and the reasons for choosing the proposed option, including with reference to supporting analysis.
 - c) The ENA greatly values the consultation on the draft determinations. The DPP reset process may have been improved by delaying the release of the draft determinations, which could have reduced the peak work load in June/July/August and allowed more time for the Commission to deliberate on how best to reflect the policy intent in the drafting.
 - d) The ENA supports the continued use of industry working groups to investigate specific components of regulatory decisions, and develop recommendations for consideration by the Commission.
 - e) The introduction of compliance guidance to the DPP reset process is a positive move, supported by the ENA.
6. In addition, in respect of the Commission's models which were developed to support the DPP reset, the ENA:

¹ Commerce Commission, Request for feedback on the process for resetting default price-quality paths for electricity distributors, 27 February 2015

- a) Appreciates the early release of the financial model and the modelling question and answer sessions.
 - b) Notes that prior to the draft decision, the financial model is of limited value to non-exempt EDBs, as it is not populated with data which is of relevance to the decision, and the supporting models are not available until that time.
 - c) Notes that the improvements made to the final models released in November 2014, would have been useful if they had been introduced prior to the draft decision.
 - d) Considers it would be helpful if common datasets were made available to all advisors and submitters early in the reset process, to avoid unnecessary divergence in views. In this respect we recommend that any changes made to disclosure data by the Commission or its advisors should be transparent and fully explained.
 - e) Notes that while the Incremental Rolling Incentive Scheme (IRIS) models provided by the Commission were useful, ENBs were also interested in what the IRIS might mean for them in practice, given the proposed DPP opex and capex allowances.
 - f) Supports early signalling of the timing and content of information requests and testing in draft form the specific requests to ensure they are fit for purpose.
7. In the ENA's view the DPP reset has somewhat diminished confidence that decisions will be made by the Commission against a clear set of principles and criteria, and accordingly, the ENA considers that ENBs remain very vulnerable to the Commission's exercise of discretion. In light of this issue, the ENA recommends:
- a) Prior to the 2020 reset the Commission develop and consult on a decision-making framework, in particular focusing on rules and principles for developing forecasts; and
 - b) Where the Commission exercises 'regulatory judgment' in future, extensive effort is undertaken to explain the basis for judgements, including qualitative and quantitative considerations, and this must form part of the consultation exercise.

2. Feedback on DPP reset process

8. The ENA welcomes the opportunity to provide feedback on each of the key components of the DPP reset process. The DPP reset started with a proposed process paper in early September 2013 and concluded with publication of the determinations and associated decision papers on 28 November 2014. There were numerous consultation papers, draft determinations, models and workshops which comprised the reset process which occurred over this 15 month period.
9. We support the initiative to seek feedback, but note that it is difficult to recall precisely the steps which worked well and those which were less successful, given the time which has elapsed since the reset process concluded. We recommend that the Commission seek feedback immediately following the conclusion of such processes to ensure that comment is made with the process fresh in stakeholders' minds.

2.1 Timetable

10. The early publication of the proposed reset timetable in September 2013 was a useful step for our members. However, there were a number of parallel IM work streams which emerged over the same period which significantly increased the amount of material which was consulted on during this period. This was not reflected in the early timetable announcements.
11. In particular the IRIS IM and the Cost of Capital IM consultations converged with the core DPP consultation papers in June and July 2014. As a result there was a significant amount of material which needed to be considered and responded to by ENBs. Much of the material was provided with overlapping consultation periods and, for a number of papers, common submission deadlines.
12. The ENA considers that this convergence, combined with the large volume of material, compromised the consultation processes for the IM and DPP reset work streams. A more reasonable timetable may have been to bring forward the quality standard, recoverable cost IM and IRIS IM consultations and defer the compliance and determination drafting consultations.
13. Accordingly we encourage the Commission to consider how it might sequence its future work streams to smooth out the consultation work load.

2.2 Consultation papers

14. As mentioned above, there were numerous consultation papers released during the DPP reset. The March 2014 Process and Issues Paper was an important initial step in the process. At this stage the ENA's Working Groups (refer below) were well underway and some of this initial work was able to be reflected in the Process and Issues Paper.
15. We note that issues which were raised in response to the Process and Issues Paper (such as the approach to forecasting opex, capex and real revenue growth) remained key issues throughout the entire process. They were also topics which were highlighted as areas for potential improvement following the previous DPP reset.
16. The draft decision comprised substantial consultation papers (including the Main Policy Paper, the Low Cost Forecasting Paper, the Quality Standards, the Compliance Paper – with accompanying models and expert reports). Four IM consultation papers were released during the same period (IM amendments Type 1, IM Amendments Type 2, IRIS IM amendments and cost of capital IM amendments). Draft determinations were also released for the IM amendments, and the DPP reset.

- 17. Our comments regarding the sequencing of the consultations are included above. In addition, we note that the large number of papers added some cost and complexity to the consultation because there was some overlap (ie: information was repeated) and each individual paper needed to be responded to. We suggest that there may be value to submitters in future in reducing the number of papers, where possible.
- 18. We also note that in some instances the explanations of a proposed approach, or the rationale for choosing a proposed approach were not sufficiently detailed, or appeared to be inconsistent with the analysis which had been undertaken. These were highlighted in submissions, and in many instances, the proposed approach was modified for the final decision. Examples from the draft decision include the use of FY13 as the opex base year; the quality standard set equal to the historical average; the calculation of the standard deviation bands for the quality standard; the opex partial productivity factor of 0 and the constant residential energy intensity assumption.
- 19. In addition, it was necessary to replicate the Commission's models in some instances (for example the quality standard models) to fully understand the proposed approach. We suggest that it may be possible to assist submitters in future consultations by ensuring the explanations in the consultation papers are as comprehensive as possible.

2.3 Working groups

- 20. The ENA fully supports the use of industry working groups to consider discrete DPP issues and to consider possible solutions and developments. The Quality of Supply, Energy Efficiency and Forecasting Working Groups were positive initiatives which the ENA believes added considerable value to the DPP reset process. We note that the Commission provided observers for each group, as did the Electricity Authority and the Energy Efficiency Conservation Authority where appropriate.
- 21. While we note it took some time to lock down the terms of reference for each of these groups, and with the benefit of hindsight, we might have narrowed the scope and/or changed the emphasis slightly, we believe that the research completed by these groups enabled the DPP to evolve in a positive way.
- 22. As the working groups were established very early in the reset process, it was possible for them to gather information, analyse it and test alternative options in a timely way. Thus the working groups were able to contribute to substantial policy developments (such as the quality incentive scheme and the energy efficiency incentive scheme) with high quality research undertaken with fewer time constraints than a typical consultation process provides.
- 23. The ENA supports further use of industry working groups to assist with future developments in price-quality regulation.

2.4 Draft determinations

- 24. The ENA greatly values the consultation on the draft determinations. This is a critical step in the consultation process, because the determinations operationalise the underlying policy decisions. Thus the draft determinations provide the test as to whether and how a decision is able to be implemented in practice.
- 25. As noted above, there were a number of different draft determinations which were consulted on, including various IM amendments and the DPP determination itself. These were consulted on initially with the draft decision papers in July/August, and then again during a technical drafting step in October. We support both steps in the process.

26. We note that there were substantive changes to the final draft determinations following the release of the draft decision determinations. While there were underlying policy changes there were also other changes which appeared to reflect a more considered approach to the drafting. As a result, we consider that the initial versions of the draft determinations were possibly released prematurely. In some instances we consider that the first drafts of the proposed clauses were too high level (ie: not fit for purpose). Accordingly, the ENA submits that the DPP reset process could have been improved by:
- a) delaying the draft determinations, which would have reduced the amount of consultation material published at one time, and provided the Commission with more time to prepare them; and
 - b) including more detailed explanations in the consultation papers (as suggested earlier) to ensure sufficient information was available about the draft decisions, in the absence of the draft determinations.
27. We suggest this may have reduced the scope of the changes between draft and final draft determinations, and therefore the amount of re-work we undertook in responding to them.

2.5 Compliance requirements

28. The 2015 DPP reset was the first reset for ENBs where specific explanation of the Commission's compliance expectations have been consulted on, and published alongside the final decision. The ENA fully supports this initiative which we consider helps non-exempt ENBs and their auditors to understand the DPP decision, and therefore reduce compliance costs. We note that this is one aspect of the draft decision which could have been scheduled later, to help to smooth out the consultation work load.

3. Supporting models

3.1 Financial models

29. The core building blocks financial model was made available to ENBs in November 2013, and updated/amended versions were subsequently released in May, June and July 2014. The model was an improved version of the building blocks model used in earlier DPP resets, particularly in terms of layout and functionality.
30. The ENA appreciated the early release of the building block model, and the question and answer session on the model. We note that the model was revised and re-released a number of times, and question whether each release was necessary. While we understand that the IM consultations contributed to some of the revisions made to the model, these were not substantive changes. We also note that prior to July, the model was of limited value to individual ENBs because it was not populated with the data which was used to determine the draft decision, released in July.
31. When the draft decision was published, the building blocks financial model was re-released along with a substantial suite of accompanying models. These models were not linked to the financial model. They had also undergone substantial redesign (and had been split into multiple models) when compared with the models which had been used for prior DPP resets.
32. While we consider the models were improved, it did require substantial effort to understand the new model structures. Individual ENBs invested considerable time in understanding how their own particular datasets had been used in the models, and how the resulting opex, capex and real revenue growth forecasts were derived. We appreciated the workshop in July which assisted ENBs with this task.
33. We note that when the final determination was released, the final suit of models had been re-named (with more intuitive titles), and an inputs/outputs model developed which demonstrated more directly the linkages between the models and the source data. We suggest that these modifications could have been useful, earlier in the process, at the draft decision stage.

3.2 Non financial models

34. In addition to the financial models which supported the price path decision, models were released which supported the productivity analysis undertaken by Economics Insights, and the derivation of the quality standards. Some aspects of this modelling were undertaken using software (eg: STATA) not widely used by ENBs. We appreciated the subsequent release of Excel readable versions of these models.
35. We note that the productivity analysis is data intensive, requiring detailed data for each ENB across a long time period. Some of the divergence between the analysis undertaken by Economic Insights for the Commission and Pacific Economics Group (who were engaged by the ENA to undertake similar work) appeared to reflect different underlying datasets. This appears to partly reflect adjustments made to the data which was originally disclosed by each ENB. We suggest that any adjustments made to disclosure data should be made transparent to all parties as early as possible in the process, including the reasons behind the changes made. We submit that it would be helpful if all advisors were able to use common datasets for future DPP decisions.

3.3 IRIS models

36. The IRIS IM consultation, which formed part of the DPP reset process, involved the development of reasonably complex capex and opex incentive mechanisms, able to operate across regulatory periods. In order to support the consultation, the Commission developed and published spread-sheet models which demonstrated how these mechanisms would operate for regulatory periods of different lengths, and when transitioning between DPPs and customised price-quality paths (CPPs).
37. These spread-sheets were critical to understanding the proposed IRIS, and ultimately formed the basis of the IRIS IM determination drafting. The ENA appreciates the effort invested in the IRIS models by the Commission.
38. We note that the examples used in the models were extremely simplified, and it appeared that these were primarily aimed at demonstrating that the proposed retention factors were achieved. However, ENBs were also interested in what the proposed IRIS might mean for them in practice, for example in the context of the capex and opex allowances which were included in the draft DPP reset decision.
39. The Regulatory Working Group (RWG) of the ENA produced additional IRIS models which compared the draft DPP allowances with each non-exempt ENB's forecasts of opex and capex (from 2014 AMPS). Each ENB was then able to use these models to test different expenditure scenarios, using their own information, to better understand possible IRIS impacts on their business. This was an important step in the DPP/IRIS consultation for ENBs and we encourage the Commission to consider more fully the practical impacts of its proposals on ENBs for future consultations.

3.4 Information requests

40. Information requests appear to be an inevitable component of DPP reset decisions, although we appreciate that the Commission relied on disclosure information as much as possible. The ENA supports early signalling of the likely timing and content of information requests, and where possible scheduling them in a way which does not coincide with other compliance deadlines (such as financial year end).
41. We also support testing in draft form the likely content of the information required to ensure it is fit for purpose, and consistent with the information which is available to ENBs. We note that this was primarily undertaken with one or two representatives of the ENA, which may be a useful first step, but in future we request that such information requests are tested more widely with ENBs, before they are issued, as otherwise it effectively requires ENA representatives to undertake a consultation exercise on the Commission's behalf.

4. Has the DPP reset enhanced certainty?

42. The Commission has frequently cited the High Court's observation that certainty will be achieved through time with the cumulative weight of decisions.
43. In the ENA's view the DPP reset has somewhat diminished confidence that decisions will be made by the Commission against a clear set of principles and criteria, and accordingly, the ENA considers that ENBs remain very vulnerable to the Commission's exercise of discretion. The ENA accepts that the Commission will have to exercise a degree of discretion in reaching its decisions, particularly where evidence may be limited or there are a range of results to choose from. However, how the Commission exercises its discretion and the reasoning to support it becomes critical in providing confidence and certainty.
44. A good example was the choice of a -0.25% per annum opex partial productivity factor. The Commission reasoned:

3.33 Submissions generally supported a greater reliance on the historic-based productivity assessment provided by Economic Insights and the Pacific Economics Group.²⁶ However, we are mindful that these productivity estimates reflect past economic conditions which may not necessarily reflect future economic conditions.²⁷ Therefore while we have based our productivity decisions on historic information we have also taken a forward-looking view.

3.34 It is not feasible to undertake quantitative analysis that incorporates the factors discussed above. Therefore, it is necessary to use regulatory judgement to determine the partial productivity figure based on the qualitative and quantitative evidence available.²

45. But why choose -0.25%? What forward looking factors were considered in assessing that the trend decline in "productivity" would significantly improve? For example:
 - a) How did the Commission consider the effects of maintaining aging assets (not captured in input or output measures) on productivity?
 - b) Were there discussions with Worksafe about changing requirements on EDBs (e.g., in relation to lone workers or live line work)?
 - c) Does the Commission anticipate that EDBs will not transition to smart grid business models, which require up-front expenditure on systems and processes to better manage their networks?
46. Given the importance of the Commission's exercising of its 'regulatory judgement' in this instance, the ENA submits that there was a significant process mis-step by not consulting on the considerations used to inform the Commission's forward-looking view. In the absence of any supporting materials to justify the Commission's selection, concern exists that the departure from historical trends was driven by a desire to deliver lower prices to consumers.
47. The key point is that the Commission had clear empirical evidence from both Economic Insights and Pacific Economics Group of *trend* declines in opex partial productivity. To effectively set aside that empirical analysis for 'regulatory judgement' because the results may seem unpalatable undermines confidence that the process reflects a neutral consideration of evidence. The fact that

² Commerce Commission (2015) *Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020: Low cost forecasting approaches* p27

the Commission has not heeded the ENA's previous recommendations for establishing *ex ante* a clear decision-making framework and criteria for selecting forecasts adds to the ENA's concern.

48. In light of these issues the ENA recommends:

- a) Prior to the 2020 reset the Commission develop and consult on a decision-making framework, in particular focusing on rules and principles for developing forecasts; and
- b) Where the Commission exercises 'regulatory judgment' in future, extensive effort is undertaken to explain the basis for judgements, including qualitative and quantitative considerations, and this must form part of the consultation exercise.

49. In regard to the specific example discussed above, the ENA would appreciate further information from the Commission as to its considerations in the course of its decision-making, to explain the basis for its selection of -0.25% opex partial productivity growth.