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Te Komihana Tauhokohoko

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How we propose to implement further amendments to input methodologies for electricity distributors subject to price-quality regulation

Incremental Rolling Incentive Scheme (IRIS)

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Associated documents

Publication date	Reference	Title
27 February 2015	ISSN 1178-2560	Draft Electricity Distribution Services (Incremental Rolling Incentive Scheme) Input Methodology Amendments Determination 2015
27 November 2014	ISBN 978-1-869454-11-1	Amendments to input methodologies for electricity distribution services and Transpower New Zealand: Incremental Rolling Incentive Scheme
27 November 2014	ISSN 1178-2560	Incremental Rolling Incentive Scheme Input Methodology Amendments Determination [2014] NZCC32
20 October 2014	ISSN 1178–2560	Draft Incremental Rolling Incentive Scheme Input Methodology Amendments Determination 2014
18 July 2014	ISBN 978-1-869453-85-5	Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme
18 July 2014	ISSN 1178–2560	Draft Incremental Rolling Incentive Scheme input methodology amendments 2014
20 September 2013	ISBN 978-1-869453-24-4	Incentives for suppliers to control expenditure during a regulatory period: Process and issues paper
30 April 2013	N/A	Notice of intention: Potential amendments to input methodologies for electricity distribution services, gas pipeline services, and Transpower

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1. Introduction

Purpose of paper

1.1 This paper invites submissions on how we propose to implement further amendments to input methodologies that would affect the incentives electricity distributors have to control expenditure when their prices are regulated. The deadline for providing submissions is Friday, 13 March 2015.

1.2 The proposed amendments are intended to complement the amendments we published on 27 November 2014, which addressed situations in which distributors move from one default price-quality path to another. In particular, the amendments proposed in this paper are intended to address situations in which a distributor transitions back and forth between default and customised price-quality paths.

Proposed amendments to input methodologies – Incremental Rolling Incentive Scheme

1.3 The input methodologies include an Incremental Rolling Incentive Scheme (or 'IRIS').[1] The IRIS provides a mechanism by which suppliers that are subject to price-quality regulation can retain the benefits of efficiency gains beyond the end of a regulatory period.

1.4 On 18 July 2014, we published a draft decision that sought feedback on proposed amendments to IRIS that would affect the incentives that Transpower and suppliers of electricity distribution services, gas distribution services, and gas transmission services have to control expenditure when their prices are regulated.[2] The proposed amendments were intended to produce an incentive to control capital and operating expenditure that is the same in each year of the regulatory period.

1.5 Following submissions on our draft decision we published a final decision on 27 November 2014 that covered amendments applying to electricity distributors under a default price-quality path, and Transpower under an individual price-quality path.

1.6 We are now consulting on the drafting of amendments that apply to electricity distributors when they transition back and forth between default and customised price-quality paths.

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1 This IRIS was set under s 52T(1)(c).

2 Refer: Commerce Commission "Draft Incremental Rolling Incentive Scheme Input Methodology Amendments 2014" (18 July 2014); Commerce Commission "Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme" (18 July 2014).

1.7 We intend to consult separately on proposed amendments to IRIS for gas pipeline services and will notify interested persons of our updated process at a later date.

1.8 In our draft decision, we sought views on:

1.8.1 our reasons for the proposed amendments to IRIS, which we set out in a 'draft reasons paper';[3] and

1.8.2 the implementation of the proposed amendments to IRIS, which were included in 'draft determinations'.[4]

1.9 We have now considered all the submissions received in response to our draft decision with respect to electricity distributors that transition back and forth between default and customised price-quality paths.

Additional consultation on drafting

1.10 Before publishing a final decision, we are providing an additional opportunity for submissions on the drafting of the proposed amendments to IRIS. In particular, we are seeking views on whether the revised drafting of the amendment determination gives effect to the matters described in this paper.

1.11 To the extent practicable, the revised version of the amendment determination takes into account submissions and cross-submissions on an earlier version.[5] We are grateful for the submissions made in response to our draft decision. We are not seeking further views on our draft reasons paper and draft determination published on 18 July 2014 at this stage. Our response to submissions received to date will be discussed in the final reasons paper.

3 Commerce Commission “Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme” (18 July 2014).

4 Commerce Commission “Draft Incremental Rolling Incentive Scheme Input Methodology Amendments 2014” (18 July 2014).

5 On 18 July 2014 we published proposed amendments to the input methodologies for IRIS. Submissions on the proposed amendments were due by 29 August 2014, and cross-submissions on 12 September 2014. We also published a reasons paper alongside the drafting of the proposed amendments for IRIS, ‘Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme’. The paper sought feedback on proposed amendments that would affect the incentives that suppliers have to control expenditure when their prices are regulated.

We invite drafting suggestions before the final determination

1.12 Before publishing a final decision on further amendments to the IRIS, we are inviting submissions on the proposed drafting of the amendments, and an additional matter for consultation. This matter relates to the approach we have proposed for the transitional situations.

1.13 Chapter 2 sets out the specific matters that should be reflected in the updated draft amendment determination that we have published alongside this paper. These explanations are supplemented by the models that we have released alongside this paper. Chapter 3 contains additional matters for consultation that are relevant to the proposed drafting. Details for how you can provide your views can be found in Chapter 4.

Material released alongside this paper

1.14 Alongside this paper, we have published:

1.14.1 An updated draft input methodology amendment determination that would affect IRIS (updated draft amendment determination);[6] and

1.14.2 Models that show the impact of applying the proposed amendments, and which follow a similar format as the models released alongside our draft decision.[7]

6 Draft Electricity Distribution Services (Incremental Rolling Incentive Scheme) Input Methodology Amendments Determination 2015.

7 These models demonstrate that the formulas in the updated draft amendment determination give effect to the desired retention factors.

2. Matters reflected in the proposed drafting of amendments

Purpose of this chapter

2.1 This chapter sets out the specific matters that should be reflected in the updated draft amendment determination that we have published alongside this paper. We invite you to highlight any instances in which the updated draft amendment determination does not reflect these matters.

General guidance

2.2 Consistent with our approach for default price-quality paths, the proposed drafting for the amendment determination is intended to implement an IRIS for electricity distributors that:

2.2.1 can be described as 'symmetric'; and

2.2.2 affects incentives to control operating and capital expenditure.

2.3 However, these provisions are not intended to affect Orion New Zealand under its current customised price-quality path.[8]

Operating expenditure

2.4 The general approach for calculating recoverable costs is the same for the transitional situations as it is for the situations in which distributors remain on the default price-quality path. In particular, the steps in this method are:

2.5 Amounts that are generally equal to the incremental change in operating expenditure are carried forward from earlier years in which the savings or losses are made; and

2.6 The amounts carried forward into each year are added together to determine the recoverable cost term.

2.7 In the second full year after the price-quality path starts to apply to the supplier, a one-off adjustment is made after the carry forward amounts are added together. These 'adjustment terms' are discussed further in the next section.

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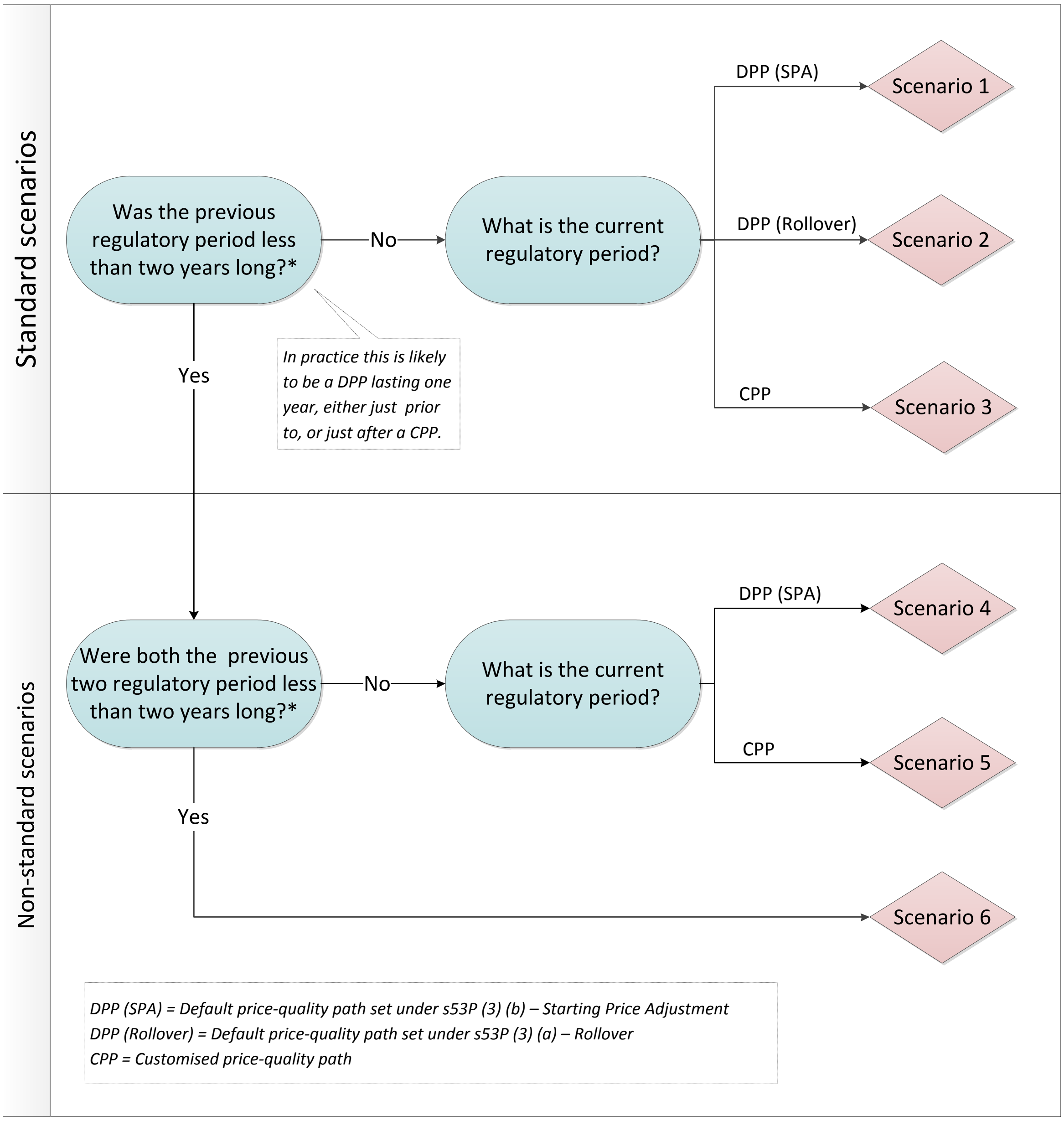
8 Existing IRIS provisions, which can be described as 'asymmetric', currently apply for Orion New Zealand (for its customised price-quality path for the five years from 1 April 2014 to 31 March 2019). The amendment determination preserves the existing rules for Orion New Zealand and allows the net IRIS balances to be included as recoverable costs in the years following those price-quality paths.

Adjustment terms are dependent on the situation

2.8 To give effect to the IRIS in all situations we have introduced a number of additional adjustment terms to the input methodologies that apply under different scenarios.

2.9 We have identified six generic scenarios that may occur under default/customised price-quality regulation. Under each of these scenarios distributors will need to apply one or more of the proposed adjustment terms.

Table 2.1–Potential scenarios under default/customised price-quality regulation



2.10 Scenarios 1, 2, and 3 are the standard scenarios that would be faced by distributors in the majority of situations. Scenarios 4, 5, and 6 apply in more uncommon situations in which a default-price-quality path is applied for less than two years.

2.11 As an example, a distributor would be in Scenario 1 if it is subject to a default price-quality path set using a starting price adjustment under s 53P (3) (b) of the Act, and if the previous price-quality path was **not** a one year default price-quality path.

2.12 Table 2.1 shows which adjustment terms need to be applied in each of the scenarios described above together with references to the clauses that apply in the accompanying draft determination.

Table 2.2– Adjustment terms used in each of the scenarios

	Scenario					
	1	2	3	4	5	6
Clause reference	3.3.4 (2) (a)	3.3.4 (2) (b)	3.3.4 (3)	3.3.4 (4)	3.3.4 (5)	3.3.4 (6)
Base year adjustment term	✓	✓	✓	✓	✓	
Baseline adjustment term			✓		✓	✓
Roll-over adjustment term		✓		✓		
Roll-over adjustment term 2				✓	✓	
Roll-over adjustment term 3						✓
Roll-over adjustment term 4						✓
Savings adjustment term 1						✓
Savings adjustment term 2						✓
Savings adjustment term 3						✓
Penultimate year adjustment term				✓	✓	
Single year adjustment term				✓	✓	
Year 5 forecast adjustment term						✓

2.13 We have ‘unpacked’ the formula in each scenario into a number of adjustment terms. On their own, these adjustment terms do not necessarily have any intuitive meaning. However, the adjustment terms applied in each scenario combine to ensure that any savings or losses are appropriately shared between the distributor and consumers consistent with the intention of the IRIS scheme that applies to default price-quality paths.[9]

2.14 In practice, we will assist distributors to comply with these calculations by providing Excel templates that are tailored to the situation the distributor is in.

Capital expenditure—No changes to determination

2.15 We have not proposed any further changes to the determination for capital expenditure as the approach determined for default price-quality paths in November 2014 also works for transitional situations. However, there are some consequential changes to clause references as a result of clause renumbering.

[9] For operating expenditure, the retention period for savings and losses is five years following the year of the gain and loss, which is equivalent to a retention factor of around 35% for a supplier, see Commerce Commission “Amendments to input methodologies for electricity distribution services and Transpower New Zealand: Incremental Rolling Incentive Scheme” (27 November 2014), paragraph 4.8.1.

3. Additional matters for consultation

Purpose of chapter

3.1 This chapter provides an overview of the approach for calculating the adjustment term for situations in which a distributor transitions from a default price-quality path onto a customised price-quality path.

3.2 The adjustment term affected is the 'baseline adjustment term' which applies in scenarios 3, 5 and 6 outlined in Chapter 2.

Transitioning on to a customised price-quality path

3.3 In the draft decision, we noted that under a customised price-quality path an adjustment would be required to re-establish the link between expenditure in one period and the next.[10] The required adjustment was dependent on the extent to which any under- or over-expenditure in the penultimate year of the regulatory period was permanent or temporary in nature.

3.4 In the draft decision, we proposed a 'conditional' formula that was intended to calculate the relevant adjustment amount. We also modelled the impact of applying the formulas to allow interested parties to assess whether they achieve the desired outcomes. This 'conditional' formula approach applied to both customised price-quality paths and individual price-quality paths.

3.5 Following the draft decision we delayed the publication of the final IRIS amendments relating to customised price-quality paths. This was done in order to give us more time to focus on introducing the amendments that affected default price-quality paths and individual price-quality paths.

3.6 Transpower's submission on the draft decision for individual price-quality paths had identified issues with the conditional formula, which were flagged to Commission staff during the consultation period. Transpower identified these issues by testing the conditional formula against more complex, plausible patterns of efficiency gains and losses. The finding was that the retention factor varied considerably depending on the pattern of expenditure.

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10 Commerce Commission, "Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme", 18 July 2014, paragraphs 140-141.

3.7 As a result of the issues identified by Transpower, for the final decision applying to individual price-quality paths we chose to determine the relevant amount having regard to the views of interested persons. This approach is consistent with that applied by the Australian Energy Regulator, although under the Australian scheme the adjustment amount does not affect the amount of revenue the supplier can recover.

3.8 We now intend to apply the same approach we took in the final decision for individual price-quality paths to customised price-quality paths. This approach is necessary because some degree of judgement may be required to determine the amount required to give effect to the desired retention factor.

3.9 In particular the relevant adjustment amount is equal to the value of any temporary (or 'non-recurrent') differences between forecast and actual expenditure in the penultimate year of the preceding regulatory period. We refer to this adjustment amount as a 'baseline' adjustment because it has the effect of re-establishing the link between the expenditure baseline and expenditure in the previous period.

3.10 In order to determine the relevant adjustment amount we would consult with interested parties in advance of any customised price-quality path being set. An illustration of one way in which the relevant amount could be assessed is by:

3.10.1 determining a forecast consistent with the approach used for setting default price-quality paths, ie, by projecting forward the level of operating expenditure from the penultimate year of the preceding price-quality path ('base year');

3.10.2 calculating the net present value of the forecast determined consistent with the projection approach used for setting default price-quality ('NPV of forecast for default price-quality path');

3.10.3 calculating the net present value of the forecast of operating expenditure that is determined for the customised price-quality path ('NPV of forecast for customised price-quality path');

3.10.4 determining the amount that would need to be added or subtracted from the level of operating expenditure in the base year (when applying the projection approach for default price-quality paths), to equalise the NPV of the forecast for default and customised price-quality paths.

3.11 This approach relies on the fact that the difference between the forecast for the default price-quality path, and the forecast for the customised price-quality path, is the result of a distortion introduced by any non-recurrent differences between forecast and actual expenditure in the penultimate year of the preceding regulatory period.

3.12 We are interested in your views on the suitability of this approach for customised price-quality paths or whether there is an alternative approach that would result in the same effect.

4. How you can provide your views

Purpose of this chapter

4.1 This chapter sets out how you can provide your views on how we propose to implement amendments to input methodologies that would affect the incentives that electricity distribution businesses have to control expenditure when their prices are regulated.

Timeframe for submissions

4.2 We welcome your views on the drafting of the amendments proposed in this paper. Submissions are due by 5pm, 13 March 2015.

4.3 We do not intend to take into account any material that is submitted outside of the timeframes provided. Any party that is concerned about the time to engage with the material should contact us with a request for an extension outlining their specific concerns.

Address for submissions

4.4 Submissions should be addressed to:

John McLaren (Manager, Regulation Branch)
c/o regulation.branch@comcom.govt.nz

Format for submissions

4.5 We prefer submissions in both MS Word and PDF file formats.

4.6 Please include "Submission on IRIS (Technical Consultation): 27 February 2015" in the subject line of your email.

Requests for confidentiality

4.7 We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner, but we offer the following guidance.

4.7.1 If it is necessary to include confidential material in a submission, both confidential and public versions of the submission should be provided.

4.7.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

4.8 We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions and cross-submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.