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Dear Dr Berry

**Cross-Submission on the 2010-15 Default Price-Quality Path Starting Price Adjustment and Other Amendments Update Paper**

## 1. Introduction and context

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to make this cross-submission to the Commerce Commission (**Commission**) on its "2010-15 Default Price-Quality Path Starting Price Adjustment and Other Amendments Update Paper" (**2011 SPA Update Paper**) that was released on 11 April 2011.

## 2. Revised SPA Framework - current and future profitability

Submitters generally do not support the Commission's Revised SPA Framework in its current form and have proposed modifications for the Commission to adopt in its Final SPA Framework.

In particular, submitters do not support the Commission's reliance on a single year of data (2009/10) escalated in accordance with the Commission's industry-wide assumptions for capital expenditure (**capex**), operating expenditure (**opex**), growth and inflation, as a basis for determining future profitability and therefore determining whether or not to adjust an electricity distribution businesses' (**EDB**) starting prices.

Submitters have generally agreed that this approach:

- Can be expected to result in the incorrect estimation of an EDB's expenditure requirements and thereby incorrect forecasts of future profitability. This can be expected to arise from the application of industry-wide estimates of rates of change in expenditure and growth that are not applicable to each individual EDB; and
- Is likely to result in an unacceptably high number of customised price path (**CPP**) applications or create pressure for inefficient under expenditure by EDBs in order to make an adequate return under the Commission's default price-quality path (**DPP**).

Submitters have proposed the above shortcomings could be addressed by modifying the Revised SPA Framework to:

- Introduce a return on investment (**RoI**) band around the weighted average cost of capital (**WACC**) at the 75$^{th}$ percentile; or
- Use a point estimate that incorporates a margin above the 75$^{th}$ percentile WACC; or
- Allow for the nominalisation of base year data, including an EDB's opex and capex, to ensure that they are representative of normal operating conditions.

These above options must be assessed in light of the ultimate objective of the 53P(3)(b) of the *Commerce Act 1986* (**Act**) being to adjust each EDB's starting prices based on their *current and projected profitability.*

Submitters recognise that the task faced by the Commission is a delicate one – the Commission must determine starting prices on the basis of the current and projected profitability of each EDB but, in undertaking this task, avoid a full CPP process, including reviewing each EDB's forecast costs and revenues.

The Commission's approach, however proposes to adjust each EDB's starting prices by reference to a point estimate of the 75$^{th}$ percentile WACC and industry-wide estimates relating to costs and revenues. This approach fails to take into account the projected profitability of *each* EDB, as required by the Act. WELL does not oppose the Commission's use of a 75th percentile WACC as a benchmark rate of return on investment, however, this rate of return must be applied to an estimate of *each* EDB's costs and revenues.

***The use of an RoI band compared to a point estimate above the WACC***

WELL submits that retention of the RoI bands remains the best way to set starting prices under a DPP, having regard to the variability in costs and revenues (and therefore the projected profitability) of each EDB, as required by the Act. In particular, WELL considers that this is a more logical approach than allowing for a margin above the WACC.

Allowing for RoI bands around the 75th percentile WACC would still move each EDBs prices towards the target RoI determined by the Commission, but would recognise that, for each EDB, the price path needed to achieve the target RoI will vary as the costs and revenues of each EDB vary. Accordingly, this approach will balance the statutory requirement to base starting prices on the projected profitability of each EDB with the need to produce a framework that is appropriate for a DPP form of regulation.

While target RoI that includes a margin above the 75th percentile may take into account variability in costs for EDBs with projected revenues above the 75th percentile, there is a risk that it will over-adjust prices for EDBs with projected revenues below the 75th percentile.

WELL submits retention of the RoI bands strikes a far better balance between the competing objectives of the legislation than a margin above the 75th percentile WACC.

***Normalisation***

WELL does not consider that normalisation will address the identified shortcomings or address the requirements of section 53P(3)(b) of the Act as effectively as retaining the RoI bands. This is because:

- Normalising base year capital and operating expenditure will not address the potential errors or inaccuracies in the myriad of other variables intrinsic to price-quality paths, including the regulatory asset base (**RAB**), depreciation, regulatory tax allowances and CPI forecasts;
- The general economic conditions in 2009/10 may not have been representative of a normal year due to the effect of the global financial crisis (**GFC**); and
- The time and costs associated with identifying all data sources that are not representative of a "normal year" and agreeing with the Commission on the appropriate method and magnitude of normalisation will place an undue burden on EDBs.

## 3. Closing

WELL appreciates the opportunity to make this submission to the Commission and would welcome the opportunity to discuss any of the matters raised in this submission.

Please do not hesitate to contact Stephanie McDougall, Manager Regulatory Projects, on (04) 915 6125 or smcdougall@welectricity.co.nz if you have any questions.

Yours sincerely

**Greg Skelton**
Chief Executive Officer