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Dane Gunnell
Manager, Price - Quality regulation
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Wellington

By email: regulation.branch@comcom.govt.nz

Dear Dane

Re: Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision

Electricity Networks Association (ENA) appreciates the opportunity to make a submission in response to the Commerce Commission's draft decision **Wellington Electricity Lines Limited transition to the 2020-2025 default price-quality path,** (WELL) published by the Commission on 25 September 2020. We submit our comments as follows.

Measuring price changes in 2020 will have significant challenges

Covid19 has altered the outlook for the economy from when the DPP was set in 2019. However, the restrictions on economic activity to manage the public health risk from Covid19 has changed output in ways not historically captured by the price indices. Therefore, there is a risk that output and price changes – especially for economy wide measures – are being affected by the restrictions imposed on commercial activity which are disguising price trends at a sector level.

Economy wide measures will reflect that sectors like tourism and hospitality have been significantly impacted by the Covid19 restrictions and are unlikely to provide a sensible measure of inflation for the energy sector which is an essential service and has largely continued to operate through the 'lock-down' period.

If it chooses to adopt a new index, we therefore recommend that the Commission must be confident that the index remains a true and unbiased outlook of expected price changes for inputs.

The ENA has reservations whether such confidence can be achieved in the current circumstances. Indeed, Statistics New Zealand has recognised that Covid19 has created unprecedented data and methodological challenges for the collection of information for developing its quarterly CPI series.

For the June Quarter, Statistics New Zealand has noted the challenges of measuring international airfares and overseas accommodation in its original basket of goods. Statistics New Zealand has noted making changes for these weights is a conservative recognition of the impact of Covid19 – meaning there are other goods and services that will have had traditional consumption unnaturally impacted by the new public health restrictions on activity.

To illustrate the impacts, we observe that Statistics New Zealand note international airfare and overseas accommodation historically accounted for 3% of CPI expenditure (a reasonable proportion of the index). Therefore, to continue to measure these services at their pre-COVID weights will overweight current consumer expenditure on these items.

To account for the changes, Statistics New Zealand has proposed alternative weightings at 50%, 20% and 5% of the original weight. This results in annual CPI price changes for the March and June Quarters at 10 basis points difference from the published index. The confidence in new data and spending patterns is far from straight forward, so we encourage the Commission to not mechanically apply new information without first judging the reasonableness and purpose of the information.

Input costs escalation

A substantive issue with the WELL draft decision is with the use of August 2020 input price inflation forecasts for opex and capex forecasts and the use of August 2019 inflation forecasts to translate the BBAR into the MAR. The use of forecasts in this manner will result in Wellington Electricity expecting not to achieve real FCM during the DPP period. It is inconsistent to pair a price inflation forecast from August 2019 for annual price changes with an expenditure forecast from 12 months later that is based on updated input price inflation forecasts.

In this instance it will result in annual price changes from the smoothing of WELL's maximum allowable revenue which are out of sync with the expected changes in nominal expenditures which have been determined at a different period-of-time and with a significantly different inflation outlook. This will have the effect of exposing WELL to a different price escalation path from the expected changes to its expected nominal expenditures.

The ENA notes the Commission's CPI forecasts for converting BBAR into the initial MAR are embedded within the IMs and so there is little opportunity for the Commission to alter this forecast. Therefore, the updating of expenditure escalators creates a disconnect between the changing of prices from one expectation of inflation and applying a different expectation of inflation for some included costs. This is undermining the purpose of the MAR escalation process to ensure annual price changes are moving in line with changes to allowable costs.

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. In resetting WELL's revenue allowance, the Commission is now constrained to use the WACC and CPI forecasts from 2019, which creates an issue in ensuring that there is logical consistency with the input price inflation forecasts affecting opex and capex.

One of the advantages of escalating the revenue allowance at the rate of actual CPI inflation over the regulatory period is that it inherently provides a degree of hedge against changes in out-turn input price inflation. If CPI turns out to be less than forecast, then it would be expected that nominal wage inflation would also reduce, as would other input price inflation outturns.

Accordingly, nominal revenue allowances are less, but the EDB's nominal costs will also be less, so there remains an expectation of achieving real FCM.

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.

Because of this mismatch WELL cannot expect to achieve real FCM.

Given the constraints on the Commission's use of 2019 CPI forecasts, this problem could be addressed in potentially one of two ways:

1. Adopt the 2019 input price inflation forecasts so that there is logical consistency in the expected revenue allowance (which will be lower than the stated MAR track) and the expected compensation for expenditure requirements (which will be lower than the stated forecast expenditure requirement); or

2. Take the 2020 input price inflation forecasts, deflate these by the 2020 CPI forecast and then re-inflate these using the 2019 CPI forecasts. In that way, the real component of the input price inflation forecasts is consistent with current economic conditions

and the nominal component of the input price inflation forecasts is consistent with the inflation assumption used elsewhere in the DPP reset (and in particular the conversion of BBAR to MAR).

We consider option 1 to be the easier solution to implement and its low cost is consistent with the overall DPP approach.

ENA's key point is that if the Commission does not ensure logical consistency in the inflation forecasts used for CPI and input price inflation, by using forecasts determined at different times for different components of the MAR, then the expectation of real FCM cannot be achieved. This would seriously undermine investors' confidence in the regime, particularly given the materiality of the change in economic environment from when the 2019 DPP forecasts were established.

Insurance costs

A specific cost pressure that ENA members are facing is increasing insurance premiums. These increases arose in part from the Christchurch and Kaikoura earthquakes and affect all EDBs but are more felt in Wellington where earthquake risks are highest. We understand that although WELL have mitigated some of the risks from natural disasters (the CPP expenditure was for this very purpose), they still face a substantial increase in premiums simply because of heightened earthquake risk in Wellington. The actual costs to WELL are beyond what is allowed for in the draft transition decision and, like the escalation of input costs we comment on above, must be funded from somewhere.

The alternative is to reduce insurance premiums and to pass the management of earthquake risk back to customers. This outcome would not be consistent with the Commissions past approach to managing the risks associated to catastrophic events. The Commission's position at the time of the Orion final CPP decision was that suppliers were more able to mitigate the risks associated to catastrophic events than consumers. Providing an appropriate level of insurance cover is a key tool for ENA members to mitigate that risk.

The ENA notes that Part 4 of the Commerce Act provides discretion as to how starting prices are set following a CPP. WELL's earthquake readiness CPP programme and the increase in insurance premiums have the same purpose - to allow WELL to manage the risk of a catastrophic event. Allowing the funding for WELL to retain its current level of insurance will ensure the customer benefits from the CPP programme aren't offset.

Closing

Throughout the DPP3 development process ENA members submitted to the Commission their concerns that the allowances for various input costs would be inadequate compared to the

escalation of input costs that they expected to face in the DPP3 period. We were disappointed that the bulk of our submissions were set aside. Members concerns were well founded and early evidence in 2020 is that input costs are increasing well ahead of forecasts, even setting aside the impacts of Covid19 which are mostly yet to be seen.

We encourage the Commission to provide some certainty to industry on how such non-trivial matters that we address in this submission will be determined for the transition from DPP to CPPs, and vice versa. Guidelines on how transitions are expected to occur will give stakeholders greater confidence about how the different price paths are expected to play out and provide information for critical decision-making.

We also urge the Commission to adjust the final WELL transition decision to correct the input cost inflation anomaly that we discuss above and to include the insurance costs that WELL faces because of the heightened earthquake risks.

Kind regards

David de Boer
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Electricity Network Association