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Keeping the energy flowing

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By email im.review@comcom.govt.nz

Incentivising efficient expenditure: Questions regarding totex, IRIS and innovation

Dear Andy

Transpower welcomes the opportunity to respond to the Commerce Commission's (the Commission) follow-up questions to the online EDB workshop[1] held 7 November 2022.

We do have concerns with how the existing capex and opex incentive mechanisms play out. Specifically, (as the CEPA (2018) report[2] demonstrated under incentive mechanisms similar to our capex incentive mechanism and our IRIS incentive mechanism) the incentives between opex and capex are not equal in all situations.

Our experience highlights two specific concerns:

1. The IRIS requires a determination (the IBAT) by the Commission in future RCPs on the baseline adjustment term (via the "differences in penultimate year"[3]) - the baseline adjustment term is complex and creates uncertainty for stakeholders.
2. Accounting changes can (and have) had a material impact on our incentive payments. The recent clarification on the accounting recognition of Software-as-a-Service implementation costs has meant a material reclassification of costs from capex to opex. This has resulted in a material IRIS penalty in RCP3 that is not fully offset via the capex incentive mechanism.[4]

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[1] Forecasting-and-incentivising-efficient-expenditure-for-EDBs-Full-slide-deck-07-November-2022.pdf

[2] CEPA Report - Expenditure Incentives May 2018.

[3] Transpower IM clause 3.6.4 (4)

[4] We have previously shared our modelling on this issue with the Commission.

That being said, in our previous submission to the issues and process paper[5] we said "*we consider that, as demonstrated in Great Britain, that a totex incentive can simplify the overall incentive regime, and ensure incentives are equalised across capex and opex. However, for Transpower there is a material cost of shifting away from our GAAP-based RAB. A wholesale shift from the current arrangements should be carefully considered and not rushed into*."

We remain of the view that new arrangements should not be rushed into; nevertheless the totex approach is worth continued regulatory attention. While the costs of change will be created in the short term a future totex approach should create option value for the dynamic efficiency to be realised under technological change. Even if the timeline is too short to implement for 2025 then 2030 could be a good starting point for a changed regime (we note 2030 is the current time-limit for the existing price-path decision for Transpower being in force). [6]

We appreciate the CC staff research and analysis to date is a good start to considering a key change to the regulatory regime for lines companies. We provide additional references to relevant material in the footnote.[7] KPMG describes the totex approach as "*a significant change in the treatment of cost performance and recovery, which, combined with outcomes, allows companies greater flexibility to move away from a list of specific schemes agreed by the Regulator towards an approach that allows them to consider alternatives that can deliver the same or better service performance in line with customer preferences.*"[8]

We consider it worthwhile noting that a totex approach can assist with financeability issues. Two features of Ofgem's totex approach is the capitalisation rate and a single 'asset' depreciation life. Both of these factors can be used as levers to alter a networks cashflows to support financeability.

In our view the main advantage is a reduction in complexity of the financial incentives including the CC potentially not needing to apply judgement in rules that are intended to promote certainty.[9] Decisions can be made unhindered by having to work out how the incentive regime would apply depending on capital or operating expenditures. We agree

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[5] Transpower-NZ-Ltd-Submission-on-IM-Review-Process-and-Issues-paper-and-draft-Framework-paper-11-July-2022.pdf

[6] Commerce (Part 4 Regulation—Transpower) Order 2010 (SR 2010/268) Contents – New Zealand Legislation

[7] Incentives and menus CEPA July 2012; Future regulatory options for electricity networks prepared by CEPA August 2016; OFWAT Innovation and efficiency gains from the totex and outcomes framework KPMG June 2018

[8] OFWAT Innovation and efficiency gains from the totex and outcomes framework KPMG June 2018 p.5

[9] Commerce Act Section 52R *The purpose of input methodologies is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part.*

with the advantages described in the staff working paper[10] while noting the disadvantages[11] identified have merit too; the issue is which is the better policy setting to ensure financial incentives do not become the barrier to embracing technological change and innovation.

As the Commission's staff paper noted, Ofgem can use benchmarking to help determine networks revenue allowances. This approach helps remove any time bias (including around the base year) by reducing the network's benefit of delaying the implementation of efficiencies.[12]

We have answered questions relevant to Transpower.

Yours faithfully

Joel Cook

Head of Regulation

[10] i. Simple to calculate and transparent about how savings lead to incentive amounts. ii. Changes to accounting standards or treatment of different types of expenditure do not necessarily require a change to the mechanisms. iii. Simplicity can encourage trust and positive behavioural change as suppliers understand the outcomes of efficiency decisions (to the extent the current incentive schemes are insufficiently understood).

[11] i. Potential unintended consequences of a change. ii. Implementing a simpler mechanism may require giving up some of the properties of the current EDB Part 4 mechanism (e.g., correcting the timing bias during a regulatory period). iii. The complexity and cost of implementing a totex scheme (including a totex incentive mechanism).

[12] Benchmarking helps remove time bias under separate opex and capex incentive mechanisms.

Answers to selected questions

Area	TP comment
B1. Should we consider introducing a totex approach for EDBs as a solution to capex bias and/or simplification of financial incentive mechanisms? Should we introduce a totex approach for other regulated services? Please provide your reasons.	As we have noted in our previous submission, and as the Commission staff articulated, there are benefits from a totex approach. From our perceptive it is the currently the best way of equalising the financial incentives between capex and opex solutions. We consider that the Commission should consider a totex incentive mechanisms for other regulated services. However, careful planning is required, and this should not be rushed.
B2 If you consider we should adopt a totex approach, do you agree with the approach described in the staff working paper? If not, please explain why not and what you would change.	While the totex incentive mechanism (as implemented by Ofgem) is relatively simple, as the Commission staff have highlighted there are number of detailed changes that need to be made. The split between what requirements need to be in the IMs and what needs to be in the IPP needs to be determined. As we have indicated in our submissions to this Review, we consider the IMs should be mainly principles based while the IPP determination contains the prescription. This allows greater flexibility when setting the IPP and responding to the requirements at the time of setting the IPP rather than when the IMs are set which maybe done out of cycle with the IPP.
B3. If you consider we should adopt a totex approach, please provide your views on: • expected benefits for your business (relative to the current RAB-based building blocks approach with WACC uplift, opex and capex IRIS) • expected implementation costs and timelines for your business • any other considerations	We have not undertaken an extensive consideration of the impacts on Transpower from shifting to a totex approach. Some initial observations are: • We would have reduced costs/ uncertainty if IRIS is replaced with a totex incentive mechanism. • We would have greater flexibility with changes in capitalisation policies (i.e., currently change in capitalisation rates post-IPP determination are not equal). • A new price control revenue model would need to be constructed and tested. • We also note the Commission staff's identification of elements that would need to be determined e.g. depreciation rates, tax pools, capitalisation rates, etc.

Area	TP comment
C9. For Transpower's IPP, we understand from stakeholders that the determination of the 'baseline adjustment term' has introduced significant complexity and uncertainty, potentially undermining incentives to achieve efficiency savings. If we were to remove this adjustment term, what other adjustments to the IPP IRIS mechanism do you consider would be necessary to achieve its purpose?	We agree that the baseline adjustment term has introduced complexity and uncertainty. As we set out to the Commission at the time of its determination, we did not consider that the method appropriately addressed the impact of permanent step changes in Transpower's opex allowance. We are concerned about this application heading into RCP4. While RCP2 and RCP3 are more comparable, RCP3 with RCP4 will be less comparable due to inflation and the impact of COVID delaying work programmes. At this time we have not determined an appropriate alternative to the IBAT. We would like to engage with the Commission further to find a better solution and/or alleviate the above concerns while retaining efficiency incentives.