TRANSPOWER

Transpower House, 96 The Terrace,
PO Box 1021, Wellington,
New Zealand
Telephone +64-4-495 7000
Facsimile: +64-4-495 7100
www.transpower.co.nz
Jeremy.cain@transpower.nz
04 590 7544

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John McLaren
Manager, Part 4
Regulation Branch
Commerce Commission

By email: john.mclaren@comcom.govt.nz

Dear John,

Proposed amendments to input methodologies: IRIS

Thank you for the opportunity to comment on the Commission's, *Proposed amendments to the input methodologies: Incremental Rolling Incentive Scheme,* dated 18 July 2014. Unless otherwise stated, comments in this submission relate to the Commission's Transpower specific proposals. No part of our submission is confidential.

Summary

We do not support implementation of a symmetric IRIS for RCP2 opex. For RCP2 we support retention of the 'semi-symmetric' IRIS arrangements that we have in place for RCP1. We also support the planned partial implementation of a capex incentive in RCP2.

Were the Commission to implement a symmetric IRIS for RCP2 opex then:

- defects in the proposed design would need to be remedied to ensure a consistent sharing ratio is achieved under realistic expenditure scenarios; and
- the proposed drafting should be corrected to ensure that the change is not retrospective (i.e. does not alter the value of 'credits' earned in RCP1).

The RCP2 reset involves forward-looking adjustments for unrealised efficiency gains in ICT business support projects and external consultants. Applying a symmetric IRIS in this case exacerbates the risk that Transpower would be unable to recover fully its efficient operating costs if these prospective efficient gains prove unachievable in practice.

A symmetric IRIS could apply from RCP3 if this was implemented in conjunction with clear and coherent policy on how the RCP3 opex reset would be undertaken. In particular, the approach to the reset would need to be consistent with the operation of a symmetric incentive scheme.

Setting incentive regulation

We support incentive regulation and are committed to assisting the Commission in implementing and operating an effective and long term incentive regime.

A 'semi-symmetric' IRIS is in place for RCP1. It is semi-symmetric in that, while it cannot produce net negative revenue adjustments in RCP2 overall, decreases in efficiency do reduce the benefits

Transpower received from earlier efficiency improvements. Transpower has achieved significant cost savings and credits under IRIS.

Transpower will have a partial capex incentive in place from RCP2 – six asset fleets have a modified incentive regime to address deliverability concerns, and 'major capex' has an administrative incentive scheme. The remainder of our capex will have simple 33% incentive rate regime.

Incentive regulation will, if well executed, sustainably reduce prices paid by consumers for a given quality of service while increasing returns to suppliers.

In our view, the Commission has and continues to make good progress in this area but some significant issues exist with the interaction between its proposals for Transpower and the approach adopted for the RCP2 opex decision.

IRIS must be coherent with IPP reset policy

In its draft decision on our RCP2 opex allowance, the Commission proposed a 'stretch targets' approach to setting our opex allowance. Our submission to that draft decision[1] pointed out that imposing a productivity adjustment is inconsistent with proper operation of the IRIS. The proposal to implement a fully symmetric IRIS for RCP2 exacerbates this concern.

Making a productivity adjustment exposes us to a risk of not being able to recover efficient costs if the 'stretch targets' are not achievable in practice. A symmetric IRIS exacerbates this risk, imposing a further penalty.

Figure 1 demonstrates the difference between no IRIS, the current semi-symmetric IRIS and a (properly operating) symmetric IRIS for a scenario where the regulator imposes a 5% productivity adjustment.

Figure 1: IRIS sensitivity

	RCP2					RCP3				
Allowance set below the efficient spend level	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
Allowance	95.0	95.0	95.0	95.0	95.0	100.0	100.0	100.0	100.0	100.0
Actual - efficient spend level	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
under/(over)-spend against the allowance	(5.0)	(5.0)	(5.0)	(5.0)	(5.0)	-	-	-	-	-
NPV of the shareholder gain or (loss)										
No IRIS	(5.0)	(4.6)	(4.3)	(4.0)	(3.7)	-	-	-	-	-
Semi-symmetric IRIS	(5.0)	(4.6)	(4.3)	(4.0)	(3.7)	-	-	-	-	-
Symmetric IRIS	(5.0)	(4.6)	(4.3)	(4.0)	(3.7)	(3.4)	-	-	-	-

Under the no IRIS and semi-symmetric IRIS scenarios the supplier bears the costs of efficient expenditure in excess of the allowance, in this case 5% of expenditure or $21.6m (NPV[2] over the period. Under a symmetric IRIS the supplier would bear those costs *plus* an additional $3.4m (NPV) penalty.

[1] Available at http://www.comcom.govt.nz/regulated-industries/electricity/electricity-transmission/transpower-individual-price-quality-regulation/transpowers-price-quality-path-from-2015-to-2020/

[2] 5.0+4.6+4.3+4.0+3.7 = 21.6

IRIS penalties are undesirable if they arise not from deteriorations in efficiency, but from the supplier's inability to meet a 'stretch target' imposed by the regulator.

Address defective IRIS construction

Were the Commission to reject our submission and implement a symmetric IRIS for Transpower from RCP2, it will need to address defects we have identified with the IRIS calculation.

The IRIS is intended to produce a consistent sharing ratio across any combination of permanent or temporary efficiency gains or losses. The Commission has tested its proposed IRIS rules against simple, stylised scenarios intended to demonstrate that the sharing ratio is consistent. We have tested the rules against more complex, plausible patterns of efficiency gains and losses and found that the ratio varies considerably.

The problem we identified is unique to the IPP. For the DPP, opex resets are based on extrapolation from a defined base year and this allows a more straightforward IRIS construction than proposed for the IPP IRIS.

We have flagged this issue to Commission staff during the consultation period.

We also note that the proposed drafting does not clearly set out how a transition would occur from a semi-symmetric to a symmetric IRIS. We understand that the intention is that the changes would alter our economic loss or gain arising from expenditure within RCP2, but would not retrospectively alter the economic gain arising from efficiencies we have achieved in RCP1.

Policy clarity over IPP opex reset needed

A key issue for our RCP2 post-project review will be obtaining clarity over the Commission's opex reset policy. No such input methodology exists and, beyond historic practice, there is little to guide us or the Commission on the appropriate approach.

As is evident from this submission, and our submissions on the reset process itself, we are unclear and concerned about the interplay between the reset policy and the incentive framework being applied.

Please let me know if you have any questions or would like to discuss any of the points made in this submission.

Yours sincerely

Jeremy Cain
Regulatory Affairs Manager