

15 August 2014

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Dear John

Submission on Low Cost Forecasting Approaches For Default Price-Quality Paths

1. Introduction

1. Horizon Energy Distribution Limited (“Horizon Energy”) welcomes the opportunity to provide feedback to the Commerce Commission (“Commission”) on the low cost forecasting approaches for default price-quality paths paper¹ (“low cost paper”) released on 4 July 2014.
2. We note the complementary proposed default price-quality paths for electricity distributors from 1 April 2015 paper² (“Main Policy Paper”) also released on 4 July 2014. Due to the degree of overlap between the Commission’s Main Policy Paper and subsequent papers³ released on 18 July 2014, we will by providing a submission to the Main Policy Paper as part of our submission to those latter papers, being due 29 August 2014.
3. We support the submissions provided by PricewaterhouseCoopers (“PwC”) and the Electricity Networks Association (“ENA”) on low cost forecasting approaches for default price-quality paths.
4. We acknowledge under s53K of the Commerce Act 1986 (“the Act”) the purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services. And continue to support the Commission’s proposal to calculate starting prices based on current and projected profitability for Electricity Distribution Businesses (“EDBs”) similar to the approach applied in November 2012.
5. We do however submit that there continues to be a number of issues for the Commission to consider for refining this proposed approach, due to this being a ‘one size fits all’ approach to setting price paths.

¹ <http://www.comcom.govt.nz/dmsdocument/12080>, 4 July 2014

² <http://www.comcom.govt.nz/dmsdocument/12079>, 4 July 2014

³ <http://www.comcom.govt.nz/dmsdocument/12120>, 18 July 2014

6. In general, we submit for the data used in the Commission's proposed approach should be as current as possible at the time of the reset such as; actual data disclosed for the 2014 disclosure year and forecast data disclosed for the 2015 disclosure year. This is to ensure any efficiency gains are passed through to consumers and also to ensure EDBs are provided the requisite incentives for continued investment by way of certainty in the use of the most recently available data prior to the start of the next regulatory period.
7. In terms of use of data and known errors in data at this point, we note the Commission's response to question 22 regarding updated data in the Questions and Answers Session for Electricity DPP Draft Decision Models⁴, and submit for the Commission to release models with updated data where errors are discovered prior to the release of the final decision. This feedback was previously provided in the ENA's response⁵ to the Commission's open letter seeking feedback on the process for setting the current regulatory period.

2. Forecasting Operating Expenditure

8. The proposed approach to forecasting consistent with November 2012 is to update an initial level of operating expenditure for the impact of expected changes in network scale, partial productivity and input prices.
9. In supporting this proposed approach, we continue to submit regard must be had to a consideration of expected step changes as has been acknowledged by the Commission in para 3.30 of the low cost paper, while the practical regard of this issue has been subsequently dismissed in para 3.32 of the low cost paper for lack of evidence provided to date.
10. Horizon Energy is expecting a 9% increase from 2014 to 2015 in Systems Operations and Network Support expenditure due to long standing staff vacancies filled during March 2014. The requirement to fill these vacancies is a result of our existing staff being fully utilised in responding to increased levels of health and safety requirements, increased price-quality/information disclosure regulation requirements and to develop the relevant skills set within the business to provide succession planning in key engineering roles.
11. We recommend EDBs be provided the opportunity to submit anticipated step changes in 2015 operating expenditure, while potentially not meeting all the criteria set out in para 3.30 of the low cost paper, by way of Director certification.
12. In terms of the initial level of operating expenditure, we note the Commission has used amounts disclosed for the 2013 disclosure year on the basis that data for the 2014 disclosure year was not available, and forecasts provided by EDBs for the 2014 disclosure year suggest the year was atypical.
13. We note the Commission's concern at the use of EDBs estimated 2014 disclosure year data for operating expenditure. However the Commission will have the benefit of actual data disclosed for the 2014 disclosure and we suggest that this should be used as it reflects the EDB's actual costs.
14. The Commission has referenced Figure 3.1 in the low cost paper to demonstrate some EDBs estimated 2014 expenditure has increased relative to actual 2013 disclosure year expenditure. While increases can be explained for operational reasons, we also note the

⁴ <http://www.comcom.govt.nz/dmsdocument/12195>, 30 July 2014

⁵ <http://www.comcom.govt.nz/dmsdocument/10089>, 24 May 2013

2013 disclosure year data was the first prepared under the Electricity Distribution Information Disclosure Determination 2012. Some recognition of inconsistencies in the initial application of the Electricity Distribution Information Disclosure Determination 2012 needs to be provided for thereby we submit that the 2013 disclosure year data may not be the most suitable for comparison.

15. We continue to submit for the use of amounts to be disclosed for the 2014 disclosure year for the initial level of operating expenditure, thereby aligning with the use of 2014 disclosure year data to inform the 'initial conditions' parameters set within the Commission's models released on 4 July 2014⁶.
16. In the event the Commission is not looking to use a single year for the initial level of operating expenditure we submit for the use of an average between the 2013 disclosure year and 2014 disclosure year data.
17. We continue to acknowledge the comments made by Frontier Economics⁷ in working with the ENA forecasting working group on the use of network length and number of users as proxies for network scale as being reasonable.
18. Consistent with the approach in November 2012, the Commission continues to inflate operating expenditure using weighted average forecasts of changes in all industries labour cost index and all industries producer price index.
19. We continue to note and support the comments made by the ENA⁸ and Frontier Economics⁹ of the merits of exploring other options for changes in input prices future regulatory periods, including the use of sub-indices more closely linked with the electricity distribution sector. And that the use of forecasts from different sources may reduce forecasting errors.

3. Forecasting Capital Expenditure

20. The Commission's proposed approach to forecasting capital expenditure is to use EDB capital expenditure forecasts as provided in year beginning disclosures for the 2015 disclosure year, with varying limitations on forecast network and non-network capital expenditure levels relative to historic levels. In general we support the Commission's proposed approach, and note the other options the Commission was considering have been set aside for this next regulatory period, but may be progressed for future regulatory periods.
21. We submit however the use of 'Capital Expenditure on System Fixed Assets' from Report FS2 under the Electricity Distribution (Information Disclosure) Requirements 2008 for the calculation of nominal network capital expenditure from 2010 to 2012 is problematic as these disclosures are not compliant with the Electricity Distribution Services Input Methodologies Determination 2012, such as for the treatment of related party transactions.
22. Similarly the use of 'Capital Contributions' from Report FS1 under the Electricity Distribution (Information Disclosure) Requirements 2008 for the calculation of nominal network capital expenditure from 2010 to 2012 is problematic as these disclosures are

⁶ <http://www.comcom.govt.nz/dmsdocument/12044>, 4 July 2014

⁷ <http://www.comcom.govt.nz/dmsdocument/11806>, 23 April 2014

⁸ <http://www.comcom.govt.nz/dmsdocument/11810>, 30 April 2014

⁹ <http://www.comcom.govt.nz/dmsdocument/11808>, 29 April 2014

not compliant with the Electricity Distribution Services Input Methodologies Determination 2012, such as for the treatment of capital contributions and vested assets.

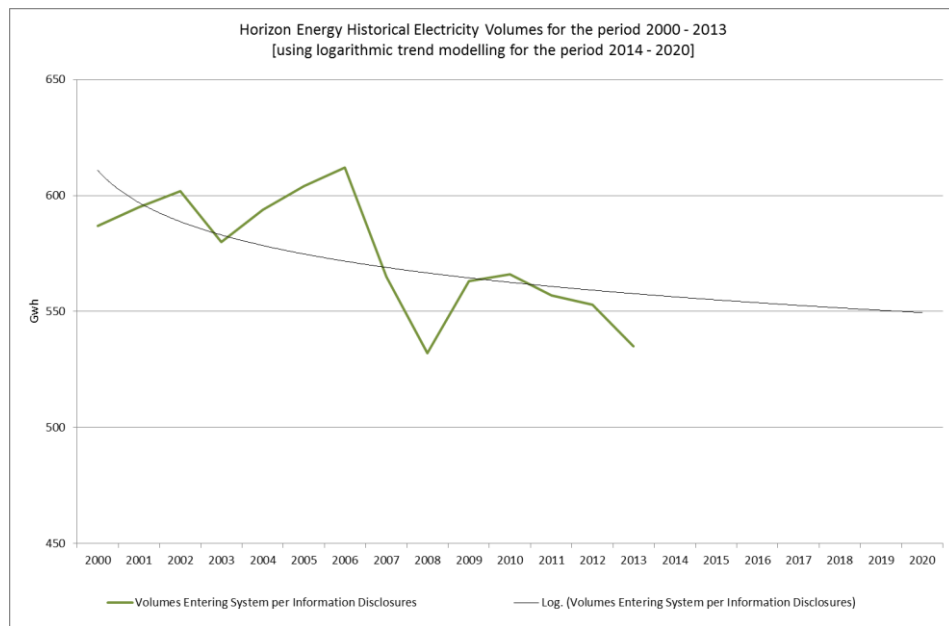
23. The required treatment and therefore disclosure of capital expenditure and capital contributions has changed significantly from the Electricity Distribution (Information Disclosure) Requirements 2008 compared with the Electricity Distribution Services Input Methodologies Determination 2012.
24. We note all data the Commission is using to calculate starting prices based on current and projected profitability is to be compliant with the Electricity Distribution Services Input Methodologies Determination 2012, therefore submit the 2010 to 2012 data disclosed under the Electricity Distribution (Information Disclosure) Requirements 2008 is not useable.
25. We submit for the Commission to therefore limit the calculation of the historic average to Schedule 6a: Report on Capital Expenditure for the 2013 and 2014 disclosure years, as these disclosures follow the requirements set out in the Electricity Distribution Services Input Methodologies Determination 2012.
26. We support the Commission's use of '31 March 15' capital expenditure forecasts as provided in year beginning 2015 disclosures to determine the value of commissioned assets that will have entered the regulatory asset base by the start of the next regulatory period.
27. We note the Commission's response in the Questions and Answers Session for Electricity DPP Draft Decision Models¹⁰ on the absence of financing costs within capital expenditure forecasts and submit for the Commission to include these costs as provided in the year beginning 2015 disclosures when calculating the constant price forecasts of network capital expenditure.
28. With the removal of finance during construction allowances post 1 April 2009 under the Electricity Distribution Services Input Methodologies Determination 2012, EDB have provided forecasts for cost of financing permissible under Generally Accepted Accounting Practices that increase the value of commissioned assets that will enter the regulatory asset base.

4. Forecasting Revenue Growth

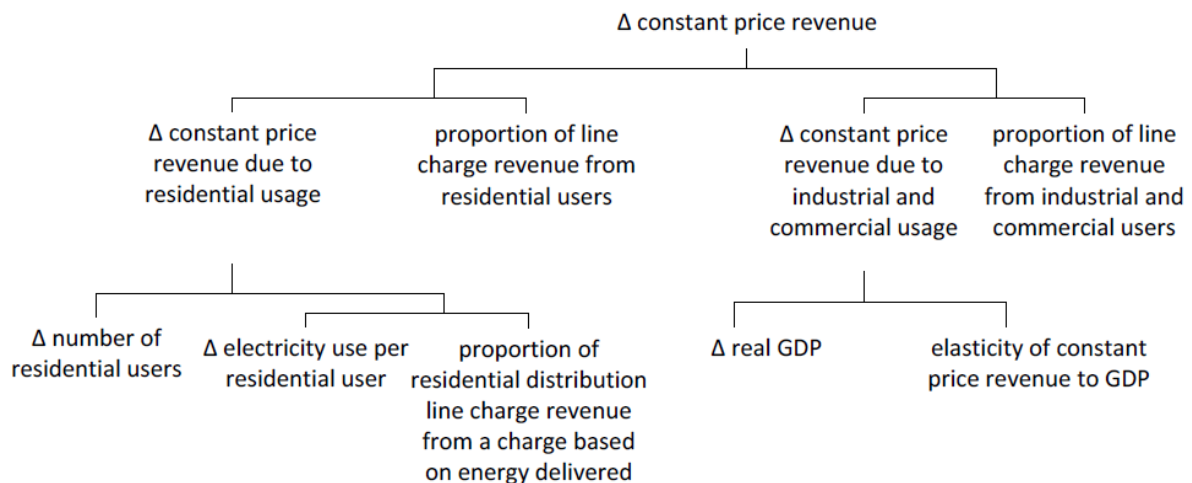
29. As the Commission has noted in para 5.4 of the low cost paper, relative to other forecasts, the forecast of revenue growth arguably has a more material impact on the starting price set based on current and projected profitability. It is critical therefore that the approach to model forecast revenue growth is in keeping with an EDB's historical experience.
30. We have concerns on the proposed approach to model constant price revenue growth, with the Commission's forecast of constant price revenue growth over the next regulatory period not matching the historical negative trend of electricity volumes entering the system from supply to consumers' connection points experienced on the Horizon Energy network as shown below in Figure 1.

¹⁰ <http://www.comcom.govt.nz/dmsdocument/12195>, 30 July 2014

Figure 1. Horizon Energy Throughput (Extrapolated)



31. We submit that it is reasonable to assume that the throughput drivers will remain consistent within historical trends for the next regulatory period. This is the same logic for any forecasting, unless specific changes are known, and it relies upon known published data, and removes any bias following the application of a derived approach. Following the logarithmic approach, Horizon Energy’s throughput growth for the period 2016 to 2020 can be viewed as being negative, as demonstrated above in Figure 1.
32. Figure 5.1 of the low cost paper provides the below high level overview of the Commission’s proposed approach to modelling constant price revenue growth.



Source: Commerce Commission “Low Cost Forecasting Approaches For Default Price-Quality Paths” 4 July 2014, Figure 5.1

33. The Commission’s proposed approach for change in constant price revenue due to residential usage is to forecast the number of residential users and forecast change in electricity use per residential user using a proportion of residential distribution line charge revenue from a charge based on energy delivered.

34. We support the use of population forecasts from Statistics New Zealand as proxy for changes in the number of residential connections, due to these forecasts being consistent with historical experience.
35. We are concerned at the Commission's inference that an inability to demonstrate likely pattern of future trends justifies the assumption that electricity use per residential consumer will remain broadly constant, when historical analysis as presented in Figure 1 suggest otherwise. We note the Commission has requested evidence on the likely pattern of future trends in electricity use per residential consumer. However the Commission when mentioning electricity price increases are starting to moderate, economic activity is picking up, and electric cars are becoming viable has not provided any correlation between these statements and actual trends as experienced by EDBs for electricity use per residential consumer.
36. We suggest the Commission has not recognised the impact that localised generation such as solar thermal and solar photovoltaic is having on the electricity use per residential consumer, with historical experience being more compelling than the notion of a potential uptake in electric cars sometime in the future. Coupled with the significant uptake of residential insulation and use of low energy lamps within the Eastern Bay of Plenty over the past ten years due to significant government and third party subsidies, from the Energy Efficiency and Conservation Authority and the Eastern Bay Energy Trust respectively, available to householders.
37. As such we submit for a negative allowance to represent the known trend of decreasing electricity use per residential consumer be made within the change in constant price revenue due to residential usage calculation.
38. The Commission's proposed approach for change in constant price revenue due to industrial and commercial usage is based on the regional real Gross Domestic Product ("GDP") forecasts provided by the New Zealand Institute of Economic Research ("NZIER") coupled with an assumption on the elasticity of constant price revenue to GDP.
39. The use of the NZIER regional real GDP forecasts continues to be problematic in that EDBs typically do not traverse across an entire region as has been assigned in the modelling, coupled with the inherent limitations in the forecasts that NZIER produce.
40. As previously cautioned by the NZIER in the use of the regional real GDP forecasts for the November 2012 reset¹¹, estimates and projections should be used with care. The NZIER noted they are indicative measures which describe the broad trends in industrial activity, mix of industries by region and people's preference to live in certain regions.
41. We continue to submit historical trends do not match the growth as provided by within the NZIER's regional real GDP forecasts, and while we appreciate alternative models are currently not available for the next regulatory period, in the absence of further models, we submit for constant price revenue from commercial usage to be modelled by extrapolating actual historical trends.
42. Without prejudice to the above we note the Commission's calculation of the change in real GDP uses the linear regression slope function within MS Excel. While linear regression may be suitable, we submit the periods to which the slope is applied should be disaggregated between the current regulatory period and the next regulatory period.

¹¹ <http://www.comcom.govt.nz/dmsdocument/9682>, 28 November 2012

We submit for the slope from the NZIER's regional real GDP forecasts should be calculated using 2016 to 2020 data applicable to the next regulatory period. For the lagged quantities periods being 2013 and 2014 (used to calculate ΔD), actual regional real GDP data as held by NZIER to produce the September 2014 quarterly predictions should be used.

43. Following the above, we submit for constant price revenue for commercial and industrial usage to be split, with real GDP only applied as a driver for constant price revenue for commercial usage. We understand the Commission is considering an information request under s53ZD of the Act to obtain information from EDBs to facilitate a split in the modelling of constant price revenue from commercial usage separate to the modelling of constant price revenue from industrial usage. We support this information request and the decoupling of the modelling due to the divergent drivers behind commercial usage compared to industrial usage.
44. Following the decoupling of the constant price revenue from industrial usage from the regional real GDP driver, and in the absence of establishing further modelling at this point in time for the next regulatory period, we submit forecast constant price revenue for industrial usage would need to be modelled using an extrapolation of actual historical trends.
45. Thank you for considering this submission. Please find contact details below to discuss any of these matters further.

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