



**Submission to the Commerce Commission on  
Information Disclosure: Approaches for  
Understanding EDB and GPB Cost Efficiency  
Technical Paper**

**4 November 2011**

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## 1. INTRODUCTION

1. Horizon Energy Distribution Limited (“Horizon Energy”) welcomes the opportunity to make this submission to the Commerce Commission (“Commission”) in response to the *Information Disclosure: Approaches for Understanding EDB and GPB Cost Efficiency Technical Paper* (“Cost Efficiency Paper”) issued 7 October 2011.
2. Horizon Energy submits for the Commission to consider the additional costs of compliance that will be placed upon Electricity Distribution Business (“EDB”) under the approach as presented in the Cost Efficiency Paper. These cost will need to be passed through, so that EDBs are not be burdened with additional compliance costs, and are able to continue to earn a normal return.
3. Furthermore, Horizon Energy submits for the Commission to provide an explanation of the intended outcome of this cost efficiency analysis. While Information Disclosure requirements meet the purpose of Part 4 of the Commerce Act 1986 (“the Act”), the Commission is looking to extend this further to analytics of cost efficiencies, the purpose for which has not been made entirely clear, and is not immediately identifiable under the Act.
4. Horizon Energy also makes note of and supports the points raised within the Electricity Networks Association (“ENA”) and PricewaterhouseCoopers (“PwC”) submissions on the Commission’s Cost Efficiency Paper.
5. The remainder of this submission follows the Commission’s format of questions and answers as set out in the Cost Efficiency Paper.

## 2. ASSESSMENT OF OPERATING EXPENDITURE

### 6. Q.1 - How much insight would an assessment of operating expenditure based on NZ comparators alone provide, for EDBs and for GPBs?

Horizon Energy considers much of the information already available on operating expenditure (“opex”), including reference material such as the annual PwC Information Disclosure Compendium, has been sufficient to date in terms of comparatives between EDBs within New Zealand.

### 7. Q.2 - How insightful could international comparators be in assessing EDB and GPB expenditure?

We should be extremely cautious when proposing to use overseas datasets for benchmarking New Zealand EDBs. There are numerous variables that would differ within the datasets between countries, potentially leading to misinformed interpretations and conclusions being drawn. We note here as an example, the Commission’s use of vertically integrated overseas companies when deriving an asset beta for the Commerce Act (Electricity Distribution Services Input Methodologies) Determination 2010 was an approach that became a point of contention for EDB submissions earlier this year. We submit for the Commission to avoid similar comparisons within this exercise.

In addition, we note Clauses 3.6 and 3.7 of the Cost Efficiency Paper comments negatively on the quality of the data available from overseas sources, which indicates that the comparisons although superficially interesting would lack credibility.

**8. Q.3 - What companies, countries or datasets should be included in the analysis?**

If any analysis were to be undertaken, it should be limited to the EDBs within New Zealand.

**9. Q.4 - How appropriate are sub-company comparisons of costs?**

Most of the New Zealand EDBs do not possess the scale necessary to produce any meaningful sub-company comparisons of costs. Collection of data at a sub-company level is open to a misinterpretation of variables, inconsistent application of parameters, and may merely provide an output of inaccurate cost allocations.

**10. Q.5 - How feasible and costly would it be to collect sub-company cost and characteristic data to enable sub-company comparisons?**

From Horizon Energy's point of view, the production of reliable sub-company opex data will be costly, as it would require the introduction of new processes and procedures requiring additional resources. More concerning than the cost however, would be the ability to produce meaningful sub-company data. The output of this resource intensive process would most likely simply produce well-intended but nevertheless arbitrary cost allocations.

**11. Q.6 What factors (outside management control) drive industry wide opex?**

There are a multitude of macro drivers within the New Zealand economy (e.g. inflation and unemployment rates) that all EDBs need to contend with. With further examples of other factors such as; increasing restrictions on access to roads for construction and maintenance, changes to the tree regulations, and the regulatory pressure to reduce outage statistics, increasing the need for live line work.

Networks with low growth like Horizon Energy replace few assets due to an absence of increased capacity requirements and therefore have to spend more on maintaining existing assets. Vegetation growth rates vary from area to area. Corrosion and therefore asset life are affected by proximity to the sea and geothermal areas.

Geography will also be a significant factor, as will the predominant agricultural and horticultural consumption which drives different needs and expectations in terms of reliability and quality. The mix of rural and urban supply areas can have a major impact on opex, just as can meeting the reliability needs of large industrial customers.

**12. Q.7 To what extent does the current information disclosure data capture these factors?**

Current information disclosure data captures Consumer Price Index inflation, however not for the purposes of measuring impact on opex. Other factors are not explicitly measured within the current information disclosure data, however to attempt to represent these factors within the disclosures would be futile. Factors that drive industry wide opex are as complex and varied as within any industry in an open market economy.

**13. Q.8 What cost drivers, if any, (outside management control) are unique to your EDB or GPB?**

As referred to above, Horizon Energy needs to contend with a considerable range of variables that impact costs such as; geothermal activity, high vegetation growth rates, and general corrosive atmospheric conditions.

**14. Q.9 To what extent does the current information disclosure data capture these factors?**

Horizon Energy considers the current information data does not capture these factors well, and maintains that spending significant resource on getting improved data will not change the quantum of opex required by EDBs to mitigate these factors.

**15. Q.10 What factors (other than changes in input prices) influence opex over time?**

We submit examples of factors that influence opex over time such as; network growth and increased investment to improve quality and reliability of network. In addition to factors outside management control, some of these are as mentioned above. While changes in technology can provide some reductions in opex, this is an option more readily available to those EDBs that can justify asset replacements due to high growth.

Horizon Energy also considers that the aging workforce in the industry will lead to higher costs, and advise caution of short term downward pressures on opex that may reduce the willingness for EDBs to invest in trainees.

**16. Q.11 To what extent should quality be taken into account when assessing cost efficiency?**

We submit that quality must be factored into the assessment. Non-exempt EDBs are all held accountable to operate within the Default Price-Quality Path, and as such must ensure sufficient expenditure is expended accordingly.

**17. Q.12 What level of opex should be assessed? Should the current sub-categories of EDB and GPB opex (e.g. general management, administration and overheads) be separately assessed, should further disaggregated cost data beyond these categories be collected and assessed, or should the analysis focus on total opex only?**

Horizon Energy does not believe assessment at the current sub-category level is advisable. We note the Commission has indicated as part of the Part 4 Review of the Information Disclosure requirements that these sub-categories may be replaced or removed. We would suggest many of the costs within these sub-categories are simply a product of internal cost allocations, and provide no immediate insight into the drivers of the costs themselves.

**18. Q.13 What components of opex should be separately benchmarked?**

Horizon Energy does not support the benchmarking of costs at this level, as noted above, detailed analysis may simply orchestrate meaning that leads to false interpretations and conclusions.

**19. Q.14 How much insight would external comparisons of common functions provide?**

We request the Commission consider the point of how reasonable it is to expect benchmarking at this level to provide meaningful conclusions, when accounting for the numerous variables within these functions such as location, scale, and expertise. For example, it is conceivable for a smaller EDB to have disproportionate accounting and finance expenditure to full time equivalents, due to statutory and regulatory compliance requirements that are mandatory to all EDBs regardless of size.

Furthermore Horizon Energy consider it interesting that the variability outlined in Clause 3.31 of the Cost Efficiency Paper demonstrates EDBs overhead costs as a proportion of total controlled opex, is not uniform amongst the industry, and to draw conclusions on an average is not appropriate.

**20. Q.15 What functions should be benchmarked and how easily available is cost data at a function-level?**

Horizon Energy submits for the Commission not to apply benchmarking at this level, for reasons as explained above.

**21. Q.16 What industries and operators should be included when benchmarking these functions?**

Horizon Energy submits for the Commission not to apply benchmarking at this level, for reasons as explained above.

**22. Q.17 Should nature-of-work comparisons be further considered in assessing EDB and GPB opex efficiency? If so, what sectors should be included in the analysis?**

We would advise caution in applying nature-of-work comparisons to EDBs. As Horizon Energy has submitted to the Commission previously, applying a top down approach either nationally or regionally does not produce reliable outputs at the more granular localised level. While many opex cost drivers may not be necessarily unique to Horizon Energy, there are localised drivers that are specific to every EDB's local environment.

### **3. ASSESSMENT OF CAPITAL EXPENDITURE**

**23. Q.18 To what extent should assessments of historical capex based on direct comparisons be considered as part of summary and analysis?**

Horizon Energy maintains that historical capital expenditure ("capex") based direct comparisons will invariably lead to false conclusions. As stated in the Cost Efficiency Paper, there are several drivers for capex and any comparison should be completed over a longer period of time to draw any meaningful conclusions.

**24. Q.19 What are the material assets and activities that should be included in a capex assessment?**

Horizon Energy's current 2011-2021 Asset Management Plan ("AMP") contains a high level disaggregation of costs, and the drivers for the asset investment decisions are listed for all asset types. It will be erroneous to focus on "material assets" (provided one could define it) and we support costs being grouped under the present categories.

Horizon Energy also submits that while not necessarily being defined as "material assets", examples of items that contribute significantly to capex are transmission and sub-transmission lines, and zone substation upgrades. However, for smaller EDBs like Horizon Energy these items are not replaced regularly enough to warrant continuous assessment.

**25. Q.20 What are the drivers of activity on these assets?**

Horizon Energy considers some EDBs have sufficient "material assets" for them to establish a routine replacement programme for these items while others are able to justify and fund early replacement due to growth in demand. Horizon Energy has neither of these features and enforces an age related condition based replacement policy on a significant number of these assets. Other possible drivers relate to safety and reliability issues, such as assets no longer meeting adequate design standards for; fire, public safety, modern security of supply criteria, and local authority requirements. Furthermore, we submit the lack of a financial incentive for EDBs to invest to reduce energy losses distorts capital investment in the industry.

Potential reductions in opex are generally a bi-product rather than a driver for capex. Exceptions being where a particular type of asset is causing faults or poses a safety risk. These are usually not large capital items but there can be a significant number of them on a network.

To demonstrate the point further, it is worth considering a couple of simple Horizon Energy examples of capex projects that in terms of description and cost are almost identical but have different drivers and different outcomes for opex. Both are service pillar box replacement projects. One involves replacing concrete and metal boxes that pose a public safety risk with plastic assets. This project will have no impact on opex. The other involves the replacement of pillar boxes that have been, or are likely to be, hit by vehicles. In this case the pillar is replaced with a buried box with the intention of reducing faults and therefore will affect opex.

**26. Q.21 How can capex effectiveness be measured?**

Horizon Energy submits for the Commission to consider AMPs that are in place to explain and justify the capex for public scrutiny. For the majority of EDBs, the specific design work and small quantity of relevant work required for substations and extra high voltage lines for example, would make benchmarking futile. Major cost items like transformers are bought from the same small group of suppliers and are often significantly affected by currency exchange rates, so even to compare these would provide little useful information and would likely breach commercial confidentiality.

It could be argued that the effectiveness of capex is more about an EDB's reliability and other investment criteria rather than the specifics of any individual asset. E.g. at what level does an EDB expect to provide N-1 reliability and how many exceptions exist on the network?

**27. Q.22 How suitable is the proposed approach for assessing capex?**

Horizon Energy would support adopting a standard template provided it is consulted on, so that the industry has the opportunity to assess the cost-benefit analysis of any template. We note however that the information already available in the AMPs set out drivers substantively similar to those the Commission is proposing here.

**4. ASSESSMENT OF TOTAL EXPENDITURE**

**28. Q.23 To what extent do suppliers consider the opex-capex trade-off could distort an assessment of expenditure that is based on separate reviews of opex and capex?**

Horizon Energy considers this to be a fundamental issue for the Commission to be cautious of. The distinction made between maintenance opex and network capex is more about applying generally accepted accounting principles than it is about the differences in expenditure. Both are investments in the network, both are expended to achieve the same goals; security, reliability, and efficiency in the network.

Caution is also required due to the timing of the trade-offs. Capital investment impacts opex over a long period of time, as such the relationship between current capex and current opex is not easily predicated, in that an increase in one may not necessarily present a decrease in another within the same (or similar) periods.

In addition, we consider EDB comparatives will be significantly affected by load growth. Higher growth EDBs often replace assets before requiring significant maintenance. Horizon Energy as a low growth EDB has to maintain lines much longer in comparison before replacing the asset.

**29. Q.24 Which components of expenditure have significant opex-capex trade-offs?**

Naturally we would expect the maintenance opex and network capex to have significant trade-offs, as mentioned above. Perhaps the most significant trade-off is in the difference between undergrounding and overhead construction. Those EDBs that enjoy high growth are able to invest in undergrounding and reduce future maintenance opex. However it is unlikely even in this example, of parity being established between capex expended and opex saved. Other opex such as overheads or non-system capex may not be as significant in terms of trade-offs, but these are nevertheless readily identifiable.

**30. Q.25 How should the cost analysis take into account any opex-capex trade-offs?**

Horizon Energy submits for the Commission to consider this trade-off undermines the very nature of the cost analysis. With the Commission looking to collate historical opex data, while proposing the use of forecast capex data, with trade-offs expected, it will become increasingly inappropriate to draw any meaningful conclusions from the cost analysis exercise. The issue of timing in itself precludes comparisons about the levels of trade-offs. An attempt to do so may produce results that become less and less reasonable, verifiable, and accurate, with the end result providing no value at all; no matter how well intended the cost efficiency analysis exercise may have been.

31. Thank you for considering this submission. Please find contact details below to discuss any of these matters further.

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