

21 February 2014



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Dear Dr Berry

Form of Price Control

1. Background

The Commerce Commission's (**Commission**) *Electricity Distribution Services Input Methodology Determination 2012* specifies that the form of control applying to Default Price-quality Path (**DPP**) regulation for non-exempt Electricity Distribution Businesses (**EDB**) is a weighted average price cap (**WAPC**). The Commission's Electricity Distribution Service DPP Determination 2012 applied the WAPC with no correction mechanism for forecasting error in relation to the Commission's constant price revenue growth forecast.

The constant price revenue growth forecasts applied by the Commission for the 2012 reset of the DPP significantly overestimated Wellington Electricity Lines Limited's (**WELL**) constant price revenue growth, as detailed in section 2.

WELL recognises that, despite the Commission's best intentions, there is a high risk of forecasting error in relation to constant price revenue growth, particularly in the context of applying the same forecasting methodology to all EDBs. Constant price revenue growth is something outside the control of an EDB and therefore no economic purpose is served by exposing EDBs to the risk of forecasting error. WELL therefore considers that the Commission should introduce a wash up mechanism around the price cap for the 2015-20 DPP to limit the exposure of both consumers and EDBs to forecasting error in relation to constant price revenue growth.

Introducing a wash up mechanism would also have the benefits of improving EDB's incentives to promote energy efficiency and demand side management by limiting the impact on revenue of reduced energy consumption resulting from the success of such initiatives. In WELL's opinion EDBs should be incentivised to support energy efficiency and demand-side management initiatives that support the efficiency of the distribution network and provide long term benefits to consumers.

While WELL considers that a revenue cap is a more appropriate form of control because it would better reflect the fixed cost nature of electricity distribution where costs are largely unrelated to energy volumes and would promote more efficient tariff structures, there is unlikely to be sufficient time for the Commission to undertake thorough consultation on a change to an Input Methodology of this nature and significance before the DPP reset. On that basis, WELL strongly encourages the Commission to consider introducing a wash up mechanism into the current WAPC to correct for forecasting error. Similar to a revenue cap, a wash up on the WAPC would better enable EDBs to pursue more efficient tariff structures and engage in energy efficiency opportunities.

2. Error in constant price revenue growth forecasting

The constant price revenue growth assumptions applied by the Commission to WELL were significantly over estimated. The Commission's forecast 0.8% per annum constant price revenue growth for WELL over the 2010-15 DPP period. In practice for the first three years of the regulatory period, 2010 to 2012 disclosure years, WELL's actual average constant price revenue growth was -1.64% per annum.

The difference results from the difference between the Commission's key input assumptions and WELL's actual data for the first three years of the regulatory period, as follows:

- The Commission assumed 2.19% GDP growth per annum. Actual annual average GDP growth in the Wellington region has been on average closer to zero over the first three years of the regulatory period. WELL has had 1.17% pa decline in the volume of energy consumed for industrial and commercial customers compared with the Commission's forecast of 1.14% pa positive growth. WELL considers that regional GDP growth is not a good proxy for forecasting constant price revenue growth for areas which have a decline in the number of industrial customers. Structural change in the economy means that industrial activity is expected to continue shifting out of the Wellington region and future GDP growth will be predominately driven by the services sector.
- The Commission assumed 0.70% per annum growth in residential customer numbers. WELL's average growth in residential customer numbers was 0.17% over the first three years of the regulatory period.
- The Commission assumed zero growth in energy volumes per residential user. WELL's actual average annual growth in energy volumes per residential user has been -2.44% over the first three years of the regulatory period. WELL expects energy use per user to continue to decline as there is increasing uptake of energy efficient housing schemes and lower energy rated household appliances. Climatic conditions are also resulting in lower electricity demand as the meteorological service reports on warmer weather patterns.

	WELL annual average growth	Commission annual growth assumption
Change in number of residential customers	0.17%	0.70%
Change in average energy per residential user	-2.44%	0.00%
Wellington Region GDP growth	0.10% ¹	2.19%
Change in energy from commercial and industrial consumers	-1.17%	1.14% ²

These examples demonstrate that the extent of forecasting error with regards to constant price revenue growth calculations has been significant over the first three years of the regulatory period. WELL does not consider that there will be any material improvement in the accuracy of the forecasts when the data for the 2014 and 2015 disclosure years are available.

¹ Regional GDP data sourced from Infometrics for 2010/11 and 2011/12 <http://www.gw.govt.nz/assets/About-GW-the-region/Regional-Governance/Local-Government-Commission-Application/App7-Wellington-region-EconomicProfile.PDF>. WELL estimate for 2012/13 year based on average on 2010/11 and 2011/12.

² Calculated as 2.19% x 0.52% based on the Commission's constant price revenue growth model for industrial and commercial customers.

Under the current WAPC, consumers bear the risk of the Commission under-forecasting constant price revenue growth and EDBs bear the risk of the Commission over-forecasting. WELL recognises that it is difficult for the Commission to accurately forecast constant price revenue growth and for this reason WELL considers that it would be more appropriate to employ a wash up mechanism for forecasting error in relation to constant price revenue growth.

WELL does not consider that EDBs are well placed to manage the impact of forecasting error with regards to the Commission constant price revenue growth assumptions. EDBs cannot control customer numbers or customer mix as this is driven by underlying economic and geographic conditions in the network region and EDBs are constrained in their ability to re-balance tariffs to reflect customer price elasticity of demand due to:

- The *Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations 2004* which require that the distribution fixed tariff rate is no more than \$0.15 per day for domestic consumers on low user retailer tariffs. Approximately 64% of WELL's domestic consumers are eligible for low user retailer tariffs.
- Distribution prices are only a small proportion, approximately 23%, of the total consumer bill and therefore a change in the distribution component of the final consumer price has only a marginal effect on the overall prices faced by consumers. Consequently, consumer responsiveness to a change in distribution tariffs is weak.
- Retailer prices to consumers are not required to reflect distribution tariff structures and retailers must also offer a low fixed charge to low user domestic consumers. Therefore tariff rebalancing by the distributor may not be directly passed on to the consumer.
- The Electricity Authority's voluntary pricing principles seek to promote distribution prices that primarily reflect the costs of supply rather than consumer price elasticity of demand. Tariffs cannot reflect both the supply curve and the demand curve. Therefore the Electricity Authority's objective of cost reflective tariffs conflicts with the incentives the Commission is inducing through the current WAPC. WELL anticipates that the Electricity Authority may seek to mandate pricing principles in the near future.

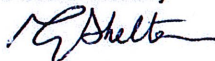
Regulators in other jurisdictions, such as Australia and the United Kingdom, have recognised that the theoretical benefits of a pure WAPC have not eventuated in practice and conflict with other policy objectives, including the promotion of energy efficiency opportunities. These regulators have increasingly shifted to revenue caps as the form of control.

3. Closing

WELL strongly encourages the Commission seriously consider the benefits of introducing a wash up mechanism into the WAPC for forecasting error in relation to constant price revenue growth forecasts for the 2015-20 DPP reset. Such an approach would provide benefits to both consumers and EDBs and promote EDBs engagement in energy efficiency and demand side management initiatives. In the longer term, WELL considers that a revenue cap should be considered as part of the next full IM review process as required every seven years.

WELL would welcome the opportunity to meet with the Commission to discuss this letter. Please do not hesitate to contact Megan Willcox, Senior Regulatory Economist, on MWillcox@welectricity.co.nz if you have any queries.

Yours sincerely



Greg Skelton
CHIEF EXECUTIVE OFFICER