

4 November 2011

Dr Mark Berry
Chair
Commerce Commission
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Dear Dr Berry



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Re: Information Disclosure Requirements (IDR) – Technical Paper

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to comment on the Commerce Commission's (**Commission**) technical paper entitled "*Information Disclosure: Approaches for Understanding EDB and GPB Cost Efficiency Technical Paper for Consultation*" (**IDR Technical Paper**) published on 7 October 2011.

2. Structure of this submission

This submission is structured as follows:

- Section 3 summarises the key points raised in this submission;
- Section 4 provides background and context to this submission;
- Section 5 emphasises the need to distinguish between the regulatory arrangements for information disclosure as opposed to price setting;
- Section 6 raises concerns about the Commission's timing and implementation of new information disclosure requirements (**IDRs**);
- Section 7 addresses the Commission's questions regarding operating expenditure (**opex**);
- Section 8 addresses the Commission's questions regarding capital expenditure (**capex**); and
- Section 9 addresses the Commission's questions regarding opex-capex trade offs.

3. Summary

WELL has over-riding concerns about the IDR Technical Paper including that the Commission

- Appears to be raising issues in this paper about the form of price setting regulation in isolation of the broader SPA Framework¹ and Input Methodology Decisions² (**IM Decisions**). If the Commission wishes to change the price setting arrangements it should deal with this by proposing explicit changes to the SPA Framework and IM

¹ Commerce Commission 2010-15 Default Price-Quality Path for Electricity, Distribution Draft Decisions Paper, 19 July 2011

² Decision 710, Input methodologies applicable to electricity distribution services pursuant to Part 4 of the Commerce Act 1986, 22 December 2010.

Decisions, rather than by proposing changes to the information disclosure framework; and

- Does not appear to have presented a compelling case for amending the IDRs to collect the nature and volume of information foreshadowed in the IDR Technical Paper. WELL emphasises that information disclosure is intended to be a "light handed" form of regulation and that the changes discussed in this IDR Technical Paper would likely result in considerable cost to both EDBs (such as audit and system replacement or upgrade costs) and the Commission (in assessing the information), which will ultimately be passed on to consumers.

Subject to its over-riding concerns, WELL:

- Agrees with the Commission that benchmarking historic expenditure is more appropriate for opex than capex;
- Considers that the 29 electricity distribution businesses' (EDBs) historic expenditure data is insufficiently reliable and robust (WELL has only been reporting since 2008) to provide an effective basis for future benchmarking. The Commission should therefore start its information collection based on a new IDR and should not rely on historically reported expenditure;
- Considers that expenditure comparisons should be limited to the 29 EDBs – WELL does not support the use of international comparators or comparisons with businesses in other industries – this is particularly because the Commission cannot ensure comparability of the information that these other businesses report; and
- Considers that opex drivers are best considered in terms of opex sub-categories – WELL has identified in this submission a range of drivers for each expenditure sub-category. It is important that any comparisons have regard for the specific characteristics and circumstances of each EDB and their reliability performance.

4. Background and context

The existing IDRs, being the "*Electricity Distribution (Information Disclosure) Requirements 2008*", were developed pursuant to Part 4A of the *Commerce Act 1986 (Act)*, which has since been repealed and replaced with Part 4 of the Act.

Section 53A of Part 4 of the Act provides that:

The purpose of information disclosure regulation is to ensure that sufficient information is readily available to interested persons to assess whether the purpose of this Part is being met.

The purpose of Part 4 of the Act is set out in section 52A (Part 4 Purpose), being:

to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
- have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and*
- are limited in their ability to extract excessive profits.*

Section 53B of the Act requires the Commission to summarise and analyse the information disclosed "for the purposes of promoting greater understanding of individual regulated suppliers, their relative performance, and the changes in performance over time".

WELL recognises that information disclosure is an essential part of the Part 4 regulatory regime and supports a robust and transparent set of IDRs. To this end, WELL does not oppose the development of new IDRs provided that they are limited to meeting the purpose for information disclosure set out in section 53A of the Act.

5. Distinction between information disclosure and price setting

The Act clearly distinguishes between the purposes of, and mechanisms for implementing, information disclosure as opposed to price setting.

As noted above, the purpose of information disclosure is set out in section 53A of the Act and the Commission has developed the "*Electricity Distribution (Information Disclosure) Requirements 2008*", which detail the mechanism by which information disclosure is to be undertaken.

Quite separately, the purpose of price setting regulation is set out in section 53K of the Act and the Commission has developed the Starting Price Adjustment (**SPA**) Framework for Default Price-Quality Path (**DPP**) regulation and the Input Methodology (**IM**) Decisions for Customised Price-Quality Path (**CPP**) regulation. The Commission has undertaken extensive consultation on these arrangements in recent years.

WELL is concerned that the Commission appears to be raising issues in the IDR Technical Paper about the form of price setting regulation in isolation of the broader SPA Framework and IM Decisions. For example, the IDR Technical Paper flags the Commission's intention to use engineering-based assessments and unit cost comparisons to assess an EDB's efficient capex and a form of benchmarking to assess an EDB's efficient opex. WELL notes that the approach that the Commission has set out for assessing capex in its IDR Technical Paper is at odds with what it has applied through the SPA Framework. In particular, under the SPA Framework³ the Commission proposes to determine forecast capex based on growth rates calculated from capex information contained in EDBs' Asset Management Plans (**AMPs**). The Commission adopted this approach consistent with the requirements of section 53K of the Act to promote a low cost approach to setting price.

WELL considers that it is not appropriate for the Commission to be proposing changes to the price setting arrangements in the context of proposed changes to the information disclosure arrangements. If the Commission wishes to change the price setting arrangements it should deal with this by proposing explicit changes to the SPA Framework and IM Decisions. To be clear, information disclosure arrangements should only deal with information disclosure, not price setting.

None of this is to suggest that the Commission should not use information it has obtained through IDRs for price setting purposes. Rather, WELL is concerned to ensure that:

- The regulatory arrangements for price setting and information disclosure are maintained in separate instruments and any changes to price setting are considered in the broader context of the price setting framework; and

³ Commerce Commission 2010-15 Default Price-Quality Path for Electricity, Distribution Draft Decisions Paper, 19 July 2011

- Any changes to the IDRs should co-exist in an efficient way with the Commission's existing information requests⁴, including those relating to DPP and CPP given the costly nature of data collection.

6. Timing and implementation

WELL has a variety of concerns about the timing and implementation of the Commission's proposed new IDRs. In particular, WELL is concerned that:

- The Commission is proposing publishing Draft IDRs in December 2011 when it is only seeking submissions in November 2011. WELL notes that the Commission is "*currently developing draft information disclosure requirements for EDBs and GPBs*"⁵. WELL is concerned that these timelines suggest that the Commission is well advanced in its thinking on these matters and will not give due consideration to EDBs' submissions;
- The Commission has not consulted on other aspects of supplier performance information that it will require EDBs to report on in the new IDRs, such as profitability, pricing and revenue. The Commission has not published its proposed approach to these matters and simply states that it will "*seek feedback... on our approach in relation to other areas of performance... in due course*"⁶;
- The Commission does not appear to have presented a compelling case for amending the IDRs to collect the nature and volume of information foreshadowed in the IDR Technical Paper. As noted, information disclosure is intended to be a "light handed" form of regulation. Accordingly, the Commission should provide an assessment of the costs versus the benefits of requiring EDBs to provide the level of information proposed in the IDR Technical Paper, which would likely result in considerable cost to both EDBs and the Commission (in assessing the information), as these costs will ultimately be passed on to consumers;
- It is unclear when WELL will need to start disclosing information to the Commission under the new IDRs. Depending on the nature of the changes, there may be a need for WELL to implement internal changes to prepare and report the required information. WELL should have appropriate time to introduce new, or to modify its existing, information collection systems to enable it to collect the required information;
- The Commission should not have commenced developing draft IDRs prior to establishing and consulting with an industry working group to assist the Commission to develop appropriate IDRs. WELL would welcome the opportunity to be a member of this working group;
- The Commission should clarify arrangements by which EDBs can fully recover any additional cost of complying with new requirements. WELL considers that this would be most efficiently carried out through a nominated pass through provision; and
- The Commission should determine, through a fully consultative process, the nature and form of comparative analysis it intends to undertake, for information disclosure purposes, prior to determining the information request. This is necessary to ensure that the information collected is relevant to the form of analysis that is chosen. It would not be prudent or efficient to collect information in advance of settling this matter.

⁴ In particular Schedule D and E of the IM Decisions respectively being '*Capital and Operating Expenditure Information*' and '*Capital and Operating Expenditure - Regulatory Templates*'.

⁵ IDR Technical Paper, page 1

⁶ IDR Technical Paper, page 1

7. Operating expenditure

This section addresses the questions raised in the Commission's IDR Technical Paper about opex. WELL emphasises that it is responding to these questions only in the context of potential amendments to the IDR, not in relation to any amendments to the price setting framework.

Question 1 - How much insight would an assessment of operating expenditure based on NZ comparators alone provide, for EDBs and for GPBs?

WELL considers that opex comparisons should be limited to New Zealand comparators only and that any such comparisons should:

- Only be based on fresh data collected under the new IDRs – historic data should not be used because there is not a robust, reliable and continuous data set for all EDBs;
- Be based on groupings of comparable businesses given that there are 29 EDBs; and
- Reflect adjustments for EDB-specific circumstances or characteristics.

Examples of factors that impact the comparability of data between EDBs include:

- The size, density and growth of their customer base;
- The size and nature of their networks, including their mix of CBD, urban and rural customers;
- Their reliability and planning standards;
- The geographic characteristics and exposure to earthquake risks;
- Their ownership arrangements and corporate objectives, given that some are corporations and others are Trust-owned;
- Their allocations of shared costs between services, such as natural gas;
- Their approaches to capitalising and expensing expenditure; and
- The types and scope of works being undertaken by EDBs and third parties and the treatments, and financial recognition, of capital contributions.

Although the Commission recognises that differences exist between EDBs, and would need to be 'normalised', it does not specify how it intends to do this or acknowledge the difficulty in doing this effectively.

Question 2 - How insightful could international comparators be in assessing EDB and GPB expenditure?

Please refer to response to Question 3.

Question 3 - What companies, countries or datasets should be included in the analysis?

WELL does not support the use of international comparators to assess relative efficiencies of New Zealand EDBs' opex.

WELL believes that this would exacerbate the data quality and comparability issues outlined above, particularly when the Commission cannot control the categories of opex that overseas EDBs report or the basis on which they undertake their reporting.

WELL believes that it would not be possible to normalise the differences of overseas EDBs due to differences in matters such as regulatory requirements, accounting policies, tax laws and corporate and ownership structures.

Question 4 - How appropriate are sub-company comparisons of costs?

Please refer to response to Question 5.

Question 5 - How feasible and costly would it be to collect sub-company costs and characteristic data to enable sub-company comparisons?

WELL is unable to address this question without fully understanding the purpose for which the benchmark information is to be used. It is possible that sub-company information (such as certain assets) may be relevant but it entirely depends on how the information is to be applied – this is not made clear in the Commission's IDR Technical Paper.

Question 6 - What factors (outside management control) drive industry wide opex?

Each sub-category of opex has factors outside of management's control that drive the levels of expenditure required.

WELL considers that opex drivers are best considered in terms of opex sub-categories – the current IDRs set out these sub-categories, which businesses are required to report against. The following provided a generalised view of what WELL considers to be the key drivers of each opex sub-category:

- Routine and Preventative Maintenance – WELL undertakes scheduled inspection and maintenance activity, which is usually conducted at predetermined intervals, or based on prescribed criteria, which differ by asset types. The objective of this sub-category of expenditure is to minimise the probability of network failure, minimise total life cycle costs, meet required operating conditions and performance standards, and promote safety. This expenditure is driven by factors such as the growth in asset numbers, the defect rates of different assets types, inspection cycle times and unit costs of maintenance activity;
- Refurbishment and Renewal Maintenance – WELL undertakes repairs and replacements after defects have been identified in order to prevent outages or other electrical events. A key driver of this expenditure is the age and condition of the asset base and expenditure levels are therefore dictated by the frequency and magnitude of events or asset failures that require repair, replacement or restoration work;
- Fault and Emergency Maintenance – WELL undertakes unplanned repair, replacement or restoration work to respond as quickly as possible to unexpected events or failures. This expenditure results from assets failing due to human and naturally driven external events or circumstances as well as assets that fail in service. The key driver of this expenditure is therefore the frequency and magnitude of these unexpected events or asset failures;
- General Management, Administration and Overheads – WELL, like all EDBs, incurs expenditure in relation to management, support and administration costs, which are essential to the on-going operation of the business, and includes insurance. These costs vary between businesses based on matters such as the size and location of the network, organisational structure including outsourcing arrangements, increasing regulatory costs, the number of employees and other specific business needs;
- System Management and Operations – WELL incurs expenditure in monitoring, controlling and designing its distribution network. These costs vary between businesses based on matters such as the size of the network, the nature of the assets deployed and the service levels required by customers;
- Pass-through Costs – WELL, like other EDBs, incurs pass-through costs associated with matters such as regulatory fees and levies and local authority rates, all of which are beyond its control.

There are a range of drivers of WELL's opex, some of which are within management's control and some of which are not. While each category of expenditure is affected by different factors, key external drivers of opex include:

- The age and condition of the regulated asset base;
- Demand leading to network growth (scale), including as a result of new customer connections;
- The frequency and magnitude of events or asset failures affecting the network⁷;
- Externally imposed service, safety, security and other regulatory requirements;
- Capitalisation policy; and
- Pass-through costs.

WELL emphasises that:

- The nature and extent of expenditure drivers will inevitably differ between individual EDBs; and
- Each sub-category of expenditure may have multiple drivers.

Recent examples of external opex drivers have included, but are not limited to:

- Change in Agricultural Land Practices – Dairying requiring higher response to fault restoration and repair than dry land sheep or beef to maintain supply for milking and irrigation services.
- Regulatory – Electricity Authority assigning Consumer Guarantee Act responsibility from Retailer to Distributors. This will increase customer response processes which increases opex costs.
- Government Initiatives – Ultra Fast Broad Band roll out requiring focused asset inspections for route plans or asset integrity or "get-ready" work to support additional infrastructure
- Council Infrastructure Replacement – replacing steel with plastic water mains removes EDB earthing facility requiring remedial works to distribution earth systems. Also unintended dig-in repairs to assets damaged from trenching companies.
- Insurance Market – Recent earthquake claims have lifted premiums which increase opex. Some regions are perceived as higher risk than others, hence insurance capacity is tight and premium increases are substantially higher than other regions.
- Weather Events – Increased expectation from customers and stakeholder agencies for detailed data instantaneously following interruption from an event with more frequent updates of restoration progress.
- Public Transport Reliability – increasing expectations for higher availability from aging infrastructure assets supplying this sector drives higher opex costs as the public purse is limited to meet capital replacement funding and maintain an affordable service to the general public.
- Product Resilience – Suppliers driving cost down to meet price competitiveness rather than compliance with standards is indicating early service failures at higher rates which draws a higher opex spend to maintain services. This typifies a false economy of accepting lowest price tenders.

⁷ This, together with geographic location, directly impacts on the level of insurance premium costs that WELL incurs.

- Public Health Initiatives – Healthy Homes Projects installing heat pumps can cause interference to consumers premises from voltage dips if incorrect appliances installed. This increase customer complaints on supply quality which increases opex expenditure.
- Legislation Change – Utilities Access to the Road Corridor Act has increased the obligations for complying with the requirements of working in the road corridor. This is a safeguarding document, however does increase compliance costs from the opex budget.
- Public Safety – An audited Public Safety Management System is required to be in place by 1 April 2012 for each EDB as part of compliance with the Electricity Regulations. The compliance costs are struck from the opex budget.
- Vegetation Management – The "2003 Hazards from Trees legislation" has required EDB's without existing agreements to pay for the first cut and trim of a tree within a specified zone adjacent to a power line. This was to allow tre owners to then manage this ongoing clearance themselves following a notification process by the EDB. There are larger than expected administration costs involved with this process which increase the drain on opex costs, particularly with customers defaulting on paying future costs by declaring "no interest" in the tree and leaving the EDB to manage the tree clearance problem.

It is necessary to understand the drivers of each EDB's expenditure in order to meaningfully compare expenditure between them. This will require extensive and time consuming analysis.

Question 7 - To what extent does the current information disclosure data capture these factors?

As discussed above, WELL thinks that it is necessary to identify and examine cost drivers by expenditure sub-category as described in question 6 above. The current IDRs do not request information on drivers of expenditure identified in question 6.

Furthermore, WELL does not consider that the cost drivers identified in Appendix B of the IDR Technical Paper adequately reflect WELL's actual cost drivers by sub-category of expenditure as discussed above.

WELL considers that the Commission needs to undertake significant further work to understand EDBs' cost drivers before they are applied in the new IDRs.

Question 8 - What cost drivers, if any, (outside management control) are unique to your business?

WELL has varying degrees of each of the cost drivers identified in the response to Question 6.

Question 9 - To what extent does the current information disclosure data capture these factors?

The IDR is a historic snapshot of past costs and does not represent cost predictions for the changing business environment. WELL reiterates that each EDB will have a range of common and unique expenditure drivers based on regional development, national and local government activities and business environment. WELL therefore would not be in a position to inform the Commerce Commission of what may have general application to other EDBs. WELL does have a detailed knowledge and understanding of its own business – it does not have an equivalent knowledge and understanding of other businesses. This outlines the difficulty of being able to analyse and draw reliable or conclusions from benchmarked data.

Question 10 - What factors other than changes in input process influence opex over time?

A sample of factors have been represented in the response to Question 6.

Question 11 - To what extent should quality be taken into account when assessing cost efficiency?

WELL considers that network performance quality and reliability of supply are the most important outputs that it provides to electricity consumers.

WELL therefore considers that network performance quality and reliability of supply are important considerations in assessing relative cost efficiency because high quality outcomes cost money to deliver. As noted above, increases in regulatory obligations are therefore a driver of expenditure. There is a cost-quality trade-off, which means that EDBs can appear more efficient than they might otherwise be by lowering the quality of the service that they deliver.

Accordingly, WELL considers that it is important that quality and reliability are taken into account in assessing relative efficiency between EDBs.

Question 12 - What level of opex should be assessed? Should the current sub-categories of EDB and GPB opex (e.g. general management, administration and overheads) be separately assessed, should further disaggregated cost data beyond these categories be collected and assessed, or should the analysis focus on total opex only?

As noted above, WELL considers that the current opex sub-categories provide an appropriate basis for assessing an EDB's opex.

Total opex would not enable the Commission or other interested parties to understand the drivers of the differences between EDBs' opex.

Question 13 - What components of opex should be separately benchmarked?

This question cannot be answered in isolation of understanding the purpose for which the benchmark information is to be used. Different information may be required if it is to be used just for information disclosure as opposed to price setting.

Given the expense of collecting and providing data, WELL's strong view is that the Commission should clearly determine how it intends to use the benchmark information before it starts collecting it.

Question 14 - How much insight would external comparisons of common functions provide?

WELL's strong view is that the Commission should restrict any opex comparisons to the 29 EDBs. A key reason for this is that the Commission is only able to obtain data on a comparable basis for these 29 EDBs – it cannot require other businesses in other industries to provide information on the basis that it may require.

Question 15 - What functions should be benchmarked and how easily available is cost data at a function-level?

Again, WELL is unable to address this question without fully understanding the purpose for which the benchmark information is to be used. It is possible that information by function may be relevant but it entirely depends on how the information is to be applied – this is not made clear in the Commission's IDR Technical Paper.

Question 16 - What industries and operators should be included when benchmarking these functions?

As noted above, WELL's strong view is that the Commission should restrict any opex comparisons to the 29 EDBs.

Question 17 - Should nature-of-work comparisons be further considered in assessing EDB and GPB opex efficiency? If so, what sectors should be included in the analysis?

Again, WELL is unable to address this question without fully understanding the purpose for which the benchmark information is to be used. It is possible that information by nature-of-work may be relevant but it entirely depends on how the information is to be applied – this is not made clear in the Commission’s IDR Technical Paper.

8. Capital expenditure

This section addresses the questions raised in the Commission’s IDR Technical Paper about capex. WELL emphasises that it is responding to these questions only in the context of potential amendments to the IDR, not in relation to any amendments to the price setting framework.

Question 18 - To what extent should assessments of historical capex based on direct comparisons be considered as part of summary and analysis?

WELL agrees with the reasons set out by the Commission in section 4.2 (page 12) of its IDR Technical Paper for using forecast capex, rather than historic capex, as a basis for assessing efficiency. However, WELL reiterates that any such assessment of future capex efficiency should be undertaken through price setting regulation.

If the Commission wishes to change the price setting arrangements it should deal with this by proposing explicit changes to the SPA Framework and IM Decisions.

Question 19 - What are the material assets and activities that should be included in a capex assessment?

Question 20 - What are the drivers of activity on these assets?

Question 21 - How can capex effectiveness be measured?

Question 22 - How suitable is the proposed approach for assessing capex?

WELL has significant concerns with the nature of these questions. They relate to price setting under a CPP framework and are not relevant to information disclosure. Similar issues are dealt with extensively in the relevant price setting regulatory instruments including the SPA Framework and CPP IM Decisions.

As noted in section 5, WELL considers that it is not appropriate for the Commission to be proposing changes to the price setting arrangements in the context of proposed changes to the information disclosure arrangements. If the Commission wishes to change the price setting arrangements it should deal with this by proposing explicit changes to the SPA Framework and IM Decisions.

9. Opex-Capex Trade Offs

Question 23 - To what extent do suppliers consider the opex-capex trade-off could distort an assessment of expenditure that is based on separate reviews of opex and capex?

Question 24 - Which components of expenditure have significant opex-capex trade-offs?

Question 25 - How should the cost analysis take into account any opex-capex trade-offs?

WELL recognises that trade-offs can be made between certain categories of opex and capex however this is a complex issue that should be dealt with in the context of the price setting framework, rather than through the information disclosure framework.

WELL believes any detailed consideration of opex-capex trade-offs should be made in the context of the price setting arrangements and any changes to these arrangements should be dealt with in the SPA Framework and IM Decisions.

Closing

As noted above, WELL would welcome the opportunity to be involved in the industry technical reference group to assist the Commission in developing its future approach to IDRs. WELL would also welcome the opportunity to meet with the Commission to discuss the issues 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

A handwritten signature in black ink, appearing to read 'G Skelton', with a stylized flourish at the end.

Greg Skelton
Chief Executive Officer
Wellington Electricity Lines Limited