Submission to the Commerce Commission

on

Proposed further amendments to input methodologies: Incremental Rolling Incentive Scheme

Made on behalf of 19 Electricity Distribution Businesses

PwC submission on behalf of group of 19 EDBs

Final

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pwc

Contents

Submission on proposed further amendments to IMs: incremental rolling incentive scheme 1
Expenditure incentives 3
Support for incentives 3
Proposed amendments 3
Baseline adjustment term 5
Next steps 6

Submission on proposed further amendments to IMs: incremental rolling incentive scheme

This submission responds to the Commerce Commission's (the Commission's) paper, "How we propose to implement further amendments to input methodologies for electricity distributors subject to price-quality regulation: Incremental Rolling Incentive Scheme" released on 27 February 2015 (the IRIS Paper). This submission has been prepared by PricewaterhouseCoopers (PwC) on behalf of the following 19 Electricity Distribution Businesses (EDBs).

- Alpine Energy Limited
- Aurora Energy Limited
- Buller Electricity Limited
- Eastland Network Limited
- EA Networks
- Electricity Invercargill Limited
- Horizon Energy Distribution Limited
- MainPower New Zealand Limited
- Marlborough Lines Limited
- Nelson Electricity Limited
- Network Tasman Limited
- Network Waitaki Limited
- Northpower Limited
- OtagoNet Joint Venture
- The Lines Company Limited
- The Power Company Limited
- Top Energy Limited
- Waipa Networks Limited
- Westpower Limited.

Together these businesses supply 26% of electricity consumers, maintain 44% of total distribution network length and service 75% of the total network supply area in New Zealand. They include both consumer owned and non-consumer owned businesses, and urban and rural networks located in both the North and South Islands.

The IRIS Paper outlines the proposed amendments to input methodologies (IMs) that affect the incentives that non-exempt EDBs have to control opex expenditure, under certain Default Price-Quality Path (DPP) and Customised Price Quality Path (CPP) situations. This proposal extends the Incremental Rolling

Incentive Scheme (IRIS) IM amendments for non-exempt EDBs subject to DPPs, which were introduced in November 2014[1].

The IRIS Paper proposes to introduce an efficiency mechanism for opex to apply when EDBs transition between DPPs and CPPs. Additional efficiency mechanisms are also proposed for less common situations, in particular where one or two year regulatory periods apply. The intent of IRIS is to reward or penalise EDBs for expenditure gains or losses relative to base allowances in DPP and CPP price paths.

This submission presents the views of the 19 EDBs that support it, and largely follows the structure of the IRIS Paper. We also note and support the ENA's submission on the IRIS Paper.

Conclusion

After careful consideration of the proposals, we have concluded that it is premature to implement the proposed IRIS amendments at this time. This conclusion reflects the concerns raised in this submission and by the ENA. Until these are resolved we do not support the further development of opex IRIS incentives, as proposed.

We trust this submission provides useful input in considering further developments to the IMs which apply to CPPs in particular. We would be happy to answer any questions you may have regarding this submission.

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[1] Commerce Commission, Incremental Rolling Incentive Scheme Input Methodology Amendments Determination 2014, 27 November 2014

Expenditure incentives

Support for incentives

1 As stated in previous submissions, the EDBs which support this submission, support initiatives to improve the consistency of incentives to control opex and capex under DPPs and CPPs and agree that time consistency is an important feature of a successful incentive scheme.

2 While we support in principle the consideration of ways to equalise incentives for opex and capex, we note that in reality it is only possible to substitute between them at the margin, as much of an EDB's expenditure plan is determined by historical investment and the impact of external factors, including legislative requirements such as health and safety.

3 We agree that the proposed 35% retention factor for opex is appropriate, because this is consistent with the strength of the incentive that occurs naturally in the first year of a 5 year regulatory period.

4 We continue however to retain significant concerns about the ability to implement an incentive scheme which delivers the desired outcomes. We note the increasing complexity of the proposals, and are concerned that as the IRIS is a mechanism which comes into effect over time, there may be unintended consequences which are detrimental to consumers and/or non-exempt EDBs in future due to the unpredictable nature of the incentive outcomes.

5 We also note that elements of the proposals rely on the Commission determining base allowances or certain adjustments, on a case by case basis. This provides some discretion to the Commission, which may negate the incentive properties of the IRIS. We question whether these proposals are consistent with the statutory intent of the IMs which is to provide regulatory certainty.

6 We have also previously noted that the uncertainty about the methods to be used to determine baseline opex and capex for the DPP, and the capex retention factor weakens the incentive scheme. We remain concerned that benefits achieved in one regulatory period may be captured at the beginning of the next regulatory period, dependent on the price reset method employed – in particular the baseline allowances provided for the next regulatory period.

7 This can only be addressed with more certainty as to how the opex and capex components of DPP price paths are reset at the beginning of each regulatory period. As we have previously submitted, the EDBs which support this submission believe that the IMs provide the appropriate mechanism to provide this certainty.

Proposed amendments

8 The IRIS Paper proposes additional opex incentive provisions, to accommodate transitional situations, including when an EDB transitions between DPPs and CPPs. The intent of these provisions is to allow EDBs to retain the benefits of opex efficiencies beyond the end of a regulatory period. This has the effect of equalising the strength of the incentive in each year of the regulatory period, and to allow for incentives to be equalised between opex and capex incentives.

9 While the November 2014 amendments introduced a capex IRIS (which applies for DPPs and CPPs), and an opex IRIS which applies to those non-exempt EDBs which choose to remain on DPPs, the opex incentive for CPPs was not completed at that time. This was because there were issues discovered with the proposal which required resolution before it could be implemented.

10 The current proposal is presented in the IRIS Paper, and supported by a Draft Determination and spreadsheet model. As explained in Chapter 2 of the IRIS Paper, it is intended that the opex incentive will be implemented via a recoverable cost (which may be positive or negative – ie: the incentive is symmetrical) and reflects the net incremental change in opex carried forward from prior years in which

savings or losses are made. The retention period for savings or losses is five years, which equates to a retention factor of approximately 35% for suppliers.

11 In the second year after a new price path commences, a one off adjustment is made in order to determine the recoverable cost amount. The adjustment is necessary because at the time price paths are reset, actual opex for the final year of the previous regulatory period is not known. Accordingly, the incentive amount is set to nil in the final year of a regulatory period and a compensating adjustment is made in the second year of the next period.

12 Additional adjustments are also required at that time under certain circumstances. These are affected by how prices are reset at the beginning of the regulatory period, as the opex allowance in the next regulatory period may include in it some of the savings or losses made in the previous period. Accordingly without these adjustment factors the target 35% retention factor may not be preserved.

13 The IRIS Paper examines a range of scenarios which may occur for EDBs subject to DPP/CPP regulation. Table 2.1 sets out six different scenarios of which three are deemed to be standard. The standard scenarios are expected to be faced by EDBs in the majority of situations.

Standard Scenarios (Prior period at least 2 years)	**Non-standard Scenarios** (One of prior 2 periods less than 2 years)	**Non-standard Scenarios** (Prior 2 periods less than 2 years)
1. DPP with prices set using SPA 2. DPP with prices set by roll-over 3. CPP	4. DPP with prices set using SPA 5. CPP	6. DPP or CPP

14 The IRIS Paper proposes 'adjustment terms' which are to apply under each scenario. These are set out in Table 2.2 of the IRIS Paper and comprise 12 different terms, with different combinations of terms applying to different scenarios. Each term is defined in the draft IM, and with one exception, the terms are mathematical (ie: a formula is provided which specifies how the adjustment is to be calculated from other components of the IM (such as actual opex or forecast opex), or assumptions which are specified with reference to other IMs (such as the cost of capital).

15 The baseline adjustment term which applies in the CPP scenarios is not fully specified in the IM, as it relies on the Commission determining the amount. We address this further below.

16 While we understand the rationale for the range of adjustment terms, we agree with the IRIS Paper, that each term does not have any intuitive meaning. We note the intention stated in paragraph 2.13, that when combined, as appropriate for each scenario, the adjustment terms together ensure the target 35% retention factor is achieved.

17 We acknowledge the modelling provided with the consultation material which illustrates this outcome under the full range of scenarios, however we note that the worked examples provided are highly simplified. We are concerned that without the benefit of hindsight, it may not be possible to be sure that each adjustment factor will operate in practice as it is intended to in principle.

18 We note the intention for the Commission to provide Excel models to EDBs to assist them to comply with the IRIS IM. We consider this proposal is useful, and necessary, given the complexity in the proposed IM, and the fact that individual components of the IM (such as the various adjustment factors) do not have intuitive meaning.

Baseline adjustment term

19 The IRIS Paper proposes that one of the adjustment terms, the 'baseline adjustment term' is determined by the Commission after consideration of the views of interested persons. This term is required to estimate the value of temporary differences between forecast and actual expenditure in the penultimate year in the preceding regulatory period. The baseline adjustment term is to be applied when an EDB is subject to a CPP and in certain situations when prior regulatory periods are less than two years long.

20 The baseline adjustment term proposal replaces the more 'formulaic' approach which was proposed in the 2014 consultation paper. We understand that the revised approach has been developed because the previous formula was found to be unstable ie: it did not produce outcomes which were consistent with the 35% retention factor when tested using credible opex scenarios. We also understand that an alternative formula has not been able to be developed which fully addresses this issue.

21 The baseline adjustment term is to be assessed by the Commission, following consultation, prior to any CPP being set. We anticipate that this is most likely to occur during the Commission's assessment of a CPP proposal, ie: in the final year of the preceding regulatory period – immediately following the penultimate year. The proposed drafting (in Clause 3.3.7(2) of the draft IM) specifies that the term will be:

a) determined by the Commission having regard to the views of interested persons

b) attributable to the impact of non-recurring factors

c) defined with reference to forecast opex and actual opex in the penultimate year of the preceding regulatory period

d) notified to the EDB.

22 The IRIS Paper explains that one way this could be assessed is as follows:

a) determine an opex forecast consistent with the approach used for setting DPPs

b) calculate a net present value of the forecast determined in accordance with a) above

c) calculate the net present value of the forecast of opex determined for the CPP

d) determine an amount that would need to be added or subtracted from the opex in the base year (using the DPP projection approach) to equalise the net present values of the opex forecast for default and customised price paths.[2]

23 The IRIS Paper also explains that this approach assumes that:

> *The difference between the forecast for the DPP and the forecast for the CPP is the result of a distortion introduced by non-recurrent differences between forecast and actual expenditure in the penultimate year of the preceding regulatory period.*[3]

24 We have concerns with the proposed approach because:

a) it does not appear to give effect to the intended 35% retention factor (as demonstrated by the ENA in its submission). We therefore conclude that the proposed approach may not be consistent with the policy intent

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[2] IRIS Paper, paragraph 3.10

[3] IRIS Paper, paragraph 3.11

b) is based on an assumed relationship between DPP and CPP opex (as described in paragraph 3.11 of the IRIS Paper) which may not always exist, particularly given the different methods used to determine DPP and CPP opex allowances

c) it is not clear that sufficient information will exist at the time the Commission will determine the baseline adjustment term. This is because ultimately it is necessary to determine to what extent variances between actual and forecast opex in the penultimate year of the DPP are permanent or temporary. This may not become apparent for some time

d) as the DPP opex allowance is not a bottom up allowance, we suggest it will be almost impossible to compare actual opex (at the programme or project level) with the DPP opex allowance in order to determine permanent or temporary variances.

25 DPP opex forecasts to date have reflected assumptions about base year opex, partial productivity, scale adjustments based on econometric modelling and sector wide input price indices. With the exception of the base year opex data, these assumptions are not EDB specific, and are applied at the total opex level. CPP opex assumptions reflect bottom up forecasts prepared by the EDB, by opex category, with particular attention to price indices and step changes which are relevant to each category of opex, for the EDB in question. The CPP assumptions put forward by the EDB are assessed by the Commission using top down and bottom up techniques, and ultimately are determined on the basis that the opex allowance reflects prudent and efficient programmes of opex for the EDB in question. Accordingly, the CPP opex allowance takes into consideration the EDB's capex programme, quality outcomes and particular challenges facing the EDB during the CPP period. The DPP opex forecasting method does not consider these factors.

26 The IRIS Paper suggests that the proposed method in paragraph 3.10 is one way that the Commission could determine the baseline adjustment, but it does not describe other ways. We are therefore concerned that there remains significant discretion in the proposed approach to the opex IRIS to apply for CPPs. This adds to the considerable uncertainty which already exists for suppliers in applying for CPPs.

27 Accordingly, we do not believe that there is appropriate certainty in the proposals. As the 'adjustment term' is not intuitive, and it is proposed that the Commission will determine it at the time a CPP application is made, we consider this proposal acts as a disincentive in applying for a CPP. If EDBs are unable to understand the regulatory consequences of their spending decisions, then the purpose of the incentive cannot be fulfilled.

28 While the proposal for the baseline adjustment term includes a consultation step, we do not believe that this is appropriate for an IM – which must be set out in sufficient detail so that each affected supplier is reasonably able to estimate the material effects on them (section 52T(2)). Consultation cannot meet this criterion in itself, and accordingly a proposed method for determining the baseline adjustment is required.

29 We understand that the complexity of the regulatory framework which applies to EDBs is the fundamental reason why this incentive is proving so difficult to implement in practice. We note and appreciate the considerable effort that has been invested in refining the proposals to attempt to address the range of circumstances which arise under the DPP/CPP framework. However at this time we do not believe we can support the additional opex incentive mechanisms which have been put forward in the IRIS Paper for the reasons outlined above because we do not believe they are fit for purpose.

Next steps

30 The EDBs which support this submission recommend that the proposed amendments to IRIS, as set out in the IRIS Paper and accompanying draft determination are not implemented at this time because the proposal is not consistent with the policy intent.

31 While we appreciate the effort which has been invested in refining and improving the proposals over the past year, we believe that they are not yet robust enough to provide appropriate levels of certainty for

EDBs, particularly those contemplating applying for a CPP. We consider this outcome is detrimental to the efficient operation of Part 4 of the Commerce Act, as the success of the relatively 'low cost' DPP framework is dependent on EDBs being confident in exercising their option for a CPP alternative. There are real risks with CPPs, including a number of uncertainties associated with them (such as how price paths are set at the end of a CPP, and what the DPP counterfactual may be for the next regulatory period). The current proposal adds to this uncertainty.

32 Accordingly we submit that it is premature to implement the proposed IRIS amendments at this time, given the concerns raised in this submission and by the ENA. Until these are resolved we do not support the further development of opex IRIS incentives, as proposed.