IM Review 2016

Submission on the four emerging view papers (29 February 2016)

1. **Process update paper**
2. **Emerging views on form of control**
3. **Emerging views on opportunities to improve the way default and customised price-quality paths work together**

   and

4. **Gas pipeline default price-quality path reset 2017: Process and issues paper.**

24 March 2016

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1. Introduction

1. This is Powerco Limited's (Powerco) feedback on the Commerce Commission's (Commission's) request for comment on their emerging views on specific matters relating to the gas pipeline default price-quality path reset 2017 (DPP reset) and Input Methodology review (IM review).

2. In relation to the 'Gas pipeline default price-quality path reset 2017: Process and issues paper', this submission only considers gas-specific IM issues. Comments on DPP reset related matters will be provided on the 30 March 2016 as requested by the Commission.

3. Feedback to Dr Lally's advice on the form of control and the asset beta and the use of Black's Simple Discount Rule published by the Commission on 25 February 2016 is commented on in a separate submission.

4. Our submission is in three parts:

   Part A: Comments on emerging views on form of control paper.

   Part B: Comments on emerging views on opportunities to improve the way default and customised price-quality paths work together paper.

   Part C: Comments on IM related matters presented in the Gas pipeline default price-quality path reset 2017: Process and issues paper.

5. We also note our support for the submission by the Electricity Networks Association.

2. Summary of Powerco's views and recommendations

6. The following summarises the key points that Powerco wishes to feedback to the Commission in response to the issues raised in the consultation paper (please refer also to our expanded comments in the body of the submission):

Process update paper

- We ask that the Commission ensure that Dr Lally's paper on the cost of debt, asset base indexation and inflation risk, planned for publication in May 2016 is published earlier to allow enough time for interested parties to provide feedback that will help inform the Commission's draft decision;
- We support the Commission's use of frequently published process update papers to inform stakeholders of timings and developing focus areas for the IM review.

Emerging views on form of control

- We conditionally support the Commission's emerging view that a 'pure' revenue path is an appropriate form of control to consider further for electricity distribution businesses. Further work will be required by the Commission and stakeholders to provide clarity about how the revenue cap mechanism would apply in practice.
- We strongly agree with Dr Lally's expert advice that concludes no change to the asset beta is required if a change to the form of control occurs; our conditional support for a transition to a pure revenue cap is predicated on this advice being upheld by the Commission.
- We recommend that no attempt is made to implement Black's Simple Discount Rule in Part 4 regulation;
- Powerco continues to consider that there are unique feature of the gas distribution sector in New Zealand that mean a WAPC is the most appropriate form of control for GDBs.

Emerging views on opportunities to improve the way default and customised price-quality paths work together

- We support the Commission's focus on exploring opportunities to improve the way DPPs and CPPs, including the change mechanisms within them, work together to promote the long-term benefit of consumers;
- We recommend that the Commission's consideration of a mechanism to allow recovery of prudent costs, incurred prior to a CPP approval (specifically between the date of application and approval) is extended to ensure that suppliers are not penalised for incurring prudent expenditure prior to the submission of a CPP application i.e. prior to application and in the years immediately preceding a CPP decision. We note that the Commission would retain discretion to only permit recovery of pre-CPP expenditure that is deemed to be prudent, following ex post assessment.
- We ask that an early signal is provided by the Commission on its emerging view on its approach to address the current CPP timing disincentive preferably by aligning the WACCs for a DPP and CPP within a regulatory period. This will enable suppliers considering a CPP in the current regulatory period to confirm CPP timing decisions and to progress preparation of CPP applications;
- We support the Commission seeking to adopt proportionality in its DPP and CPP decision making framework and look forward to the release of further details on how proportionality will apply in practice, at the draft decision stage of the review.

- We support the ENA's suite of recommendations, made in response to the emerging views, on opportunities to improve the way default and customised price-quality paths work together paper.

IM related matters presented in the Gas pipeline default price-quality path reset 2017: Process and issues paper

- We support the Commission's emerging view that the application of an IRIS mechanism to GPBs would not be beneficial to suppliers or consumers at this stage due to implementation complexity, associated costs outweighing potential benefits and there being little evidence of any perverse investment timing behaviour. However, we believe that an IRIS mechanism should not be ruled out for the future and that the Commission should continue to monitor GPB investment trends.

3. Part A: Comments on emerging views on form of control paper.

7. The Commission has set out its emerging view on the appropriate form of control for electricity distribution businesses (EDBs) and a proposed approach to gathering further information to help support a decision on the form of control for gas distribution businesses (GDBs).

8. The Commission's emerging view can be summarised as:

   - to implement a pure revenue cap for EDBs, and
   - for GDBs, to conduct further analysis and gather more evidence to support an emerging view that a weighted average price path should be retained..

9. In addition to general feedback on the above, the Commission is also seeking comments on the criteria used to analyse the form of control options and GDB related information on Constant Price Revenue Growth (CPRG) forecasts, quantities, pricing, and incentives for new connections.

10. Powerco's earlier IM Review submissions have supported the Commission reviewing the form of control for EDBs[1] and recommended that a WAPC is the appropriate form of control for GDBs[2]. We continue to hold this view and consider it beneficial for the Commission, in its decision making, and industry participants to have an early understanding of the Commissions emerging views on the issue.

3.1. Form of control for EDBs

11. The Commission has accurately stated the problem definition. In summary:

    11.1 Suppliers are exposed to an unmanageable quantity forecasting risk;

    11.2 There is a disincentive under the WAPC to pursue energy efficiency and demand-side management (DSM) initiatives; and

    11.3 The current WAPC and compliance requirements create potential disincentives to tariff restructuring.

12. Powerco considers that on balance these problems are sufficient enough to justify a consideration of a revenue path for EDBs. However, as the Commission has not clearly provided detail on how a pure revenue cap would apply, our support is conditional on a revenue path mechanism allowing for annual revenue 'wash-ups' with recovery of any revenue under or overs in full within a regulatory period.

13. Our conditional support for a pure revenue cap being the most appropriate form of control for EDBs is based on the assessment that it:

    13.1 Ensures that EDBs can receive an ex-ante determined revenue requirement and will not face the risk of earning more or less than a normal return as a result of errors in demand forecasting.

    13.2 Enables EDBs to implement required tariff reforms with reduced compliance risk.

    13.3 Removes current disincentives to pursue energy efficiency and demand side management outcomes (although a revenue cap does not provide direct incentives for such investments).

14. Powerco notes Dr Lally's recommendation[3] that asset beta is not affected by the form of control. This view is consistent with the Powerco's own view, as set out in previous

[1] Powerco. "Input methodologies review: Invitation to contribute to problem definition". (21 August 2015).
[2] Powerco. "Gas pipeline default price-quality path reset 2017". (28 January 2016).
[3] Dr Martin Lally. "Review of WACC Issues". (25 February 2016).

submissions, and also aligns with the views of internationally recognised independent experts[4].

15. The Commission is considering whether the following could be implemented to support a revenue cap:

15.1 Smoothing mechanism to minimise intra-period average price volatility and to limit the ability to take under-recovery into future pricing periods.

15.2 Introduce incentives for new connections.

15.3 Introduce incentives on suppliers to plan for catastrophic events.

16. This type of implementation detail is more usefully considered during the 2020 DPP reset process, but it is helpful to start thinking about it now. Our initial responses are:

16.1 Preventing carry-over into future pricing periods would not be consistent with implementing a "pure" revenue cap. Price volatility at the start of each regulatory period is likely to be a feature of both revenue caps and WAPCs.

16.2 EDBs already have reputational and relationship incentives to connect new customers and it is not clear a lack of specific incentive would be a problem for most new connections. However, problems would arise where large and unforeseen new connections occur and significantly increase costs on the network. Extra revenues should be permitted in such circumstances, potentially through a recoverable cost.

16.3 Incentives to plan for catastrophic events are unnecessary and we are concerned about the impression such an incentive would create. EDBs take their position as suppliers of essential services very seriously and planning for catastrophic events is part of being a prudent and efficient network operator.

3.2. Form of control for GDBs

17. The Commission's initial preference appears to be to retain a WAPC for GDBs but there is a need to conduct further analysis and gather more evidence to support such a decision.

18. Powerco continues to consider that there are unique feature of the gas distribution sector in New Zealand that mean a WAPC is the most appropriate form of control for GDBs.[5] Gas is a discretionary fuel for most residential and commercial customers, whereas electricity is generally considered to be an essential service. This is an important difference when considering the regulatory settings that should apply to the gas sector and when deciding where the incentives and risks should be allocated. Being suppliers of a fuel of choice, gas pipeline businesses are subject to greater demand volatility compared to electricity networks[6]. A revenue cap applied to GDBs could create a disincentive to connect new customers and increase volumes (over and above the volumes assumed when setting the revenue cap). Gas consumers have the discretion / option to only connect to a gas supply or increase gas consumption if they consider it is economically viable for them compared to other energy sources; a WAPC that incentivises a company to devote its resources to stimulating growth should therefore be encouraged.

19. The following points are relevant to the consideration of a WAPC for GDBs:

20. An accurate forecast of constant price revenue growth (CPRG) is an important input to the WAPC setting processes. We have suggested previously that a working group is established to assess factors impacting on future gas demand and how the current CPRG mechanism can be refined. There is no evidence that the application of a WAPC by

[4] HoustonKemp Economists. "Comment on the Commerce Commission's cost of capital update paper: A report for Powerco". (5 February 2016).

[5] Powerco. "Gas pipeline default price-quality path reset 2017". (28 January 2016).

[6] HoustonKemp Economists "Asset Beta for Gas Pipeline Businesses (March 2016)

GDBs has constrained the ability of suppliers to maintain stable prices to individual customer groups.

21. Powerco supports the continued use of lagged quantities to be applied to a WAPC for GDBs. The mechanism has worked successfully to date and as the approach is not based on an annual forecast of quantities (like the alternative mechanism suggested in the Commission's paper), it has delivered price certainty and transparency.

4. Part B: Comments on emerging views on opportunities to improve the way default and customised price-quality paths work together paper.

4.1. General comments

22. Powerco supports the Commission's focus on exploring opportunities to improve the way DPPs and CPPs, including the change mechanisms within them, work together to promote the long-term benefit of consumers. The Commission's paper sets out the issues and the emerging views very clearly focusing on eight specific areas. In this section we provide our feedback on each of these questions.

23. There are two very important DPP / CPP overlap issues, which are both currently relevant to Powerco[9], on which the Commission has not set out an emerging view. These are:

23.1 **Removing the current CPP timing disincentive by aligning the WACC for a DPP and CPP.**

The issues created by the misalignment between the DPP and CPP WACCs were well canvassed last year and are generally understood. Powerco supports moving to single regulatory WACC and a solution based on carrying over a DPP WACC to a CPP (until the DPP WACC is reset). An early signal by the Commission on its emerging view on this matter is required (preferably prior to the draft decision in June) to remove the current disincentive to seek a customised price path and to allow confirmed CPP timing decisions to be made.

23.2 **Ensuring that suppliers are not penalised for incurring prudent expenditure in the years preceding a CPP decision** (if this is in excess of a DPP allowance).

A CPP application will invariably set out a case for increased expenditure above that allowed for under a DPP (this being essentially the purpose of a CPP). The Commission has indicated, in emerging view "number seven", that they are open to considering approval of costs incurred prior to a CPP approval (specifically between the date of application and approval). Powerco considers that the scope of any proposed "ex post prudency mechanism" should be extended to ensure that suppliers are not penalised for incurring prudent expenditure prior to submission of a CPP application i.e. in the years immediately preceding a CPP decision. This retains the Commission's discretion to "strike out" pre-CPP expenditure that is not considered to be considered consistent with "investment case" submitted and approved as part of a CPP application.

[9] These two issues would be equally relevant to any other supplier currently considering a CPP application during the current regulatory period.

Response to the Commission's eight emerging views

4.2. Emerging view 1: We are open to taking a more tailored approach to setting the DPP where this can be done without significantly increasing cost

24. We support the addition of pragmatic, cost-effective mechanisms into the DPP process that better fit the circumstances of suppliers, and ultimately promote the long-term benefit of consumers.

25. The Commission's summary at paragraph 19 succinctly captures the legal background against which this review is taking place.

26. Paragraph 36 sets out the Commission's view on factors to consider when introducing appropriate tailoring mechanisms. We consider that the Commissions has captured the important considerations.

27. Introducing tailoring of a DPP discourages potentially inefficient outcomes for both suppliers and / or consumers by incentivising suppliers to stay on a DPP where it is appropriate to do so and avoid incurring the cost of a full CPP application for matters that could be more efficiently and expeditiously considered as part of a tailored DPP.

4.3. Emerging view 2: That 'single-issue' CPPs are not appropriate

28. We note the Commission's emerging view that introducing a single issue CPP mechanism is not appropriate. Powerco's agrees with the ENA position that the Commission's position can be supported provided the DPP reopener mechanism is sufficiently comprehensive to avoid unnecessary CPP applications.

29. However, we query whether the reasoning supporting the Commission's emerging view, identified at paragraph 43 of the emerging views paper, would apply to single-issue CPPs in relation to quality standards and demand forecasts (CPRG). As acknowledged in paragraph 43.3 of the emerging views paper, quality standards and demand forecasts are discrete inputs that can be adjusted independently (without raising the cherry-picking concerns that arise in the context of forecast costs). Tailored outcomes for these areas could feasibly therefore be progressed via a bespoke DPP or a single issue CPP.

4.4. Emerging view 3: We should apply a proportionate scrutiny principle in continuing to refine the CPP requirements and in assessing CPP proposals

30. We support the Commission's proposal that the level of scrutiny applied to a CPP (and DPP) should be commensurate with the price and quality impact on consumers of the tailoring that is being sought"[10]. This is a good principle to apply across all of the Commission's activities and decisions.

31. At this stage, and in the absence of any guidelines, there remains some uncertainty as to how the Commission's discretion to apply proportionality will be applied in practice.

4.5. Emerging view 4: We are open to expanding the role of DPP reopeners

32. We support the Commission's proposed approach to expanding the range of circumstances when a DPP is able to be reopened. The circumstances described in paragraph 48 capture the most likely scenarios and are considered sensible.

33. We support the ENA position on DPP reopeners but make the following additional observations:

    33.1 At paragraph 53.2, the Commission notes that it has potential concerns around the costs arising from DPP reopeners which will be borne by all consumers; noting that this concern could be significant if the number of DPP reopeners is large. We query the scale of the costs associated with DPP reopeners, considering that the

[10] DPP and CPP paper, paragraph 35.

situations in which suppliers may apply are in any case likely to be limited to defined circumstances.

33.2 The Commission notes a reservation that DPP reopener provisions might create asymmetric risk/opportunity in favour of suppliers, and that one of the ways this could be remedied is by providing well-defined, narrow trigger events that only provide for exceptional circumstances (paragraph 54). We note that thresholds are difficult to set and apply in practice. A balance needs to be struck between setting a threshold at a level that discourages inefficient applications for reopening and setting thresholds at a level that is too high and is rarely triggered, which would effectively render a reopening mechanism redundant. Powerco suggests that any initial thresholds should not be set too conservatively (i.e. not set cautiously high) but the Commission should monitor, review and amend any initial thresholds, as appropriate, based on the reaction and behaviour of suppliers.

4.6. Emerging view 5: The quality-only CPP option should be replaced with a DPP reopener

34. We support a quality-only adjustment mechanism to a price / quality path but think it is an open question as to whether it is best addressed as a CPP single issue option or via a DPP reopener, as either approach is workable in principle.

4.7. Emerging view 6: We are open to considering a CPP reopener for contingent and unforeseen projects

35. We agree with the Commission's approach to considering a CPP reopener for contingent and unforeseen projects that may affect suppliers operating under a CPP. This proposal is consistent with the Commission's commitment to taking a more tailored approach to the regulatory regime.

4.8. Emerging view 7: We are open to considering approval of costs incurred prior to CPP approval

36. We support the Commission's proposal to be able to approve costs prudently incurred between the time of CPP application and CPP approval. As noted earlier, Powerco considers that the scope of any proposed "ex post prudency mechanism" needs to be extended to ensure that suppliers are not penalised for incurring prudent expenditure prior to submission of a CPP application i.e. in the years immediately preceding a CPP decision. This retains the Commission's discretion to "strike out" pre-CPP expenditure that is not considered to be considered consistent with "investment case" submitted and approved as part of a CPP application.

4.9. Emerging view 8: We are open to providing for the expansion of the range of pass-through costs that can be added when setting the DPP

37. We endorse the Commission's consideration of whether the range of pass-through costs that can be added when setting the DPP should be expanded. It seems appropriate and in-keeping with the nature of the Commission's emerging views on the interaction between the DPP and CPP that it reviews the range of costs that can be passed through.

5. Part C: Comments on IM related matters presented in the 'Gas pipeline default price-quality path reset 2017: Process and issues paper'.

38. The Commission's Gas pipeline default price-quality path reset 2017: Process and issues paper presents a number of emerging views on matters relating to both the IM review and the 2017 DPP reset. Only matters relating to gas-specific IM issues are commented on in this submission. Matters relating to the DPP reset will be provided on the 30 March 2016 as requested by the Commission in the process and issues paper.

5.1. Incentives for expenditure

39. Powerco supports the Commission's emerging view that the application of an IRIS mechanism to GPBs would not be beneficial to suppliers or consumers at this stage due to implementation complexity, associated costs outweighing potential benefits and there being little evidence of any perverse investment timing behaviour. However, we believe that an IRIS mechanism should not be ruled out for the future and that the Commission should continue to monitor GPB investment trends. Our recommendation is that the Commission's focus and resource, at this current Gas DPP / IM review, is best centred on ensuring that suppliers' expenditure forecasts are robust and suitable to form the basis of DPP allowances at the next reset.

40. With respect to the opex IRIS currently applying to CPPs, we consider option 2: removing the existing asymmetric IRIS altogether, is the correct approach. Option two is consistent with the Commission's past decision[11] that we supported at the time as it removed a flawed concept.

5.2. Form of Control

41. Please refer to section 3.2 of this paper to view our discussed on the form of control in a GDB IM context and section 4.4 of our Feedback on Input methodologies review: Gas pipeline default price-quality path reset 2017[12.]

42. We recognise the importance of forecasting constant price revenue growth (CPRG). Further comment on CPRG and the other matters relating to the DPP framework raised In the Commission's Issues and process paper will be included in our submission to the Commission on 30 March 2016.

43. If you wish to discuss this submission please contact Oliver Vincent (Regulatory Policy Manager), at oliver.vincent@powerco.co.nz. or on (06) 757 3397, in the first instance.

[11] Commerce Commission "Incentives for Suppliers to Control Expenditure During a Regulatory Period: Process and Issues Paper" (20 September 2013) at 28-31.

[12] Powerco. "Input methodologies review: Gas pipeline default price-quality path reset 2017". (28 January 2016). Section 4.4.