



Wellington Electricity

Submission on

The Commerce Commission's 'Wellington Electricity's proposal to customise its prices to better prepare its network for an earthquake' draft decision

February 2018

Wellington Electricity's Submission

1. Thank you for the opportunity to make a submission on the Commerce Commission's draft decision on the proposal to customise our price path.
2. We appreciate the Commission's significant efforts to date in enabling a process to deliver better preparedness which ultimately result in benefits to Wellington consumers ahead of a major earthquake event.
3. We agree with the Commission that the decision to approve the price path meets the purpose of Part 4 and promotes the long term benefit of consumers. Our submission focusses on those areas where we seek further improvement to the details of the decision.

Transition from weighted average price cap to a revenue cap

4. We acknowledge that by moving to a CPP, we move from a weighted average price cap to a revenue cap. This is the result of application of the CPP IMs, when the IMs were amended in 2016 to address EDBs' exposure to quantity forecasting risk and under recovery when actual demand was lower than the Commission's demand forecasts. That has been the case for Wellington Electricity which, as the Commission acknowledges, has experienced lower demand growth than forecast. This has had a negative impact on allowable revenues of around 5.5% per year.
5. Moving to a revenue cap is an effect of moving to a CPP to enable recovery of expenditure which will improve our readiness to respond to a major earthquake in Wellington. We are fully supportive of such a move given it both enables our earthquake readiness proposal and addresses the potential for future under recovery of revenue.

Pass through balance moving off the DPP

6. We support the return of pass-through and recoverable costs of around \$10m to consumers within the control period. However, we are concerned with the potential impact on consumer pricing if that money is returned in a single year. The impact of such a refund would be a drop in prices for the 18/19 year, followed by a larger increase in prices in the following year.
7. This "sawtooth" effect on consecutive price changes does not promote any price certainty or stability for consumers and is likely to cause price uncertainty. This price uncertainty could become exacerbated by repackaging by retailers who deliver the final price to consumers. As such we do not believe it is consistent with the intent of 52R of Part 4:

"The purpose of input methodologies is to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part."

8. We instead suggest a materially better price smoothing approach to managing the pass-through balance credit being returned to customers. This would reduce the year-on-year movements in line charges, thereby reducing price volatility and uncertainty caused by fluctuations in pricing inputs. It will also be more efficient for retailers to pass through line charges, reducing the need for annual rebalancing of retail prices and margins over time.
9. Smoothing the return of the pass-through balance would be done on an NPV-neutral basis, using the time value of money adjustment applied to the revenue wash-up mechanism.
10. To allow this NPV-neutral smoothing we suggest the following amendments are made to the Input Methodologies and the CPP Determination. This allows us to recover the pass-through balance over three years rather than one, and allows us to determine the proportion of the pass-through balance to return in each year in such a way as to smooth line charges.

Input methodologies proposed change:

3.1.3 Recoverable Costs

(13) For the purpose of subclause (12)

- (l) where a **pass-through cost** or **recoverable cost** is incurred by the **EDB** prior to a **regulatory period** and an amount of the cost is not otherwise able to be recovered by the **EDB**, the amount plus any related time value of money adjustment made in accordance with a **DPP determination** or **CPP determination** shall be included in the **wash-up account** in accordance with the method specified in a DPP determination or CPP determination.

CPP Determination proposed change:

Schedule 1.6: Calculation of opening wash-up account balance

- (1) The 'opening wash-up account balance' means
 - (a) for the first **assessment period**, ~~-1 × the 2019 pass-through balance recovery amount the estimated amount of the pass-through balance at 31 March 2018 of \$10,280,000;~~ and
 - (b) for second to third assessment periods, the *closing wash-up account balance* of the previous assessment period.
- (2) For the purpose of paragraph (1)(b), the 'closing wash-up account balance' means
 - (a) for the first assessment period, the amount calculated in accordance with the formula –

~~-1 × the 2020 pass-through balance recovery amount (pass-through balance – the estimated amount of the pass-through balance at 31 March 2018 of \$10,280,000) × (1 + 67th percentile estimate of post-tax WACC); and~~

(b) for the second assessment period, the amount calculated in accordance with the formula –

$(-1 \times (\text{pass-through balance} - \text{the 2019 pass-through balance recovery amount} - \text{the 2020 pass-through balance recovery amount}) \times (1 + 67\text{th percentile estimate of post-tax WACC})^2)$

+ (wash-up amount for the previous assessment period $\times (1 + 67\text{th percentile estimate of post-tax WACC})^2$); and

(cb) for the ~~second to~~ third assessment periods, the amount calculated in accordance with the formula

wash-up amount for the previous assessment period $\times (1 + 67\text{th percentile estimate of post-tax WACC})^2$.

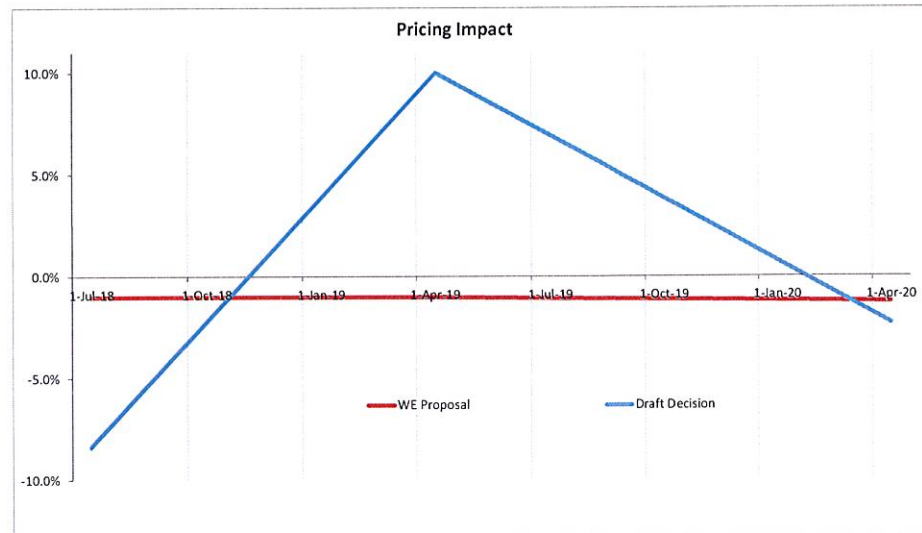
(3) For the purpose of paragraphs (1)(a) and 2(b), the ‘2019 pass-through balance recovery amount’ means-

an amount greater than zero and less than the estimated amount of the pass-through balance at 31 March 2018 of \$9,634,000, which is determined by the EDB in such a way it smooths prices to customers during the CPP regulatory period.

(4) For the purpose of paragraphs (2)(a) and (2)(b), the ‘2020 pass-through balance recovery amount’ means-

an amount greater than zero and less than the difference between the pass-through balance and the 2019 pass-through balance recovery amount, which is determined by the EDB in such a way it smooths prices to customers during the CPP regulatory period.

11. We note that the amendment to Schedule 1.6 of the CPP Determination proposed above allows WE the discretion to determine how much of the pass-through balance to recover in each of the three years of the CPP period. We submit that this is the best method for achieving smooth prices for customers, as it allows all inputs to allowable revenue and pass through and recoverable costs to be considered when smoothing prices.
12. We note that the pass-through balance value needs to be included as a negative input to the revenue wash-up. For the DPP pass-through balance a positive value represents over-recovery, but for the revenue wash-up a positive value reflects under-recovery. Therefore, while our pass-through balance is currently positive, the amount added to the wash-up account needs to be negative.
13. In Schedule 1.6(2)(b), we suggest that two years of time value of money adjustment be applied, given that this wash-up is recovered with a 2-year lag. The current drafting only includes a one year adjustment.
14. The chart below shows the pricing impact of our proposed change against the impact of returning the balance in one year (Commission’s draft decision method).



Cost Benefit Analysis

15. The Commission makes mention in its draft decision that we could have better articulated our quantitative analysis of costs and benefits. We regard the analysis put forward as well articulated, and consider Strata's observation to relate to the range of sensitivity analysis, which could have been broader to include load variations.
16. The points raised by Strata¹ were valid and focused on the potential for a reduction in demand after an earthquake. We note however, in respect of our analysis, that our demand assumptions through the period of analysis were conservative - we assumed no growth at all over time and, additionally, assumed an average demand, rather than weighting the analysis towards a worst case of peak demand.
17. We also note MEUG's comments in its 15 December 2017 submission as follows:
- "MEUG believes WELL's estimate of the expected Net Present Value (NPV) of a Cost-Benefit-Analysis (CBA) of the proposal of \$26m is overstated because the counterfactual is not the status quo over the 20-year CBA time-frame. The counterfactual should be the status quo for the next 2 or 3 years until stage 2 and then stage 3 comprehensive resilience work is approved in a future CPP process. Once those later stages are in place the benefits of the stage 1 expenditure to shorten recovery times will have diminished materially; hence the NPV for stage 1 will be less. Therefore, WELL have not established that there is a clear and material benefit to consumers."*
18. We do not agree with MEUG's assertion. Our investigations into longer term resiliency measures are likely to include increasing the diversity of supply into Wellington CBD by reducing the risk posed by a single point of supply at Central Park. Central Park provides supply from the National Grid and is a Transpower owned Grid Exit Point. The investigation into the most appropriate diversity option is ongoing and is subject to its own High Impact Low Probability risk analysis from a

¹ Refer page 11 of the letter from Strata to the Commission dated 18 December 2017, *Assessment of Wellington Electricity CPP readiness expenditure*.

range of risks, beyond just the earthquake risk. We consider it to be independent from this readiness investment which assumes that supply from Central Park continues uninterrupted - in which case, the benefits are not overstated.

Resilience quality requirements

19. The Commission is proposing an additional resilience quality standard with a revenue linked incentive.
20. This is described as an “incentive” mechanism, but operates only as a penalty, and we are concerned that it is overly prescriptive and will be too rigid in application to allow for operational decisions, particularly on the seismic strengthening program.
21. To date, the Commission has focussed on reliability as the core quality standard in its prior CPP determinations. We note that the Commission can apply additional quality standards at its discretion under a CPP, but there has never been an indication of including a deliverability quality standard in previous IM reviews or CPP decisions.
22. In addition, we note that the Commission regularly refers to the touchstone of “realistically achievable performance”. Our view is that this is in contrast to the rigid way in which the resilience quality assessment would occur as currently proposed.
23. The proposed \$5.2 million penalty at 15% of spend is not symmetrical and is designed as a significant and absolute penalty at a single point of time. In this way it is significantly different from the IRIS incentive scheme which provides rewards and penalties proportionate to any over or under spends. We urge the Commission to re consider the proposed quantum and structure of the resilience quality incentive to bring it more in line with the IRIS incentive schemes under which all other EBDs currently operate.
24. Whilst we acknowledge the Commission’s efforts to enforce delivery of what we have undertaken to do, we believe there is an alternative and preferable approach which will achieve the intended outcome and allow us flexibility to make operational decisions which will benefit consumers in the long term.
25. There are key elements of the proposed resilience index which will limit our operational flexibility and have the potential to incentivise decisions which will not be in the consumer’s long term interests as an unintended consequence of proposing a very rigid quality scheme. This applies specifically to the proposed performance measures on the seismic strengthening program.
26. The Commission’s proposed index requires each individual building to be strengthened to at least 67% of NBS. While this appears mathematically efficient, it will be difficult to administer identical performance measures against the range of uncertainties` including geotechnical conditions, constructability and capital efficiency at each site. The buildings cover a range of designs, construction styles,

locations and dimensions which by their nature require individual economic and condition based risk decisions. As noted on page 24 of our proposal:

“The ultimate decision on what to strengthen at each building will be made on a case by case basis following detailed site analysis and considering the risk/ cost trade off. This will be a conscious risk based decision.”

27. Strata in their review contained in its letter to the Commission dated 18 December 2017 stated:

“The choice of 67% appears quite arbitrary and could be fine-tuned to reflect a risk based approach.”

This is correct as it is an upper limit for a building not to be considered “earthquake risk”. The lower limit of 33% is set under the NBS as an arbitrary dividing line or guide between earthquake risk and earthquake prone.

28. It is important to note that the seismic strengthening program is in its early stages of delivery and there have been no designs undertaken as yet. We may have to make decisions on some buildings where the cost of strengthening to 60% (for example) is the most cost effective outcome. In other cases, strengthening above 67% may be prudent. In the first instance, under the proposed regime, we are incentivised to do nothing. This unintended consequence of doing nothing incurs the penalty under this quality target which then balances with an equal compensation for efficient spend under the capex IRIS scheme. We do not believe such an outcome would benefit Wellington consumers over the long term.
29. We propose an alternative approach, for the seismic strengthening program, which addresses both our concerns at the application of the test at an individual building level and the lack of a proportional incentive in the Draft Determination. This provides more tolerance around the metrics, and will allow us flexibility to make efficient risk-based decisions on a case-by-case basis as the program evolves. It will accommodate the individual site uncertainty, while recognising that investment in seismic strengthening has clear resilience` value.
30. Our proposed approach treats the seismic strengthening work as one programme, rather than 91 specific projects. We propose that performance is demonstrated by meeting the program intent of achieving the strengthening across the full set using a risk-based approach rather than individual performance levels. Taking an individual standard for each building also introduces an unintended compliance issue as seen in other remediation work where specialist structural assessments can differ widely and due to this would introduce significant compliance costs and risk.
31. To reflect the principles of the SAIDI/SAIFI quality standard, we propose a target of 67% NBS with a symmetrical quality incentive equivalent to the 35 points of the resilience index to be applied at an average 60% NBS and 74% NBS respectively. Should the average % NBS across the program fall between 60% NBS and 74% NBS,

there will be no penalty or reward. This provides us with operational flexibility and also allows for the inherent uncertainty in the single figure target for NBS.

- 32. We propose that for each 1% NBS reduction below 60% or above 74 %, a resilience performance value of 2.33 on a linear sliding scale will apply, down to a collar of 45% NBS and up to cap of 87%NBS.
- 33. We propose that the table below replaces the ‘Strengthening of key Substations’ section of Schedule 9 of the Draft Determination.

Strengthening of key Substations		
Resilience performance	Measured by demonstrating	Resilience performance value
Ability of key buildings to withstand earthquakes	The 91 buildings in the seismic strengthening program are strengthened to a target of 67% of NBS, on average across all 91 buildings	2.33 per 1% of NBS below an average of 60% or above and average of 74% subject to a minimum of 0, and a maximum of 35

Quality standard reporting and audit requirements

- 34. The Commission’s draft decision proposes that we be required to report progress against the resilience index annually through our annual compliance statement which is subject to the same compliance and audit requirements applicable to SAIDI and SAIFI. This will not be practical as it would require an audit against something that hasn’t happened as yet for those items that were yet to be delivered. This is not consistent with clause 11.6 of the draft determination which proposes that the resilience performance value be measured against what has been delivered.

To address this inconsistency, we suggest the following change to paragraph 87 of the Decision to read:

“WELL will be required to report what ~~it has delivered its progress~~ against the resilience index on an annual basis through its annual compliance statement”.

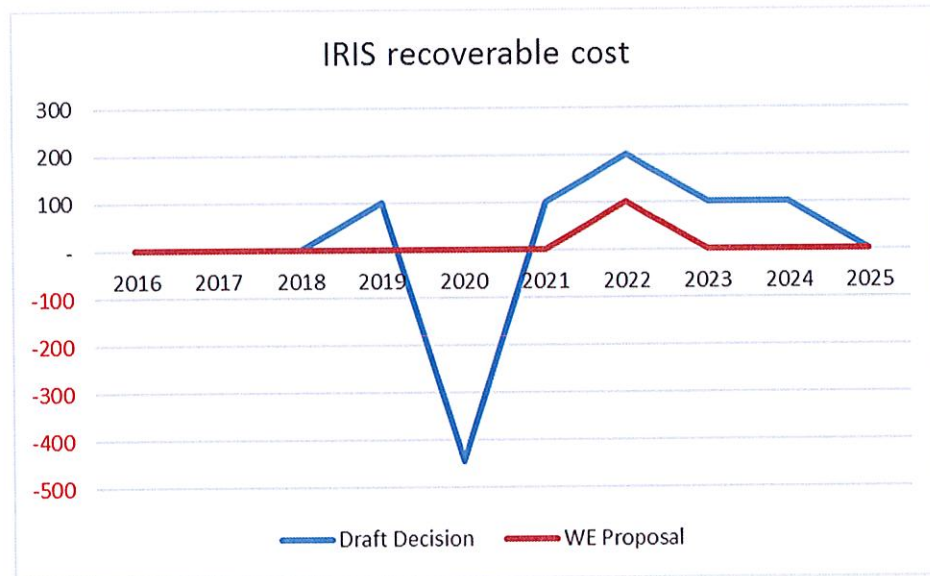
Opex IRIS variation

- 35. We have reviewed the Commission's analysis of the opex IRIS and agree that retaining the current IM version of the opex IRIS proposed in the draft decision achieves the expected retention factors. The proposed variation that we put forward does this as well. However, the difference is that our proposal results in less pricing volatility which we think is better for consumers and is consistent with

the streamlined CPP approach. For these reasons, we ask that our original variation is accepted as it results in a smoother pricing profile for consumers. This is explained in more detail below.

- 36. Under the IMs, we would include a recoverable cost for the opex IRIS from the start of the CPP period in RY19. In the CPP Proposal, we proposed a variation to the IMs, to defer the opex IRIS recoverable cost to the start of the following regulatory period in RY22. The rationale was that the introduction of the recoverable cost should coincide with the reset of the revenue building blocks, and the streamlined CPP deferred the reset of building blocks until RY22.
- 37. The Draft Decision proposes retaining the opex IRIS IMs as they stand. The Draft Decision states that the proposed IM variation is not required, because the existing IMs will produce retention factors which are broadly 34% each year, which is consistent with the policy intent. Whilst we agree that the IMs produce expected retention factors, this is achieved through a cash flow profile which is volatile and thus results in substantial price swings for consumers over time.
- 38. Our proposed approach produces the same retention factors but also links the introduction of the recoverable cost to the reset of building blocks, so that the cash flow/pricing profile is much smoother. This is illustrated below using the example provided by the Commission in support of the Draft Decision. That example involves a permanent saving of \$100 in RY17. Both our proposed IM variation and the existing opex IRIS IMs as proposed in the Draft Decision produce a retention factor of 34% for this saving. However, under the proposed variation, as illustrated below, the recoverable cost impacts are much smoother during the current and next DPP regulatory period.

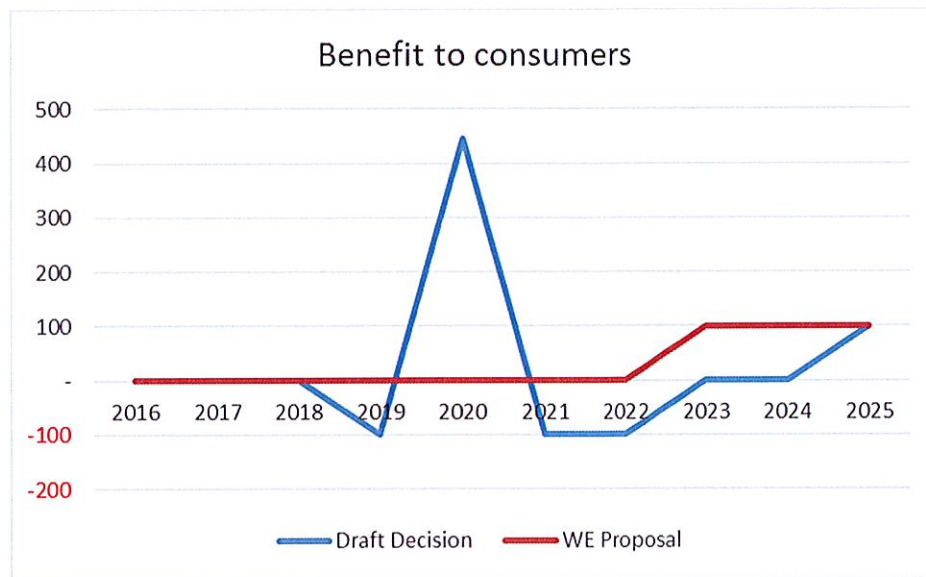
	RY17	RY18	RY19	RY20	RY21	RY22	RY23	RY24	RY25
Permanent saving	100	-	-	-	-	-	-	-	-
Recoverable cost - Draft Decision	-	-	100	-444	100	200	100	100	-
Recoverable cost - WE proposal	-	-	-	-	-	100	-	-	-



- 39. The sharing of the benefits of the cost saving with consumers under the two IM options is illustrated below. As shown, under the streamlined CPP, with no building

block reset until RY22, the existing IMs generate a benefit sharing profile which involves substantial year on year variation. The proposed alternative avoids this variation by aligning the recoverable cost adjustment to after the beginning of the next regulatory period, when the building blocks are reset. We submit that this is a better outcome for consumers, which fully meets the Commission’s policy intent for the opex IRIS. This variation is consistent with the streamlined CPP because it acknowledges that the underlying building blocks are not reset at the beginning of the CPP regulatory period, unlike a standard CPP.

- 40. We have attached the model which demonstrates these impacts.



Other Income

- 41. As part of our streamlined application for a CPP, we agreed with the Commission an approach to determining CPP MAR, which used the DPP MAR values stated in the 2014 DPP Financial Model without adjustment. We considered it appropriate given the streamlined nature of our CPP application and the CPP Draft Decision was consistent with that approach.
- 42. However, the Commission has now proposed that the CPP revenue path will not be derived from the DPP MAR due to the Commission’s decision to open up the DPP MAR and adjust the CPI values applied to the price path, to update them for actual and forecast inflation. We note that this change gives rise to inconsistency in the treatment of other regulated income which has arisen from the transition between a DPP BBAR model to the CPP BBAR model.
- 43. The treatment of other regulated income under a revenue cap differs from its treatment under a price cap. This change was introduced during the 2016 IM review. Other regulated income represents BBAR costs which are not recovered from electricity consumers through line charges.
- 44. This is provided for on an ex ante basis (i.e. forecast basis) in the DPP price path building block formula. That is, under the DPP price cap, forecast other income is

deducted from the other building blocks, such that the MAR used to set allowable revenues is net of forecast other income.

45. Under the revenue cap, other regulated income is provided for on an ex post basis (i.e. actual basis). That is, under the CPP revenue cap, forecast other income is not deducted from the CPP BBAR, and MAR is gross of forecast other income. The MAR values are intended to cover both income from prices and other income.
46. Under the CPP revenue cap, a revenue wash-up mechanism ensures that other regulated income is provided for. Allowable revenue (gross of other regulated income) is compared to the sum of actual revenue from prices and other regulated income, with the difference being included/deducted from allowable revenue in a subsequent year.
47. However, for the purpose of the SCPP proposal the DPP MAR (RY19 and RY20) and DPP BBAR (RY21) values are net of other regulated income. This is consistent with the streamlined approach to the CPP MAR set out in our CPP proposal. The impact of this is that, under the CPP Draft Determination, the CPP MAR is stated as net of the forecast value of other regulated income, and under the revenue cap wash up mechanism we will also be required to deduct actual other regulated income from prices. This double counts the impact of other regulated income on the prices to be recovered from consumers through line charges.
48. We submit that it is therefore appropriate to correct for this inconsistency in the treatment of other regulated income as follows:

IM variation

To implement this, we propose an IM variation, to remove the deduction of forecast other regulated income from DPP MAR and BBAR values. This is consistent with the policy intent of the CPP revenue cap for an ex-post provision for other regulated income.

The Draft Determination includes an IM variation which adds new clauses 5.3.2(7) and (8). We propose the following changes to those clauses:

“(7) ‘ MAR_{bt} (DPP)’ means the value for “maximum allowable revenue before tax in revenue-date terms for applicable X factor”, for Wellington Electricity Lines Limited for the applicable **disclosure year**, ~~calculated specified~~ in the **2015 DPP Financial Model** ~~as if the values for “other regulated income” in each year are nil;~~”

“(8) ‘ $BBAR_{bt}$ (DPP)’ means ...
 ...
 (v) ‘other regulated income’ is ~~nil~~ ~~the value of that term for disclosure year 2021 specified in the DPP Other Regulated Income and Disposed Assets Model.~~
 ...”

Note that we understand that the above clauses are also going to be amended to incorporate the revision to the Draft Determination related to CPI. Our suggested amendments above do not incorporate that change.

CPP Determination change

An alternative approach for correcting for the inconsistent treatment of other regulated income is to amend the revenue wash-up. The amendment of the CPP Draft Determination set out below achieves this. However, this is not our preferred option, since it does not achieve the policy intent of the CPP revenue cap for an ex-post provision of other regulated income, and instead retains the treatment used under the DPP price cap.

Paragraph 2 of Schedule 1.5 of the Draft Determination is amended as follows:

“Actual allowable revenue

(2) For the purposes of paragraph (1), ‘actual allowable revenue’ means-

(a) for the first **assessment period-**

actual net allowable revenue plus actual pass-through costs and recoverable costs plus actual other regulated income

(b) for the second to third **assessment periods-**

actual net allowable revenue plus actual pass-through costs and recoverable costs plus actual other regulated income plus revenue wash-up draw down amount”

The following definition is added to clause 4.2 of the Draft Determination:

“actual other regulated income means the sum of all **other regulated income which was earned in the assessment period”**

Other items of note

49. In Schedule 4(11), the formula includes the 'cap' and 'collar' terms, but the subsequent definitions are of 'cap' and 'target'. These should be made consistent and resolved by defining the term 'collar' not 'target' for the purpose of the formula.
50. The resilience incentive rate is defined as a negative number (Sch 4(11)). This is counter intuitive. A preferable way to express these terms, and achieve the same

outcome, would be to make the incentive rate positive (by removing the "-1" term in its formula) and then switch the 'target' and 'assess' terms in the Sresilience formula (Schedule 4(10)(a)).

51. The first two items in column B of Schedule 9 of the Draft Determination appear to have been transposed in error.
52. Wellington Electricity appreciates the opportunity to provide this submission and if you wish to discuss this submission please contact Gerry Glynn at gglynn@welectricity.co.nz or at (04) 915 6134.

Yours sincerely



Greg Skelton

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