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Commerce Commission

Infrastructure Regulation

Wellington

New Zealand

Input Methodologies Manager

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Feedback – Input Methodology (IM) Review 2023 - Options to maintain investment incentives in the context of declining demand – Orion

Introduction

1. Orion appreciates the opportunity to submit on the Commerce Commission's (Commission) Paper on options to maintain investment incentives in the context of declining demand.
2. The Options Paper[1] explores alternatives to accelerate returns on investment on which the Commission is seeking feedback.

Summary

3. We have reviewed the options paper which was published on the Commission's website[2] and responded to the options which the Commission has proposed.
4. The focus on the options is on the gas industry, however there may be declining demand in other regulated sectors which the Commission oversees.
5. The various option all have pros and cons and we have tried to give constructive feedback on these options from our perspective.

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[1] https://comcom.govt.nz/__data/assets/pdf_file/0016/302452/IM-Review-2023-Options-to-maintain-investment-incentives-in-the-context-of-declining-demand-20-December-2022.pdf

[2] https://comcom.govt.nz/regulated-industries/input-methodologies/input-methodologies-for-electricity-gas-and-airports/input-methodologies-projects/2023-input-methodologies-review?target=documents

Other Feedback

6. In principle, Orion supports any Electricity Network's Association's submission on this topic.

Purpose of Part 4 of the Act.

7. "The purpose of Part 4 is to promote the long-term benefit of consumers in markets where there is little or no competition by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services."
8. The electricity industry is facing several challenges around increased expenditure relating to decarbonisation and security in the coming years. Electricity Distribution Businesses (EDBs) require a level of flexibility to be innovative and to comply with other regulators through in-period adjustments while aligning with the long-term benefit of consumers. We envisage that the Commission may use these options to incentivise other related businesses who are subject to Input Methodologies (IMs).
9. We acknowledge that there is a common theme in achieving part 4 of the Act in the proposed options, which is to smooth pricing in order that consumers are not impacted by price shocks.

Orion's context of options to maintain investment incentives in the context of declining demand.

10. Orion has experienced declining volumes over the past decade. This is partly due to the earthquake, where uninhabitable damaged older inefficient buildings were replaced with modern efficient buildings. Under normal circumstances, the replacement of new for old buildings would not occur so rapidly in other regions, but rather over several decades when buildings no longer complied with revised building standards.

11. The table below shows Transpower GXP volumes delivered to Orion's network which has a 1% decline per year over the past 4 years:

GXP Volumes	Total kWh	% Decrease
2019-2020	6,833,818,942	
2020-2021	6,764,602,472	-1%
2021-2022	6,675,025,322	-1%
2022-2023	6,583,996,764	-1%

Note: 2022-2023 includes estimates for December-March

Volumes delivered is only indicative of a decline in consumption and does not account for capacity changes on the network.

12. The Canterbury region has also experienced significant growth in new connections over the past few years, with more than 5,000 new connections per year, mostly smaller residential. This has counteracted the drop in demand from the replacement of older inefficient buildings.

13. The electricity industry is also facing future challenges with increased electrification to comply with decarbonisation and digitisation and foresee that this decline in volumes will not be a long-term trend. Furthermore, the demand and challenges are articulated in the Boston Consulting Group's report "The future is electric"[3]
14. We appreciate that the gas industry foresees declining demand due to legislative changes in conjunction with the Emissions Reduction Plan. This increases their risk of their assets being stranded given the uncertainty about the timing and scale of repurposing options. We agree that the economic lives of assets should reflect their useful economic lives, which better reflect the period on which the recovery needs to be made in the instance of declining demand for suppliers.
15. Unlike the gas industry, we see the electricity industry being in a state of flux with some significant challenges in the near future (decarbonisation to meet net zero targets, digitisation to improve efficiency and system coordination) as opposed to the gas industry (driven by emissions reduction legislation) and airports (short term reduction in demand due to COVID-19 travel restrictions). The decline in gas due to legislative changes could result in consumers converting to electricity as a substitute going forward.
16. We are concerned that the electricity industry does not require *"options to maintain investment as a result of declining demand,"* but rather *"options to maintain investment as a result of increased electrification, decentralised generation and flexibility services to deliver electricity at an optimum level in the face of uncertainty."*
17. The forecast growth in the electricity industry and expenditure to comply with regulations and growth (decarbonisation, access to data, etc) over the next 15 years is expected to be significant and this may require more responsive revenue signals. We therefore recommend that the Commission considers making 2 options available:
    - an unindexed Regulated Asset Base (RAB) approach for EDBs who require cashflow for larger investments to respond to consumer demands and legislative requirements in a timely manner, while being able to service the financing arrangements associated with these investments.
    - continue to offer an indexed RAB approach for EDBs with investment levels in line with historic trends. This approach aligns the allocation of cost of investments to future demand or utilization.
18. The longer-term outlook for airports and electricity distribution businesses are different from for gas, but we do appreciate that the IMs need to be flexible to accommodate all regulated businesses.

[3] https://web-assets.bcg.com/b3/79/19665b7f40c8ba52d5b372cf7e6c/the-future-is-electric-full-report-october-2022.pdf

Feedback on Options Paper

19. We have reviewed the paper in respect of the options proposed by the Commission on maintaining investment incentives, the expected outcomes (pros and cons) and practical implementation of each option. The numbering used below cross-references to the sections in Chapter 1 of the Options Paper.

Further changes to IMs to better align regulatory asset lives with economic asset lives

Table 1: Options for further changes to regulatory asset lives (Pages 12 and 13)

There are 2 approaches to the treatment of assets:

- Generally Accepted Accounting Practice (GAAP)
- Economic lives of Assets (estimated useful lives of assets)

Aligning regulatory asset lives with GAAP would simplify and streamline the approaches of accounting and economic lives used to set the Building Blocks for Allowable Revenue (BBAR). In principle, we agree with the proposal for Gas Pipeline Businesses (GPB) to align asset lives using GAAP principles to set BBAR. This would mean it aligns with the assumptions in the stat accounts. Currently, the accounting treatment of assets is different to setting economic regulatory expenditure allowances which are included in It therefore may be challenging to retrospectively align the historic regulatory asset lives with GAAP for all regulated businesses IMs.

Option A:

Amend current approach to give suppliers discretion to set economic asset lives for new assets consistent with GAAP (retain current approach for existing assets).

Our view:

The ability for EDBs to have the discretion to align assets with GAAP would have reduced the complexity of indexing RAB and would have been practical if it were done so from inception of the Default Price-Quality Path (DPP) framework. However, the historic RAB indexation creates a mismatch to the current annual calculation of depreciation aligned to GAAP and amortised over their useful lives. Furthermore, some EDBs do not keep detailed regulatory asset registers for indexing purposes, with larger EDBs more likely to have detailed regulatory assets registers in addition to tax and financial asset registers. Maintaining several registers creates additional administrative burden and the potential for errors.

EDBs who do not maintain detailed regulatory assets registers, add their annual commissioned by way of consolidating annual additions by regulatory category on Schedule 4 of the Information Disclosures (IDs) as opposed to creating individual regulatory assets. These “grouped additions” by asset category are indexed annually according to the Commission’s guidelines. Unbundling these could be challenging for some EDBs.

The discretionary approach would also create another layer of analysis for the Commission with DPP resets and could be inconsistently applied across EDB’s and we agree that it would be difficult for the Commission to assess whether the proposed asset life adjustments are appropriate.

Option B:

Allow suppliers to propose updated economic lives (consistent with GAAP) for all existing assets at a DPP reset.

Our view:

This would be a better option as it would give the Commission the ability to either:

- Align the asset lives consistently across EDBs.
- Assess the proposed economic lives in advance of a DPP reset

There would still be the issue of re-indexing historical asset (by category) and identifying individual assets. This could be done, by reworking all asset additions or acquisition and then apply depreciation rates in line with GAAP. We note, in doing so we would need to ensure consistency between GAAP and economic replacement values so that they are aligned.

This may create more administrative burden on the Commission when assessing or updating economic lives consistent with GAAP.

Table 2: IM changes to support the use of alternative depreciation methods (Page 15)

Option C:

Applying a front-loaded depreciation method to individual assets

Our view:

Applying a front-loaded depreciation method makes sense for the gas industry of front ending cash and where there is relative certainty around end of useful life of assets.

We do not see the need for a front-loaded depreciation for Orion. The outcome sought, could be achieve though other regulatory mechanisms like indexed or unindexed RAB in the BBAR.

We agree that administering this option is more complex as opposed to straight line depreciation which is simple and results in an aggregated depreciation profile which broadly reflects declining demand.

Table 3: Tools to support reallocation of asset stranding risk to suppliers (Page 17)

Option D:

Mechanism to enable ex-ante compensation in DPPs.

Our view:

The electricity industry expects some level of flex in consumer demand, trends, and uncertainty in the coming 10-15 years, it would be beneficial from a financing perspective to compensate regulated business in anticipation of expected future events occurring (like legislative and responding regulatory changes in the gas sector) within the 5-year reset periods through incentives or in-period adjustments.

We agree that it would add complexity if too many new mechanisms are introduced. We recommend that the Commission provide better design and clarity on the existing rules governing incentives, like the innovation allowance and re-openers, so that application processes are more efficient for regulated businesses and the probability of timely approval by the Commission is increased.

Option E.

Allow stranded assets to be removed from the RAB.

Orion's view:

We do not foresee a notable change in the RAB because of stranded assets for Orion. Assets sold with proceeds are removed from the RAB in schedule 4 of the IDs. As a result of the earthquake, Orion removed stranded assets (mostly lines) which were no longer serviceable so that they would not be included for BBAR purposes. The removal of these assets was immaterial in value.

It may also be difficult to identify and remove stranded assets from the RAB which the Commission has said, "…could add significant cost to the DPP (Default Price quality Path) process and there may be a need for regular re-optimisation of the RAB." We also agree that, as stated in 2.15, under the current approach removing sunk assets from the RAB would undermine ongoing incentive investments.

There are other mechanisms in the building blocks for allowable revenue which can be used to ensure that regulated businesses are compensated reasonably and equitably.

The Commission also mentioned that "We are seeking views on the appropriateness and timing of changes to IMs given the continued policy uncertainty for GPBs"

The IMs affect all regulated businesses. We therefore see that the IMs need to be appropriate and flexible to meet the needs of these businesses.

The IMs need to be reviewed every 7 years at least but can be reviewed more regularly at the Commission's discretion. An IM decision typically comes 2 years before a DPP reset (e.g., 2023 IM Decision for a 2025 DPP Reset) and this process usually takes at least a year.

- Moving to a 5-year review cycle may not be achievable given the resources required by stakeholders and the Commission. However, it would fall within the cadence of the DPP reset cycle going forward
- A 6-year cycle for the next review could be an option based on the past two IM Reviews. (2016 IM Review which was finalised in 2017[4] and reviewed again in 2023). *The 2017 final decisions were due to additional work on Transpower's Incremental Rolling Incentive Scheme (IRIS), customised price-quality path (CPP) information requirements for gas and the related party transactions provisions. This may be appropriate given the anticipated changes in the electricity industry over the coming decades.*

We recommend a 5-year, or at least a 6-year IM review cycle.

Concluding Remarks

We consider that some of the options the Commission is proposing may result in significant additional administrative burden. However, we do appreciate that these options could assist regulated businesses in accelerating revenues to recover investments where there is relative certainty regarding declining demand.

We believe that the timing of the gas reset decision was appropriate to address their needs in accelerating compensation while anticipating declining demand.

Thank you for the opportunity to provide feedback. We do not consider any part of this feedback as confidential.

If you have any questions or queries or aspects of the submission which you would like to discuss, please contact me at Orion Group on 03 363 9898.

Yours sincerely

Rob Tweedie

Regulatory Manager

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[4] https://comcom.govt.nz/regulated-industries/input-methodologies/input-methodologies-for-electricity-gas-and-airports/input-methodologies-projects/201516-input-methodologies-review/final-decisions