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**Submission to the Commerce Commission  
2010-2015 Electricity Distribution Default Price-Quality  
Path Refinements Discussion and Draft Decisions  
Paper**

Submitted by

**Wellington Electricity Lines Limited**

**27 September 2010**

## 1. Introduction

Wellington Electricity Lines Limited (**Wellington Electricity**) welcomes the opportunity to make this submission on the Commerce Commission's (**Commission**) 2010-2015 Electricity Distribution Default Price-Quality Path Refinements Discussion and Draft Decisions Paper (**Discussion Paper**), published on 13 August 2010.

### Contact person

For any questions related to this submission please contact the person below.

Jan de Bruin  
Regulatory Manager  
Wellington Electricity Lines Limited  
75 The Esplanade Petone  
PO Box 31049  
Lower Hutt 5040  
Email: [jdebruin@welectricity.co.nz](mailto:jdebruin@welectricity.co.nz)  
Phone: (04) 915 6140  
Fax: (04) 915 6130

### Involvement with the Electricity Network Associations

The Electricity Networks Association (**ENA**), on behalf of its members, is making a submission to the Commission on the Discussion Paper (**ENA Material**). WELL is an active member of the ENA. WELL attends and participates in the ENA working group discussions and supports and endorses the submissions made in the ENA Material.

## 2. Background

The current Default Price Path (**DPP**) determination, published on 30 November 2009 commenced on 1 April 2010 and is due to expire on 31 March 2015.

Importantly, the Commission made the 2010-15 DPP determination (**Initial DPP Determination**) in advance of finalising the Input Methodology Decisions under the 'new' Part 4 of the *Commerce Act 1986* (**Act**). Since publishing the Initial DPP Determination and the commencement of the 2010 regulatory control period, the Commission has:

- Published draft Input Methodology Decisions. These Draft Decisions set out various matters of importance to regulation under both a DPP and a Customised Price Path (**CPP**). These matters include:
  - Cost of capital;
  - Asset valuation;
  - CPP;
  - Cost allocation;
  - Treatment of taxation;
  - Pricing methodology; and
  - Rules and process.

Wellington Electricity has responded to these draft Decisions and emphasises that this submission should be read together with previous submissions and reports provided by Wellington Electricity on the draft Input Methodology Decisions.

The Commission is required to publish its final Input Methodology Decisions by no later than 31 December 2010.

- Published a Discussion Paper which sets out a proposed framework under which the Commission will assess the need to implement starting price adjustments for non-exempt EDBs during forthcoming regulatory resets and during this current regulatory control period.

Wellington Electricity submitted a response to this Discussion Paper on 11 September 2010; and

- Published a Discussion Paper on how it proposes to amend its Initial Determination to be consistent with the decisions set out in its Input Methodologies.

This submission sets out Wellington Electricity's views on the matters raised by the Commission in this Discussion Paper.

### **3. Regulatory framework**

The Act provides that when making a determination under section 52P of the Act, the Commission is required by section 52P(3) to specify all relevant Input Methodologies that apply.

As noted, the Commission is currently developing the Input Methodology Decisions. Accordingly, these Decisions were not prepared, and therefore not available, at the time that the Commission published the Initial DPP Determination in November 2009.

In order to give effect to the requirement of section 52P(3) of the Act the Commission has published a Discussion Paper setting out how it intends to amend the Initial DPP Determination in light of the final Input Methodology Decisions.

Wellington Electricity notes that the Commission has not set out how the provisions of Part 4 of the Act enable it to amend the Initial DPP Determination in respect of the matters set out in the Discussion Paper. These matters are:

- The inclusion of a revenue differential term in the DPP price path formula;
- An adjustment to the CPI index for GST; and
- Various modifications to ensure consistency with the Input Methodologies.

The ENA Material provides a legal interpretation of the Act with respect to the Commission's ability to amend the Initial DPP Determination in light of the above matters. Wellington Electricity supports the arguments presented by the ENA that:

- The inclusion of a revenue differential term in the DPP price path formula is permissible under section 52Q of the Act. This is because this amendment is correctly classified as an 'error or omission'. As set out in the ENA's submission, section 52Q of the Act provides that the Commission can correct the Initial DPP Determination, made pursuant to 52P of the Act, for 'errors or omissions';
- The proposed CPI adjustment is inconsistent with the circumstances in which a DPP may be amended under the current regulatory framework;

- While the Commission may amend the Initial DPP Determination for consistency with Final Input Methodology Decisions, the Act limits the scope and timing of any amendments. In particular, sections 54K(3) and(4) provide that:
  - Changes resulting from the Final Input Methodology Determination must be material (section 54K(3)); and
  - Changes consistent with 54K(3) must be made within nine months within from the date of publication of the Final Input Methodology Decision.

#### **4. Commission's proposed approach to amending the Initial DPP Determination**

The Commission's Discussion Paper addresses the following three matters:

- The introduction of a revenue differential term to be added to the DPP price path formula;
- The GST adjustment to the CPI index; and
- Modifications to the Initial DPP Determination to ensure consistency with the Input Methodologies, which are currently being preparing. In particular, the Commission identifies the following matters as being relevant to the Initial DPP determination:
  - Specification of control mechanism;
  - Recoverable costs;
  - Pass through costs;
  - Transmission costs;
  - Incremental Rolling Incentive Scheme (IRIS);
  - CPP application window;
  - The treatment of transactions between EDBs; and
  - Reconsideration (i.e. re-opener) provisions.

#### **5. Wellington Electricity's views**

The following sections of this submission (i.e. sections 5.1 and 5.3) address each aspect of the Commission's Discussion Paper for refining the Initial DPP Determination.

##### **5.1. Revenue differential term**

Wellington Electricity strongly supports the Commission's commitment to reconsider the proposal for a revenue differential term (revenue adjustment term within the allowable notional revenue) to take account of the difference between allowable notional revenue and allowable revenue. The revenue differential term currently being considered by the Commission was initially proposed by the ENA on behalf of EDBs during earlier consultation on the Initial DPP Determination.

The purpose of the revenue differential term is to ensure that allowable notional revenue, which is based on the previous years' prices, is not:

- Lower than it otherwise would be, due to the carry forward of prior year headroom<sup>1</sup>. The revenue differential term allows prior year headroom to be recovered through the current year's allowable notional revenue. This is important under the current regulatory framework because EDBs may choose to set prices below allowable notional revenue in order to avoid consequences of a price breach, which typically result from variability in pass through costs forecasts; and
- Higher than it otherwise would be, due to the effect of a prior year price path breach<sup>2</sup>, which may result from recovery of more pass through revenue than forecast. The revenue differential term ensures that a prior year price path breach is not validated in future price paths by removing its effect when determining the current year's allowable notional revenue.

Wellington Electricity supports:

- The Commission's view that the impact of any price shock to consumers resulting from an EDB, which has been charging below its allowable notional revenue, returning to maximum prices would be offset by the benefits of reduced prices in the assessment periods preceding the price increase;
- The specification of the revenue differential term set out in Appendix A of the Discussion Paper; and
- The ENA's proposal that this revenue differential term be implemented prior to 30 November 2010 so that it can take effect from April 2011.

Wellington Electricity also considers that in light of the Commission's preliminary decision to adopt the revenue differential term, which will address a price path breach by removing the effect in the following year, it is now timely for the Commission to publish Enforcement Guidelines<sup>3</sup>, which set out in detail the Commission's position with respect to:

- Criteria for determining whether a price-quality breach constitutes a contravention of section 87 of the Act. Wellington Electricity considers that any criteria should address, amongst other things:
  - Materiality threshold;
  - "Technical" drivers of price path breaches (such as changes in forecast pass through costs); and
  - Remedies undertaken by an EDB including but not limited to the counter effect of the revenue differential term;
- Penalties and information requests that will be issued to EDBs who are deemed to have contravened section 87 of the Act.

Wellington Electricity considers that Enforcement Guidelines are required to satisfy the purpose of Part 4 of the Act set out in Section 52A, in particular the requirement to promote certainty and transparency, which is necessary in order to incentivise EDBs to continue to innovate and invest.

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<sup>1</sup> Headroom results if prices in the previous year were set below the allowed revenue

<sup>2</sup> Price path breach results if prices in the previous year were set above the allowed revenue

<sup>3</sup> Wellington Electricity notes that the Commission has acknowledged, in previous Discussion Papers, that Enforcement Guidelines need to be developed. In particular, the matter is discussed in the Commission's Consultation Update Paper, dated 16th November 2009 and the Commission's February 2010 Process Paper.

## 5.2. GST adjustment term to the CPI index

The Commission's view is that the increase in GST from 12.5 per cent to 15 per cent will have a positive impact on CPI and that this will in turn have a positive impact on allowable notional revenue. This is because under the Initial DPP Determination (clause 8.4) allowable notional revenue is indexed by CPI. This is consistent with the requirements of section 53(b) of the Act.

The Commission proposes to remove the GST impact on CPI by making an adjustment to the CPI derivation in the compliance assessment formula. In particular, the Commission proposes to multiply the CPI values, prior to October 2010 by 1.02 (GST impact estimate published by the Reserve Bank of New Zealand). This will have the effect of increasing CPI prior to October 2010 by 2 per cent.

Wellington Electricity supports the ENA's position (set out in the ENA Material) that the proposed CPI adjustment is inconsistent with the circumstances in which a DPP may be amended under the current regulatory framework.

Even if this were allowable (which is not accepted), Wellington Electricity considers that the Commission should defer any adjustment to the CPI until at least the end of the 2011 September quarter, in time for the April 2012 to 31 March 2013 pricing year. Deferring this adjustment will allow the Commission to undertake further analysis to better estimate the **actual** impact of the increase in GST on the CPI index (rather than simply relying on an estimate of the impact as provided by the Reserve Bank of New Zealand).

Wellington Electricity further supports the ENA's position that the CPI index is used by regulators because it provides a measure of the real versus nominal value of money that is readily available, albeit that it is a blunt means of achieving this. The ENA highlights that the shortcomings of this measure are compounded in regulated sectors, such as the electricity distribution industry, where assets have long lives. Accordingly, applying a 'blunt' adjustment, as proposed by the Commission, to a 'blunt' instrument such as CPI, only acts to further compound the shortcomings of this measure.

## 5.3. Consistency with Final Input Methodology Decisions

### 5.3.1. Timing of consultation and amendments

Wellington Electricity supports the submissions made by the ENA in paragraphs 43 to 46 of the ENA Material.

In terms of implementing the changes to the Initial DPP Determination required to ensure consistency with the final Input Methodology Decisions, Wellington Electricity supports:

- The introduction of non-price related amendments to the Initial DPP Determination in early 2011. Non-price amendments relate to re-opener provisions, the CPP application window and transactions between EDBs; and
- Deferring the introducing of price related amendments (pass through costs) until as late as possible within the 9 month window required by section 54K(4) of the Act. This is required in order to provide EDBs with sufficient time to take the effects of these matters into account when setting prices for the 2011-12.

Notwithstanding these views, the following sections of this submission (i.e. 5.3.1 to 5.3.9) responds to each of the matters raised in the Discussion Paper, referring back to previous submissions made by Wellington Electricity, particularly in response to the Draft Input Methodology Decisions, as appropriate.

### 5.3.2. Specification control mechanism

Wellington Electricity's views in relation to the control mechanism are set out in its submission of 9 August 2010 and are not repeated here to avoid unnecessary duplication.

In summary, Wellington Electricity supports the application of a weighted average price cap (**WAPC**) control mechanism, subject to the Commission undertaking a further review in 2011 to ensure that the WAPC formula is appropriately modified to ensure that EDBs are appropriately compensated for foregone revenue resulting from energy efficiency measures such as demand management solutions.

### 5.3.3. Recoverable costs

Wellington Electricity's views in relation to 'recoverable costs' are set out in its submission of 9 August 2010 and are not repeated here to avoid unnecessary duplication.

In summary, however, Wellington Electricity does not support the distinction between recoverable costs and pass through costs and the reclassification of some existing pass through costs as recoverable costs. This is because the Commission's proposed distinction increases risk and uncertainty for EDBs without providing any compensation to manage those additional risks, and with no apparent justification other than to increase incentives for the EDBs to manage costs.

Wellington Electricity considers that all of the recoverable costs identified by the Commission, other than costs associated with a CPP application, should be treated in the same way as pass through costs and recovered through the 'k' factor in the price path formula.

Accordingly, Wellington Electricity does not support any changes to the Initial DPP Determination to give effect to the concept of 'recoverable costs', such as the proposed introduction of the 'v' factor.

### 5.3.4. Pass-through costs

Wellington Electricity's views in relation to pass through events are set out in its submission of 9 August 2010 and are not repeated here to avoid unnecessary duplication.

In summary, however, Wellington Electricity considers that there should be two types of pass through events being:

- Defined pass through events – these categories should be broadened from just Local Authority Rates and Commerce and Electricity Commission levies to include:
  - Electricity Authority Levies;
  - EECA levies;
  - Transmission Use of System (**TUoS**) charges;
  - Avoided TUoS;
  - A tax change event;
  - Regulatory / legislative change event costs;
  - A catastrophic event for which the associated costs are material; and
  - A terrorism event costs.

'Nominated' pass throughs (i.e. nominated by EDBs) – these are necessary because there

may be events that are specific to EDBs at particular times that need to be treated as cost pass throughs, which cannot be foreseen. They might be one off type events that do not generally apply to EDBs.

Wellington Electricity endorses the ENA's proposed modifications to the criteria for determining nominated pass through events. The proposed modified criteria are as follows:

1. *Outside the control of the supplier, or subject to regulation under Part 4 ; and*
2. *That have not otherwise been recovered under a DPP, or were not otherwise included in the derivation of a CPP; and*
3. *Have been approved as a pass-through cost by the Commission, such approval to not be unreasonably withheld in relation to costs that comply with criterion (1) and (2).*

Wellington Electricity supports the Commission's proposal that pass through costs continue to be recovered through the 'k' factor in the price path formula.

### **5.3.5. Transmission charges**

Currently, transmission charges include avoided transmission charges and new investment contract costs, and are recovered as part of the transmission pass through provision:

- Avoided transmission charges are costs incurred by EDBs arising from:
  - Payments to distributed generators; and
  - EDB purchasing transmission assets from Transpower.
- A new investment contract cost is defined as '*a contract entered into at any time between Transpower and a customer of Transpower, under which Transpower agrees to provide any new or upgraded grid assets and the customer agrees to pay charges based on Transpower's cost of providing the new or upgraded grid assets. It includes, but is not limited to a "new investment agreement contract" as defined in Part A of the Rules*';<sup>4</sup>

The Commission's draft Input Methodology Decision proposes that these costs are identified and recovered separately from transmission charges, albeit that the Commission proposes that all of these charges are recovered through the 'recoverable cost' provisions.

As noted above, Wellington Electricity considers that these costs should all be classified as pass through costs and recovered through the 'k' factor in the price path formula.

Wellington Electricity, however, understands that providing separate information and forecasts for avoided transmission charges and new investment contract costs is consistent with improving transparency and therefore Wellington Electricity supports this proposal.

### **5.3.6. Incremental Rolling Incentive Scheme (IRIS)**

Wellington Electricity's views in relation to the IRIS are set out in its submission of 9 August 2010 and are not repeated here to avoid unnecessary duplication.

Wellington Electricity emphasises, however that while it generally supports the IRIS, it considers that the Commission should clarify a number of matters, including how efficiency carryovers will be treated at the end of the regulatory control period if an EDB transitions from

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<sup>4</sup> Electricity Governance Rules – 17 January 2008, Schedule F5 Transmission Pricing Methodology

a CPP to a DPP. Wellington Electricity considers that this process is not clearly set out in the draft Input Methodology Decision.

### **5.3.7. CPP application window**

Wellington Electricity's views in relation to the CPP application window are set out in its submission of 23 August 2010 and are not repeated here to avoid unnecessary duplication.

However, Wellington Electricity emphasises that it does not support the CPP application window as proposed by the Commission in its Draft Input Methodology Decision, being that it will only accept CPP applications in the following instances:

- The last week in January; and
- Any time, in response to a catastrophic event.

Wellington Electricity proposes that the Commission should accept the ENA position, presented in its submission of 23 August being:

*That the Commission should reasonably consider:*

- *Any proposal made between 1 February and 31 March, where fewer than four proposals are received for a regulated service during the application window, with the objective of making a CPP determination by 1 December in the same year; and*
- *Any other proposal received at any other time during the year, with the objective of making a CPP determination as early as practicable.*

### **5.3.8. Transactions between EDBs**

Wellington Electricity's views in relation to transactions between EDBs are set out in its submission of 9 August 2010 and are not repeated here to avoid unnecessary duplication.

Wellington Electricity supports the Commission's proposal that where two or more EDBs become related entities, they may merge their price-quality paths at the end of the regulatory control period provided that EDBs retain full discretion as to whether to merge their price-quality paths or retain separate price paths.

The ability for EDBs to choose whether to merge their price quality paths, post a merger transaction, is consistent with the section 52A of the Act and the focus of Part 4 regulation being on "markets" where there is little or no competition and little or no likelihood of a substantial increase in competition.

It is possible that a 'transaction' between two EDBs could involve the merger between EDB's characterised by different operating environments (i.e. subject to different environmental conditions such as weather patterns and terrain) and different network characteristics (different average asset age). Accordingly, in such circumstances, a merged price path may not adequately achieve the requirements of section 52A of the Act including promoting outcomes in each market which are consistent with outcomes produced in competitive markets.

Wellington Electricity therefore believes that an EDB is best placed to assess whether a merged price path is appropriate or not.

### **5.3.9. Reconsideration provisions**

Wellington Electricity's views in relation to reconsideration provisions are set out in its submission of 9 August 2010 and are not repeated here to avoid unnecessary duplication.

Wellington Electricity does not support the concept of reconsideration (re-opener) provisions for CPPs and considers that the costs associated with such events, including those incurred as a result of catastrophic events, would be better dealt with as positive and negative pass-through events.