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Matthew Lewer

Manager, Regulation Development

Commerce Commission

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Dear Mr Lewer

Reconsideration of Customised Price Paths – WACC change

1. Executive Summary

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to make a submission in response to the Commerce Commission's (**Commission**) consultation paper *Reconsideration of customised price-quality paths of Powerco and Wellington Electricity Lines Limited following changes to weighted average cost of capital* (**Consultation paper**) published on 5 March 2020.

WELL understands that the regulatory framework, while complex, must deliver consistent and predictable results. Errors and inconsistencies may arise from time to time and the Commission must respond appropriately to correct errors where they change what was intended. If necessary, WELL supports change also being applied to the Input Methodologies and Determinations to correct an error.

The Commission's proposed approach to 'work around' the error in the Input Methodologies (IMs) does not address the underlying error and creates perverse outcomes for all stakeholders. The proposal to work around a known error would in this case result in unacceptable and unnecessary price volatility for customers. WELL estimates that the proposed approach results in annual distribution price fluctuations of between 3% and 17%. The annual price fluctuations are illustrated in the body of the response in Figure 1.

The Commission's proposal would result in unacceptable and unnecessary cash flow volatility for WELL and Powerco. Both WELL and Powerco would receive revenue that does not reflect their underlying costs. It will result in material misalignment between allowable costs and allowable revenues resulting in wealth transfers between customers during the regulatory periods affected.

The proposed approach will also increase the Commissions regulatory costs due to the additional consultations and regulatory complexity. WELL is also concerned that wider government programmes and other regulatory bodies will question the credibility of the regulatory framework.

The pricing volatility will come at a time when the government has recently completed their review of the electricity sector with a clear aim of providing guidance to the sector to promote energy fairness, affordability and sustainability.

The proposal arises due to inadvertent and unforeseen errors in the IM Determination drafting at the time the WACC change was first introduced. Correcting the drafting error now in order to achieve the policy intent, will not undermine regulatory certainty. WELL believes that correcting the error will improve regulatory certainty, because the policy intent is preserved and implemented in the manner intended.

It is not unexpected that drafting errors occur in the IMs when a new mechanism is introduced. Error corrections are expected and are the rational solution. They are easily communicated stakeholders and we suggest this is what stakeholders would expect to occur when an error is identified.

Conversely, work arounds like the proposal put forward in the consultation paper are unpredictable, add complexity, and can generate perverse outcomes, as we will demonstrate. We submit that work arounds should be avoided in favour of correcting the underlying error, otherwise further unintended errors may be introduced. Correcting errors preserves confidence in regulatory certainty and understanding.

WELL recommends alternative options which allow the wash-up calculations to operate as originally intended and avoids the perverse customer price volatility outcomes outlined in this submission. It appears that the Commission is able to make the changes to Actual Net Allowance Revenue (ANAR), even without explicit reference to it in IM clause 5.6.8(5), given the requirements of IM clause 5.6.8(1) and (3).

2. Proposed Commission solution – creates perverse outcomes for all stakeholders

WELL understands the problem the Commission is trying to solve. Clause 5.6.8 (a) of the IM's is missing the instruction to adjust ANAR in line with FNAR so that Distribution prices can reflect when there is a change in WACC. This has the effect of undoing the WACC reduction applied to consumer 2020/21 prices during the subsequent Compliance Statement wash-up calculation.

WELL was expecting the Commission's proposed initial step of adjusting the Forecast Net Actual Revenue (FNAR) to reflect the reduction in WACC. WELL has already reflected this expected change in its 2020/21 prices, budgets and planning as previously discussed with the Commission.

WELL disagrees with the second adjustment to Powerco's CPP Determination in the 2022/23 regulatory year which WELL assumes will also apply (in principle) to WELL's CPP impacted wash-up calculations in the DPP3 period. WELL understands that the Commission proposes consulting on this adjustment for WELL in stage two of the consultation process. However, we think it's important to address this as part of the current consultation as the method set for the treatment for Powerco CPP Determination is likely to be also applied to WELL's DPP Determination. More importantly, addressing this issue now highlights the advantages (i.e. all of the problems that can be avoided) of WELL's preferred solution of correcting the Determinations or IMs so that the WACC adjustment can be implemented as originally intended.

The Commission is proposing that the FNAR for each regulatory year during the DPP3 period is reduced to offset the large wash-up difference in the 2022/23 regulatory year caused because the ANAR in the 2020/21 regulatory year wash-up calculation cannot be adjusted to reflect the reduction in WACC. The adjustment is required to maintain a revenue neutral position over the DPP3 period.

The reduction in FNAR, the large wash-up difference in the 2022/23 regulatory year and the price smoothing due to the changes exceeding the 10% price increase limit, will create price volatility.

Table 1 below compares Distribution prices as they were intended by the IM's (calculated as if the ANAR was adjusted for the reduction in WACC) and prices calculated using the Commission's proposed method of adjusting FNAR to offset the incorrect wash-up balance in 2022/23.

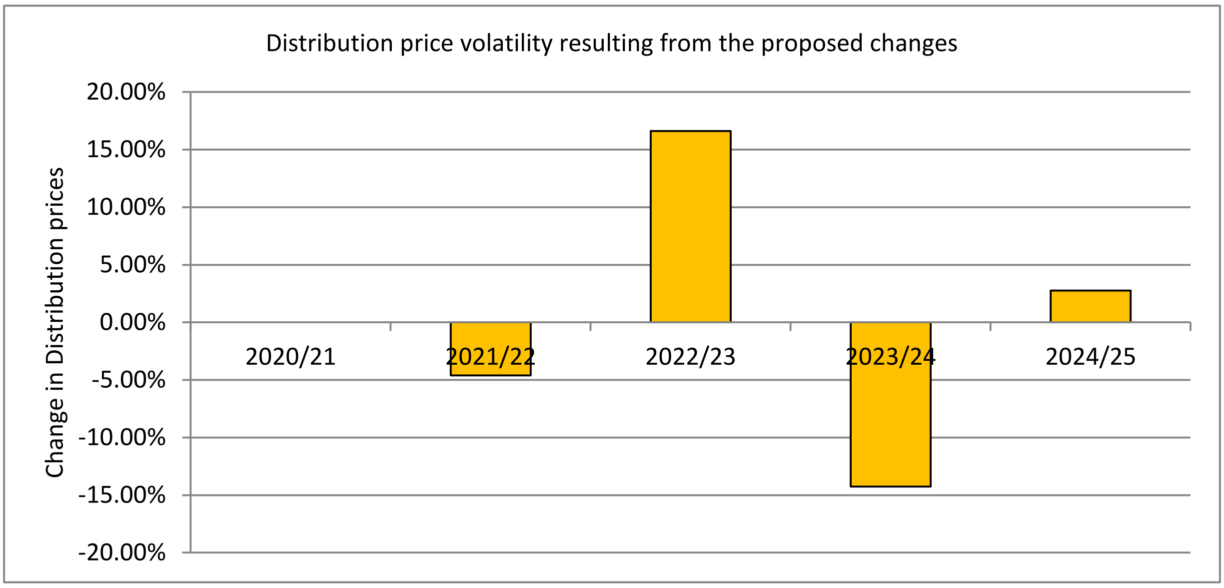
Table 1: Distribution price impact of the proposed change ($m)

Determination	CPP	DPP3	DPP3	DPP3	DPP3	DPP3
Regulatory year	2020/21	2021/22	2022/23	2023/24	2024/25	Total for DPP3 period
Prices as intended	92	92	92	92	92	460
Proposed prices	92	88	102	88	90	460
Difference	0	4	-10	4	2	0

The revenue and price change presented in Table 1 and Figure 1 have been provided to demonstrate the revenue volatility that would be caused by the proposed method and has been calculated using a simplified set of assumptions[1]. Actual revenue figures will differ slightly.

Figure 1 illustrates the Distribution price volatility that applying the Commissions proposed method would cause.

Figure 1: Distribution price volatility resulting from the proposed changes



The proposed solution deviates from the intent of the IMs:

- Large differences created in the wash-up account are not reflective of the differences the wash-up is intended to show (the over or under collection of revenue).
- The FNAR during the DPP3 period is no longer reflective of the underlying cost of providing services.

More importantly, applying the proposed approach to WELL's DPP Determination will create significant price volatility to customers to an extent which would result in price shocks (greater than 10%). Rather than correcting the error, the Commission's proposal results in four years of continual adjustments and price volatility. The additional regulatory complexity is at odds with the intended low price regulatory tool.

[1] The simplified calculation excludes inflationary changes, time value of money adjustments and assumes that WELLs DPP3 MAR (which has yet to be determinate) aligns with the 2020/21 MAR. The price smoothing adjustment also assumes that pass-through and recoverable costs align with the 2020/21 Price Setting Compliance Statement and excludes Pass-through balance annual recovery.

The price volatility will come at a time when customers are likely to still be recovering from the economic impact of Covid-19.

3. Preferred approach – correct the error and apply the WACC reduction as intended

The proposal outlined in the consultation documents arises due to inadvertent and unforeseen errors in the IM Determination drafting at the time the WACC change was first introduced. Allowing for corrections to those drafting errors now, in order to achieve the policy intent, will not undermine regulatory certainty. We would suggest that the opposite is true - that it will improve regulatory certainty, because the policy intent is preserved, and implemented in the manner intended.

WELL supports the two solutions provided in detail by Powerco. The amendments are simple, cost efficient, unlikely to have unexpected outcomes and are similar to what the Commission would have originally drafted had they been aware of the error:

1. To use the general power under clauses 5.6.8(1) and (3) to amend the ANAR provisions in the CPP Determination as part of the WACC Change reconsideration. WELL agrees with Powerco that amending ANAR is a change that would be considered as "reasonably necessary" to applying the WACC change; or
2. To amend the clause 5.6.8 (5) of the EDB IMs to add an ability to amend ANAR as well as FNAR. The Commission has the discretion to amend an IM rather than wait for a 7 year review.

There are previous examples of the Commission making IM changes outside of the formal review cycle. Proposed and final IM changes include:

- Proposed amendment to the IMs to correct an error in the IM definition of discounts.
- IM changes to reflect how operating leases are now treated under the Accounting Standards.
- IM changes to support the DPP3 and to correct errors in the IRIS.
- WELL's current CPP Determination includes a deed to vary the Input Methodologies that apply to WELL's CPP.

Powerco's submission outlines the proposed solution in details. WELL refers to Powerco's submission and will not repeat these points.

The alternative approaches have the advantage off:

1. **Avoiding consumer price shocks**: Correcting the error in the IM's will avoid unnecessary price shocks and will maintain the regulatory approach of smoothing the price path by applying the MAR (the MAR being a result of smoothing the BBAR).
2. **Maintaining the intent and form of the revenue cap:** The proposed solution deviates from the intent of the wash-up calculation, that the wash-up calculation represents the difference between a EDBs allowance and revenue collected. The proposed solution creates regulatory uncertainty and inconsistency.
3. **Pragmatic and sensible outcome**: The alternative solution provides an outcome which is consistent with how the mechanism would have worked without the error in the IM's. Error corrections are the most rational solution - they are easily communicated and able to be understood by all stakeholders. This is what stakeholders would expect to occur. The solution proposed in the consultation document does not address the error and results in additional regulatory expenses, price volatility and regulatory complexity for at least five years for WELL and longer for Powerco.
4. **Maintain certainty and credibility of the regulatory framework**: The proposed solution will create a regulatory result outside of what was intended by the Commission. The resulting price volatility could also be questioned by wider government programmes and other regulatory bodies who are promoting energy affordability and sustainability.
5. **Avoiding regulatory complexity**: The proposed solution creates additional steps to the DPP methodology, adding regulatory complexity. This will make the calculations and disclosures more difficult for customers and the public in general to understand, monitor and to comment/assess.
6. **Maintaining the relationship between FNAR and underlying costs**: Adjusting the IMs will allow FNAR to continue to reflect the cost of providing Distribution services. Both FNAR and ANAR are important metrics for measuring and presenting the aggregated costs of providing distribution services. The material misalignment of allowable costs and allowable revenues will also resulting in wealth transfers between customers during the regulatory periods affected.
7. **Addressing the error within the current regulatory period**: Adjusting the IMs will allow this error to be corrected in the current regulatory period rather than corrective measures continuing into DPP3 and DPP4. This has the added benefit of avoiding the cost of future consultations on the proposed stage two and three which is in line with the low regulatory cost approach of the DDP.

8. **Maintaining price stability while the economy recovers:** The price volatility is likely to fall at a time when the consumers and the economy are recovering from the impact of Covid-19**.** It is important that unnecessary hardship is not passed onto our customers.

The IMs will have to be changed at some stage to correct the error. WELL believes the change should be made now to maintain consistency of the wash-up calculation overtime time. If the change to the IM's is made now, temporary work arounds in the Powerco CPP Determination and potentially WELL's DPP3 Determinations can be avoided.

4. Closing

WELL appreciates the opportunity to provide a submission on the Commerce Commission's draft determination to amend "Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018". WELL understands that the regulatory framework is complex and that errors and inconsistencies will inevitably arise from time to time. Correcting these errors is the most rational solution and is the approach that stakeholders would expect to occur and avoids the perverse outcomes that the proposed work around would cause.

If you have any questions or there are aspects you would like to discuss, please don't hesitate to contact Scott Scrimgeour, Commercial and Regulatory Manger, at sscrimgeour@welectricity.co.nz .

Yours sincerely

Greg Skelton
Chief Executive Officer