

## INPUT METHODOLOGIES REVIEW - CUSTOMISED PRICE-QUALITY PATHS

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### Overview of matters to be discussed at the workshop for electricity distribution businesses

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#### Purpose of paper

1. This paper outlines our evolving thinking on proposed improvements to certain requirements for customised price-quality path (CPPs) which will be covered at the 19 April 2016 workshop.<sup>1</sup>
2. This outline is to:
  - 2.1 help interested parties prepare for the workshop; and
  - 2.2 provide an opportunity for questions and comments, in advance of the workshop, to help us focus the workshop where there is the most value.

#### Objective of the workshop

3. The objective of the workshop is to test our evolving thinking on improvements to two aspects of the CPPs requirements ahead of the June 2016 draft decision for the IM review:
  - 3.1 refinements to Schedules D and E of the CPP information requirements; and
  - 3.2 the potential to introduce flexibility to the number of projects the verifier will review and the criteria for selecting this number.
4. Our evolving thinking relates to improving the IMs for electricity distributors, but we expect discussions on the number of projects the verifier will review may be of interest to gas pipeline businesses ahead of future work to the IMs for this sector. We encourage gas stakeholders to provide any questions on this matter ahead of the workshop.

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<sup>1</sup> Full details of the workshop are set out in the accompanying [‘Notification of workshop for CPPs’] available on our website alongside the workshop materials at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/interactions-between-dpps-and-cpps-and-the-requirements-for-cpps/>.

## Changes in the context of the IM review

5. In July 2015 we published a draft framework for the IM review which set out the high-level factors we would consider any proposed changes to IMs against.<sup>2</sup> We said we would consider changing the current IMs where change appears likely to:
  - 5.1 promote the Part 4 purpose in s 52A more effectively; or
  - 5.2 promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
  - 5.3 significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).

### *Feedback and experience suggests opportunity to reduce cost and complexity*

6. Our experience with the process to set Orion's CPP in 2013, and feedback we received as part of that process, highlighted opportunities for improvements across the CPP requirements.<sup>3</sup> In light of the IM review draft framework, we described this in our June 2015 problem definition paper for the IM review as:<sup>4</sup>
  411. Key identified areas in which additional costs in excess of the setting of a DPP could arise under the CPP rules and processes, and which could therefore be examined for their cost-effectiveness, include the:
    - 411.1 costs of the applicant meeting the CPP information requirements;
    - 411.2 engagement of external parties to advise and assist in the preparation of the CPP application, for example, advice on conducting consumer consultation, the use of a verifier, and the engagement of auditors or independent engineers; and
    - 411.3 costs of us evaluating the CPP proposal (including our use of experts and the extent to which the views of interested persons are sought), which are then recharged to the CPP applicant as a fee.
7. Submissions received following the problem definition paper and views expressed by interested parties at the IM review forum, provided broad agreement that we should consider improvements to reduce the cost and complexity of the CPP requirements.<sup>5</sup>

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<sup>2</sup> Commerce Commission "Developing decision-making frameworks for the current IM review and for considering changes to the IMs generally"; 22 July 2015. Available at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>

<sup>3</sup> Feedback received on process to set the customised price-quality path for Orion is available at <http://www.comcom.govt.nz/regulated-industries/electricity/cpp/orion-cpp/>.

<sup>4</sup> Commerce Commission "Input methodologies review – Invitation to contribute to problem definition", 16 June 2015; paragraph 411. Available at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>.

<sup>5</sup> Input Methodologies review forum 29-30 July 2015 – Transcript is available at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/input-methodologies-review-forum-2/>. Submissions on the Problem definition paper are available at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/>.

*Workshop focuses on select issues ahead of draft decision*

8. The workshop is focused solely on making improvements to the cost and complexity associated with Schedules D and E of the CPP information requirements, and the number of projects the verifier is required to assess.
9. We intend to cover issues relating to the remainder of the CPP requirements at the draft decision stage and interested parties will have opportunity to comment on the full spectrum of CPP issues at that time.
10. In the remainder of this paper we set out our proposed improvements for both Schedules D and E of the information requirements, and the number of projects the verifier is required to assess.

**Proposed changes to Schedule D**

11. Below, we discuss the main issues we have identified with qualitative information requirements on expenditure forecasts and our proposed approach to resolving them.

*Main issues*

12. We have identified the following key issues with Schedule D of the IMs for EDBs:<sup>6</sup>
  - 12.1 The information requirements are not aligned with the way that suppliers' are required to provide information in their asset management plans (AMP) as part of their information disclosure obligations.<sup>7</sup> This causes duplication of information between the CPP proposal and the AMP.
  - 12.2 Some of the required information is not relevant to assessing expenditure.
  - 12.3 Some of the required information cannot be provide ex ante.
  - 12.4 Not all of the information necessary to determine a CPP proposal is included. An example is the deliverability plan for the expenditure forecasts proposed in a CPP proposal.

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<sup>6</sup> Commerce Commission "Electricity Distribution Services Input Methodologies Determination 2012", 3 February 2016.

<sup>7</sup> Commerce Commission "Decision No. NZCC 22 Electricity Distribution Information Disclosure Determination 2012", 1 October 2012.

### *Summary of proposed changes*

13. We set out below a summary of the changes we propose Schedule D. The proposed changes to Schedule D are set out in full in the accompanying document—Review of CPP IMs - Schedule D—available on our website:<sup>8</sup>
  - 13.1 Schedule D – a statement that Schedule D contains all the requirements on qualitative information supporting a CPP proposal.<sup>9</sup>
  - 13.2 Section D1 – align the definitions, where relevant with those in the AMP.
  - 13.3 Section D3 – set out only the information requirements relating to governance, business procedures and process.
  - 13.4 Sections D6 to D15 – set out the information requirements for each expenditure category and identified projects and programmes.
  - 13.5 Section D16 – remove the information requirements for controllable opex.
  - 13.6 Section D17 – simplify the information requirements for related party information, by requiring the information at the aggregate level of capex.
  - 13.7 Section D20 – include the requirements for a deliverability plan for the proposed expenditure.

### **Proposed changes to Schedule E**

#### *Main issues*

14. We have identified four main issues with Schedule E:
  - 14.1 the expenditure tables are not aligned with business practices and information disclosure;
  - 14.2 there is significant complexity due to disaggregating forecasts by asset type;
  - 14.3 the templates are only in nominal prices; and
  - 14.4 the related party rules are impractical to apply to forecast expenditure.

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<sup>8</sup> <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/interactions-between-dpps-and-cpps-and-the-requirements-for-cpps/>.

<sup>9</sup> We consider that the information requirements in Schedule D are asking suppliers to justify their CPP expenditure forecasts whereas the AMP under the Information Disclosure Determination focusses on how the assets are being managed.

### *Summary of proposed changes*

15. We set out below a summary of the changes we propose for Schedule E. The proposed changes to Schedule E are set out in full in the accompanying document—*Review of CPP IMs—Schedule E*, available on our website.<sup>10</sup>
  - 15.1 Table 2 – remove disaggregation by service categories. Align expenditure categories with those required for AMPs, to align with business practices. Change the requirements for information on related party transactions to an aggregate level of capex rather than at the project level.
  - 15.2 Table 3 – remove disaggregation by service categories and controllable and uncontrollable opex. Align expenditure categories with ID.
  - 15.3 Table 4 – change to require reporting at capex project level rather than at asset category level. Split table 4 into two groups – 4a for development capex category and 4b for other categories.
  - 15.4 Table 5 – change to require reporting at opex project and programme level.
  - 15.5 Table 6 – align with AMPs.
  - 15.6 Table 9 – this is a new table on demand forecasts.
  - 15.7 Table 10 – A new table for submitting forecast capex by asset type. Proposed Table 10 is similar to the previous Table 4. Forecast by asset types was specified for the purpose of the Valuation and Tax IMs and generally used to calculate depreciation of forecast assets. In aiming to reduce complexity and costs of preparing this forecast, we wish to discuss options for simplifying this Table. Options include:
    - 15.7.1 using the DPP approach of assuming a 45 year asset life to estimate the value of depreciation of forecast commissioned assets;
    - 15.7.2 disaggregating by asset class at an aggregate capex level rather than at a project level;
    - 15.7.3 disaggregating by asset expenditure categories – defined in Schedule D – at a project level; and
    - 15.7.4 disaggregating by asset expenditure categories at aggregate capex level.

### **Proposed changes to verification**

16. Below we highlight the main issues we have identified with the verifier process and we discuss the specific issue regarding the number of projects and the potential to introduce flexibility to this process which is the focus at the workshop.

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<sup>10</sup> <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/interactions-between-dpps-and-cpps-and-the-requirements-for-cpps/>.

### *Main issues*

17. We have identified a number of issues with the IMs relating to verification. The key issues are listed below:
  - 17.1 the verifier's role and purpose is unclear;
  - 17.2 the verifier is spending time on inputs that are not relevant to the expenditure objective (e.g. non-standard depreciation);
  - 17.3 during the verification process the communication and expectations between parties is unclear, particularly the approach to confidentiality during verification;
  - 17.4 the verifier needs to be used during the Commission's review of a CPP proposal;
  - 17.5 there is insufficient time allowed for verification;
  - 17.6 the number of projects to be verified is too onerous for smaller suppliers; and
  - 17.7 the verifier and engineer roles overlap and create unnecessary cost and complexity.
18. While there are a number of issues that we have identified regarding verification, the workshop will solely focus on the number of projects to be verified. Our preliminary views on the remaining issues and potential solutions will be provided in our draft decision due in June 2016. Interested parties will have the opportunity to comment on these views at that time.

### *The introduction of flexibility into the number of projects a verifier reviews*

19. The current IMs require the verifier to carry out a detailed review the of following:
  - 19.1 the five largest capex projects or programmes by total expenditure;
  - 19.2 the five largest opex projects or programmes by total expenditure;
  - 19.3 the two largest categories of non-system fixed asset capex by total expenditure; and
  - 19.4 ten capex/opex projects/programmes that relate to the business-specific key drivers of the CPP application, selected by the independent verifier based on 'specified' or 'pre-set' selection criteria.
20. We propose to set the maximum number of projects that the verifier will review and intend to discuss an appropriate number at the workshop.
21. Discussion at the workshop will relate specifically to the introduction of flexibility to the number of projects the verifier is required to assess as set out in paragraph 19.4.

The introduction of flexibility is aligned with the proportionate scrutiny principle discussed in our CPP Emerging views paper.<sup>11</sup>

22. We consider that this flexibility will reduce some of the cost and complexity of applying for CPPs. Flexibility could address situations where a smaller supplier has only one or two large projects that will account for the large majority of the CPP proposal's price impact on consumers. For example, it would seem excessive to have a stringent requirement for verification of 22 projects, where a supplier may not have 22 projects.
23. Our preliminary view is that criteria for this flexibility could include:
  - 23.1 where the verifier judges the number of projects is sufficient to:
    - 23.1.1 provide an opinion as to whether the expenditure forecast information has been sufficiently prepared in accordance with the policies and planning standards at both the aggregate system level and for each of the expenditure categories; and
    - 23.1.2 form an opinion on any quality standard variations that have been made;
  - 23.2 where the verifier judges that the issue the CPP intends to resolve can be adequately represented by a proposal with fewer projects;
  - 23.3 the extent that the proposed number of projects in the proposal reasonably reflects information from the previous AMP of the business, if this is relevant;
  - 23.4 the extent that it would be in the best interests of consumers to verify fewer projects;
  - 23.5 where the verifier judges that examining the fewer projects has no material impact on the ability of the Commission to adequately test the applicants' expenditure objective;

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<sup>11</sup> Commerce Commission "Emerging views on opportunities to improve the way DPPs and CPPs work together"; 29 February 2016. Available on our website <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/input-methodologies-review/interactions-between-dpps-and-cpps-and-the-requirements-for-cpps/>