BOARD STAFF RESPONSE TO
ENBRIDGE GAS DISTRIBUTION INC. #6

INTERROGATORY

ISSUE A1: Is Enbridge's proposal for a Customized IR plan for a 5 year term covering its 2014 through 2018 fiscal years appropriate?

Evidence Ref: ExhL/T1/S2

I.A1.Staff.EGDI.6

Preamble:
On page 3, PEG states, "CEA has not developed any independent evidence that can be used to confirm, reject or otherwise test the reasonableness of EGD's forecast costs over the term of its Customized IR proposal. The reasonableness of EGD's Custom IR application depends on the reasonableness of its cost projections. Since CEA's empirical analysis provides no evidence on the latter issue, it does not affirm the reasonableness of EGD's Customized IR proposal."

Request:

a. Please describe, with references to relevant regulatory decisions, the role that company forecasts play in the current regulation of U.K. and Australian gas distributors.

RESPONSE

In the current regulation of gas distribution in the UK, the role of company forecasts is to initiate the regulator's review process, which ultimately leads to the establishment of gas distribution price controls. The regulator's review of the company's forecasts includes different assessments of the forecasts using benchmarking techniques, as well as the application of an information quality incentive (IQI) designed to offset the companies' incentive to inflate their cost projections.

This process is explained in Ofgems' first decision establishing gas distribution price controls, the December 3 2007 report *Gas Distribution Price Control Review: Final Proposals*. When discussing its capital expenditures (capex) and replacement capital expenditure (repex) analysis, Ofgem writes (p. 27):

> In October 2006, we received responses to our BPQs from each of the GDNs (gas distribution networks) setting out their historical capex and repex for 2002-03 to 2005-06 and forecast expenditure for 2006-07 to 2012-13. We appointed PB Power to support our assessment of the forecast capex and repex.

Over the period October 2006 to March 2007 PB Power carried out a detailed assessment of each GDN's capex and repex requirements. It reviewed the GDNs' BPQ submissions and raised supplementary questions to gain a better understanding of the GDNs' data and, where appropriate, gather additional information to support the cost assessment.

PB Power, together with Ofgem staff, visited each GDN in order to discuss their BPQ submissions, ask follow-up questions and to challenge and improve their understanding of the GDNs' forecast assumptions.

PB Power's work included:

- a high-level assessment of policies, procedures and forecasting processes associated with capex and repex;
- a review of GDNs' forecast costs to understand whether they were based on appropriate assumptions including the justification for their workload forecasts, assumptions for real price increases and productivity;
- an assessment of GDNs' efficiency for particular capex and repex activities by benchmarking costs across GDNs; and
- bottom-up analysis to consider the appropriate costs for particular activities based on information submitted by the GDNs and its own engineering experience.

The report also explained (p. 43) Ofgem's decision

> to use an information quality incentive (IQI), as used in DPCR4, where it was called a sliding scale incentive, in order to incentivise appropriately accurate forecasting by the GDNs. This incentive allows us to compare the GDNs' forecast against the results of our consultants' and our own analysis, and use the differential between the two figures (the IQI ratio) to determine three things:
>
> - an appropriate level of allowance for capex and repex;
> - the incentive rate to be applied to the under/overspend of capex, and;
> - a reward for those GDNs that forecast close to our analysis (or a penalty for those where there is wide disagreement).

The report described the capital expenditures allowed in gas distribution rates (*i.e.* the capex allowance) as follows on pp. 64-65:

> Traditionally, the capex allowance is set based on *our views of the GDNs' capex forecasts*. GDNs also have an incentive to inflate their capex forecasts in order to maximise their scope for outperformance. There is also a significant information asymmetry between the regulator and the

> company. It can be difficult for the regulator to differentiate between additional investment necessary to maintain network integrity and artificially inflated capex forecasts.
>
> We addressed this concern by implementing the IQI which was developed as part of DPCR4. The IQI manages this risk by allowing the GDN to choose higher allowances than we forecast but incentivises them not to inflate their bids. The incentive does this in two ways – by giving additional income to companies who forecast capex spend close to our assessment and by providing these companies with a higher capex rolling incentive rate than those companies with higher capex forecasts, thereby increasing the reward those companies receive for outperformance (emphasis added).

As this passage indicates, Ofgem sets the capex allowance for gas distribution rates based on its "views" of the gas distributors' capital expenditure forecasts, not directly on the forecasts themselves. These views are informed by extensive benchmarking analysis. The capex allowance is also determined through the application of an IQI that is designed to mitigate the distributors' "incentive to inflate their capex forecasts."

Although some of the details differed, capital forecasts played a very similar and analogous role in its next update of price controls for gas distributors. The details of this process are described in the December 17, 2012 Ofgem report *RIIO-GD1: Final Proposals – Supporting Document – Cost Efficiency*.

In Australian regulation of gas distribution, company cost forecasts are an important component of the distributor's "gas access arrangement proposal," which the distributor submits to the regulator. The regulator then reviews the Company's expenditure forecasts, including its assumptions for inflation in construction labor prices, inflation in capital goods prices, and proposed capital investment plans. The regulator's review can include consultant reports that assess various aspects of the Company's expenditure proposals and which can include independent benchmarking. Considering all this evidence, the regulator then comes to a view on appropriate magnitudes for final *allowed capital and operating expenditures to be allowed in distribution price controls.*

In 2007-2008, PEG was extensively involved in the review of gas access arrangement proposals for gas distributors in the Australian state of Victoria. We analyzed a number of different issues that entered into the distributors' proposed expenditures for the price control period. This work is summarized in our response to I.A1.Staff.EGD.3. The regulator's decision on this gas access arrangement was presented in the March 7, 2008 Essential Services Commission report, *Gas Access Arrangement Review 2008-*

2012. A more recent review of a gas access arrangement proposal that is currently in effect is contained in the Australian Energy Regulator's March 2010 report, *Final Decision-Public: Access Arrangement Proposal ACT, Queanbeyan and Palerang Gas Distribution Network*, *1 July 2010 – 20 June 2015*.