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Chair
Commerce Commission
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NEW ZEALAND

24 August 2011

Dear Dr Berry

**Submission on the 2010-15 Default Price-Quality for Electricity Distribution –
Draft Decisions Paper**

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to make this submission to the Commerce Commission (**Commission**) on its “2010-15 Default Price-Quality Path for Electricity Distribution Draft Decisions Paper” (**Draft SPA Decision**) that was released on 19 July 2011.

The Commission is relying on section 53P of the *Commerce Act 1986* (**Act**) to develop its starting price adjustment (**SPA**) Framework. This is in contrast to the Commission’s approach to other elements of the regulatory framework, which have been developed as Input Methodology Decisions (**IM Decisions**)¹ under section 52T of the Act.

You will be aware that WELL has a strong view that the high level principles for the SPA Framework should have been dealt with by the Commission as an IM Decision. This is the subject of a separate Merits Appeal to the High Court and is not the subject of this submission. This submission is made without prejudice to the Merits Appeal before the High Court.

WELL does not support certain elements of the Draft SPA Decision and is seeking that the Commission make modifications in its Final Decision so that:

- WELL can earn a ‘normal return’ over the remainder of the regulatory control period consistent with the Commission’s stated intention;
- The financial model, which underpins the SPA Draft Decision is robust² and is capable of being readily understood by Electricity Distribution Businesses (**EDBs**); and
- It is consistent with the requirements of the Act.

¹ Decision 710, *Input methodologies applicable to electricity distribution services pursuant to Part 4 of the Commerce Act 1986*, 22 December 2010.

² Does not contain errors in formulae and is of audit standard.

2. WELL's understanding of the Commission's approach

The Commission's stated intention of the Draft SPA Decision is to³:

'...reset the 2010-15 DPP as follows:

- *Resetting maximum allowable prices in 2012/13 such that each EDB is projected to earn a normal return between 2012/13 and 2014/15.'*

The Commission has applied a forward looking approach to determine a 'normal return' for WELL over the remainder of the regulatory control period. In particular, the Commission has determined WELL's 2013 maximum allowable revenue (**MAR**₂₀₁₃) using the following key inputs:

- The adjusted regulatory asset base (**RAB**);
- Forecast capital expenditure based on information contained in WELL's 2010 Asset Management Plan (**AMP**);
- Forecast depreciation;
- Forecast operating expenditure; and
- A weighted average cost of capital (**WACC**) of 8.77 per cent.

Applying these elements, the Commission has determined that WELL's **MAR**₂₀₁₃ is \$109 million.

The Commission has then applied the price control formula to adjust WELL's **MAR**₂₀₁₃ by a real revenue growth (**RRG**) forecast of 4.2 per cent between 2011/12 and 2012/13. This converts the **MAR**₂₀₁₃ to an allowable notional revenue figure based on lagged quantities from two years earlier (Q_{t-2}).

Weighted average prices for the remainder of the regulatory control period are allowed to increase annually by CPI lagged by 18 months.

WELL supports the use of a forward looking approach to determine its 'normal return' but considers that there are still shortcomings in the way in which the Commission has applied the approach which means that WELL faces an unacceptable level of risk that it will not recover its **MAR**₂₀₁₃. This is because:

- The price control formula may not allow WELL to recover its **MAR**₂₀₁₃ if forecast **RRG** between 2011/12 and 2012/13 is different to actual **RRG** over this period;
- The Commission's **RRG** factor for WELL is inaccurate;
- The timing of cash flow assumptions is overly complex and potentially inaccurate;
- There is an error in the Commission's capital expenditure input assumption;
- The Allowable Notional Revenue formula for the third assessment period does not include the revenue differential term consistent with the formula for all other assessment periods; and

³ Commission, Draft SPA Decision, page 8

- There is currently not an allowance for increased insurance premium costs.

WELL addresses each of these matters in turn below and makes recommendations for the amendments that it considers the Commission should reflect into its Final Decision.

3. Price control formula

WELL considers that the Commission's use of growth forecasts to 'deflate' an EDB's allowable revenue introduces unnecessary risk into the DPP and, in so doing, detracts from the Part 4 Purpose of the Act (**Part 4 Purpose**).

This is because in the event that the Commission has:

- Overstated an EDB's actual energy growth experienced over this period, then it will earn less than the 'normal return' determined by the Commission; and
- Understated an EDB's actual energy growth experienced over this period, then it will earn more than the 'normal return' determined by the Commission.

While the use of forecasts for expenditure can create the types of incentives referred to in section 52A of the Act, an EDB cannot control energy growth. Using forecast growth to affect the allowable revenue recoverable by an EDB (other than as a driver for expenditure) does not create the types of incentives referred to in section 52A of the Act. It simply means that an EDB may, due to circumstances beyond its control, under or over-recover the revenue which has been determined as efficient under the relevant price path.

The Part 4 Purpose suggests such risks should be avoided if possible. This risk can be avoided by adopting an adjustment term as discussed below.

WELL submits that in order for each EDB to earn a 'normal return', as determined by the Commission through its forward looking cost build-up, the Commission should incorporate an adjustment term into the DPP price control formula to allow EDBs to fully recover its MAR_{2013} .

This adjustment could be accommodated in accordance with the formula in Attachment 1. This would:

- Accommodate the requirements of the existing DPP that EDBs must set prices at the beginning of 2013 assessment period prior to actual quantities being known;
- Minimise the risk to EDBs arising from forecasting errors in the RRG between 2011/12 and 2012/13; and
- Not impact on the volume risk inherent to a price control in any other year of the regulatory control period.

If the Commission does not accept this approach then it could allow a margin above the WACC that recognises that there are significant estimation risks in the Commission's proposed approach to forecasting RRG. This is not WELL's preferred approach because it is less accurate than applying an adjustment term.

4. Real Revenue Growth

The Commission has defined RRG as growth attributable to changes in demand for services provided by EDBs.

The Draft SPA Decision has modified the approach to determining RRG set out in the 2011 SPA Update Paper to incorporate more EDB specific information and to recognise regional differences in growth. In particular the Draft SPA Decision recognises that:

- There are different drivers of growth for variable charges, fixed charges and demand or capacity based charges; and
- Growth will vary between regions in New Zealand.

The Draft SPA Decision forecasts regional RRG for each tariff category and relies on:

- Revenue weights by tariff category provided to the Commission by each EDB;
- Variable real revenue growth derived from the Electricity Authority's (**EA**) 2009 regional throughput projections;
- Fixed real revenue growth derived from the New Zealand Statistics 2011 regional population projections; and
- Demand or capacity real revenue growth derived from New Zealand Institute of Economic Research Inc (**NZIER**) regional 2011 GDP projections⁴.

The Draft SPA Decision maps each EDB's distribution area to 'regions' using the EDB's installation control points (**ICPs**).

The Commission has calculated an average RRG for WELL of 2.04 per cent per annum over the current regulatory control period.

WELL supports the Commission's modifications to its approach for calculating RRG by incorporating more EDB specific information and recognising regional differences in growth. However, WELL considers that the data relied on by the Commission is inaccurate. This means that WELL will not achieve an RRG forecast of 4.2 per cent between 2011/12 and 2012/13 and it will therefore not recover its MAR_{2013} .

The RRG calculated for WELL is primarily (around 75 per cent) driven by variable real revenue growth derived from the EA's 2009 regional throughput projections. These throughput projections are based on 2009 GDP projections which are out of date and significantly overstated. This is evidenced by the more recent GDP forecasts prepared by NZIER. The Commission is familiar with these forecasts as it relied on these to derive demand (capacity) real revenue growth.

WELL engaged NZIER to prepare an independent forecast of RRG over this period using its forecast of GDP from 2011 to 2015 which underpins the regional GDP growth forecasts in the Commission's model. NZIER's report, provided at Attachment 2 of this submission, states that:

⁴ NZIER forecasts (*Quarterly Predictions – June 2011, Table A25 Regional Outlook*)

'Introducing the updated (revised) GDP forecasts into the Electricity Commission's forecasts reduces average demand growth for 2011-2015 from 2.4% in the original 2009 forecasts to 1.5% (see Figure 5). A significant change is also observed at the regional level.

The following figures are taken from NZIER's report:

EDB	2010/11	2011/12	2012/13	2013/14	2014/15	Average
Alpine Energy	1.80%	1.75%	2.03%	1.70%	1.83%	1.82%
Aurora Energy	0.62%	-0.65%	0.63%	-0.88%	0.08%	-0.04%
Centralines	0.18%	-0.13%	1.38%	-0.39%	0.84%	0.37%
Eastland	0.12%	-0.32%	1.89%	-0.72%	1.09%	0.41%
Electricity Ashburton	2.24%	2.05%	3.20%	1.81%	2.35%	2.33%
Electricity Invercargill	1.38%	-0.21%	1.40%	-0.50%	0.70%	0.55%
Horizon Energy	0.52%	0.12%	2.17%	-0.24%	1.03%	0.72%
Nelson Electricity	1.46%	1.27%	2.43%	1.03%	0.79%	1.39%
Network Tasman	1.30%	0.95%	3.08%	0.51%	0.06%	1.18%
OtagoNet	0.63%	-0.69%	0.65%	-0.94%	0.07%	-0.06%
Powerco	0.48%	0.13%	1.76%	-0.16%	1.12%	0.67%
The Lines Company	1.19%	1.19%	1.19%	1.19%	1.19%	1.19%
Top Energy	1.23%	0.91%	3.25%	0.46%	2.04%	1.58%
Unison	0.35%	0.04%	1.62%	-0.24%	0.92%	0.54%
Vector	1.50%	1.20%	3.28%	0.80%	2.24%	1.81%
Wellington Electricity	0.85%	0.48%	2.43%	0.12%	1.76%	1.13%

Figure 1: NZIER's Real revenue growth by EDB with updated GDP forecasts

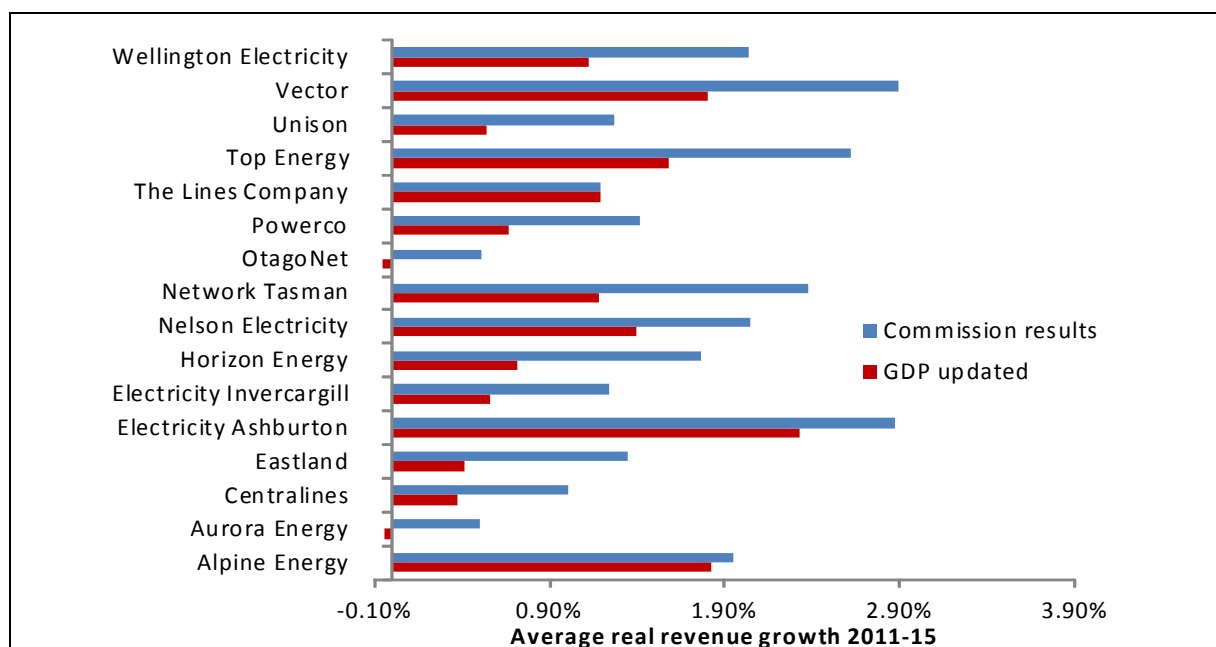


Figure 2: Updated real revenue growth vs. Commission results

As shown in the Figure 1 above, NZIER's forecasts support a growth rate for WELL of around 2.92 per cent growth over 2011/12 and 2012/13.

WELL submits that NZIER's report provides an accurate forecast of likely growth between 2011/12 and 2012/13, which the Commission should apply in its Final Decision.

WELL notes that the accuracy of the Commission's growth forecasts between 2011/12 and 2012/13 is less important if it modifies its price control formula to include an adjustment term in accordance with the formula detailed in Attachment 1 and discussed in section 3 above. However, if the Commission is determined to deflate each EDB's allowable revenue using forecast demand growth, the most accurate and current available information should be used as the basis for these forecasts.

5. Timing of cash flow assumptions

The Draft SPA Decision has modified the cash flow assumptions used for the purpose of the present value calculation set out in the 2011 SPA Update Paper. The Draft SPA Decision assumes that:

- Revenue is received at the midpoint of each year on the basis that '*revenues are received throughout the year*'. The SPA Update Paper assumed that revenue was received at the end of the year;
- Operating expenditure occurs at the midpoint of each year;
- Depreciation occurs at the end of each year;
- Return on capital occurs at the end of each year; and
- Tax costs are incurred at the end of each year.

The Commission notes that its timing assumptions for revenue and opex should work in the EDBs' favour, on the basis that '*due to seasonal factors, revenues are likely to be higher in the first half of the year than the second half of the year. This provides a slight timing benefit for EDBs*'. The Commission seeks to address this by modelling tax costs at the end of the year '*rather than throughout the year as would be likely in practice*'.

WELL does not support the proposed modifications to assumptions relating to the timing of cash flows for the purpose of the present value calculation because they:

- Are not consistent with regulatory practice in other countries such as Australia. The Australian Energy Regulator (**AER**) post tax revenue model (**PTRM**) handbook indicates that⁵:

'As a result of the PTRM's particular timing assumptions, i.e. all cash flows except capex are assumed to occur on the same (final) day of each regulatory year, there is no need to provide DNSPs an allowance for working capital in the modelling';

The AER adopted end of year cash flow timing assumptions for its complex customised price path regulatory approach. By contrast, the Commission's draft decision proposes to apply more complex and controversial cash flow timing assumptions in the context of a less complex default price path regulatory approach;

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[http://www.aer.gov.au/content/item.phtml?itemId=720375&nodeId=1cc5d55c65999d998ffef7ad08d213b3&fn=Appendix%20C%20-%20Distribution%20PTRM%20handbook%20\(26%20June%202008\).pdf](http://www.aer.gov.au/content/item.phtml?itemId=720375&nodeId=1cc5d55c65999d998ffef7ad08d213b3&fn=Appendix%20C%20-%20Distribution%20PTRM%20handbook%20(26%20June%202008).pdf), p14.

- Introduce significant and unnecessary complexity, which is inconsistent with promoting a low cost approach to setting price-quality paths as is required under section 53K of the Act. WELL understands that other EDBs have highlighted to the Commission their concerns about the present value formula⁶ (which incorporates the timing assumptions) and that several EDBs have commissioned independent expert assistance to review it for accuracy. WELL understand that, in some cases, this expert advice has confirmed that the formula is incorrect. This highlights the complexity and potential inaccuracy of the Commission's proposed formula and approach;
- Fail to recognise that the timing of each EDB's cash flow is different – a 'simple' approach that is easily understood would therefore be the best way to recognise these differences;
- Fail to recognise that WELL bills retailers monthly in arrears and requires payments to be made on 20th of the month after the service was provided. This more than off-sets any benefit that WELL receives from the favourable seasonal profile of revenue. This means the Commission's justification of its assumptions about timing of taxation is without basis;
- Represent an attempt to apply cash flow assumptions into a profitability measure. The Commission's model has not, however been developed to project cash flow in a comprehensive manner. For example, the model does not include an allowance for working capital, including the financing of inventory, which is a key aspect of an EDB's cash flow; and
- Represent a significant departure from the approach set out in the 2011 SPA Update Paper, which assumed consistent timing of cash flows. This change in approach has a materially adverse effect on SPA calculations for WELL.

WELL submits that the Commission should simplify its cash flow assumptions by assuming end of year timing for all cash flows. This is consistent with Australian regulatory practice and the intent of the DPP to be a simple, low cost form of regulation.

6. Inflation issues

The Draft SPA Decision forecasts inflation by using the last year of the Reserve Bank of New Zealand's (**RBNZ**) short term forecast as a proxy for the long term forecasts. The Commission does not provide a justification for its approach.

WELL does not support the Commission's approach on the basis that the mid point of the RBNZ target range for inflation is a more reasonable proxy for long term inflation. This is recognised by the AER who determined in the Final 2011-15 Decision for Victorian Distribution Network Service Providers (**DNSPs**) that⁷:

'The AER considered that the most reliable 10 year inflation forecast was... the mid-point of the RBA's target inflation range for the remaining years in the 10 year period.'

Further, the Commission's model does not apply inflation to depreciation within each year (thus setting the allowance in beginning of year terms), which is inconsistent with the implicit assumption in

⁶ Set out in the following document , Commerce Commission: *Derivation of a formula for the 2012/13 allowable revenue, taking into account intra-year timing of cash flows, 19 July 2011*

⁷ AER, Final decision Victorian electricity distribution network service providers Distribution determination 2011–2015, October 2010 Found at: <http://www.aer.gov.au/content/item.phtml?itemId=740898&nodeId=c7b10ddc909d7b32f3d1a1687ce00767&fn=Victorian%20distribution%20determination%20final%20decision%202011%20-%202015.pdf>

the Commission's target revenue formula that the depreciation allowance be specified in end of year terms.

WELL submits that the Commission should:

- Base forecast inflation on the mid point of the RBNZ target range for inflation. The RBNZ Monetary Policy Statement (September 2009, December 2010 and March 2011) has consistently confirmed that the policy target is to keep future consumer price index (CPI) between 1 per cent and 3 per cent over medium term⁸. This means that the Commission should base forecast inflation on the mid point target of 2 per cent; and
- Apply inflation to depreciation within each year of the regulatory control period to ensure that the depreciation allowance is specified in end of year terms.

7. Capital expenditure input assumptions

The Draft SPA Decision determined the capital expenditure growth rate for each EDB based on WELL's 2010 Asset Management Plan (AMP). In particular, it calculated year-on-year increases in nominal capex and applied these increases to actual 2010 actual capex in order to forecast capital expenditure to 2015.

WELL supports the Commission's approach to determining the capex growth rates but notes that WELL's 2010 AMP is in 2009 dollars. Under the Commission's proposed approach, WELL's AMP forecasts need to first be converted to 2010 dollars using the 2010 CPI and then converted to nominal dollars using the capital goods price index.

WELL submits that the Commission should correct WELL's capital expenditure growth forecast by first converting it to 2010 dollars before applying the capital goods price index to convert it to nominal dollars.

8. Revenue differential term

The Draft SPA Decision does not include the revenue differential term in the Allowable Notional Revenue formula for the third assessment period.

WELL considers that the revenue differential term should be included consistent with the formula for all other assessment periods because it allows it to adjust for the difference between Notional Revenue and Allowable Notional Revenue from the prior year.

The revenue differential term ensures 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 headroom⁹; or
- Higher than it otherwise would be, due to the effect of a prior year price path breach¹⁰, which may result from recovery of more pass through revenue than forecast.

⁸ <http://www.rbnz.govt.nz/monopol/statements/0094172.html> - refer 'Policy Targets Agreement'.

⁹ Headroom results if prices in the previous year were set below the allowed revenue

¹⁰ Price path breach results if prices in the previous year were set above the allowed revenue

WELL therefore submits that the 2013 Allowable Notional Revenue formula should incorporate the revenue adjustment term being $(R_{2012} - NR_{2012})$ from the existing DPP price path.

9. Insurance premium costs

The Commission has invited EDBs to apply for an additional allowance to recompense them for increased insurance premium costs where these costs are certified by Directors. The Commission has invited interested parties to comment on whether this should be in the form of:

- A uniform percentage increase to opex that would apply to all EDBs; or
- An EDB specific allowance, which reflects the specific increase in insurance costs faced by each EDB.

WELL supports an EDB specific allowance on the basis that there are significant differences in the increase in insurance premium costs experienced by different EDB in New Zealand. An EDB specific allowance would therefore best meet the requirements of section 53P(3)(b) of the Act, which requires the Commission to set starting prices based on the projected profitability of each EDB.

WELL requests that the Commission adjust its forecast operating expenditure allowance for each remaining year of the regulatory control period to reflect the higher insurance premium cost from 2011-12. WELL will provide its 2010-11 and 2011-12 insurance premium costs together with Director's certification of these costs in a separate confidential letter to the Commission.

10. 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
Wellington Electricity Lines Limited

Attachment 1: DPP adjustment to ensure that EDBs recover ‘normal returns’

The DPP should be adjusted as follows to ensure the EDBs fully recover their ‘normal returns’ over the remainder of the regulatory control period.

To adjust for the forecast under / over recovery in the 2013 assessment period add the following adjustment term (similar to the revenue differential term):

$$MDT_{2013} = MAR_{2013} - ForecastAR_{2013}$$

where:

MDT_{2013}	The adjustment factor in dollars representing the difference between the MAR_{2013} and the $ForecastAR_{2013}$
MAR_{2013}	The Maximum Allowable Revenue as determined in the DPP
$ForecastAR_{2013}$	The amount of revenue forecast to be earned in 2013, in effect $\sum P_{i,t}Q_{i,t}$

To adjust for the estimated impact of the 2013 under / over recovery to 2014 assessment period add the following adjustment term (similar to the revenue differential term):

$$MDT_{2014} = (MAR_{2013} - ExpectedAR_{2013})(1 - \Delta CPI_t)(1 - X)$$

where:

MDT_{2014}	The adjustment factor in dollars representing the difference between the MAR_{2013} and the $ExpectedAR_{2013}$ adjusted for X-factor and CPI
MAR_{2013}	The Maximum Allowable Revenue as determined in the DPP
$ExpectedAR_{2013}$	The amount of revenue expected to be earned in 2013, in effect $\sum P_{i,t-1}Q_{i,t-1}$

To adjust for the actual impact of the 2013 under / over recovery to 2015 assessment period add the following adjustment term (similar to the revenue differential term):

$$MDT_{2015} = (MAR_{2013} - ActualAR_{2013})(1 - \Delta CPI_t)(1 - \Delta CPI_{t-1})(1 - X)^2$$

where:

MDT_{2015}	The adjustment factor in dollars representing the difference between the MAR_{2013} and the $ActualAR_{2013}$ adjusted for X-factor and CPI
MAR_{2013}	The Maximum Allowable Revenue as determined in the DPP
$ActualAR_{2013}$	The amount of revenue actually earned in 2013, in effect $\sum P_{i,t-2}Q_{i,t-2}$

Attachment 2: NZIER's Report