Submission on Input Methodology amendments for the Incremental Rolling Incentive Scheme

29 August 2014

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Introduction

1. Vector welcomes the opportunity to provide this submission to the Commerce Commission (Commission) on the consultation paper *Proposed amendments to input methodologies: Incremental Rolling Incentive Scheme*, dated 18 July 2014.

2. Vector's contact person for this submission is:

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Scope of this submission

3. Due to the short time for responding to the Commission's consultation and the large amount of other consultation material being considered at the same time, Vector has only reviewed the capex incremental rolling incentive scheme (IRIS) and the more straight-forward scenario for the opex IRIS of a regulated supplier continuously subject to DPP regulation with a base year adjustment.

4. Vector reserves the right to comment on the merits and application of the other IM amendments, if and when they become relevant to its business.

5. Vector **recommends** the proposed IM amendments for different IRIS scenarios that are less relevant to the current DPP reset (e.g. rollover prices, regulated suppliers migrating to a CPP or back onto a DPP) are subject to further consultation with affected suppliers in future, if and when they become relevant to one or more suppliers and the supplier(s) request that amendments be considered.

Incremental rolling incentive scheme – overview of Vector's position

6. It is non-controversial that regulated suppliers themselves are the best judge of day-to-day decisions for operating and investing in their networks to deliver electricity lines services to the required level of quality. Vector supports the aim of the IRIS to make a regulated supplier agnostic about when it will make efficiency improvements to its business. Vector also welcomes the proposed adjustments for return on and of capital investments that varied from forecast within a regulatory period.

7. However, Vector believes the IRIS would be improved if any or all of the following changes were made to the current proposal:

a) The opex and capex IRIS mechanisms were structured asymmetrically such that savings were rewarded more than dis-savings were penalised (which we consider to be appropriate given the low-cost forecasting techniques create a risk the forecasts will systematically under-forecast expenditures, resulting in penalties being applied for forecast error rather than inefficiencies).

b) The opex forecasts for the first year of the IRIS are either:

i. closely based on supplier forecasts; or

ii. based on performance against forecast in the first year *relative* to performance against forecast in the previous year (see formula and more detailed explanation below);

These approaches would be better suited to the IRIS which is intended to reveal efficient costs over time, and would avoid the risk of imposing significant penalties due to forecasting error.

c) The WACC utilised in the calculation of the second-year adjustment is the WACC that applied in the regulatory period in which the savings or dis-savings were made.

d) Variances between actual and forecast input price inflation are adjusted for when the 'amount carried forward' is determined – it would not be reasonable to reward or penalise suppliers for making savings or dis-savings when the variance is driven by inflation changes over which they have no control.

e) The capex IRIS adjustment is spread over years 2-5 of the regulatory period, adjusted for the time value of money, rather than all applied in year 2.

f) The capex retention factor for gas pipeline businesses (GPBs) is set to be the same as the capex retention factor for electricity distribution businesses (EDBs).

8. We expand on these points and make further recommendations below.

Opex IRIS

9. The opex IRIS is the proposed incentive mechanism to consistently reward EDBs for making opex savings irrespective of when in the regulatory period those savings opportunities arise.

10. The Commission's proposed symmetric opex IRIS is a hybrid of:

    a) For the first year of the regulatory period: an incentive based on performance of actual opex against forecast in that year; and

    b) In the remaining years of the regulatory period: an incentive based on performance of actual opex against forecast in each year relative to the performance against forecast in the previous year.

Asymmetric or symmetric IRIS

11. Vector believes the Commission's model is unnecessarily complicated. For this reason, Vector **recommends** an asymmetric model (rewarding savings) for the opex IRIS on similar terms to the one applying to Orion's CPP. This model is much easier to understand. An asymmetric model also delivers on the principle for EDB's to consistently seek out opex savings. EDB's will then have full knowledge that any savings from the proposed opex allowance will be kept by the EDB for a set period of time.

12. The rest of this section discusses the Commission's proposed symmetric opex IRIS without prejudice to our preference for an asymmetric model.

Opex in the base year and first year of the regulatory period

13. Clause 3.3.2(2) of the proposed IM amendments specifies a formula for the 'amount carried forward' for first year opex. This requires a regulated supplier to subtract forecast opex from actual opex for that year.

14. The first year is the only year where the carried-forward amount is based solely on the performance against the Commission's opex forecast. In all other years of the regulatory period the carried-forward amount is based on performance of actual opex against forecast in each year relative to the performance against forecast in the previous year.

15. Where the Commission has significantly under forecast first year opex this will result in a significant negative carry-over balance for the recoverable cost. The consequence of this will be that for the first year of the ensuing

regulatory period when the opex IRIS recoverable cost is first applied (2021), EDBs will have a significant negative recoverable cost for that year.

16. The value of the recoverable cost based on performance in the first year is likely to be more significant than the relative changes from the other years.

17. Accordingly, Vector **recommends** against the Commission from significantly under-forecasting opex (as its draft decision would do) when it is also applying an opex IRIS for the first time.

18. Should the Commission forecast opex for the next regulatory period on information that significantly differs from the supplier's most recent available reported opex (as it is proposing to do for Vector), then it is very likely to have the effect of creating a negative opening opex IRIS carry-over value. This negative value will have more to do with the Commission's judgement about starting opex (which is necessarily based on limited information) than on relative changes in operating costs of each supplier.

19. Vector does not support an opex IRIS that is set up with the intention of making a regulated supplier commence with a negative carry-over amount. Doing so will not promote the IRIS as a positive tool for the industry to adopt.

20. Vector notes that the benefit of the opex IRIS is that it *incrementally* reveals the supplier's efficient opex over time. The different model for determining the first year opex 'amount carried forward' is significantly dependent on the forecasting accuracy of the Commission for first year opex which could be significantly different to actual opex.

21. The further the Commission's forecast for first year opex is from attainable actual opex, the greater the volatility it will cause the recoverable cost between years in the next regulatory period. Vector cautions against the Commission encouraging such significant fluctuations in the recoverable cost between years as this is unlikely to be in the long-term interests of end-users.

22. For EDBs, Vector submits the carried forward amount for the 2015/16 year should be based on the performance of actual opex compared to forecast in that year, relative to performance against forecast in the 2014/15 year. Therefore, the recoverable cost for the first year should be based on that year's *relative* actual expenditure compared to forecast with the final year of the previous regulatory period. A similar provision should be made for the first year of every subsequent regulatory period and for the IRIS that is applied to gas pipeline businesses.

23. The formula for first year 'amount carried forward' would be:

(Y5 forecast opex – Y5 actual opex) – (Y1 forecast opex – Y1 actual opex) = 'amount carried forward' for year Y1

Y5 refers to the final year of the previous default price path.

Y1 refers to the first year of the proposed default price path period.

24. Vector **recommends** that clause 3.3.2(2) of the proposed IM amendments for first year opex 'amount carried forward' is modified to be consistent with the opex IRIS model for other years. This is feasible as the Commission's 2015 DPP opex model includes an opex forecast for each non-exempt EDB for the 2014/15 regulatory year.

25. Should the Commission continue with its current proposed clause 3.3.2(2) then Vector **recommends** the Commission use actual 2014 opex as the base year when resetting the DPP opex to ensure the opex IRIS is less skewed by judgements influencing the carry-over amount.

26. Vector also believes it would be useful if, at the same time the IRIS is implemented, the Commission specified that the penultimate year of the regulatory period is used as the opex base year. This would give certainty to suppliers and ensure that the most recent revealed actual costs are used to inform the reset decisions.

Real versus nominal changes in expenditure

27. Vector notes the importance of ensuring the changes in opex only capture real changes in expenditure rather than capturing changes in cost resulting from comparing forecasts with inflation-related changes to expenditure. If it does reward or penalise changes in input price inflation, the opex IRIS will fail to achieve its purpose of revealing efficient supplier costs.

28. Accordingly, Vector **recommends** that variances between actual and forecast input price inflation should be adjusted for when the 'amount carried forward' is determined.

WACC changes over time but this is not recognised in the Commission's model

29. The Commission's sharing factor for opex is premised on a particular WACC being realised by the supplier. A higher WACC means that a supplier retains a greater portion of the saving. Therefore, where WACC reduces, the incentive for a supplier to save declines.

30. The Commission's model assumes WACC is unchanged across all regulatory periods. This is clearly an incorrect assumption. Where WACC changes between regulatory periods, the sharing factor will be greater or lesser than the Commission's model assumes.

31. In most years, this is arguably only a notional problem. However, the second-year adjustment uses the WACC to calculate the adjustment for any expenditure shift relative to forecast between the penultimate and final years of the previous regulatory period.

32. Where the WACC changes between regulatory periods, it seems a supplier will be over-compensated or under-compensated by the Commission's formula as the discount rate applied to the second year adjustment will be a WACC that differs from the WACC during the regulatory period in which the savings were made.

33. Vector **recommends** the WACC used in the calculation of the second year adjustment should be the WACC that applied in the regulatory period in which the savings or dis-savings were made.

Second year adjustment

34. Any over or underspend between the penultimate and final years of the regulatory period are subject to the second year adjustment.

35. The change in cost between penultimate and final years of the regulatory period is addressed by the second year adjustment term in the proposed IM amendments, which makes an explicit transfer between suppliers and consumers to share the saving or dis-saving.

36. The "one-off" second year adjustment will cause a notable change in the recoverable cost between years of the ensuing regulatory period. Vector submits that such one-off changes are unlikely to result in the savings to be passed on to end-users and for the sharing benefit to be fully realised. Rather, the "one off" adjustment (where it is negative – which it will be when the regulated supplier achieves efficiencies) is likely to be a transfer from regulated suppliers to retailers.

37. Given this undesirable effect, the Commission should consider whether there are alternative approaches. In particular, for permanent savings made in the final year there is an alternative approach available that gives an NPV-equivalent outcome to the Commission's model, is more straightforward to apply and does not require a second-year adjustment. This is simply to make no adjustment for any permanent savings or dis-savings in the final year. In

this case the base year opex for the next regulatory period will be set equal to year 4, thus regulated suppliers will automatically retain the benefits for the requisite number of years without the need for any second year adjustment or recoverable cost.

38. Vector's **recommendation** of determining the 'amount carried forward' for the first year by the formula in paragraph 23 of this submission, will also capture any temporary changes between final year expenditure and first year expenditure and significantly reduces the need for a second year adjustment.

Opex IM drafting suggestions

39. Vector notes the IM base year adjustment term in clause 3.3.5 is different to the Commission's formula for the term in its DPP opex IRIS model. In the DPP1b opex model cell O83 includes a negative sign in front of the calculation which does not appear in the draft IM amendments. This negative sign does appear material as it inverts the assumed sharing relationship between suppliers and consumers.

40. Vector also notes in clause 3.3.3(2) the term "after a regulatory period" does not reflect the operation of the Commission's proposed model. The addition of the above phrase appears to imply a saving made in a current regulatory period is carried forward into the next regulatory period and then the opex incentive adjustment is made in the following regulatory period.

41. Vector also notes (a minor point) that clause 3.3.4(1) does not require the word "of", but instead this word should be applied to the beginning of clause 3.3.4(1)(a) and clause 3.3.4(1)(b) to make the list in clause 3.3.4(1) flow more accurately.

Capex IRIS and wash up for return on and of capital on additional assets

Capex forecasting

42. The Commission's proposed capex incentive scheme intends to provide incentives for suppliers to make savings from their allowable capex across the whole regulatory period. For a capex IRIS to pose useful disciplines on capex decisions, forecast capex for a regulated supplier must be a reasonably close representation of required capex for the regulatory period.

43. The Commission's proposal for capex forecasts for the next electricity DPP reset is to entitle EDB's to 120% of historical capex expenditure coupled with a tougher cap for suppliers whose 2010 AMP forecasts were "less accurate".

Such EDB's (Vector being one) are only entitled to 110% of historical capex for the reset regulatory period.

44. The Commission's capex incentive proposal is based on the difference between a supplier's performance and the Commission's forecast capex for the supplier in the regulatory period. This places significant emphasis on having accurate capex forecasts. Given the Commission's forecasts of EDB and GPB capex are necessarily high-level, Vector considers the impact of the capex IRIS should require the Commission to err on the side of caution when setting allowable capex for the future regulatory period.

45. Vector does not consider the deductive logic that overspending relative to forecast is inefficient or warrants significant penalty necessarily holds in all circumstances. Rather, Vector submits that in some circumstances regulated suppliers will be required to invest greater than forecast to efficiently and safely run their businesses.

46. Vector does not consider there to be a significant history of over-investment by regulated suppliers in New Zealand. While this does not mean that a capex incentive scheme is not warranted, Vector cautions against an aggressive scheme that results in an overly excessive incentive to defer capex to the detriment of network quality.

An asymmetric retention factor – rewarding savings over penalising overspending

47. Vector **recommends** an asymmetric retention factor where rewards for savings are greater than penalties for overspending relative to forecast. This will still encourage efficient capex decisions but also minimise the risk of dis-incentivising efficient and necessary capex just to avoid the significant penalty that would otherwise result from the use of erroneous capex forecasts.

48. Vector supports a retention factor design that entitles regulated suppliers to retain 20 percent of any underspend relative to the Commission's capex forecast; and to retain the penalty of five percent of any overspend for the period.

49. This design will deliver on the Commission's objective of an incentive that would "always be positive and never neutral".

Cautious approach to setting the retention factor percentage

50. Should the Commission retain a symmetric retention factor percentage it should have regard to the undeveloped approach to estimating capex for the

forthcoming DPP. For this reason Vector **recommends** a lower retention factor (say 5%) as a more risk averse approach for the practical implementation of a capex incentive.

51. A higher capex retention incentive may become reasonable when the Commission has developed a more sophisticated approach to forecasting capex.

52. Alternatively, Vector **recommends** the Commission consider the ENA's proposal of having a different retention factor for any dis-savings that are between EDB forecast AMPs and the Commission's capex forecast (where the AMP is greater than the Commission's allowance) and another for dis-savings that are greater than forecast AMP.

Retention adjustment formula

53. The Commission's retention adjustment formula is specified by clause 3.3.10(8). This clause requires the Commission to determine the value of the difference between the supplier's actual capex from forecast capex for the regulatory period. This remainder is multiplied by the Commission's retention factor.

54. The Commission has indicated that it would use its discretion when setting a retention factor at the time of future regulatory resets. Vector considers that periodic reviews of the retention factor are appropriate, provided the Commission does not seek to back-date a new retention factor (i.e. at the 2020 reset the Commission can choose the retention factor to apply to savings or dis-savings made over the 2020-2025 regulatory period, but should not change the retention factor that it decided in 2014 would apply to the savings or dis-savings made in the 2015-2020 regulatory period).

Wash-up for return on and of capital for additional assets

55. Clause 3.3.10(1)(b) of the proposed IM amendments specifies that the final value of the capex incentive adjustment is determined by the retention adjustment added together with a wash-up for the return on and of capital for the additional assets commissioned in the period. The addition of the wash-up for return on and of capital to the retention factor will influence the final value of the capex incentive adjustment.

56. Vector supports the Commission's approach of washing up for the return on and of capital during a regulatory period where the actual capex varies from the Commission's forecasts. The application of the retention factor

mechanism still means there is an incentive for regulated suppliers to be efficient, despite this wash-up.

57. Vector particularly welcomes the change to account for actual asset lives as opposed to the standard DPP assumption that new assets will have lives of 45 years. This change will help ameliorate the current disincentive for making investment into shorter life assets and thus promote the section 54Q objective.

Timing of the capex incentive adjustment

58. Vector **recommends** the capex incentive adjustment be spread over time rather than applied in full during the second year of next regulatory period as this will minimise price shocks and volatility for consumers and suppliers. A smoothed model for the capex incentive recovery will help mitigate any single year fluctuations in prices resulting from the IRIS.

IRIS capex wash-up adjustment IM drafting inconsistent with the model

59. The Commission's capex IRIS model for determining the IRIS capex wash-up adjustment refers to clause 3.3.10(5) for the investment return adjustment. However, this term does not appear in the proposed IM amendments. Rather, Vector understands the IM amendments for the IRIS capex wash-up adjustment requires the investment return wash-up to be calculated by following the substitution required by clause 3.3.10(2)(a) with the requirement to determine the series of revenues as required by clause 3.3.10(3)(b)(i).

Application of IRIS to gas pipeline businesses

60. Vector supports the proposal to apply the IRIS to gas pipeline businesses prior to the 2017 reset.

61. Vector does not agree with the proposal to apply a retention factor of 35% to GPB capex. The GPB capex forecast was derived on the same basis as the proposed EDB capex forecast (using suppliers' AMP forecasts with a cap based on a percentage of historical expenditure); thus the Commission's concerns to mitigate the effect of low cost forecasts being too high or too low should be the same for gas as they are for electricity.[1] Vector **recommends** the capex retention factor for GPBs is the same as is applied for EDBs.

[1] IRIS consultation paper, footnote 7.

IRIS recoverable cost versus revenue linked service-quality incentives

62. The IRIS and the revenue-linked service quality incentive scheme will apply for the first time at the 2015 DPP reset. The proposed revenue-linked service quality regime will reward suppliers with additional revenue for improving their network's performance to exceed the defined quality targets up to a specified "cap". Conversely, a supplier will be penalised financially for any reduction in network performance up to a specified "collar".

63. The two initiatives do create financial incentives that can militate against the success of the other. Accordingly, it is very possible that a supplier may overspend the Commission's expenditure forecast but benefit from additional revenue from exceeding its service quality target. Conversely, a supplier may also benefit from inefficiently deferring capex or opex but incur some penalty if they compromise network quality. For the two initiatives to deliver the optimum outcome for consumers, the relative incentives for one should not overpower the other.

Other issues relevant to the IRIS

Catastrophic event or change event

64. Vector notes that clause 3.3.11 of the proposed IM amendments provides for the situation when a supplier is subject to a catastrophic event. When the Commission exercises its judgment about carried forward savings from a major event, it must have explicit regard to the fact that changes in cost are being driven by the exogenous event and should not be entitled to carry-forward any dis-savings for those years.

65. Vector **recommends** clause 3.3.11 be amended to also include change events as well as a catastrophic event and there be a prohibition against carrying forward any dis-savings in the year of the catastrophic event and in the subsequent years of the regulatory period. Alternatively Vector recommends the suspension of the IRIS for the remaining years.

Penalty payments

66. Under the proposed new service quality incentive scheme, an EDB may receive incentive payments or penalties for either exceeding or not meeting the quality target for that particular year. The incentive scheme focuses around a particular bound of performance. Vector **recommends** that such annual rewards and penalties be excluded from the IRIS scheme as they would either over-reward or over-penalise the EDB in excess of the financial incentives contemplated by the service-quality incentive scheme.

67. Vector also **recommends** that any financial penalties imposed under the Act are also removed from the IRIS as they would also amount to penalising the regulated supplier twice for a single offence.