21 December 2010

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Dear Dr Berry

On 10 September 2010, Wellington Electricity Lines Limited (**Wellington Electricity**) and the Electricity Network Association (**ENA**) provided their Initial Submissions on the Commerce Commission's (**Commission**) Starting Price Adjustments for Default Price-Quality Paths Discussion Paper (**Discussion Paper**).

In their Initial Submissions, Wellington Electricity and the ENA indicated an intention to provide further detail on the appropriate approach to determining an Electricity Distribution Business's (**EDB**) starting price adjustment. The ENA's Subsequent Submissions, dated 10 December 2010, sets out in detail its preferred approach to determining an EDB's starting price adjustment, and in particular to forecasting an EDB's return on investment (**ROI**).

Wellington Electricity supports the approach set out in the ENA's Subsequent Submissions on the basis that it considers that it will result in an outcome that better meets the section 52A purpose statement (**Part 4 Purpose Statement**) of the *Commerce Act 1986* (**Act**) than the approach proposed by the Commission in its Discussion Paper.

Notwithstanding, for the reasons discussed in this submission, Wellington Electricity believes that the ENA's proposed approach should be further refined to include consideration of future expenditure step changes and therefore future profitability. Wellington Electricity considers that this refinement is not only consistent with, but necessary in order to satisfy, the requirements of the Act, including, in relation to, the starting price adjustment.

1. Summary of earlier submission

As the purpose of this submission is to build on Wellington Electricity and the ENA's Initial Submissions and the ENA's Subsequent Submission, Wellington Electricity has not sought to repeat all of the matters raised in those submissions. Accordingly, this letter should be read together with those submissions.

However, for the purposes of clarity the key points raised in Wellington Electricity's Initial Submission are summarised below:

- The method for adjusting Default Price Path (**DPP**) starting prices should be determined as an Input Methodology pursuant to section 52T of the Act;
- The Commission should consider future profitability in determining an EDB's starting price adjustment in order to ensure that the EDB can fully recover its efficient costs of investment in distribution;
- Wellington Electricity supports normalising certain revenue and expenditure data used to calculate an EDB's return on investment, albeit that it does not support the level of discretion that the Commission proposes to retain; and

- It would not be consistent with the Act's Part 4 Purpose Statement to undertake a starting price adjustment in 2012 due to the resultant uncertainty. Therefore, the Commission should undertake the first starting price adjustment reset at the end of the current regulatory control period. This would facilitate a more streamlined, orderly and consistent approach to adopting and implementing the new regulatory framework.

2. Issues – Consideration of future profitability

An EDB's ROI is a key input into the starting price adjustment framework proposed by the Commission in its Discussion Paper.

The ENA has commissioned expert advisors to prepare detailed reports, which set out a proposed method for calculating an EDB's ROI for the purpose of the starting price adjustment framework currently being developed by the Commission.

While Wellington Electricity considers that the ENA's proposed approach is materially better than the approach set out by the Commission in its Discussion Paper, Wellington Electricity considers this approach should be refined further to include consideration of future expenditure step changes, and therefore future profitability.

Importantly, the ENA acknowledges that consideration of future expenditure step changes, and thereby future profitability, would be consistent with its proposed approach, albeit that it has focused on the use of historic data only in its submission. In particular, the ENA's submission states:

> *It may be possible to refine this method by modifying the ROI forecasts (based on historic ROIs) with EDBs' forecasts of expected change in their cost structures in the upcoming regulatory control period. This could apply, for example, where an EDB is entering a period of capital expenditure that is significantly higher than in the existing regulatory period.*

Wellington Electricity believes that consideration of future expenditure step changes and thereby future profitability (ROI) is not only consistent with, but necessary in order to satisfy the Act's requirements relating to the DPP regulation, including the starting price adjustment. In summary, the Act requires that in determining a starting price adjustment the Commission must consider:

- The current and projected profitability of each supplier (section 53P(3) of the Act).
- The fact that a DPP is designed to be a relatively low cost form of regulation.
- The Act's Part 4 Purpose statement, which requires EDBs:
  - *have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
  - *have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
  - *share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
  - *are limited in their ability to extract excessive profits.*

Each of these statutory requirements is addressed in turn below:

2.1. 'Current and projected profitability'

Section 53P(3)(b) of the Act states that the Commission must set an EDB's starting prices *based on the current and projected profitability of each supplier.*

This requires the Commission to determine an EBD's starting prices having full regard for future expenditure requirements.

In cases where an EDB is operating in a 'steady state', meaning that they are subject to little external change, then their future expenditure and profitability are likely to be closely aligned to past expenditure requirements and profitability performance. In these circumstances an extrapolation of historic data is likely to provide an accurate guide as to future expenditure requirements and profitability. The approach set out by the ENA in its Subsequent Submission provides a robust statistical basis to assess the forecast profitability for EDB's operating in a 'steady state'.

However, there are likely to be circumstances where an EDB is not operating in a 'steady state' and it is reasonably foreseeable that its capital and/ or operating expenditure requirements will change.

Future expenditure step changes, and therefore changes in future profitability, may be driven by a range of external factors such as:

- An ageing asset base and therefore the need to replace or refurbish assets;
- The effect of transitioning to a lower emissions environment, which will impact on the nature and type of investment an EDB makes in the future, such as the roll-out of smart meters and smart networks; or
- Technological change including moving to a 'smart network' which involves, amongst other things, greater accommodation of electric vehicles. These changes could be accommodated within existing network capacity if there is increased investment in demand management initiatives. This may assist in deferring major network upgrades and / or investment that may otherwise be required in order to satisfy the increased demand resulting from technological change, such as moving to a 'smart network'.
- Other circumstances specific to the EDB, which are readily predictable such as asset acquisitions or demergers, an increase in insurance premiums (for example, driven by an increase in natural disasters, such as earthquakes), an increase in superannuation payment requirements or changes in service contract charges.

The impact of these factors may mean that an EDB's historic expenditure requirements and profitability performance are not likely to be a reasonable or unbiased predictor of future profitability or expenditure requirements. Hence, any analysis of an EDB's *projected profitability* based on historic data will be misleading and inaccurate.

It follows that to fulfil the requirements of section 53P of the Act, expected future step changes in expenditure must be reflected in the starting price adjustments. Failure to do so is inconsistent with the Act.

While Wellington Electricity recognises that the Act provides EDBs with the opportunity to pursue a CPP to determine their future revenue requirement if they consider that they will not recover their efficient costs under the DPP, this does not – and cannot – override the requirement that any starting price adjustment must be based on an EDB's projected profitability.

2.2. Low cost

Including expected increases in expenditure is not a costly or onerous exercise and will not undermine the relatively low cost nature of the starting price adjustment process required under a DPP form of regulation.

If an EDB believes that future expected changes in expenditure should be considered by the Commission in assessing its starting price adjustment, then it would need to provide the Commission with relevant information to support its expenditure step change in the next regulatory control period. This should include information on the nature, scope, timing and deliverability of the projects or programs that will result in an expenditure step change in the next regulatory control period.

The provision of this information should not be costly or burdensome for an EDB to prepare or for the Commission to assess. EDBs should have the relevant and necessary documentation to support significant step changes in expenditure for the purposes of internal governance and review. Where step change projects are forecast to occur in the first or second year of the next regulatory control period, then these projects are likely to have already been subject to rigorous internal verification by senior management, the Board and capital investment committees[1,2]. Accordingly, EDBs should not have to prepare additional documentation for the Commission, but rather should be able to draw on existing documents.

2.2.1. Timing of provision of information of future expenditure and profitability

The documentation on future expenditure requirements will need to be provided to the Commission during the starting price adjustment process, which in turn will generally be at the time of the regulatory reset. We therefore propose that this information should be provided to the Commission to assist it in setting any starting price adjustment.

This is distinct from a CPP Application which can be made to the Commission in the nominated window in each year of the regulatory control period.

For the avoidance of doubt, the cost of providing this projected information as proposed by Wellington Electricity should not be any where near as large as the cost of preparing a CPP application and therefore will be relatively low cost. Providing supporting documentation of step changes in expenditure is not the same as preparing a CPP application because:

- In relation to capital expenditure, it does not require a full bottom-up build of expenditure (as is required for a CPP application), but only the identification of additional programs or projects, over and above the base line expenditure, that will be required in the next regulatory control period;
- Many EDBs are likely to be subject to similar future expenditure step changes. That is, the drivers of <u>*some (but not all)*</u> future expenditure changes may be industry, rather than EDB specific and therefore the Commission will need to consider the effects of these expenditure drivers on all businesses where they are industry specific; and

[1] Refer Wellington Electricity Customised Price-Quality Path Post-Workshop Submission, 19 April 2010, Q17, p. 6 – 7: http://www.comcom.govt.nz/assets/Pan-Industry/Input-Methodologies/WE-CPP-Postworkshop-Submission-Input-Methodologies-April-2010.PDF

[2] While high level project descriptions and indicative approval may be available for projects forecast to be commenced later in the regulatory control period, detailed project scopes and descriptions as well as full internal verification is not likely to be available. These documents will be prepared closer to the commencement of the project or program and can be provided to the Commission at that stage.

- The CPP application is required to contain a considerable amount of additional information on a range of other matters as set out in the Draft CPP Input Methodology.

The cost of preparing a full building block regulatory proposal is well documented in other counties, including Australia. These costs are highly relevant as they provide an indicative estimate of the likely costs to New Zealand EDBs of preparing a CPP application. This is because the Commission's CPP Input Methodology is heavily based on the Australian Energy Regulator's (**AERs**) Regulatory Information Notice (**RIN**) for the building block approach to regulation.

By contrast, the costs of providing supporting documentation on future expenditure step changes under a DPP form of regulation are significantly lower.

2.3. Part 4 Purpose statement

If an EDB's starting price adjustment is not reflective of its future profitability or expenditure requirements then not only will it be inconsistent with section 53P but it will also mean that the EDB does not have a reasonable opportunity to recover efficient costs.

This is inconsistent with the Part 4 Purpose, which requires that EDBs:

- *have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
- *have incentives to improve efficiency and provide services at a quality that reflects consumer demands.*

Wellington Electricity considers that the presence of the CPP process does not provide a solution to this because the CPP process:

- Imposes significant other additional costs on an EDB – given the statutory direction in section 53P of the Act, an EDB should not be required to incur these costs so as to make up for a starting price adjustment process, which does not reflect its projected profitability. Such an outcome is not in the long term interests of consumers;
- Imposes a significant level of risk and uncertainty on an EDB – the outcomes of a CPP cannot be accurately determined by an EDB prior to commencement of the process; and
- Is also limited in its application as only four EDBs can apply for a CPP each year. An approach, whereby a starting price adjustment does not reflect an EDB's projected profitability may not be able to be addressed by a CPP application if application has been "de-prioritised". Such an outcome is not consistent with section 52A of the Act.

Accordingly, as contemplated by the Act, the Commission must determine an EDBs revenues or prices having regard for future expenditure needs. This is the most efficient way to provide EDBs with the required certainty that their future revenues will be sufficient to meet their future efficient costs, including those required to innovate, invest, improve efficiency and provide services requested by customers.

3. Closing

Wellington Electricity would welcome the opportunity to discuss with the Commission the matters raised in this submission prior to the Commission publishing any further decision papers on starting price adjustment framework.

Please do not hesitate to contact Jan De Bruin, Regulatory Manager, on (04) 915 6140 or jdebruin@welectricity.co.nz if you have any questions.

Yours sincerely

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