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John McLaren
Regulation Branch
Commerce Commission
PO Box 2351
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Dear John

Re: Submission on Preliminary version of the DPP financial model

Thank you for the opportunity to comment on the preliminary version of the financial model for electricity default price-quality paths from 2015, published by the Commission on 29 November 2013.

As a general comment, we have welcomed the process the Commission has followed in this consultation. The long time frame to respond, the Q&A session and the quality of documents comparing the previous and current model have all been excellent. We also welcome the early release of the model.

Recommendations to aid understanding and transparency of the model
Broadly we consider the model is very good in terms of presentation, but have some specific comments below.

Inconsistency between the DPP and CPP models
Following the release of the Orion CPP model in 2013 we can now compare the financial models used to regulate suppliers under the DPP and the CPP for the first time. We note that while the structures of the two models are similar, there are significant differences in how the calculations are put together. This largely comes down to the CPP model following the Input Methodologies and constructing the Building Blocks in an after tax manner, while the DPP model constructs the Building Blocks in a before tax manner. We would like to see improvements in comparability of these two models, which should be helped by the below suggestion.

Transparency of the Building Blocks
In some instances we think that the complexity of some cells within the Draft DPP model does not aid understanding and transparency. In particular Rows 49:52 of the BBAR sheet.

This section could be improved by separating out each of the Building Block calculations, and then using this area to sum all of the relevant building blocks. This would provide clarity around what the total building block for each section is rather than the current model that calculates a preliminary total for each building block, then makes further adjustments to those building blocks in this section.

We have attached a workbook that gives a practical example of how this might work using the Operating Expenditure section as an example. Refer to rows 42:50 that have been highlighted green for clarity in the workbook.

In this example the complex row's calculations have not been altered, however once this approach was applied to all building blocks in the sheet, rows 54:57 would become sums of the above building blocks rather than complex calculations.

This will increase the size of the worksheet, however the complexity will be removed and clarity will be increased. This will also aid in comparison of the model to external sources of information that users may have.

Calculating ROI for each year before smoothing
The ENA has submitted previously that it would be very helpful for a model output to be the expected ROI for each year of the regulatory period before smoothing. We agree with this recommendation. The forecast cash flows may create different ROI results each year and making this transparent should assist with understanding the implications of the Commission's modelling.

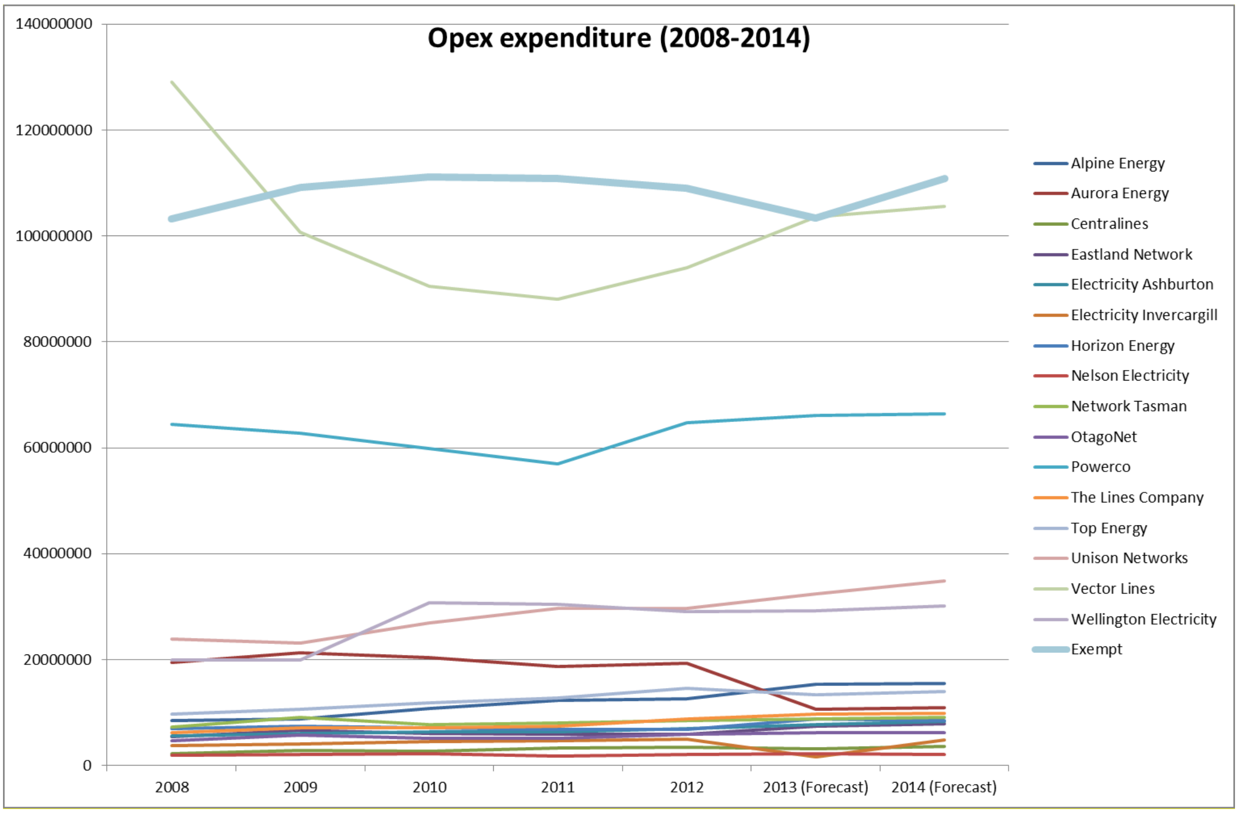
Selection on the base year
The Commission has asked how it should determine the "base year" used when applying the input methodologies – in particular, our views on options and factors it should consider when reaching its decision. The base year impacts the period covered by the financial model, the cost allocation for operating expenditure and the opening RAB value.

Powerco supports using the 2013/14 information as the base year for the model. We recognise this audited data not be available to the Commission for the DPP Draft Decision. We support providing the Commission with draft information on FY2013/14 to be used in the Commission's financial model.

The main factor we've considered in reaching our view is the accuracy of the model. Clearly using the actual RAB as at 31 March 2014 will be more accurate than a forecast. We also consider cost allocation information to be stable over time, and that it will be unlikely that 2014 will be an aberration. For example, our cost allocation is based on the split of assets, revenue and staff between our gas and electricity businesses and these are stable over time.

We also are still of the view that using 2014 as the base year for opex is preferable over an averaging approach. This is because it is the most recent information available and reflects the latest operating costs of the EDB. While we recognise the Commission may have concerns about suppliers inflating 2014 costs as there is no IRIS mechanism, the 2013 AMP forecasts don't suggest this is the case.

The graph below is taken from the Commission 2013 AMP summary database, and shows opex expenditure for non-exempt EDBs from 2008 to 2014 in constant 2013 dollars. There is no obvious forecast lift in expenditure for 2014. The trend for exempt EDBs has also been added to the graph (the bold light blue line). This in contrast indicates an uplift in 2014 – which must have no relation to the DPP, as these companies are not subject to the P0.



Calculating implied price changes

The Commission has asked how it should best calculate price changes that would be implied by its draft and final decision – and what information distributors could provide to ensure that the implied price changes are calculated correctly.

We recommend that price changes implied by the model should just reflect a comparison on FY2015 MAR from the 2012 DPP reset model and FY2016 MAR from the 2015 DPP reset model. These figures would just need to be amended to reflect FY2015 clawback.

We note that this calculation would not include the impact of changes in recoverable costs and pass through costs. However, these costs are directly passed on and are of less relevance to interested people looking at the DPP Determination.

Technical issues

Commissioned assets

We note that the ENA has raised a query on the treatment of commissioned assets, and we agree with their submission. Namely, that the Preliminary Model treats assets commissioned in the base year as “additional assets”, when the input methodologies state they should be treated as “existing assets”. This affects depreciation values, since the two groups of assets use different remaining lives.

We agree with ENA’s recommendation, that to be consistent with the DPP IMs, the Preliminary Model should:

- include the value of commissioned assets for FY13 in the roll-forward of existing assets in the ‘RAB’ sheet; and
- exclude assets commissioned in FY13 from the roll-forward of additional assets in the ‘RAB’ sheet.

Aligning the BBAR formula with the CPP IM

We also support ENA's recommendation that the BBAR formula should be the same as the CPP IMs. We note the main difference currently is that the timing adjustment applied to the term credit spread differential allowance (TCSD) is different. We also agree with ENA's recommendation that both formulae are reviewed to determine which is the most consistent with the timing factor and tax logic applied elsewhere in BBAR, and amendments are made accordingly to ensure the formula are consistent for the DPP and CPP price paths.

I would be happy to discuss any of these points with Commission staff.

Yours sincerely

Richard Fletcher
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