

23 October 2020

Dane Gunnell

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Dear Mr Gunnell

Cross submission to the Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision

1. Introduction

Wellington Electricity Lines Limited (**WELL**) welcomes the opportunity to make a cross-submission in response to the submissions which were made in response to the Commerce Commission's (**Commission**) draft decision on "*Wellington Electricity Lines Limited transition to the 2020-2025 default price-quality path*" published on 25 September 2020. This submission refers to this paper as the "**Draft Decision**". The submission will also reference WELL's initial submission to the Draft Submission provided to the Commission on 16 October 2020. This submission refers to this as the "**WELL's Initial Response**".

In addition to WELL's Initial Response, submissions on the Draft Decision were made by MEUG, ENA, Powerco, Unison and Aurora. These submissions address two key topics which were central to WELL's Initial Response – the treatment of inflation in the price path and underlying building blocks and expenditure allowances. In addition, Powerco has commented on the process for transitioning from CPPs to DPPs. We respond to these submissions in this cross submission.

2. CPP operating expenses not included in the base year

MEUG's submission (submission point 3.b.) disagreed with the draft decision to include the operating expenses approved under the CPP when setting the operating expenditure allowances for the DPP. The concern appears to be that as the process for setting WELL's streamline CPP was tailored to reflect the policy directives in the September 2017 Government Policy Statement—Resilience of Electricity Services in the Wellington Region, and the urgency for the earthquake readiness spend, that the approved spend should not form baseline allowable expenditure for WELL going forward.

We disagree. The Commission approved the incremental CPP opex allowances for the streamlined CPP after consideration of the evidence WELL put forward. This included independent review and consultation with stakeholders. Unlike capex, the additional opex expenditure was not one-off, as it relates to ongoing storage costs for spares and software and hardware maintenance and support

expenses for the new data centre and communication systems. We believe there is a misunderstanding about what the adjustment is for and why it is needed.

The need to include these expenses is unrelated to the form of the CPP application and this issue (CPP costs not captured in the base year) could still have occurred if a full application was applied. The issue relates to the process of transitioning from a CPP to a DPP. As outlined in the Draft Decision, sections 2.6 to 2.14, there is not a set transition process and the Commission have a degree of flexibility in deciding how to transition an EDB to a new price path.

This flexibility is needed as characteristics of a specific CPP programme (e.g. how reflective a base year is of on-going cost, length of the CPP programme etc.) and how the CPP and DPP regulatory periods align will mean that a single transition method will not always be appropriate. The transition process is also not decided at the time of the CPP application and it is not known how CPP operating expenses will be captured in the next regulatory period. It is expected that these will be assessed on their merits.

The adjustment reflected in the Commission Draft Decision ensures that WELL can continue to deliver the earthquake readiness benefits in line with what the Commission approved during the CPP application process.

3. Adjusting Capex and Opex forecasts to reflect the effects of Covid-19

MEUG's submission (submission point 3.d.) requested that the Commission review the demand growth projections for WELL as a result of Covid-19 and reduce the starting Maximum Allowable Revenue (MAR).

As outlined in section 6.2 of WELL's Initial Response, electricity distribution is an essential service industry and has been largely operating through the pandemic but with heightened availability initially due to the declared national emergency. While the initial lock down work was scaled back to essential work only, this required additional planning for the restart program to meet the annual maintenance and capital work program. Figures 1 and 2 of WELL's Initial Response illustrated that energy use quickly returned to pre-Covid-19 levels. While economic activity has reduced, and this is likely to continue into the regulatory period, WELL expects the electricity sector to be less impacted than other sectors, such as tourism and hospitality – as is evident in the current statistics.

The majority of WELL's capital and operating expenditure relates to maintaining its network assets and meeting its quality of supply expectation. WELL does not expect to reduce its asset maintenance and replacement and renewal programmes as these activities are an important part of delivering a reliable and continuous electricity supply to our existing customers.

WELL has considered the impact that current economic conditions resulting from Covid-19 may have on WELL's work programmes relating to network growth - specifically the new connections and system growth and reinforcement capital programmes (this submission will collectively refer to these programmes as **network growth**).

WELL develops its network growth programmes and budgets by modelling capacity down to a feeder level, adding security criteria and applying current demand and future demand expectations.

Forecast demand growth is based on consumer connection requests, local government planning expectations and other indicators like the impact of the electrification of transport fleets.

It is important to note that WELL stretches out the time that capital investment is required to reinforce the network for as long as possible by using alternative asset configurations or by implementing demand management tools. The network is therefore reinforced when we can no longer rely on operational measures to manage load. Often investment occurs after demand has already depleted existing capacity (unless the new demand is unable to be accommodated within the remaining capacity head room available). This helps ensure that WELL only invests when it is confident the additional capacity is needed.

Chapter 8 of WELL's AMP (published 1 April 2020) provides an analysis of network capacity and details of the growth programme. WELL's AMP can be found at <https://www.welectricity.co.nz/disclosures/asset-management-plan/>.

In response to the pandemic and current economic forecasts we have reviewed the key network growth programmes included in the AMP and confirm that the planned network growth programme to the end of the current regulatory period (2025) remains unchanged. The key reasons that network growth investments on the Wellington network will not change because of the economic impact of Covid-19 are:

- 1. Housing shortages and new sub divisions:** The New Zealand media frequently reports about the Wellington housing shortage which is resulting in record house prices and high rent costs. Housing costs in Wellington have increased 13.1% this year alone as a direct result of low interest rates, additional 'cash' available due to lack of overseas travel and some uplift from kiwi's returning home from overseas¹. The housing shortage remains in Wellington and the demand for new connections has not been, and is unlikely to be, materially slowed by the economic impact of Covid-19.
- 2. High growth in new connections continues:** WELL continues to see a high number of customer requests for residential, commercial and industrial new connections. With low interest rates and high demand for housing, developers have a ready market for their subdivision product as building becomes more economic than buying older high priced housing stock. New connection requests slowed over the Covid-19 lock down but quickly returned to the high, pre-Covid-19 levels. As of 22 October 2020 WELL made 1,453 new connections. Extrapolated out for the full regulatory year this is ~2,500 new connections which is in line with 2020 even with the Covid-19 lock down period included. As highlighted in our 2020 Information Disclosures, 2020 provided the highest number of new connections in the last 10 years. WELL expects these high levels of new connections to continue through the regulatory period.

¹ Wellington.scoop, Median house prices reach new record in Wellington, Hutt Valley and Kapiti, <http://wellington.scoop.co.nz/?p=131664>

- 3. Decarbonisation initiatives:** The electrification of transport fleets (both private and public) may require WELL to reinforce parts of the existing network until smarter charging collaboration is in place. In February 2021, the Climate Change Commission will consult on and finalise the plan for New Zealand to meet its emissions targets over the next 30 years. The plan will formalise the pathway for current and future Governments to electrify those parts of New Zealand’s energy system which rely on non-renewable energy sources. An increase in demand for renewable electricity of 40% - 70% over the next 30 years is expected to substitute for carbon-based fuels, initially for transport and industrial sectors but is expected to extend to gas domestic heating. Currently, one home in three on the Wellington network has both gas and electricity connections.

WELL is already seeing an immediate impact of the decarbonisation programmes. WELL is in discussions for the electrification of public buses, ferries and extending the rail network. The Hutt City Council is switching pool heating from gas to electric heat pump systems. In addition, the average capacity of new residential connections has been increasing as new connections are choosing to be fully electric, rather than gas and electric. Kainga Ora have also made a conscious decision to upgrade their housing with electric heat pumps and remove gas appliances.

Figure 1 below provides a summary of WELL’s review of the key network growth work programmes. We have reviewed the top 80% of growth projects by expenditure. There appear to be very few opportunities for deferrals. Indeed, if we deferred any part of the work programme, we would likely constrain economic development in the region and restrict added electrical capacity for decarbonisation efforts.

Figure 1: Review of network growth projects

Network growth project	Cost (\$m)	Year	Network capacity and supply security status	2020 AMP section reference	Continuing drivers for growth
Porirua Zone Substation capacity upgrade	16.0	2025	Current load exceed N-1 capacity	8.5.2.6	Commercial, industrial and residential load growth Network security and resilience
Frederick Street Zone Substation 33kV sub-transmission capacity upgrade	7.5	2022	Current load exceed N-1 capacity	8.4.2.3	Continued residential growth Also supported by Wellington City Council growth forecast
Upgrade communication and protection network	5.1	2024	Condition and limitation of existing communications and protection network	8.7	Communications network capacity, and network security and resilience
Evans Bay Zone Substation sub-transmission cable condition	4.5	2022	33kV cable at the end of their life and in poor condition	7.5.1 and 7.5.2	Network security and resilience

Network growth project	Cost (\$m)	Year	Network capacity and supply security status	2020 AMP section reference	Continuing drivers for growth
Palm Grove Zone Substation transformer capacity upgrade	4.5	2025	Current load exceed N-1 capacity Upgrade PAL transformer capacity - replace existing with 36 MVA units	8.4.2.8	Residential and commercial load growth Supply security and resilience
Porirua northern growth area including Plimmerton Farms Plimmerton Zone Substation feeder capacity upgrade	3.0	2023	Load forecast to exceed security criteria	8.5.3	Continued residential growth Growth confirmed by Porirua City Council growth forecast
Porirua Zone Substation 11kV feeder capacity Porirua Zone Substation 11kV feeder reconfiguration and upgrade	1.7	2023-2025	Current load exceeds security criteria	8.5.3	Porirua CBD load growth, industrial load growth, supply security
Korokoro Zone Substation 33kV subtransmission capacity Korokoro Zone Substation 33kV subtransmission upgrade	1.2	2021	Current load exceed N-1 capacity	8.6.2.4	Residential load growth
Hataitai Zone Substation subtransmission capacity Hataitai Zone Substation subtransmission cable reconfiguration	1.2	2024-2025	Load redistribution to manage zone substation loading requires network reconfiguration to avoid exceeding N-1 capacity	8.4.2.4	Network security and resilience
Kaiwharawhara Zone Substation 11kV feeder capacity Kaiwharawhara Zone Substation 11kV feeder reconfiguration	0.8	2023	Current load exceeds security criteria	8.4.3	Network security and resilience
Waitangirua Zone Substation 11kV feeder capacity Waitangarua Zone Substation 11kV feeder reconfiguration	0.5	2025	Load forecast to exceed N-1 capacity in 2025	8.4.2.8	Whitby area residential load growth

MEUG's submission (submission point 3.d.) said that the forecast growth assumptions also needs reviewing. We note that since moving to a revenue cap form of control from 1 April 2018 there is no explicit demand growth forecast in the MAR calculation.

We assume the submission was referring to the economic growth metrics used in the capex gates and in the opex network growth indices. We note that the Commission reviewed whether to update the economic growth metrics used in the capex gates and in the opex cost network growth inflators – these being the general economic inputs reflecting new growth on the network (as opposed to the specific growth programs provided by the AMP). Specifically:

1. Econometric analysis used to determine the network growth factors for opex have not been updated as these are expected to be stable, and are applied consistently across all non-exempt EDBs. The growth factors are based on a historic regression which will not change and the forecasts are based on:
 - The household growth forecast which does not have a later forecast available
 - Past trend in growth in the circuit length which has changed very little with another year of actual data.
2. The capex gates use household growth which does not have a later forecast available. Even if a new forecast was available, the results of the gates would not change because the historic connection growth measure becomes the relevant gate in the pass/fail assessment.

4. Cost inflation

WELL's Initial Response outlined why the cost inflators used in the Draft Decisions would not be representative of the energy sector and therefore is likely to result in a revenue path which is unreasonably low. The draft price-quality path, if implemented, means that WELL does not have a reasonable expectation of earning normal returns, which is inconsistent with the statutory purpose of Part 4 regulation. Powerco, Aurora, ENA and Unison have all responded in support of this point.

ENA has raised the issue of consistency in WACC and inflation when setting the DPP:

As ENA understands it, when the Commission reset the DPP in 2019, there was consistency between the WACC, the CPI used for revaluations, the CPI for conversion of the BBAR to MAR and the input price inflation forecasts used to generate the forecast tracks for nominal capex and opex allowances. It was our understanding that the CPI, LCI and PPI forecasts were all linked, or at the very least consistent with the expected inflationary environment at that time.

And:

However, under the Commission's proposed approach for WELL's DPP reset, CPI forecasts are held constant from 2019 and exceed current expectations, but the Commission is proposing to update the input price inflation forecasts to a lower track, because of the currently worse economic conditions. This means that WELL's revenue allowance will almost certainly not be realised, but the compensation for expected nominal expenditure allowances has already been lowered for the change in economic circumstances.

WELL agrees with ENA's analysis and we note that Powerco's submission suggested consulting with NZIER on this issue. In response, WELL asked PwC to test with NZIER (NZIER are responsible for preparing the input cost inflation forecasts which the Commission has relied on in the Draft Decision) the suitability of the forecasts for the intended purpose given the mismatch with the CPI forecast. This response is appended to this cross submission, and highlights:

- NZIER's expectation that a suite of inflation measures should have similar drivers in order to be internally consistent in a forecasting framework.
- The factors that are contributing to the high level of uncertainty in the current forecasting environment.

WELL notes that ENA has proposed two options for addressing the inflation errors in the Draft Decision:

1. Adopt the 2019 input price inflation forecasts which align with the CPI forecast period (which is consistent with WELL's Initial response); or
2. deflate the 2020 input price inflation forecasts using the 2020 CPI forecast and reflate using the 2019 CPI forecast.

WELL supports option 1, to adopt the 2019 input price inflators as it maintains consistency with the CPI inflation forecast, it is simple and low cost to apply and it maintains consistency with the inputs of the other non-except EDBs also subject to the DPP3.

5. Inability to earn a real return

Submissions provided further insights into the impact of the inflation forecast used to calculate the draft price and the impact this has on WELL's expectation of earning a real return consistent with the regulated cost of capital. Specifically:

- The ENA's and Unison's submissions provided detailed descriptions of how using inconsistent inflation forecasts will knowingly lead to WELL not achieving real financial capital maintenance (FMC), ex-ante. WELL's own calculations are aligned with Unison's estimation of the impact this will have (NPV of \$2.4m). The submission provided additional clarity of the issue by describing the 'natural hedge' that using consistent forecasts provides – a hedge that is removed by using inflation forecast set in two very different economic environments.
- The ENA submission provided additional examples of the impact that Covid-19 has had on inflation forecast methods and suggests that the economy wide metrics will no longer be representative of the energy sector. The example of Statistics New Zealand re-considering the weighting of the basket of goods used for the CPI index highlights the uncertainty and volatility in estimating inflation in the current economic conditions. If cost inflation is unrepresentative of the energy sector then it is likely that opex allowances will differ from actual costs and WELL is unlikely to achieve FMC.

These are not symmetrical risks – the circumstances of WELL's transition from a CPP to DPP are unique and it is unlikely WELL will ever be in a position to be over-compensated for similar circumstances in the future. For example, it is unlikely WELL will be in a position where the cost

inflaters and CPI inflation forecasts are set under such markedly different economic conditions so that WELL benefits from high cost inflators while retaining the price smoothing benefits of a lower CPI inflation forecast. Even if WELL was, this is clearly not the intent of the inflation hedging mechanisms in the regulatory framework.

It is important to provide EDBs assurance that the regulatory framework will allow them the opportunity to earn a real return or FMC when moving between CPPs and DPPs. Specifically:

1. The ex-ante expectation of earning a real return is consistent with the statutory purpose of section 52A (1) (a) of Part 4 of the Commerce Act.
2. Provides confidence that the underlying economic principles are maintained through regulatory periods, including when moving between CPPs and DPPs.
3. Provides EDBs with the confidence to continue to invest in their networks – this will be especially important because of the increase in electricity demand from New Zealand’s decarbonisation programmes and the electrification of transport and manufacturing process heat.

The current draft decision knowingly sets MAR at a level that WELL isn’t realistically expected to achieve a real return. The statutory purpose of Section 52A (1) (a) is therefore not being met.

Insurance

WELL’s Initial Response outlined why the additional operating expense allowances should be included for the increase in insurance premiums. WELL believes it is consistent with the Commission’s policy intent regarding catastrophic risk to include the additional insurance cost because it will allow WELL to continue to manage the risk associated with catastrophic events on behalf of Wellington consumers. Powerco, Aurora, ENA and Unison have responded in support of this point. MEUG also responded saying that they agreed with the Commissions draft decision.

Aurora noted the difference between allowances and the cost of funding a reasonable level of coverage:

The key issue is that, having determined a level of insurance cover that is reasonable to manage risk on behalf of consumers, EDBs are being faced with premium increases that far exceed the CPI rate-of-change embedded in price paths.

Powerco said that reducing the options for an EDB to manage the risks of catastrophic events, could transfer the risk to consumers who may not have the ability to manage those risks:

The draft decision has excluded known insurance costs. Because distributors are in the best position to manage risks, including the risk of catastrophic events, the Commission should consider whether constraining Wellington’s risk management options is the best interest of its consumers. The absence of alternative risk mitigation options that are cost-effective means the likely outcome of not funding these costs is that risk will transfer to consumers who have a limited ability to manage it. We think this outcome would be bad for consumers and would be inconsistent with the Part 4 purpose to promote the long-term benefit of consumers

Both Aurora and Powerco’s views align with those presented in WELL’s Initial Response.

Powerco's suggestion of discretion around the length of the historic reference period

WELL agrees with Powerco's submission that shorter historical reference periods for forecasting capex may be more appropriate. Long reference periods are likely to capture periods which are no longer representative of actual expenditure requirements on a network. As provided in WELL's submission on the Draft DPP3 last year²:

"It is more important for the historical data to be robust than for the data set to span a longer period of time. Data prepared post 2013 using the current Information Disclosure rules will provide a more sensible (apples with apples) comparison than data prepared using a different set of rules. The more recent data set is also more representative of the asset management practices currently employed. A five year reference period is also in line with the IEEE recommended approach³ for quality and we recommended both price and quality align with a five year reference period".

Powerco's suggestions to improve the CPP process

WELL agrees with Powerco's suggestion that earlier CPP transition decisions and additional guidance on how the Commission will select a transition methodology would help EDBs make an informed choice about whether to apply for a CPP or to transition to a DPP. While WELL agrees that some flexibility is needed to transition from a CPP to another price-quality path, too much uncertainty around the outcomes makes the decision to apply for a CPP difficult. Additional guidance could allow EDBs to model the transition and highlight potential inconsistencies before committing to the significant, non-recoverable cost of applying for a CPP. EDBs could then implement the due diligence needed to avoid committing to a price-quality path that may not provide the ability to achieve a real return.

6. Closing

WELL appreciates the opportunity to provide a cross-submission on the Commerce Commission's Draft Decision, *"Wellington Electricity Lines Limited transition to the 2020-2025 default price-quality path"*.

If you have any questions or there are aspects you would like to discuss, please don't hesitate to contact Scott Scrimgeour, Commercial and Regulatory Manager, at sscrimgeour@welectricity.co.nz.

Yours sincerely



Greg Skelton
Chief Executive Officer

² Wellington Electricity's response to DPP3 Draft Decision (18 July 2019).

³ IEEE Guide for Electric Power Distribution Reliability Incidences (1366).

Appendix 1 – NZIER Inflation Comments



Scott Scrimgeour
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23 October 2020

Inflation forecasting for WELL's DPP

Dear Scott

In accordance with your instructions of 6 October 2020, and in the context of the Draft Decision¹ on Wellington Electricity Lines Limited's (WELL's) transition from the Customised Price-Quality Path (CPP) to a Default Price-Quality Path (DPP), we report below on our discussions with NZIER on inflation forecasting. This letter is subject to the restrictions attached.

As the Draft Decision applies to certain input cost inflation forecasts published by NZIER you are interested in the proposed application of those forecasts in the Draft Decision. The purpose of this letter is to convey to you NZIER's responses, which we received by email on 21 October 2020, to two questions which we posed to NZIER's Principal Economist & Head of Membership Services on your behalf.

Q: Could you describe the impacts of the Covid-19 pandemic and the subsequent global economic disruption on the August 2020 quarterly predictions - in particular what factors need to be considered when using these forecasts given the heightened level of uncertainty in the current forecasting environment. The forecast indices may be locked in for the remaining regulatory period to 2025.

A: The September 2020 Quarterly Predictions captures the impact of the COVID-19 outbreak, primarily the impact of:

- 1. The lockdowns across the sectors given the restrictions on business activity.*
- 2. The border restrictions on services exports, primarily international tourism and education*
- 3. Reduced business and consumer confidence on retail spending and business investment*

The New Zealand outlook is highly uncertain, and remains dependent on three key factors: 1) how well New Zealand can contain the COVID-19 outbreak; 2) how policymakers such as the Government and central bank respond with fiscal and monetary policy support; 3) how the global pandemic evolves in the other major economies. The last factor is largely beyond our control, and the ability of other countries to contain or find a treatment for COVID-19 will influence how quickly borders can reopen and pave the way for a recovery in tourism activity.

The degree to which activity remains persistently weak, eg repeated lockdowns if community transmission was to return, or the global situation deteriorated sharply which has a much more negative impact on our export demand, will influence how long it will take for inflation to return to

¹ Commerce Commission, Wellington Electricity Lines Limited transition to the 2020-2025 default price-quality path, 25 September 2020



its target of 2% “on average over the medium term”. This in turn will influence the other inflation measures. Our September QP forecasts assume no further lockdowns for the New Zealand economy, and the economy will recover over the coming years as export demand picks up.

Q: What are your views on using a combination of forecast indices drawn from different starting periods? It is possible that recent 2020 forecasts of input cost inflators (PPI, LCI etc) may be used in conjunction with an earlier 2019 RBNZ CPI forecast in setting regulatory allowances. Given the significant economic disruption that has occurred since the 2019 CPI forecast, are there any observations you may have about this approach?

A: Given forecasts of input cost inflators rely on CPI forecasts (or the suite of inflation measures should have similar drivers in order to be internally consistent in the forecasting framework), during times of such large changes in the outlook for inflation (in the short term – up to the next 2-3 years) using forecasts from different periods mean that essentially we are incorporating different assumptions which are not consistent i.e. the higher growth underpinning 2019 CPI forecasts vs weaker growth underpinning 2020 input cost inflator forecasts.

Over the “medium term” inflation expectations measures indicate longer-term inflation remains anchored around 2%. So the key changes in the assumptions from 2019 to 2020 reflecting the effects of COVID (reduced economic activity leading to more capacity in the economy leading to reduced inflation pressures) would have the most significant implications for the inflation outlook up to the next 2-3 years.

We trust this assists you in your consultation with the Commerce Commission on the Draft Decision.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Lynne Taylor'.

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A handwritten signature in black ink, appearing to read 'Craig Rice'.

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Restrictions

This letter has been prepared for WELL to report on our discussions with NZIER on inflation forecasting in the context of resetting WELL's regulatory price path at the end of the current regulatory period. This letter has been prepared solely for this purpose and should not be relied upon for any other purpose. We accept no liability to any party should it used for any purpose other than that for which it was prepared.

To the fullest extent permitted by law, PwC accepts no duty of care to any third party in connection with the provision of this letter and/or any related information or explanation (together, the "Information"). Accordingly, regardless of the form of action, whether in contract, tort (including without limitation, negligence) or otherwise, and to the extent permitted by applicable law, PwC accepts no liability of any kind to any third party and disclaims all responsibility for the consequences of any third party acting or refraining to act in reliance on the Information.

We have not independently verified the accuracy of information provided to us and have not conducted any form of audit in respect of WELL. Accordingly, we express no opinion on the reliability, accuracy, or completeness of the information provided to us and upon which we have relied.

The statements and opinions expressed herein have been made in good faith, and on the basis that all information relied upon is true and accurate in all material respects, and not misleading by reason of omission or otherwise. The statements and opinions expressed in this letter are based on information available as at the date of the letter.

We reserve the right, but will be under no obligation, to review or amend our letter, if any additional information, which was in existence on the date of this letter, was not brought to our attention, or subsequently comes to light.

This letter is issued pursuant to the terms and conditions set out in our letter of engagement dated 26 November 2019 and your instructions of 6 October 2020.