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Dear Dr Berry

INITIAL OBSERVATIONS ON FORECASTS DISCLOSED IN 2013 AMP

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to comment on the Commerce Commission's (**Commission**) paper "*Initial observations on forecasts disclosed by 29 electricity distributors in March 2013*" (**Initial observations paper**) published on 29 November 2013.

WELL notes that while the Initial observations paper is intended to provide a summary and analysis of Electricity Distribution Businesses (**EDB**) expenditure forecasts, the paper goes further by setting out potential models that the Commission may use to develop its own expenditure forecasts for the purposes of the 2015-20 Default Price-quality Path (**DPP**).

WELL notes that the Commission will be consulting in more detail on the proposed methods for forecasting expenditure for the DPP and therefore this submission provides high level preliminary comments only.

2. Framework for considering expenditure drivers

The Initial observations paper develops a high level framework for identifying three key categories of expenditure drivers. However, it is unclear how this high level framework is to be used for the purposes of the summary and analysis or for determining the expenditure forecasts for the DPP.

WELL considers that the Commission should focus on understanding the drivers of each of the specific categories of expenditure which the Commission intends to develop models for. This would assist the Commission to better understand EDB's expenditure forecasts disclosed in the AMPs and to determine the expenditure forecasts to be applied for the DPP.

The Initial observations paper identifies some key drivers under each of the high level expenditure categories. WELL makes the following comments on the identified key drivers:

- Total energy delivered – WELL considers that total energy delivered is not a key expenditure driver. Expenditure is driven by the level of demand on the individual assets at the peak time of consumption not the annual total volume transported through the whole network. Expenditure is required to ensure that the capacity of the network accommodates the peak volumes expected in different parts of the network.

- Maximum coincident peak demand (actual or forecast) – WELL considers that it is maximum non-coincident peak demand at the zone substation level which drives capacity investments. It is at the point when the peak demand at a particular zone substation is forecast to exceed capacity that further investment is needed. Coincident peak demand is not used for investment planning purposes.

WELL notes that the Commission has not identified any drivers that can be used to model expenditure required for meeting compliance obligations, for example obligations relating to network security and resilience.

3. Operating expenditure (opex)

In the Initial observations paper the Commission has developed its own forecasts of opex using the same model it applied for the 2012 reset of the DPP and compared the model results with EDBs disclosed opex forecasts.

A key difference between the Commission model and EDB forecasts is that the Commission model does not attempt to capture any step changes in EDBs opex. For example, increased opex associated with changes to the health and safety legislation, business insurance costs, large national infrastructure projects involving installation of underground UFB networks, vegetation management and meeting code compliance for network building seismic strengthening. It may be necessary to capture the impact of step changes which are either not known or not adequately accounted for in the DPP allowances through a DPP re-opener.

The Commission's model is also unable to take account of increasing maintenance costs associated with aging assets or assets which begin to exhibit signs of premature mortality. The ENA working group is looking into how asset age and/or health can be taken into account in an opex model.

The Initial observation paper also indicates that the Commission intends to analyse options for assessing the relative efficiency of EDBs for the purpose of making adjustments to its opex model. WELL notes that clause 53P(10) of the *Commerce Act 1986* prohibits the Commission from using comparative benchmarking for setting starting prices or rates of change under the DPP. Comparative benchmarking requires information on the operating environment of the EDB, including, but not limited to, weather, terrain and geography. Many of these factors are very difficult to properly take account of in an opex model.

WELL considers that the Commission should prioritise developing its approach to setting capex forecasts for the DPP rather than further analysing options for including comparative efficiency adjustments in the model as these cannot be utilised for setting the opex allowances in the DPP.

4. Capital expenditure (capex)

The Initial observations paper indicates that the Commission proposes developing total capex forecasts by combining the outputs of a number of models for separate capex categories, for example age-based asset replacement models and capacity driven system growth models.

WELL cautions that there is a high risk of material forecasting error when capex models are used in a deterministic manner to directly set capex allowances. There will also likely be a large proportion of expenditure that cannot be accounted for solely through key driver analysis.

In other jurisdictions where capex models have been developed, such as Australia, the distributors forecasts are the starting point for determining the capex allowance, then the regulator uses its models to assess the appropriateness of the forecasts. The regulator also reviews the detailed analysis and explanation presented by distributors which accompanies the expenditure forecasts and employs a range of other assessment tools, including engineering reviews, governance assessments and detailed engagement with individual distributors on the basis for their forecasts. In this respect capex models used in other jurisdiction have been applied in a context similar to a Customised Price-quality Path rather than the DPP.

Deterministic use of capex models requires high quality data of an extended period of time to ensure that the outputs of the model can be relied upon. After the first round of disclosures under the 2012 Information Disclosure Requirements it is apparent that there are still large inconsistencies in the reporting of data across EDBs. The proposed capex category models also require unit cost data. There are good reasons why unit costs will vary across EDBs due to different operating environments, such as terrain and geographical location, as well as changes in Council ordinances regarding restrictions around road access, opening and reinstatement. Collection and reporting of unit costs is a very onerous task and is not something which should be expected in the context of a low cost regulatory regime.

There may also be major capex projects required during the forecast period that are not currently planned, for example projects that are not notified in advance due to customer commercial sensitivity or major deals (such as the Government tax breaks for international motion picture production) which require a customised network solution . Many of these unplanned capex investments requiring bringing forward expenditure on capacity, security and supply resilience. The DPP re-opener provisions will be an important aspect of the regulatory regime for managing major unexpected capex.

5. Input price escalation

The Initial observations paper states that EDBs are forecasting for input prices to increase by 1-3% each year, and average around 2% per annum over 10 years. The Commission then compares this with input price growth forecasts developed by independent economic consultants NZIER.

WELL considers that this analysis is mis-leading as many EDBs, including WELL, have interpreted the information disclosure requirements to require forecasts of the consumer price index (CPI) be used to convert nominal to real values and vice versa. Therefore the Commission paper is effectively only comparing various independent CPI forecasts (EDBs generally relied on either the RBNZ or Statistics NZ published figures) with NZIER's weighted average forecasts of the labour price index and producer price index.

WELL definitely considers that the price of labour and materials relevant to electricity distribution services will increase at a faster rate than CPI. For example labour price growth for electricity distribution services is expected to exceed general economy labour price growth due to a shortage of skilled electrical workers and an increasing amount of work necessarily being completed outside normal hours (as the result of being a 24/7 business, managing reliability and changing customer demands for continuity of supply and supply restoration expectations following a major weather event). Additional penalty rates are incurred for work completed outside normal business hours as well as stand down costs to meet the new driving hour limitations and fatigue managements requirements to ensure we maintain a safe and healthy work place.

Notwithstanding this view, WELL notes that EDBs may not be well placed to internally prepare well justified forecasts of input price inflation over the 10 year AMP period. It would seem contrary to the purpose of low cost regulation under the DPP to require each EDB to engage external consultancy services to provide these forecasts every year.

WELL recommends that the Commission review the relevance of the analysis in section 5 of the Initial observations paper in light of the way EDBs have interpreted the disclosure requirements. WELL also strongly encourages the Commission to publish the NZIER input price growth forecasts to enable EDBs to choose whether to utilise this information for the 2014 AMPs.

6. Interaction between forecasting models and incentive schemes

Importantly, WELL considers that the Commission decisions on the models for determining opex and capex allowances under the DPP must be made in conjunction with decisions on the incentive schemes to be applied to allowances to ensure that the interaction between the allowances and the incentives does not result in unintended or perverse outcomes.

For example, the Commission's opex model involves escalation from an initial level of opex. The Initial observations paper suggests that rather than using a single base-year, an average of multiple years of historical opex could be employed. WELL notes that as part of a separate consultation process, the Commission is also considering introducing an Incremental Rolling Incentive Scheme (**IRIS**) for opex with the intention of smoothing the strength of the incentives for making opex efficiency savings across the regulatory period. If the Commission applies an IRIS, then also applying a historical average to set the initial level of opex will undermine the objective of the IRIS by creating a disincentive to make efficiency savings in the earlier years of the regulatory period.

Additionally, using a historical average to set the base year would distort the Commission's proposed forecasting models as the base year expenditure would not be associated with the current level of network scale, input prices or asset age or health profile.

7. Quality standards and energy efficiency

The Initial observations paper states that quality should reflect the customers' willingness to pay. The quality standards set under the DPP however reflect historical average performance from 2004 to 2009. Consequently, EDBs that had good performance during the period have been set more difficult standards and will have less ability to improve performance. Furthermore, the quality standards do not adequately normalise for 1 in 40 year events, as recently experienced by WELL, the 2013 calendar year has been characterised by several major weather events and three significant earthquakes.

The Initial observations paper shows that few EDBs are forecasting expenditure on energy efficiency, demand side management and loss reduction. This is not surprising to WELL as the weighted average price cap (**WAPC**) form of control applied in the current DPP provides a disincentive for EDBs to invest in energy efficiency and demand side management initiatives as there is no adequate return mechanism (risk sharing, new technology obsolescence or displacement and volume reduction reducing variable based revenue – items identified and communicated by the ENA Smart Network Working Group paper in July 2012). Under the current WAPC these types of initiatives reduce energy throughput and consequently lead to lost revenue. EDBs are constrained in the ability to effectively rebalance tariffs in response to reduced energy volumes 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 using less than 8000 Kwh per annum.

EDBs would be more willing to participate in energy efficiency and demand side management initiatives if the Commission amended the DPP to remove the link between revenue and total energy volumes. For example the Commission could employ either a price cap with a wash up for the difference between volume forecasts and actuals, or a revenue cap. Consumers would benefit in the longer term through lower prices resulting from efficient reductions or deferral of network investment.

8. Closing

WELL looks forward to engaging with the Commission on the process for developing the expenditure forecasts and incentives that will apply in the 2015-20 DPP reset. Please do not hesitate to contact Megan Willcox, Senior Regulatory Economist, on (04) 915 6126 or mwillcox@welectricity.co.nz if you have any questions.

Yours faithfully,

A handwritten signature in black ink, appearing to read 'G Skelton', written in a cursive style.

Greg Skelton
CHIEF EXECUTIVE OFFICER