

Network Tasman Submission on the Commerce Commission's Companion paper: Default price-quality paths for electricity distribution businesses from 1 April 2020 – Updated draft models

9 October, 2019

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Dear Dane,

This letter constitutes Network Tasman's submission on the Commission's Companion paper *Default price-quality paths for electricity distribution businesses from 1 April 2020 – Updated draft models*.

Network Tasman has read and contributed to the development of the ENA's submission and supports its conclusions and recommendations.

This submission focuses on the changes the Commission has proposed to its assessment and forecasting of system growth capex.

System growth forecasting

A distributor fails the Commission's system growth gating test if their forecast per-connection consumer connection and system growth expenditure (system growth expenditure) is more than 150% of system growth expenditure for the reference period 2013-2019.

In the updated draft paper, the Commission states that the tests appear to produce logical results – identifying distributors that have forecast system growth expenditure that is out of step with their past expenditure and independent expectations of growth in their regions.¹

Beyond the statement above, the Commission provides no explanation for this conclusion or how a 150% cap represents an efficient limit on the degree to which a distributor can expect its system growth expenditure to increase as a result of prudent and efficient capital expenditure.

The Commission's test universally accepts any reduction in system growth expenditure – irrespective of the magnitude. For example, having recently completed an efficient major network investment programme it is reasonable for this distributor's system growth expenditure to fall by 2,000%. However, the test does not accept that a distributor heading into a comparable major capex programme could experience an increase in system growth expenditure of a similar magnitude.

Four distributors are forecasting a reduction in their system growth expenditure of more than 600%, one is forecasting a reduction of over 2,800%.

The second column of the table below reproduces the results of the Commission's Gate 3 test – forecast system growth expenditure as a proportion of historical. The third column presents the inverse of column two – historical system growth expenditure as a proportion of forecast.

¹ Commerce Commission, *Default price-quality paths for electricity distribution businesses from 1 April 2020 – Updated draft models: Companion paper*, 25 September 2019, page 41, para 4.27

	Forecast per-connection consumer connection and system growth expenditure as a proportion of historic	Historic per-connection consumer connection and system growth expenditure as a proportion of forecast
Alpine Energy	4%	2,810%
Aurora Energy	124%	81%
Centralines	114%	88%
EA Networks	69%	144%
Eastland Network	13%	796%
Electricity Invercargill	21%	475%
Horizon Energy	16%	632%
Nelson Electricity	7%	1,486%
Network Tasman	319%	31%
Orion NZ	99%	101%
OtagoNet	91%	110%
The Lines Company	129%	77%
Top Energy	63%	158%
Unison Networks	55%	182%
Vector Lines	70%	142%
Wellington Electricity	117%	86%

It stands to reason that once a distributor has completed a major capex project, all other things being equal, its capex expenditure would revert back to levels comparable to historical levels.

We submit that the degree to which Alpine Energy, Eastland Network, Horizon Energy and Nelson Electricity have seen their system growth expenditure fall following the completion of recent major investment programmes is instructive of the degree to which a distributor heading into a major investment programme can reasonably expect their system growth expenditure to increase.

The only circumstances under which a distributor's change in system growth expenditure is instructive on this point would be if it can be shown that:

- A recently completed capex programme has resulted in the distributor reverting to a baseline system growth expenditure that is materially different to their baseline expenditure prior to the investment programme being undertaken.
- The recently completed capex programme was demonstrably inefficient and that this would have been obvious prior to the investment programme being undertaken (it would be unreasonable to apply this assessment with the benefit of hindsight).

On the first point, adjustments could be made to account for any structural changes in a distributor's baseline system growth expenditure after the project is completed, in the unlikely event it is required.

On the second point, given all historical system growth expenditure assessed as part of this test has been undertaken by distributors that were subject to Commission DPP regulation, regulation would have prevented distributors from undertaking investments that are egregiously inefficient.

The Commission has implicitly accepted that there is volatility in system growth capex, and that this volatility can be substantial but applies an asymmetric view of the magnitude of volatility that is

acceptable. If the Commission accepts that there is considerable volatility in system growth capex spending, it must accept that this volatility is symmetric (or at the very least, broadly symmetric).

The considerable difference in the 150% cap applied in the Commission's test and the actual reduction in system growth expenditure experienced by distributors following the completion of major capex investment suggests that irrespective of any possible adjustments, the 150% cap cannot reasonably be justified.

Transpower offers an excellent example of this. Between 1995/96 and 2004/05 Transpower's capex spend averaged around \$100m/year. Between 2006/07 and 2011/12 it averaged \$520m/year, with a peak of \$915m in 2011/12.²

It is worth noting that these Transpower figures are for total capex, not system growth capex, but the relativities are likely to be comparable and instructive.

Applying the Commission's system growth gating test as at 2005/2006, Transpower's forecast expenditure would have been more than 400% higher than its historical expenditure. Transpower would have failed the test and had its allowable system growth capex forecast scaled back to 25% of its forecast. A sum that would have been entirely inadequate for Transpower's and the country's needs.

Conversely, the Commission's test would pose no barrier to Transpower's capex spending if applied in 2012/13.

This example highlights again that the 150% cap on forecast system growth expenditure inappropriately limits capex spending to a level below that required for significant, but necessary and efficient capex expenditure.

Similarly, it demonstrates that timing has a disproportionate effect on performance against this test as it is currently specified.

Unless the Commission can provide robust justification for why distributors entering into a programme of significant system growth expenditure would not see changes to their relative expenditure that is consistent with those changes experienced by distributors that have recently completed significant expenditure and robustly justify its proposed cap, Network Tasman submits that the Commission must considerably increase the cap so it reflects the reality facing distributors undertaking significant system growth expenditure.

However, this is all moot if the Commission retains its initial forecasting accuracy test because none of the subsequent tests are conducted for a distributor that fails the first test. We submitted on the merits of the forecast accuracy test as part of the consultation on the initial draft reasons paper and will not repeat the issues raised in that submission. Although we will observe that scaling forecasts for distributors that fail the initial forecast accuracy to levels consistent with historical expenditure demonstrates the same shortcomings as the system growth test – except it doesn't allow any increase from historical levels, especially for distributors forecasting significant system growth expenditure.

² Office of the Auditor General, *Transpower New Zealand Limited: Managing risks to transmission assets*, September 2011, section 3 (accessed at <https://www.oag.govt.nz/2011/transpower/part3.htm>) and various Transpower Annual reports.

We note that the Commission appears to be having difficulty finding robust ways to accurately forecast each non-exempt distributor's capex requirements, as the discussion above demonstrates. Network Tasman urges the Commission to use caution when refining its forecasting techniques because there is a considerable risk of false precision. The Commission identified this as a risk in the Issues Paper.³

If the Commission's forecasts weren't materially different to Network Tasman's forecasts, the effect of the Commission's forecasts would be of less immediate concern.

However, the Commission's current capex forecast is less than half of what we are forecasting. In real terms the Commission is forecasting \$33.2m (constant 2019) of capex expenditure over the DPP3 period, Network Tasman is forecasting \$72.3m (constant 2019). There is a gulf between the two forecasts and the considerable IRIS implications for Network Tasman if the Commission's forecast is incorrect. At the current retention ratio of 23%, Network Tasman would incur IRIS penalties of almost \$9m across DPP3 (approximately 7.5% of Network Tasman's entire revenue cap over DPP3), in the event our forecasts are correct.

These numbers are significant and carry significant risk for Network Tasman and our consumers/owners if the Commission's forecasts are not accurate.

Given these significant differences, the Commission must be absolutely certain that its models are accurate and robust if it is to rely on them in its final decision.

If the Commission cannot satisfy itself that its models are robust and accurate, Network Tasman submits that it must reduce the capex IRIS retention ratio to account for this uncertainty. We have previously commented on this issue in our submission on the draft reasons paper and refer the Commission to this submission for further information on our views about the capex IRIS retention ratio.

I am happy to discuss any further details, should the Commission have any questions.

Kind regards,

Daniel Vincent

Regulatory and Commercial Manager

³ Commerce Commission, *Default price-quality paths for electricity distribution businesses from 1 April 2020: Issues paper*, p.33, para 3.49.