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Input Methodologies review – Report on the IM review

Submission to the Commerce Commission

Final

From the Electricity Networks Association

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1. Introduction

1. The Electricity Networks Association (**ENA**) appreciates the opportunity to make a submission to the Commerce Commission (**Commission**) on the consultation paper **Input methodologies review draft decisions –Report on the IM review, 22 June 2016 (Report on the IM review)**.
2. The Report on the IM review identifies all changes the Commission proposes to make to the input methodologies (**IMs**) and also the IMs it proposes not to change. There is overlap between this report and the IM review Topic papers as many of the proposed IM changes are discussed within a Topic paper.
3. This submission records the ENA's view on each of the IM amendments proposed within the package of draft decisions. Where an IM amendment is discussed in a submission on a Topic paper, this submission refers back to the other submission. This submission also comments on selected draft decisions to not change an IM.
4. The ENA represents all of New Zealand's 26 electricity distribution businesses (EDBs) or lines companies, who provide critical infrastructure to NZ residential and business customers. Apart from a small number of major industrial users connected directly to the national grid and embedded networks (which are themselves connected to an EDB network), electricity consumers are connected to a distribution network operated by an ENA member, distributing power to consumers through regional networks of overhead wires and underground cables. Together, EDB networks total 150,000 km of lines. Some of the largest distribution network companies are at least partially publicly listed or privately owned, or owned by local government, but most are owned by consumer or community trusts.

2. Submission summary

5. In relation to draft decisions to change the IMs, the ENA recommends that:
 - The Commission review whether the next closest alternative (**NCA**) mechanism is consistent with the Act.
 - If the NCA mechanism is progressed, the Commission is required to consult with electricity distribution businesses (**EDBs**) and other stakeholders on all proposed applications of it.
 - If the NCA mechanism is progressed, it should not be able to reopen price paths or quality standards.
 - The Commission explain why the section 52Q reopener is required, as this is already provided for under the Act and whether the treatment is different for material and non-material amendments.
 - The Commission consider the views of the ENA on each IM change as summarised in tables 1 - 8.

6. In relation to draft decisions to not change the IMs, the ENA recommends that:
- Easements are able to be added to the RAB from the time the rights are acquired.
 - Inverters and lithium ion batteries are added to Schedule A with a standard life of 10 years.
 - The term 'weighted average remaining useful life of relevant assets' is defined within the IMs.
 - The DPP includes a constant price revenue growth reopener if the form of control remains a weighted average price cap.
 - The IRIS IM is not amended in response to Dr Lally's concerns, consistent with the draft decision.
 - The Commission does progress a solution to the way IRIS recoverable costs are calculated for single year DPPs, consistent with the draft decision.

3. Proposed IM changes

3.1. Proposed next closest alternative provision

Overview

7. The Report on the IM review describes a proposed new mechanism for making minor and urgent changes to the IMs. The NCA provision is intended to allow for an alternative approach to be applied when a prescriptive approach in the IMs becomes unworkable.
8. The NCA would be determined by the Commission and “published outside the IMs”.¹ It may be subject to consultation, but from the draft decision this appears to be at the Commission’s discretion. The Report on the IM review also notes that in “rare” circumstances the NCA provision may lead to a price path being reopened.
9. The NCA is not intended to deliver different outcomes to the IMs as they are determined, but to resolve any issue of the IMs becoming unworkable. An example provided by the Commission relates to the reference in the 2010 IMs to the Bloomberg A curve. When Bloomberg stopped publishing this information the IM provisions relating to the calculation of the term credit spread differential was no longer workable.
10. The Commerce Act 1986 provides a process for amending the IMs (sections 52X and 52V). No simplified amendment process is provided for urgent or minor amendments.

Discussion

11. The ENA can appreciate why the Commission wants to make this change and it seems like it would only be used in a limited number of circumstances. However, the ENA is concerned that the approach may not be consistent with the Act (as it effectively amends the IMs without going through the process specified in the Act) and also provides too much discretion to the Commission.
12. We consider that if this proposal is progressed, it should contain the following process requirements:
 - All NCA proposals should be consulted on by the Commission
 - NCA proposals should explicitly not be able to reopen a price path or quality standard or to change the scope of reopeners that are available – they should only be able to lead to reopeners of a price path where they relate to a price path compliance requirement.

Section 52Q amendments

13. Similar to the NCA proposal, the Report on the IM review also puts forward a reopener to apply amendments to price-quality paths that are made under section 52Q of the Act. We request clarification about whether this is necessary as the Act already provides for amendments to section 52P determinations.

¹ Report on the IM review, paragraph 68.

14. Additionally, section 52Q makes a distinction between material changes to a section 52P determination, which need to be consulted on, and non-material changes, which do not. It seems this reopener is only intended to apply to non-material amendments. If this is the case, and a reopener is necessary, it is not clear how material amendments to a section 52P determination would be applied in practice.

Recommendations

15. The ENA recommends:
- The Commission review whether the NCA mechanism is consistent with the Act.
 - If the NCA mechanism is progressed, the Commission is required to consult with EDBs and other stakeholders on all proposed applications of it.
 - If the NCA mechanism is progressed, it should not be able to reopen price paths or quality standards.
 - The Commission explain why the section 52Q reopener is required, as this is already provided for under the Act and whether the treatment is different for material and non-material amendments.

4. List of changes to the IMs

16. This section considers the proposed changes to each of the IMs in turn.

4.1. Proposed changes to cost allocation IM

17. The table below summarises the ENA's response to each proposed change to the cost allocation IM.

Table 1: Cost allocation IM changes

Proposal	ENA response
CA03 – Reducing the materiality threshold for applying ACAM from 20% to 10%.	Disagree. This is discussed in our submission on the Emerging technologies topic paper.
CA03 – Clarify that distributions to customers are not operating costs.	Agree. This is not controversial.
CA03 – Clarify that intercompany revenue is not included in revenue for the purpose of assessing the ACAM revenue threshold.	Agree. This is not controversial.
CA04 – Require regulated suppliers to explain any use of proxy allocators, rather than causal allocators. The Commission indicates that under information disclosure EDBs will also need to justify the use of the proxy allocator(s) chosen.	Agree. This is discussed in our submission on the Emerging technologies topic paper.

4.2. Proposed changes to asset valuation IM

18. The table below summarises the ENA's response to each proposed change to the asset valuation IM.

Table 2: Asset valuation IM changes

Proposal	ENA response
AV05 – Finance leases cannot be included in the RAB while the associated lease payments are treated as recoverable costs.	<p>Agree in principle with the removal of a risk of 'double counting' these costs. However, the mechanism in the draft determination to achieve this is incorrect.</p> <p>The draft determination does not exclude from the RAB the value of any finance lease for which annual payments are included as a recoverable cost (i.e. it doesn't restrict the double-dipping). But it does appear to exclude from opex any payments associated with a finance lease, including any which are not capitalised into the RAB (i.e. it restricts the ability to recover the operating component). This is not correct. We will provide more detail on this in our submission on the draft determination.</p>
AV09 – Expand the definition of capital contributions to include money received in respect of asset acquisitions.	Disagree. This is not a workable mechanism or a useable definition of capital contributions.
AV09 – Ensure that the calculation of financing costs that can be capitalised on a commissioned asset is based on a value of works under construction that is net of capital contributions.	Agree. This ensures the financing costs relate to the portion of an asset funded by the EDB without contributions.
AV12 – Change references from 'related company' to 'related party'.	Agree. This corrects an error.
AV13 – Require EDBs to use their GAAP cost of financing capped at the EDB's New Zealand dollar weighted average cost of borrowing, when calculating the cost of financing for assets under construction.	Disagree. While this is an improvement on the current requirement to use the 67 th percentile estimate of post-tax WACC, which does not vary as financing costs change over a regulatory period, a better approach would be to simply use GAAP as this will then match the actual cost of financing.
AV17 – EDBs are able to apply for a reduction in asset lives of up to 15% where the asset is at risk of stranding.	Agree in principle but this should be available to all EDBs, not just those that are subject to price-quality paths. This is discussed in our

Proposal	ENA response
	submission on the Emerging technologies topic paper.
AV17 – The asset life of non-system fixed assets is determined by applying the asset life used under GAAP.	Agree. This is a sensible approach as the most cost-effective means of identifying asset lives for non-system fixed assets.
AV17 – Clarify that asset lives are not reset on the transfer of assets.	Agree. Asset lives should not be reset on the transfers of assets between regulated suppliers.
AV17 – Ensure that the value of an asset is adjusted for depreciation and revaluation applying in the year of the transfer.	Agree. This ensures the correct recovery of depreciation on the asset is achieved.
AV17 – Remove a requirement for suppliers to spread depreciation for ‘end of life’ assets over the regulatory period for CPPs.	Agree. This removes a compliance burden.

4.3. Proposed changes to treatment of taxation IM

19. The table below summarises the ENA’s response to each proposed change to the treatment of taxation IM.

Table 3: Tax IM changes

Proposal	ENA response
TX01 – Provide that the ID and CPP IM calculations for closing deferred tax include an adjustment for asset disposals.	Agree. This corrects an oversight in the original IMs and makes the IMs consistent with the Information Disclosure Determination.
TX04 – Clarify the tax effect of capital contributions on asset acquisitions.	Agree.

4.4. Proposed changes to cost of capital IM

20. The table below summarises the ENA’s response to each proposed change to the cost of capital IM.

Table 4: Cost of capital IM changes

Proposal	ENA response
CC03 – No longer publish a CPP WACC and apply DPP WACCs to CPPs	Agree. This is discussed in our submission on the CPP requirements topic paper.
CC05 – Use three months’ data to estimate the prevailing risk-free rate and debt premium	This is a positive change. However, a trailing average methodology should be used for the estimation of the cost of debt.

Proposal	ENA response
CC05 – Reference the Nelson-Siegel-Svensson curve when estimating the debt premium	Agree. This approach provides more certainty as to the methodology.
CC05 – Set debt issuance costs to 0.2%	Disagree. This should be set at a minimum 0.25%, as discussed in our submission on the cost of capital topic paper.
CC05 – Remove an allowance for swap costs from the TCSD and instead including it in the value of debt issuance costs	Swap costs are a material expense that need specific compensation. If the allowance is moved from the TCSD into the debt issuance costs, it should be added on top of the debt issuance cost allowance, not incorporated within it. We submit that this allowance should be set at 0.06%, as discussed in our submission on the cost of capital topic paper.
CC06 – Use a fixed linear relationship to determine the additional debt premium associated with longer-term debt	Disagree. If trailing average methodology is not adopted, disagree with the proposed approach to estimating this relationship. As discussed in our submission on the cost of capital topic paper, actual debt premium information should be used and methodological changes should be made.
CC07 – Change the leverage estimate for EDBs to 41%, while the asset beta remains at 0.34. This results in a change to the equity beta estimate for EDBs to 0.58	Support the asset beta remaining at 0.34, but disagree with the change in the leverage estimate, as discussed in our submission on the cost of capital topic paper.
CC07 – Estimate the asset beta by updating the comparator sample and then estimating an average asset beta using 4-weekly and weekly estimates over the two most recent 5-year periods	Agree.

4.5. Proposed changes to specification of price IM

21. The table below summarises the ENA's response to each proposed change to the specification of price IM.

Table 5: Specification of price IM changes

Proposal	ENA response
SP01 – Change the form of control for EDBs to a revenue cap	Agree. This is discussed in our submission on the Form of control paper.

Proposal	ENA response
SP05 – Create a recoverable cost to provide for the revenue cap wash-up	Agree. This is discussed in our submission on the Form of control paper.
SP05 – Create a recoverable cost to allow recovery of prudently incurred expenditure prior to the start of a CPP.	Agree in principle. However, this is contingent on applying a capex wash-up for the year prior to the start of the CPP, similar to the DPP. This is discussed in our submission on the CPP requirements paper.
SP05 – Enable new pass-through costs to be specified in a DPP Determination.	Agree. This is a minor adjustment that enables new pass-through costs to be established when a DPP determination is set.
SP05 – Enable any type of cost that meets the relevant criteria to be specified as a pass-through cost in a DPP Determination, rather than just levies.	Agree. This is a minor adjustment that extends the range of new pass-through costs that can be established in a DPP determination.
SP05 – Create a new recoverable cost for reopening a CPP relating to contingent projects.	Agree.
SP05 – Remove the energy efficiency and demand-side management allowance.	Agree, subject to the introduction of a revenue cap. If a WAPC is maintained, this allowance should be retained and strengthened (e.g. applied to tariff changes).
SP05 – Clarify that transmission charges are recoverable costs for exempt EDBs also.	Agree. This is a helpful clarification as current drafting suggests transmission charges are not recoverable costs for exempt EDBs.

4.6. Proposed changes to reconsideration of price-quality paths IM

22. The table below summarises the ENA's response to each proposed change to the reconsideration of price-quality paths IM.

Table 6: Reconsideration of price IM changes

Proposal	ENA response
RP01 – Create a quality standard reopener for DPPs.	Agree. However, we note this will not be available to EDBs until 2020. Potentially the quality-only CPP option should remain available until that time
RP01 – Create a price-quality path reopener to address any problems caused by a major transaction.	Agree. It is difficult to envisage all circumstances created by a major transaction in advance and then draft the determination to capture all of

Proposal	ENA response
	these circumstances, so a reopener of this type will be helpful.
RP01 – Create a reopener to apply the NCA provision or a section 52Q amendment where it requires a change to a price-quality path.	Agree regarding the NCA reopener, subject to some restrictions on when this can be applied. Regarding the section 52Q reopener, we request clarification of this proposal. See discussion in section 3 of this submission.
RP02 – Create a reopener for a CPP where the DPP WACC is amended.	Agree. This is discussed our submission on the CPP Requirements topic paper.
RP03 – Change the materiality threshold so the 1% materiality threshold would only apply to errors in allowable revenue rather than errors that might affect other aspects of the price-quality path	Based on the content of the draft IM determination, it appears the intent is the 1% of revenue materiality threshold will continue to apply for errors in the price path, while for errors in the quality standard the materiality threshold will be specified in the DPP Determination. We agree the 1% of revenue threshold may be difficult to apply to errors in the quality standard, so this approach seems reasonable.

4.7. Proposed changes to IRIS IM

23. The table below summarises the ENA's response to each proposed change to the IRIS IM.

Table 7: IRIS IM changes

Proposal	ENA response
IR02 – Spreading the second-year adjustment over the regulatory period.	Agree. This does not change the value of the IRIS incentives but reduces the risk of price shock problems resulting from the opex IRIS 'second-year adjustment'.

4.8. Proposed Changes to CPP IM

24. The table below summarises the ENA's response to the proposed changes to the CPP IM.

Table 8: CPP IM changes

Proposal	ENA response
CP01 - Building block allowable revenue information is able to be provided in spreadsheets	Agree. Avoids duplication of information which reduces cost and complexity

Proposal	ENA response
CP02 - Qualitative information requirements for capex, opex, demand and network aligned to Attachment A of the IDD (Asset Management Plans), with some reductions in the level of disaggregated information	Agree in principle. Refer to our submission on the CPP IM for improvements to the proposals
CP03 - Quantitative information on capex, opex, demand and network to better align with the IDD schedules	Agree in principle. Refer to our submission on the CPP IM for improvements to the proposed schedules. Also, schedules B and C should be aligned with the IDD cost allocation schedules to further reduce cost and complexity
CP05 - More flexibility in the number of detailed projects or programmes to be reviewed	Agree in principle. Refer to our submission on the CPP IM for suggested refinements to the proposal
CP07 – CPP application to include verification report, information provided to the verifier, verifier’s certificate	Agree, subject to clarification that all information provided to the verifier is not required to be included in a CPP application
CP12 – Information regarding quality	The decision is to remove the engineers report, and extend the verifier’s terms of reference to include review of quality information. Reference to an engineer’s report on page 95 of Topic Paper 2 is therefore incorrect. Refer to our submission for suggested improvements to the quality standard variation requirements
CP14 – Group projects and programmes by asset categories, simplify depreciation of forecast commissioned assets, and amend depreciation information requirements accordingly	Agree in principle. However the draft decision fails to implement the change to the depreciation methods. Refer to our submission on the CPP IM for further explanation
CP15 – Tax information to be included in the proposal is unchanged	This decision fails to recognise the implications of decision CP14 on tax information, and tax depreciation calculations. Refer to our submission on the CPP IM for further explanation
CP20 – Quality only CPP option removed	Agree. However the DPP re-opener for quality should be made available immediately the IMs come into effect to allow for an alternative quality standard option for the remainder of the current DPP regulatory period

Proposal	ENA response
<p>CP21 – Verification requirements modified:</p> <ul style="list-style-type: none"> – Terms of reference to include role, purpose and obligations – High-level summary of proposal for the Commission when verifier engaged – Communication protocol in verifier’s deed – Flexibility in selecting projects and programmes – Remove assessment of non-standard depreciation – Verifier to review quality standard variation – Retain assessment of cost allocation 	<p>Refer to submission on CPP IMs for detailed views:</p> <ul style="list-style-type: none"> – Agree but drafting requires substantial improvement – Disagree as unnecessary, intrusive, distracting and verification role meets this objective – Agree, open/frank communication required – Agree, but information needs and timing require refinement – Agree, outside verifier’s core competency and focus – Agree, reduces complexity, aligns with expenditure assessment – Disagree, auditor better suited given CPP method is drawn from audited disclosures
<p>CP22 – Auditor requirements modified:</p> <ul style="list-style-type: none"> – Differentiate role for historical and forecast information – Clarify audit report requirements 	<p>Refer to submission on CPP IMs for detailed views:</p> <ul style="list-style-type: none"> – Agree but drafting requires improvement including form of assurance to be provided – Agree, submission includes refinements
<p>CP23 – Consultation requirements modified:</p> <ul style="list-style-type: none"> – To include notification of impact of investment alternatives – Verifier to report on extent and effectiveness of consultation – Pre verification summary report for Commission to include consultation plan 	<p>Refer to submission on CPP IMs for detailed views:</p> <ul style="list-style-type: none"> – Agree, but only those alternatives that directly relate to the reason for the CPP proposal – Agree, but this should exclude any assessment of the reasonableness of the price impacts – Disagree, because this comes too early in the CPP development phase and we do not support the summary report proposal
<p>CP25 – Reopener provisions expanded</p>	<p>Agree in principle. Implementation suggestions included in our CPP IM submission</p>

Proposal	ENA response
CP26 – Scale of supplier to be considered when approving modifications or exemptions to CPP requirements	Agree, helps to reduce cost and complexity
CP27 – Commission’s CPP evaluation criteria unchanged	Agree. However the CPP paper suggests a number of other evaluation criteria will be applied by the verifier and/or Commission in evaluating certain aspects of a CPP proposal. We strongly oppose these additional criteria which are not consistent with decision CP27, and as a result add cost, complexity and uncertainty to the CPP process.

4.9. Recommendations

25. The ENA recommends that the Commission consider the views of the ENA on each IM change as summarised in tables 1-8.

5. Selected draft decisions to not change the IMs

5.1. Overview

26. The Report on the IM review discusses numerous parts of the IMs that the Commission does not propose to change at this time. This section of the submission considers selected items where no change is proposed.

5.2. Asset valuation

Commissioning of easements

27. The Report on the IM review indicates the Commission does not intend to make changes to the definition of commissioned asset. The ENA submits that the definition of commissioned asset in the electricity distribution IMs should be revised in relation to easements. Under the current IMs, EDBs are not permitted to add easements to their RABs until the asset is actively used to supply electricity distribution services. We note this is inconsistent with the description in the 2010 Reasons Paper which states that “[a]ll regulated suppliers must include new easement rights in the RAB value at cost in the year in which the rights are acquired”².
28. Transpower’s IMs permit Transpower to add easements to its RAB at the time the rights are acquired, even before an active line uses them, if the easement purchase has been approved by the Commission under the ‘grid investment test’. The ENA supports EDBs being able to include easement rights in the RAB at cost in the year the rights are acquired. This would also make the

² IM Reasons Paper 2010, paragraph E6.1.

IMs consistent with the explanation in the 2010 Reasons Paper of how easements should be treated.

Asset lives

29. The Report on the IM review indicates that the Commission considered making changes to the list of standard life assets in Schedule A of the IMs. The draft decision was made not to change the list at this time but the Report on the IM review invited submitters to propose new assets lives supported by evidence. The ENA will consider this in more detail for our submission in response to the draft determination.
30. However, we consider that it would be useful to specify in Schedule A the life of standard modern battery assets and inverters. We understand that most modern inverters and lithium ion batteries have a physical life of approximately 10 years. We intend to provide more evidence in support of this view in our submission on the draft determination.

5.3. Treatment of taxation

31. The Report on the IM review indicates the Commission does not intend to define the term 'weighted average remaining useful life of relevant assets' because it provides guidance to suppliers to use the definition of a similar term in the ID determination instead. The ENA does not agree with this draft decision. It is appropriate for the ID determinations to refer to definitions that lie within the IMs. It is not appropriate for the IM determinations to refer to ID definitions as the IMs generally take precedence over the ID determination.

5.4. Reconsideration of price-quality paths

32. The Report on the IM review indicates the Commission does not intend to introduce default price-quality path reopeners for constant price revenue growth (CPRG) forecasts (where the form of control is a weighted average price cap)
33. The ENA considers that if the form of control does not change, a CPRG reopener should be incorporated within the IMs to address material errors in regulatory revenue forecasts made when the DPP is set.

5.5. IRIS

34. Dr Lally identified a minor issue in the opex IRIS. He considered that changes in opex due to variations between actual and forecast CPI should not be addressed in the opex IRIS as they are accounted for under the real return. The Commission considers that the complexity of fixing this problem is not worth the benefits. We agree with the Commission.
35. The draft decision notes a problem with the way IRIS recoverable costs are calculated for single year DPPs. The Commission does not propose to fix this as it is not currently aware of a CPP application with an approval date of 2019. We do not consider this is a sound rationale. A catastrophic event could occur requiring a CPP application to be made at that time.

5.6. Recommendations

36. In relation to draft decisions to not change the IMs, the ENA recommends that:
 - Easements are able to be added to the RAB from the time the rights are acquired.

- Inverters and lithium ion batteries are added to Schedule A with a standard life of 10 years.
- The term 'weighted average remaining useful life of relevant assets' is defined within the IMs.
- The DPP includes a constant price revenue growth reopener if the form of control remains a weighted average price cap.
- The IRIS IM is not amended in response to Dr Lally's concerns, consistent with the draft decision.
- The Commission does progress a solution to the way IRIS recoverable costs are calculated for single year DPPs, consistent with the draft decision.

6. Appendix

The Electricity Networks Association makes this submission along with the explicit support of its members, listed below.

Alpine Energy
Aurora Energy
Buller Electricity
Counties Power
Eastland Network
Electra
EA Networks
Horizon Energy Distribution
Mainpower NZ
Marlborough Lines
Nelson Electricity
Network Tasman
Network Waitaki
Northpower
Orion New Zealand
Powerco
PowerNet
Scanpower
The Lines Company
Top Energy
Unison Networks
Vector
Waipa Networks
WEL Networks
Wellington Electricity Lines
Westpower