

31 July 2018



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Dear Matthew

## Feedback on recent customised price-quality path processes

### 1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to respond to the Commerce Commission's (**Commission**) paper '*Requesting feedback on recent customised price-quality path processes*' (**the paper**) published 3 July 2018. WELL appreciates the Commission's assistance during our recent streamlined customised price-quality path (**SCPP**) application process.

WELL supports the objectives of the consultation to:

- improve the quality of customised price-quality path (**CPP**) proposals
- provide guidance for complying with the CPP input methodologies (**IMs**)
- reduce the cost and complexity of preparing CPP proposals
- seek feedback on the effectiveness to the changes to the CPP IMs introduced in 2016.

The paper suggests potentially introducing a number of additional requirements for CPP applications. In general, WELL does not support formally extending the CPP application requirements in the ways suggested in the paper, because they will add to the costs and complexity of CPPs, without necessarily improving the quality of CPPs. The cost of complying with the regulatory requirements is ultimately borne by consumers.

It is important that electricity distribution businesses (**EDBs**) are not discouraged from making CPP applications where they are in the long term interests of consumers. Each CPP will be unique, addressing the particular circumstances of the applicant. Expanding the application requirements and/or reducing flexibility will introduce additional cost and complexity which may deter applications from being made. This is not in the long term interests of consumers.

WELL considers that a number of the suggestions made in the paper can be included in guidance for CPP applicants, who will be able to assess it in the context of their individual proposals. This flexibility will assist in meeting the cost and complexity objectives, while ensuring CPP applications meet the Commission's expectations and provide better outcomes for consumers.

The remainder of this submission addresses each of the topics listed in Attachment A of the paper in turn. We also comment on the changes to the CPP IMs which were introduced in 2016, of relevance to our SCPP proposal.

## **2. Consideration of alternatives**

The paper suggests that prior to submitting CPP proposals, applicants could be required to consult with third parties on potential alternative solutions for major investments.

WELL agrees that market testing of alternatives could potentially enhance a CPP proposal under certain circumstances, however WELL does not consider that this suggestion should be included as a compulsory requirement for all CPP proposals.

Consistent with the objective of reducing the cost and complexity of CPPs, the CPP IMs were redrafted in 2016 to allow for an asset management plan (AMP) -plus approach. This approach allows CPP applicants to leverage the existing regulatory disclosure requirements for AMPs when preparing their CPP proposals. These disclosure requirements require EDBs to demonstrate how alternative solutions are considered when establishing network development plans. The CPP IMs build on this requirement by including an explicit requirement for detailed information to be provided on the alternatives considered for each identified programme.

WELL submits that it is not appropriate for EDBs to test for market solutions for all major investments, given the legislated obligations for EDBs to provide continuity of supply and maintain supply quality. This responsibility sits with the EDB, and market solutions provided by third parties using new technologies may introduce additional and unacceptable supply risks for EDBs. In addition, the nature of particular investments, such as the resilience investments included in our S CPP may not always lend themselves to market solutions.

Accordingly, WELL submits that it is possible to improve the quality of CPPs by providing guidance for demonstrating how alternative solutions for major investments have been considered, including through market testing, where appropriate.

## **3. Use of cost-benefit analysis**

The paper suggests that the CPP IMs could be amended to require the Commission to undertake cost-benefit analysis (CBA) to determine whether a CPP proposal promotes the Part 4 purpose statement, as set out in s52A of the Commerce Act.

WELL submits that this proposal does not adequately recognise the CPP evaluation criteria which form part of the IMs (refer IM Clause 5.2.1). The evaluation criteria were consulted on and established in 2010 when the IMs were initially determined, and have been subsequently reviewed following Orion's CPP in 2014 and again in 2016. The Commission must apply them when assessing a CPP proposal and they are consistent with the Part 4 purpose statement. Introducing an additional CBA requirement at this stage would be a fundamental change to the CPP IM.

WELL notes that the evaluation criteria do not specify the tools or techniques to be applied. This is consistent with the CPP IMs more broadly which recognise that a range of possible evaluation approaches can be applied to CPP applications. This approach permits flexibility in the way in which CPPs are prepared, verified and assessed, subject to meeting the overarching evaluation criteria. This flexibility is important as each CPP proposal is unique and unnecessary prescription introduces undue cost and complexity.

Importantly, the expenditure contained in a CPP proposal delivers multiple benefits, many of which are not explicitly captured in the quality outcomes quantified in a CPP proposal. These reflect the broad utility benefits associated with electricity distribution services, for example maintaining

continuity of supply, network resilience, compliance, public and employee safety, power quality and environmental protection. WELL considers CBA has significant shortcomings in being able to assess these utility benefits which are not explicitly quantified as part of a CPP proposal.

The existing CPP expenditure objective appropriately acknowledges the breadth of the obligations of EDBs, and allows the applicant, the verifier and the Commission to apply a wide range of tools (including CBA if desired) to test the CPP proposal against this objective. This is appropriate and sufficient.

Accordingly WELL does not support the proposal that the Commission undertakes CBA on every CPP proposal, but notes this may be a tool applied to assess components of a CPP proposal. WELL considers that the existing CPP IM evaluation criteria and expenditure objective are fit for purpose, and have been successfully applied in CPP application processes to date. WELL considers CBA is inferior to the current requirements, which are operating effectively. It is therefore inconsistent with the objectives of this review to introduce additional CBA requirements for the Commission's assessment of CPP proposals.

#### **4. Long term pricing impact**

The paper suggests that CPP applicants may be required to consult with consumers on the longer term pricing impacts of their proposals, ie: beyond the CPP period. This is because capex incurred during the CPP period affects prices over the long term.

WELL acknowledges that investments made during a CPP period have long term pricing implications. However WELL cautions against assuming that elevated investment during a CPP period will always result in higher prices than will otherwise be incurred in the long term. This is because the counterfactual is unlikely to be static ie: it is probable that a CPP applicant may require elevated expenditure at some stage, either during the CPP period or in the future, in order to maintain asset performance or address network constraints.

As noted in the paper, there is judgement required when estimating the future pricing impact of CPP expenditure proposals. This is due to a number of factors, including uncertainty over:

- how the default price-quality path (**DPP**) will be set at the end of a CPP
- forecast revenue building blocks
- forecast network parameters including consumer demand
- future network performance and expenditure.

Given the judgement required, WELL cautions against prescribing an approach for consulting on longer term pricing impacts. WELL suggests that better outcomes for consumers can be achieved without introducing unnecessary complexity, by the Commission providing further guidance on the consumer consultation component of the CPP IMs. This could include the expectation that CPP applicants consider the long term impacts of CPP proposals on consumers.

#### **5. Calculating revenue and pricing changes**

The paper suggests introducing a standard approach to calculating and communicating price changes, which could be used for DPPs and CPPs. It is suggested that this approach could be used by CPP

applicants when communicating with consumers about their CPP proposals, and the Commission when making its DPP and CPP decisions.

WELL supports in principle the proposal for a standardised format for presenting pricing impacts, which may assist in reducing complexity and improving transparency for consumers. WELL does not support however standardised calculations. This is because it is most important that it is the pricing impact for the CPP applicant's consumer base which is demonstrated. This is consistent with the objective of promoting better outcomes for consumers.

In regards to the proposals set out in Attachment B of the paper, and reflecting on our recent S CPP experience we note the following.

- A typical consumer on one network differs to a typical consumer on another. For example residential consumers in Wellington have substantially lower average consumption than residential consumers located in Taranaki. Annual bills and annual distribution charges per consumer differ considerably between EDBs, as illustrated in Figures A.1 to A.3 of Attachment B of the paper. WELL's average distribution charges are relatively low, and our average residential consumption of approximately 7,000 kWh per annum is significantly below the 8,000 kWh typical residential benchmark referred to in the paper. Accordingly the standard calculations proposed in Attachment B do not adequately reflect our circumstances, and if applied, will result in misleading outcomes for consumers.
- The paper suggests that pricing impacts should reflect changes to distribution prices associated with the CPP proposal. However there are pass through and recoverable cost impacts of moving from DPPs to CPPs. Non-distribution revenue components which influence prices include the opex IRIS recoverable cost and CPP specific recoverable costs. In our S CPP, reductions in pass through prices significantly offset increases in distribution prices. It was our experience that some retailers were misled by the S CPP decision papers, which ignored the pass through price impact, and as a result they did not factor this offset into their pricing. WELL therefore submits that it is not appropriate to focus only on the maximum allowable revenue (MAR) component of the revenue allowances, as CPP decisions also influence non MAR components of line charges.
- The paper suggests that an estimate of the change in revenue at the start of the next regulatory period should be included in CPP applications and decisions. WELL does not support this proposal, which is inconsistent with promoting better outcomes for consumers, because there are a number of key variables which are unknown at the time a CPP application is made. These include:
  - what method the Commission applies when resetting the price path at the end of the CPP period
  - the slope of that price path
  - whether the EDB in question applies for a subsequent CPP
  - the underlying revenue building block assumptions
  - the CPP applicant's expenditure performance during the CPP regulatory period

- changes which may be introduced for DPPs during the CPP regulatory period.

Accordingly WELL considers the proposed approach is overly simplistic and will generate information which is misleading and therefore inconsistent with achieving better outcomes for consumers. As previously suggested, EDBs are able to provide information to consumers about long term pricing impacts after considering their own particular circumstances, and potential counterfactuals. A standardised approach is not well suited to this task.

## 6. Deliverability and accountability of CPP commitments

The paper suggests that CPP applicants should demonstrate how they are delivering on their CPP commitments in a transparent and easily understandable way, using a stakeholder facing delivery report.

WELL supports this suggestion in principle, subject to:

- ensuring the additional delivery and accountability requirements are proportionate. WELL considers that Powerco's CPP delivery report, and WELL's resilience compliance obligations are not proportionate, and that the Commission's accountability objectives could be met more effectively with less granular, and less costly, accountability requirements
- not imposing unrealistic compliance costs and obligations, which ultimately will be borne by consumers through prices
- focussing only on the key drivers of the proposal, not business as usual (BAU) activities
- maintaining incentives for EDBs to innovate, improve and substitute within the CPP expenditure envelope, without incurring unnecessary additional compliance costs
- ensuring the Commission and other external stakeholders maintain appropriate distance from the operational decisions of the EDB.

The paper also suggests that CPP applicants should propose additional quality measures that are linked to the key drivers of the proposal, and that these could be linked to revenue.

WELL agrees that there may be instances where additional, or alternative quality measures are relevant for a CPP proposal. The CPP IM includes provision for applicants to propose alternative approaches to quality standards. WELL considers that these provisions are sufficient to accommodate the approaches suggested in the paper. Each CPP will be unique and flexibility should be retained in this regard. The Commission could also raise the possibility of additional service measures in its guidance papers, allowing applicants to assess and test the relevance or otherwise of these when preparing their CPPs.

WELL does not support the compulsory extension of CPP financial incentives beyond those which exist in the IMs. We note that the Incremental Rolling Incentive Scheme (IRIS) has been specifically designed to accommodate transitions between DPPs and CPPs and to incentivise EDBs to innovate and achieve expenditure efficiencies. In conjunction with the IRIS, the quality scheme incentivises EDBs to maintain reliability performance. These financial incentive schemes are symmetrical. They include rewards for out-performance and penalties for under-performance.

WELL does not support asymmetrical financial incentive (ie: penalty) schemes which focus solely on the delivery of CPP projects or programmes. WELL does not consider this is consistent with the revenue cap form of control, or the Part 4 purpose statement. EDBs should not be unduly incentivised to deliver predetermined outcomes at all costs because this is not in the long term interests of consumers. CPPs include quality standards which must be met, and EDBs should have flexibility about how they achieve those standards. Further, EDBs should be able to refine their projects and programmes within the CPP expenditure envelope, to react to changes in their external or internal environments. This is consistent with promoting better outcomes for consumers.

## **7. Link between price and quality**

The paper suggests that CPP applicants should be able to demonstrate the impact of individual investments on quality outcomes for consumers. However in addressing this topic the consultation paper diverges into a discussion on how an asset criticality framework could inform investment decisions and quality outcomes. It is not clear from the paper how this could impact CPPs, as the topic extends beyond CPP processes into a broader discussion about implementing an asset criticality framework across the sector.

As our SCPP focussed on immediate readiness spend for catastrophic events, the asset criticality framework referred to in the paper was not a significant consideration as we focused on vulnerability and interdependency. However, our SCPP considered the link between the pricing impact of the proposal and the key outcomes for consumers. Our evaluation of the benefits of the proposed investment quantified the impact for consumers and the community. This wider community impact was particularly relevant for our proposal.

Our SCPP did not demonstrate an explicit link between the pricing impacts of the additional readiness spend, and the regulatory quality targets which reflect network reliability measures. This was not appropriate in our case. Our SCPP spend is targeted at improving the resilience of key assets and our ability to restore supply following a catastrophic event. We therefore focussed on the consequences for the community and our consumers should a catastrophic event occur in our network region.

Accordingly, WELL submits that the current flexibility in the CPP IMs for demonstrating the price and quality impacts on consumers should be retained.

## **8. Consumer consultation**

The paper suggests that consumer consultation undertaken by CPP applicants to date could have been improved, including by:

- providing more detail and / or optionality in the consultation material
- better articulating the price/quality trade-offs between options using typical household bill impacts.

WELL is open to a range of communication techniques and processes for consumer consultation. During the SCPP process we were able to formally consult with a number of consumer and community representatives in different ways. This provided valuable input into our proposal. For example we consulted specifically with members of the business community to understand their needs for power restoration following a catastrophic event. We were able to use the 2016 Kaikoura earthquake experience to frame this consultation. These representatives were also local residents and therefore we were also able to discuss the proposal from a residential perspective.

Accordingly WELL cautions against including additional prescription in the CPP consultation requirements. Our SCPP was focussed on readiness investment, which does not align well with a traditional price/quality trade-off view. However, in order to promote better outcomes for consumers, WELL supports engagement between CPP applicants and the Commission prior to submitting a CPP proposal. This can help to ensure that the Commission's expectations for consumer consultation are met.

## **9. Verification**

The paper suggests some improvements to the CPP verification process.

WELL did not undertake a formal verification process when preparing the SCPP. Instead we obtained independent review of the expenditure proposal and the review material was included in the SCPP proposal. This was a proportionate approach consistent with the limited scope of the SCPP. We found the independent review useful, and were happy to publish the findings as part of our proposal.

While we are unable to comment on the verification process for the Powerco CPP proposal, we do not support the suggestion that an emerging views or preliminary verification report should be published. We consider this would be detrimental to the CPP application process because it could unduly influence stakeholder views on the final CPP proposal.

In our view a key benefit of the verification process is to test the draft CPP proposal and, along with the feedback from the consumer consultation and audit processes, provide the applicant with the opportunity to reconsider, refine or improve its proposal before it is submitted. It also provides the CPP applicant the opportunity to respond to any errors or misunderstandings which may be included in the draft verification report.

The Commission benefits from this refinement step by receiving a CPP proposal which has been challenged and improved. This is consistent with the objective of promoting better outcomes for consumers through achieving high quality CPP proposals.

The CPP IMs include significant safeguards over the verification process which ensure that the Commission is able to rely on the verification outcomes. The verifier has a duty of care to the Commission; must be independent of the EDB; the Commission vets and approves the verifier appointment; the material relied upon by the verifier is made available to the Commission; and the verifier must report against a detailed terms of reference which is specified in the IMs.

WELL therefore considers that the current verification requirements are fit for purpose.

## **10. Defining and applying proportionate scrutiny**

WELL continues to support a proportionate scrutiny approach to CPP assessments. We acknowledge that the Commission demonstrated this principle during our SCPP process. This was consistent with the direction provided in the 'Resilience of Electricity Services in the Wellington Region' Government Policy Statement (GPS).

However WELL remains concerned that the Commission retains significant discretion in whether and how it applies proportionate scrutiny. Accordingly EDBs and other stakeholders have little understanding of how this principle might be applied in practice.

Proportionate scrutiny is one tool which can be applied to minimise the cost and disruption associated with CPPs. Even though our CPP process was streamlined, there was significant business commitment required to prepare the proposal, consult on it, have it reviewed, audited and certified, and to respond to the Commission's assessment processes and investigation. This commitment required staff to be diverted away from BAU tasks and for external assistance to be engaged. It placed substantial pressure on our organisation.

In addition, the Commission incurred significant costs in assessing our proposal. These costs are ultimately passed on to consumers.

WELL considers that the costs and complexity of CPP proposals could be reduced by better defining the proportionate scrutiny principle, including when it may be applied in practice. This could include, for example:

- whether the Commission will take into consideration the scope and scale of the CPP proposal relative to an EDB's DPP
- whether the Commission will limit its investigation to those aspects of a proposal which depart materially from BAU.

## **11. Changes made during 2016 IM review**

### *Flexibility to apply modifications and exemptions*

WELL supports the flexibility to apply for IM modifications and exemptions, which were a critical component of our SCPP process. We applied for a number of exemptions and modifications consistent with the SCPP and GPS. This enabled our CPP application process to proceed more quickly than the IMs permit, to allow us to undertake immediate investments for earthquake readiness. Accordingly our SCPP was able to focus on the incremental readiness spend, while maintaining WELL's underlying default price-quality standards.

In seeking modifications and exemptions, we proposed substitutes which ensured we:

- maintained revenue building blocks and regulatory incentives consistent with the IMs
- provided meaningful information about our proposal to the Commission, consumers and other stakeholders
- received robust independent review of the proposed expenditure
- obtained an audit of the CPP modelling
- certified the CPP proposal.

WELL supports this feature of the CPP IMs.

### *Ability to use alternative methodologies that have equivalent effect*

During the SCPP process WELL investigated using the alternative methodologies option to facilitate the streamlined approach to the CPP. However we discovered that the 'equivalent effect' requirement limited our ability to apply alternatives in practice, for revenue building blocks.

Accordingly, WELL suggests that this IM refinement, which was introduced in 2016, may not in practice achieve its policy intent, which was to reduce the cost and complexity of CPPs. We therefore suggest that a materiality threshold could be included in the equivalent effect test, which allows for alternative methodologies which result in outcomes which are materially equivalent.

*Adoption of a single WACC for default and customised price-quality paths*

WELL supports the change to a prevailing WACC approach for CPPs. However as the WACCs that will apply during the entire CPP period may not be known at the time a CPP proposal is prepared, this approach adds some complexity to quantifying the pricing impact of a CPP proposal.

Powerco addressed this issue with an IM variation for its CPP proposal. Powerco applied a WACC estimate which reflected a forecast WACC for the CPP period extending beyond the current DPP. This resulted in better information for consumers about the pricing impacts of the proposal.

In order to improve stakeholder engagement, WELL recommends that the CPP IMs are amended to include the option of using a forecast WACC for the CPP period which extends beyond the current DPP regulatory period. A forecast WACC will also be able to be used when estimating the DPP counterfactual to a CPP. This is required when quantifying the pricing impacts of a CPP, where a CPP extends into the next DPP regulatory period.

As a number of the WACC parameters are fixed, and the methods and data sources for determining the variable parameters are set out in the IMs, it is possible to estimate forecast WACCs consistent with the IMs. Applicants could be required to disclose the basis for establishing the forecast WACC parameters in their CPP proposals.

We note that the revenue path will be adjusted for the difference between the forecast WACC and the WACC the Commission determines at the beginning of the next DPP regulatory period. Thus the forecast WACC will not ultimately impact prices. However it will improve the quality of the CPP application process, by presenting more accurate pricing impacts for consumers.

**12. Closing**

WELL appreciates the opportunity to respond to the Commission's request for feedback on the recent CPP processes. We support the Commission undertaking assessments following major decisions as feedback can help refine and improve processes over time and improve regulatory certainty.

Please do not hesitate to contact Gerry Glynn on [gglynn@welectricity.co.nz](mailto:gglynn@welectricity.co.nz) if you have any queries about this submission.

Yours faithfully



Greg Skelton

**CHIEF EXECUTIVE OFFICER**