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Dear Keston Ruxton

## Input Methodologies review – Commission emerging views



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### 1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to respond to the following Commerce Commission's (**Commission**) papers:

- *Input methodologies review – Emerging views on form of control*, 29 February 2016;
- *Input methodologies review – Emerging views on opportunities to improve the way default and customised price-quality paths work together*, 29 February 2016; and
- *Dr Martin Lally, Review of WACC issues*, 25 February 2016.

WELL appreciates the Commission publishing papers setting out its emerging views and seeking stakeholder comment in advance of making its draft decision.

### 2. Emerging views on form of control

WELL agrees with the Commission's emerging view that a pure revenue cap should be implemented as the form of control for electricity distribution businesses (**EDB**). As acknowledged by the Commission, the key benefits of a revenue cap, relative to the weighted average price cap (**WAPC**) are:

- removing the potential for EDBs and consumers to incur windfall gains and losses as a result of quantity mis-forecasting;
- removing disincentives for tariff restructuring to implement more cost reflective tariffs; and
- removing disincentives for EDBs to participate in and encourage energy efficiency and demand-side management activities, which could assist to defer or reduce capital expenditure and therefore provide long term benefits to consumers.

WELL also considers that under a revenue cap there are positive incentives for EDBs to support energy efficiency and demand-side management initiatives that efficiently defer or reduce capital expenditure and be rewarded under the capital incremental rolling incentive scheme (**IRIS**);

In assessing the advantages and disadvantage of a revenue cap, the Commission's paper raises the following as potential disadvantages of the revenue cap:

- potential for price volatility;
- reduces incentives for EDBs to connect customers;
- does not incentivise preparation for catastrophic events; and
- in theory, does not provide as strong incentives for efficient pricing as the WAPC.

Each of these is addressed below.

## **2.1. Potential price volatility**

Under a revenue cap, EDBs only need to forecast quantities at the time of setting the annual tariffs and can utilise the most recent information available. EDBs also have the best information available regarding consumption and demand on their network. Therefore, moving to a revenue cap where EDBs can utilise the most accurate and up to date information to forecast quantities should reduce the risk of forecasting error and price volatility, compared with the WAPC where the Commission must forecasts consumption more than five years in advance.

Revenue predictability and stability is very important for commercial purposes, including for liquidity and budgeting purposes. The commercial benefit of revenue predictability creates a strong discipline on forecasting accuracy. Importantly, EDBs would have no incentive to mis-forecast quantities, provided an appropriate time value of money is applied to any over or under-recoveries.

Further, EDBs take seriously the potential for reputational and political risk arising from price shocks. For example, for the 2016/2017 pricing year, WELL has made some initial progress towards improving the alignment of its tariffs with the cost of supply. WELL decided to implement tariff changes gradually to smooth the impact on consumers.

WELL therefore considers that introducing a capping mechanism for dealing with over or under-recoveries in a particular year is unnecessary and would introduce additional complexity.

## **2.2. Customer connections**

While WELL is not aware of any current obligation to connect customers on to its network, in practice WELL always provides a customer with a connection offer and has never refused to connect a customer. Obligations exist to maintain connections to existing customers provided this remains a requirement of the customer.

Over the long term, to remain competitive with alternative technologies the network needs to ensure its prices are competitive. Greater usage of the network will spread the costs across more customers and keep average prices lower. Therefore, there remains an incentive to connect new customers to retain the value of the network long term.

Additionally, contestability in the connections market creates an incentive to provide a good service and competitive capital contribution rate or risk the customer choosing an alternative provider for aspects of the connection works. As noted above, WELL values maintaining positive customer relationships and seeks to minimise the reputational and political risks arising from customer dissatisfaction.

Notwithstanding, to the extent that a partial disincentive is created through the revenue cap, this could be addressed through:

- ensuring the DPP allowances are set taking into account of forecast connections growth on the network; and
- EDBs setting individual contracts within their capital contributions policy, particularly for large scale commercial or industrial connections.

WELL therefore does not consider it necessary to mandate EDBs to provide connection offers or introduce a connections incentive scheme.

### **2.3. Preparation for catastrophic events**

WELL considers it important for EDBs to prepare for catastrophic events where doing so is in the long term benefit of customers. However, currently EDBs are limited because:

- the DPP forecasting approach, which is based on historic trends, does not accommodate additional expenditure for investment in network resilience. During the 2015-20 DPP reset process WELL submitted that it would like to undertake further work to improve the resilience of its network against high impact low probability events. However, the operating and capital expenditure forecasting methods under the 2015-20 DPP did not accommodate such step changes in expenditure requirements. WELL is now undertaking a review of resilience expenditure requirements and is working with other business leaders in Wellington to better understand inter-dependencies and considering a broader range of options; and
- catastrophic event insurance is expensive and full insurance would be uneconomic for customers. WELL has also investigated alternative options such as a catastrophe bond form of insurance cover but to date quoted costs are prohibitive and uneconomic for customers.

However, WELL does have training and response plans which support preparing for response and recovery for managing catastrophic events.

WELL would be happy to discuss with the Commission potential options for better enabling EDBs to prepare their networks for the additional investment required to manage catastrophic events.

### **2.4. Efficient pricing**

WELL considers that under a revenue cap EDBs would have positive incentives to move towards more cost reflective tariffs. This is because the lower volume risk will enable EDB's to be more innovative with their pricing without the fear of unintended revenue loss or compliance issues. This will also enable clearer price signals to encourage consumer responses that could potentially assist to reduce peak demand periods to defer network capital expenditure. EDBs would be incentivised through the capital expenditure IRIS.

For the 2016/17 pricing year, WELL has made some initial progress towards improving the alignment of its tariffs with the cost of supply. WELL has identified and repriced customer groups that impose higher costs on the network. However, further progress towards cost reflective tariffs is currently limited by the risks of revenue under-recovery (while subject to the WAPC) and the imposition of the *Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations (LFU Regulations)*.

The concept that EDBs would increase tariffs to price sensitive customers, to encourage them to reduce demand or leave the network, while reducing tariffs to price insensitive customers is purely theoretical. It is very unlikely to occur in practice because:

- EDBs do not have expertise regarding customer price sensitivity and cannot adjust tariffs accordingly. In particular, EDBs are limited by the LFU Regulations;
- distribution charges are only one component of the final retail bill and changes in distribution tariffs and/or tariff structures are not fully passed on to consumers through retail prices; and
- consumers do not fully respond to price changes.

These are the same reasons the WAPC does not lead to efficient pricing in practice.

### **3. Emerging views on opportunities to improve the way default and customised price-quality paths work together**

#### ***3.1. Emerging view 1: More tailored approach to setting the Default Price-quality Path (DPP)***

WELL supports the Commission taking a more tailored approach to the DPP. WELL considers that the Commission should be in a position to apply a degree of tailoring for the 2020 reset for EDBs. An example of tailoring would be considering step changes in expenditure that affect a sub-set of suppliers or considering quality targets in light of EDB circumstances and expenditure requirements.

It is not clear at this stage how tailoring would work in practice and whether this could create unintended consequences. WELL therefore considers the Commission should keep an open mind regarding the form of tailoring that could be applied, and under which circumstances, and should not pre-determine a limit on the number of suppliers that could be affected or the level of certainty that must be present.

Importantly, WELL does not consider that taking a more tailored approach is a substitute for moving to a revenue cap form of control and therefore tailoring should not be used to address errors in CPRG forecasts for specific suppliers while retaining a WAPC for other suppliers. For the reasons previously noted, a revenue cap better promotes the long term interests of consumers.

#### ***3.2. Emerging view 2: Single issue CPPs***

WELL originally proposed a 'CPP mini' option to manage the situation where a supplier's circumstances are unable to be taken into account in the setting of the DPP, due to the low cost one size fits all approach, but the full CPP option would be inefficient for EDBs, the Commission and consumers given the single issue nature of the change required. WELL proposed this option specifically in the context of CPRG forecasting under the current WAPC and step changes in capital expenditure for investment in network resilience.

Provided the IMs are amended to sufficiently broaden the scope of the DPP reopener provisions, as discussed in section 3.3 below, WELL accepts that a single issue CPP option is not necessary.

#### ***3.3. Emerging views 4 and 5: Expanding the role of DPP reopeners***

WELL agrees with the Commission that DPP reopeners should be available for both:

- CPRG forecasts, if a revenue cap is not introduced; and
- Quality path, where the standards are set independently of expenditure forecasts.

In addition, WELL considers that DPP reopeners should be available for:

- step changes in operating and capital expenditure not taken into account in the DPP forecasting methodology, discussed below; and
- contingent and unforeseen projects as proposed for CPPs, discussed in section 3.5.

##### ***DPP reopener for step changes in expenditure***

There is currently a gap in the DPP/CPP regulatory regime for dealing with circumstances where a supplier requires expenditure above historic levels, for example due to a specific program of works, but it is not of sufficient materiality to justify undertaking a full CPP application.

The CPP option:

- is resource intensive, particularly relative to the small scale of New Zealand EDBs;
- is slow to implement, requiring a two to three year process from start to finish; and

- carries a high level of uncertainty regarding the outcome.

Therefore, an EDB is only likely to consider applying for a CPP if it requires a significant adjustment to the price and/or quality path.

This leaves a wide range of potential circumstances where the long term interests of consumers may not be served. This is because consumers would have been better off funding the supplier to undertake the program of works but it is not efficient for an EDB to undertake a CPP application, when it takes account of the costs and risks of a CPP.

For example, the Christchurch seismic events have shown that in Wellington additional capital expenditure is required to seismically strengthen substation buildings on the network and allow critical equipment to be protected, so that delivery of a faster response and recovery process post event can occur. While we have outlined to the Commission that seismic strengthening could require material additional expenditure, under the DPP process there is currently no mechanism to accommodate this type of step changes in expenditure. At the same time however, the step change in expenditure required for the seismic strengthening and resilience work is unlikely to be sufficient to justify undertaking a CPP process.

WELL considers that allowing DPP reopeners for step changes in operating and capital expenditure are appropriate because:

- it provides an avenue for dealing with the large gap between the DPP and CPP, discussed above;
- step changes in expenditure required for specific programs of works can be considered in isolation from other inputs to the price-quality path, particularly where the other inputs have been set based on historic trends or otherwise without reference to proposed step change in expenditure;
- it is only necessary to apply scrutiny to the incremental costs of the proposed step change in expenditure, i.e. the same principle as suggested for CPP reopeners for contingent or unforeseen projects;
- it allows for a supplier's business-specific circumstances to be taken into account where the DPP one-size-fits-all-approach is unable to; and
- it would be significantly less costly and more timely, for all parties, than a CPP application.

#### *Potential criteria for DPP reopeners*

WELL suggests some key criteria for DPP reopeners could include:

- an upper and lower materiality threshold, for example equivalent to between 1% and 5% of revenue in the relevant disclosure years;
- the proposed change can be considered with reasonable independence from other inputs into the price-quality path;
- the expenditure is not already provided for in the price-quality path;
- the change sought affects one or a sub-set of suppliers; and
- the suppliers circumstances differ materially from the assumptions applied in the DPP.

#### *Commission initiating DPP reopeners*

Importantly, WELL does not support the Commission initiating a DPP reopener, because:

- under the DPP regime the Commission has a high level of discretion regarding the methods it applies to forecast the price-quality path and its final decision is not subject to merits appeals rights. Therefore, it is not clear why the Commission would need to initiate a DPP reopener, as it

has already had opportunity to set the price or quality path in a different manner, including applying a level of tailoring to business-specific circumstances;

- the right for the Commission to reopen a final DPP decision would create unprecedented uncertainty for suppliers. WELL is not aware of any regulatory regime where the regulator can change its decision ex post;
- suppliers would be subject to both upside and downside risk from applying for a DPP reopener as the Commission's final decision on the DPP reopener is not proposed to be one-sided, would be binding, and is not subject to merits appeal rights. Therefore, DPP reopener provisions do not create asymmetric risk in favour of suppliers; and
- suppliers would be subject to the costs of responding to a Commission initiated DPP reopener process with no form of cost recovery available and potential penalties incurred under the operating expenditure IRIS.

### ***3.4. Emerging view 3: Applying a proportionate scrutiny principle to CPP***

WELL agrees with the principle of applying a level of scrutiny to CPP inputs which is proportionate to the importance of the input to the overall price-quality path. WELL supports the Commission adopting this principle when reviewing the CPP IM requirements and assessing a CPP application.

Further, WELL supports the Commission adopting this principle for a broader range of its decisions, including:

- setting the DPP;
- assessing supplier requests for tailoring under the DPP; and
- assessing DPP reopeners.

### ***3.5 Emerging view 6: CPP reopeners for contingent and unforeseen projects***

WELL supports allowing CPPs to be reopened for contingent and unforeseen projects. Such an approach is consistent with other jurisdictions, including Australia, where:

- during the reset process suppliers nominate events that are foreseeable but carry a level of uncertainty regarding timing, scope or cost of the project. Suppliers also nominate the trigger for the event occurring which establishes the point at which the uncertainty is removed. Suppliers may then put in an application to recover the additional costs once the uncertainty is reduced; and
- following the reset process suppliers may make an application to pass through the costs associated with unforeseen events.

WELL considers the approach an appropriate way of managing uncertainty and considers it should also be available under the DPP regime as a DPP reopener.

### ***3.6 Emerging view 7: Approval of net additional costs before CPP approval***

In principle where due to circumstance, a supplier needs to commence incurring additional expenditure before a CPP application is approved, it should be able to recover all of the expenditure prudently incurred. Currently, the IM's enable recovery of costs prudently incurred between a catastrophic event and the approval of a CPP or DPP reopener. The same provisions should apply to both a change event and an urgent project.

Cost recovery for prudently incurred expenditure should not be limited to the time between making the application and the effective date of the Commission final determination. The nature of the work required may mean that work must commence before a DPP reopener or CPP application can be

prepared and submitted. It takes time to prepare applications for DPP reopeners and CPPs that are complete, thorough and compliant. It is in the interests of the Commission and consumers, for suppliers not to unduly rush the preparation of DPP reopeners or CPP applications, with the effect of compromising the application quality, in-order to limit the extent of cost under-recovery.

WELL therefore recommends that the IMs permit recovery of prudent cost incurred between the time of the change event or urgent project and the effective date of the Commission final determination, under both a DPP reopener and CPP.

### ***3.7 Emerging view 8: Expanding the range of pass through costs when setting the DPP***

WELL supports changing the pass through IMs to:

- enable new pass through costs to be specified in a DPP determination; and
- allow any cost that meets the pass through criteria to be specified as a pass through cost, rather than just levies.

The ability to amend the DPP determination to add new pass through costs should also be retained.

## **4. Cost of capital related issues**

WELL welcomes Commission's engagement on cost of capital by providing this opportunity to review the expert material being prepared. Dr Lally's conclusion that there is no empirical evidence to support different asset betas for different price control regimes provides further support for no adjustment to the asset beta for the form of control.

As previously submitted, WELL does not consider there to be any basis for adjusting the asset beta for the form of control, because:

- there is no evidence that the form of control materially influences the systematic risks of regulated suppliers;
- international regulators, including the Australian Energy Regulator (**AER**) and Ofgem have not adjusted the asset beta when changing the form of control from a WAPC to a revenue cap; and
- the Commission currently applies the same asset beta for EDBs, subject to the WAPC, and Transpower, subject to a revenue cap.

Further, WELL notes that there is already low beta bias in SBL CAPM. The low beta bias has been acknowledged by the Australian Competition Tribunal in recent decision on the Networks New South Wales appeals where it supported the AER choice of selecting 0.7 beta at the higher end of its range of 0.4 to 0.7, despite the consumer group arguing for a beta of 0.5.<sup>1</sup> Therefore, despite Dr Lally's belief that there might theoretically be a margin between revenue and price caps betas, empirically the beta estimates themselves suffer from low beta bias.

WELL agrees with Dr Lally's conclusion that Black's simple discounting rule has significant limitations and should not be introduced in the process for determining the WACC.

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<sup>1</sup> Australian Competition Tribunal, Applications under S 71B of the National Electricity Law for a review of distribution determination made by the AER in relation to Ausgrid pursuant to Rule 6.11.1 of the National Electricity Rules, Feb 26, 2016 [731].

WELL notes some submissions have pointed out that the market information on Regulatory Asset Base (RAB) multiples indicate that the cost of capital allowance is too high. WELL considers that such a conclusion is erroneous and superficial as the RAB multiples are reflection of<sup>2</sup> –

- the bidder's expected cash flow over the full lease period (99 years) and not just 5 year regulatory period;
- the bidder's ability to outperform the regulatory benchmarks;
- the bidder's assessment of the value of non-regulated assets owned by the business and their future growth potential; and
- strategic considerations such as gaining entry to a particular market.

Based on similar considerations the AER also decided that RAB multiples will not have any role as a cross check in its current Rate of Return Guideline.

## 5. Summary

In summary, WELL:

- supports the implementation of a revenue cap as the form of control;
- does not consider it necessary to introduce additional regulatory provisions to accompany a revenue cap, including
  - capping the annual revenue wash up; or
  - introducing connection obligations or incentives.
- notes that EDBs are currently well planned and rehearsed in their preparedness for catastrophic events, however improving network resilience to catastrophic events requires additional investment and we would be open to discussing this further with the Commission;
- supports the Commission applying a more tailored approach to the DPP, provided this is not used as a substitute for introducing a revenue cap as the form of control;
- supports broader provisions for reopening the DPP, including to allow step changes in expenditure that are material but not sufficient to justify a full CPP application;
- supports reopener provisions for contingent and unforeseen events and considers this should be available under both the CPP and DPP regimes;
- does not support the Commission initiating a DPP or CPP reopener;
- supports the Commission applying a proportionate scrutiny principle to both the CPP and DPP regimes;
- considers Dr Lally's conclusion that there is no empirical evidence to support different asset beta under different forms of control provides further support for no adjustment to the asset beta for the form of control;
- agrees with Dr Lally's conclusion that Blacks simple discounting rule should not be introduced into the process for determining the WACC
- disagrees with submissions that suggest RAB multiples indicate the costs of capital is too high.

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<sup>2</sup> Frontier Economics, Response to submissions on the relevance of the Transgrid sale, report prepared for Jemena Electricity Networks, ActewAGL distribution and United Energy, submitted to AER, Feb 2016. Attached.

## 6. Closing

WELL appreciates the opportunity to contribute to the IM review. Please do not hesitate to contact Megan Willcox, Regulatory Projects Manager, on [MWillcox@welectricity.co.nz](mailto:MWillcox@welectricity.co.nz) if you have any queries.

Yours faithfully



Greg Skelton

**CHIEF EXECUTIVE OFFICER**