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Dear John McLaren

Revised Draft Default Price-Quality Path Determination

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to make a submission on the Commerce Commission's (**Commission**) consultation papers titled '*Electricity Distribution Services Default Price-Quality Path Determination 2015*' and '*How we propose to implement the default price-quality paths for electricity distributors from 1 April 2015*', published 20 October 2014. These papers are collectively referred to in this submission as the 'revised draft determination'.

2. Treatment of pass through and recoverable costs

WELL supports the proposal in the revised draft determination to:

- introduce a Pass-through Balance for the recovery of pass through and recoverable costs; and
- separate the Pass-through Balance from the compliance test for distribution prices.

The proposal removes the risk of non-compliance with the Default Price-Quality Path (**DPP**) due to unintentional mis-forecasting of pass through and recoverable costs and enables Electricity distribution Businesses (**EDBs**) the opportunity to fully recover these third party costs.

However, WELL considers that the time value of money adjustment should be the Weighted Average Cost of Capital (**WACC**) rather than the cost of debt. The WACC is the opportunity cost of capital for both EDBs and customers and therefore reflects the true time value of money. The time value of money is a function of the riskiness of cash flows and is independent of the party who is receiving or paying the cash. The time value of EDB distribution revenue cash flows must be equivalent to the time value of customer distribution charge cash flows because these cash flows are equal and opposite and have the same level of risk associated with them. The time value of money associated with cash flows for an EDB has been calculated by the Commission as the WACC. The time value of money associated with cash flows for a BBB+ EDB bond has been calculated by the Commission as the cost of debt. The cash flow risk for an investor in a BBB+ EDB bond is not the same as that for an investor in an EDB, and is therefore not a relevant measure of the time value of money for EDB revenue or charges.

Applying the WACC as the time value of money for delayed revenue recovery is also required for consistency with the Commission's DPP financial model. The DPP financial model consistently assumes that the WACC is the time value of money for an EDB, for instance:

- Any cash flows which occur at mid-year which are required to be escalated to the end of the year are escalated by half a year's WACC;
- The smoothing of maximum allowable revenue to recover building block costs is performed using WACC as the time value of money.

In the DPP financial model, any asset owned by the EDB earns a WACC return, including fixed assets and deferred tax assets. There is no reason why a deferred revenue asset (e.g. unrecovered pass through costs) should be treated any differently.

Additionally, unlike the cost of debt, applying the WACC as the time value of money for pass through and recoverable costs would ensure that EDBs are neutral to under or over-recovering these costs in any given year.

3. Quality of supply

WELL supports the revised draft determination to:

- remove the adjustments applied in the draft DPP determination to pro-rata back raw historical SAIDI and SAIFI data in years when quality compliance limits were exceeded under the current 2011-15 DPP. Making such adjustments to raw historical data would have distorted the validity of the historical data and remove valuable information regarding natural variation. Making such adjustments would also have resulted in unjustified penalties being imposed on EDBs where the reason for the quality limit being exceeded was not due to either deliberate or negligent behaviour.
- reinstate the 'two-out-of-three' test for compliance with the quality path. Defining the quality compliance test as occurring when the reliability cap (mean plus one standard deviation) is exceeded in both the current regulatory year and one of the immediately preceding two regulatory years ensures that there is a lower probability of breaching the quality path simply due to natural variation.
- independently normalise SAIDI and SAIFI based on individual major event day boundary values. Depending on network configuration and the type of unplanned events that occur, SAIDI and SAIFI may not be well correlated. Independent normalisation allows the MED boundaries to be set to better reflect the nature of the network and better control for the range of unplanned events that may occur.

WELL considers that the revised approach to setting the Major Event Day boundary values may potentially be suitable given New Zealand's unique conditions. However, WELL has reservations that deviating from the IEEE method, which is an international recognised standard, may lead to unintended consequences. WELL generally cautions the Commission against deviating from international standards except in exceptional circumstances. It would therefore be appropriate for the Commission to test the assumption that the reliability data does not reflect the log-normal distribution in order to validate whether departure from the IEEE standard is justified in this circumstance.

WELL does not support using a ten year reference period for setting the reliability targets. The targets should be set by reference to the most recent five years of historical data because this provides the best estimate of EDBs currently achievable quality standards given current network condition and current expenditure levels required to meet the current level of performance.

Using five years of historical data to set the targets is consistent with the approach taken by energy regulators in the United Kingdom and Australia.

Using five years of historical data is also consistent with the IEEE recommendations. Annex B.8 of IEEE 1366:2012 states that:

'From a statistical point of view, the more data used to calculate a threshold, the better. However, the random process producing the data changes over time as the distribution system is expanded and operating procedures are varied. Using too much historical data would suppress the effects of these changes.'

And

'The consensus of the Design Working Group members was that five years was the appropriate amount of data to collect. The group felt that the distribution system would change enough to invalidate any extra accuracy from more than five years of data.'

Additionally, using five years of historical data to determine the quality targets is consistent with the Commission's proposed methods for forecasting opex and capex allowances which are derived from each EDB's recent years' expenditure levels. Recent expenditure reflects the level required to maintain the current level of underlying reliability performance of the network. Applying a ten year historical average to set reliability targets, would result in the proposed expenditure allowances being inconsistent with the reliability requirements.

WELL therefore recommends that for the final decision the Commission use the past five years of historical data to set the reliability targets.

4. Closing

WELL appreciates the opportunity to make this submission in response to the Commission's revised draft determination.

Please do not hesitate to contact Megan Willcox, Senior Regulatory Economist, on MWillcox@welectricity.co.nz if you have any queries.

Yours faithfully



Greg Skelton

CHIEF EXECUTIVE OFFICER