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Submission on Gas DPP reset 2017 Policy paper

Introduction

- 1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the Commerce Commission's (the **Commission**) consultation paper "Default price-quality paths for gas pipeline services from 1 October 2017: Policy for setting price paths and quality standards", 30 August 2016 (the **Policy Paper**). Our submission mainly comments on the expenditure forecasting section of the Policy Paper, but also briefly considers the quality standard section.
- 2 Our submission also considers the reports prepared by Strata Energy Consulting Limited (**Strata**) on the expenditure forecasting methodology that support the Policy Paper:
 - 2.1 "Low cost review framework for gas pipeline expenditure: Pilot Study, Report for The Commerce Commission", 29 August 2016
 - 2.2 "Low cost review framework for gas pipeline expenditure: Proposed Framework and Methodology, Report for The Commerce Commission", 29 August 2016.
- 3 We have reviewed and support the submission by the Electricity Networks Association (the **ENA**) on this consultation.
- 4 We are making this submission from the following perspective:
 - 4.1 having undergone a customised price-quality path (**CPP**) application, we have an understanding of the different levels of scrutiny that apply to default price-quality paths (**DPPs**) and to CPPs
 - 4.2 as noted in the consultation paper¹ the proposal may be applied to electricity distribution businesses (**EDBs**) at a future reset.

¹ Policy Paper, paragraph 3.67.

- 5 Our comments and recommendations are focused on the implications of this approach being applied to EDBs in 2020 or subsequently.

Summary of submission

- 6 We support the use of supplier forecasts to inform expenditure allowance decisions at price resets and we appreciate that the Commission will require some assurance that the forecasts are reliable.
- 7 However, we are concerned that the proposals in the Policy Paper appear inconsistent with the intent of having a relatively low-cost DPP and we recommend a number of areas where the proposals could be improved.
- 8 A proposal in the Policy Paper is to use the CPP expenditure objective to assess the forecasts and we submit that this standard is unlikely to be reachable in a low-cost context. We recommend the Commission develops an expenditure objective that is workable for a DPP.
- 9 In addition, the proposed process itself provides the Commission with wide discretion to determine what expenditure is and is not well enough justified to be included in DPP allowances, akin to a CPP. We consider, and as our experience from our CPP shows, that this level of subjectivity adds significant cost, uncertainty and time to any process, both for the Commission and a supplier (and cost for our customers). We accept that there is a place in a CPP for some latitude in regard to the Commission's discretion. However, we believe more boundaries to that discretion are required for a DPP, if the DPP is to achieve the low cost objective.
- 10 If scrutiny of suppliers' forecasts is to be used to determine DPP expenditure allowances for EDBs², we recommend a series of improvements are made, including:
- 10.1 Assessments of BAU variances, AMPs and additional information should be made in accordance with criteria that are consulted on and published in advance. This includes the evidential threshold for expenditure being approved or excluded.
 - 10.2 Where total opex or total capex sits below the BAU variance threshold, there should be no further assessment of the opex and/or capex expenditure categories.
 - 10.3 Expenditure should be assessed against meaningful expenditure drivers that are in context. This is likely to require engagement with the industry and specific suppliers to identify useful drivers that can be assessed. Drivers should not be developed by the Commission in isolation.
 - 10.4 The BAU variance threshold should not be set by simply cherry picking the lowest recent disclosure year and then applying an arbitrary margin on top of this. Using the average level of expenditure over time as the 'base year' would be a better approach.
 - 10.5 The 'default' outcome that will apply if expenditure is not considered to be justified should be clearly specified.

² These recommendations may also be useful suggestions for improving the gas DPP process, but as Orion is not a GPB we do not specifically recommend these changes are made for GPBs.

- 11 We also recommend the Commission considers what other forms of scrutiny could be used to obtain assurances regarding the forecasts. We suggest that where an AMP has been certified as meeting the ISO 55000 series of standards, the Commission should have confidence that the process of developing them is robust and that they are prudent and efficient forecasts.

Use of supplier forecasts is supported in principle

- 12 We support the use of supplier forecasts to inform expenditure allowance decisions at price resets. In particular, we agree the Asset Management Plan (**AMP**) forecasts should form the core basis for the opex and capex forecasts within a DPP.
- 13 We recognise that, before it relies on AMP forecasts, the Commission will require some assurance that AMP forecasts are reliable. However, we are concerned with the subjectivity and breadth of discretion in the proposals in the Policy Paper, which appear to go beyond what the legislative framework intended and which would be costly, resource intensive, time consuming and uncertain to implement.

Legislative framework considerations

- 14 This section considers the proposal in the light of the legislative direction for DPPs to be relatively low cost. We consider that these points of principle are likely to apply to both EDBs and GPBs.

The process must be low cost

- 15 The process for scrutinising supplier forecasts must recognise the legislative intent behind the DPP/CPP legislative framework. The proposal developed by the Commission looks to us, based on our CPP experience, to be very similar to the level and type of scrutiny that was applied to our CPP application.
- 16 The Act provides that DPPs should be relatively low cost (section 53K). The Policy Paper states that this means low cost relative to the alternative, which is a CPP.³ We do not agree. Setting the CPP as the benchmark means a DPP could be very high cost indeed, which is inconsistent with the legislative intent.
- 17 In our view the proposal put forward in the Policy Paper goes beyond what we would expect a low-cost DPP to be. The CPP expenditure objective and assessment criteria appear to have been transferred into this process without sufficient consideration of the nature of DPP regulation.

Process is too subjective

- 18 The proposed process gives the Commission wide discretion to determine what expenditure is and is not well enough justified to be included in DPP allowances. We consider that this subjectivity will itself create costs and is inconsistent with the intent of DPPs.
- 19 We note the Commission has given itself discretion to:

19.1 set the BAU variance threshold;

³ Policy Paper, paragraph 3.45.

19.2 determine whether AMPs or additional information sufficiently explain forecasts; and

19.3 to decide what action to take if expenditure is excluded.

- 20 This creates material uncertainty for suppliers and consumers about how expenditure allowances are set and about what evidential threshold will be applied. It also risks creating a costly process where a supplier may prepare (unnecessary) information in advance that the Commission does not review or where more information is required to be produced by suppliers and the Commission incurs additional costs in reviewing it.
- 21 The approach will incentivise suppliers to place more effort in developing justifications for their expenditure forecasts, both within their AMPs and other documents. A plausible outcome is that the dashboard will be included in the AMP process (and possibly in the document) and any areas that seem higher than BAU will receive additional explanation. Much of the additional explanation will also need to explain historical expenditure shifts (as this is what the Commission's assessment seems to focus on) which is inconsistent with the forward-looking nature of the AMPs.
- 22 Therefore additional information will be placed in the AMP for regulatory rather than business planning purposes. The Commission will then need to devote more resources to reviewing and scrutinising this material. The result will be increased costs for the Commission, suppliers and customers.

Comments on the approach

- 23 This section summarises our other key concerns with the proposal put forward in the Policy Paper and the Strata reports. It makes recommendations for improving these proposals if they were applied to EDBs.
- 24 We have focused on relatively high-level points. If this process was considered for application to EDBs we will have more detailed comments on that proposal.

Evidence for expenditure forecasts

- 25 The Policy Paper states that the Commission is "expecting a level of information from suppliers that is equivalent to a board level assessment or business case"⁴. We note that this level of information was also required for our CPP application.⁵ We believe the Commission is seeking more information that what is required for a board level assessment or business case in some cases.
- 26 For example, detailed business cases of projects contemplated by an AMP that are 3-4 years in the future are not necessarily prepared that far in advance – it is not prudent to do so given the number of variables at play and the likelihood that circumstances will change. The additional cost of creating prospective business cases or detailed analysis for projects that far in advance would not add any

⁴ Policy Paper, paragraph 3.110.

⁵ For example, Geoff Brown & Associates Ltd, *Verification Report*, page 17. Strata Energy Consulting, *Technical Advisor Report: Further advice on the Orion New Zealand Ltd CPP Proposal and submissions*, 19 November 2013, paragraph 168. Strata Energy Consulting, *Technical Advisor Report on the Orion New Zealand Ltd CPP Proposal*, 2 August 2013, paragraph 70(f).

business value and drive costs into a business. Unlike transmission businesses, where transmission projects are sizeable and planned well in advance, distribution projects are usually relatively small and responsive to quickly-changing customer demands. Therefore suppliers are aware that expenditure is needed but design decisions often occur closer to the time of implementation.

- 27 We accept that where information in the AMP does not demonstrate why a particular project is required the Commission may request further information from the supplier. However, we submit that the level of documentation that is readily available will vary depending on the nature of the project and the timing of it. Criteria around this should be set out.

Expenditure objective

- 28 The Policy Paper proposes using the CPP expenditure objective to assess the forecasts within the AMP in order to set the DPP. We consider that the CPP expenditure objective is likely to set a standard that is unreachable in a low-cost context. We doubt the Commission would be able to identify the efficient costs that would be incurred to meet demand in the regulatory period and over the longer term in a low cost way. The necessary information to demonstrate this will not all be available in a DPP context. We recommend the Commission develops an expenditure objective that is workable in the DPP context.

Improvements to the proposed methodology

- 29 If scrutiny of suppliers' forecasts is used to determine DPP expenditure allowances, we recommend the following improvements are made:
- 29.1 The process should be much less subjective. Assessments of BAU variances, AMPs and additional information should be made in accordance with criteria that are consulted on and published in advance. In particular, the criteria should specify what must and must not be considered by the Commission when applying AMP scrutiny and supplier scrutiny.
 - 29.2 The Commission should ensure that all parties understand what evidential threshold will be required for expenditure to be included within the DPP allowances.
 - 29.3 Clarify that the review will only consider the next DPP regulatory period and not expenditure beyond that regulatory period.
 - 29.4 Confirm that where total opex or total capex sits below the BAU variance threshold, there will be no further assessment of the opex and/or capex expenditure categories. .
 - 29.5 Assess expenditure against meaningful expenditure drivers. This is likely to require engagement with the industry to confirm in advance which expenditure drivers should be considered. Orion has less expertise in relation to gas network cost drivers, but it appears to us that the Strata reports read too much into small variances. For example, Strata seeks to draw conclusions from changes in expenditure per unit supplied, but these are likely to reflect the large portion of fixed costs corresponding to variable throughput. There is not necessarily any efficiency insight that can be gained from changes in such metrics.
 - 29.6 Confirm how the BAU variance threshold will be established. We do not support the approach of picking the lowest recent disclosure year and then applying an arbitrary margin

on top of this. Assuming that the year of lowest expenditure represents an efficient level of expenditure is not correct – expenditure requirements will fluctuate due to one-off network events and a low-cost year is likely to understate the necessary level of expenditure to maintain a network.

- 29.7 Set out clearly what the outcome will be if expenditure is not considered to be justified even after going through the supplier scrutiny step. All parties need to understand what the fall-back option will be if forecasts are deemed not to meet the expenditure objective.

Alternative approach – draw on international standards

- 30 We recommend the Commission considers what other forms of scrutiny could be used to obtain additional assurances. An AMP which is certified to comply with the ISO 55000 Standards for Asset Management will have undergone considerable scrutiny and review and can be viewed with some confidence as a high-quality AMP. We suggest that where an AMP has been certified as meeting these standards, the Commission should have more confidence that the process of developing them is robust and that they are prudent and efficient forecasts; as such less additional information could be required in such circumstances.

Major interruptions quality standard

- 31 We note the Commission has proposed a new quality standard for gas pipeline businesses of “no major interruptions”. Where a major interruption (which is not yet defined, but is likely to be based on average customer minutes without supply) occurs this will be a breach of the quality standard and will be investigated by the Commission.
- 32 Orion has no view on whether this standard is appropriate for GPBs. However, for the record we do not consider that such a standard would be appropriate for EDBs. The SAIDI and SAIFI quality standards are well understood and measure interruptions that affect consumers, including major interruptions up to the major event day boundary. The different nature of the electricity system – with more frequent interruptions and greater susceptibility to weather events – would make a major interruptions standard unworkable in the electricity context.

Concluding remarks

- 33 Thank you for the opportunity to make this submission. We do not consider that any part of this submission is confidential. If you have any questions please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours sincerely



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