Major Electricity Users' Group

22 February 2018

Dane Gunnell
Acting Manager on behalf of Matthew Lewer
Commerce Commission
By email to regulation.branch@comcom.govt

Dear Dane

Wellington Electricity CPP draft decision

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission draft decision Wellington Electricity's proposal to customise its prices to better prepare its network for an earthquake, 1 February 2018 (the WELL CPP draft decision).[1]

2. Attached and to be read as part of this submission is a report by NZIER, WELL earthquake resilience, Review of the cost benefit analysis by WELL, 21 February 2018.

3. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.

4. The following sections comment on:

   a) Problems with the flexibility mechanism of the CPP regime;

   b) WELL's CBA;

   c) The incentive mechanism; and

   d) Other details.

Problems with the flexibility mechanism of the CPP regime

5. MEUG has already submitted on who should pay and to the extent customers pay for this resilience work, what should be the appropriate cost of capital.[2] The draft decision is silent on those matters apart from noting:

   > "In reaching our draft decision, we have considered submissions on WELL's CPP proposal. We have not specifically addressed all submissions in this paper though we have addressed some as necessary."[3]

6. We assume the concerns we have raised on the problems with the flexibility mechanism of the CPP regime that have arisen with this first test of those mechanics will be addressed in a comprehensive review following final decisions. Suffice to say MEUG believes the CPP

[1] Refer http://comcom.govt.nz/regulated-industries/electricity/cpp/cpp-proposals-and-decisions/wellington-electricitys-2018-2021-cpp/

[2] Refer MEUG submission to the Commerce Commission, Wellington Electricity CPP proposal, 15 December 2017, paragraphs 7 to 9, http://www.meug.co.nz/node/895.

[3] Draft decision, paragraph 20.

regime for "normal" applications and the flexibility mechanism under which the WELL proposal has been considered have fundamental flaws.[4]

7. Our concern at the use of the flexible mechanisms and risk of unintended consequences for unexpected urgent CPP applications were heightened with the last-minute advice by the Commerce Commission that the Input Methodology variation used to implement the streamlined CPP would be amended to use updated forecast CPI assumptions otherwise:[5]

> "If left unchanged we estimate the issue would result in additional revenue for WELL of around $6m over the three year CPP."

8. An important policy design question for the post-final-decision reviews of the WELL and Powerco CPP applications will be the use of cost-benefit-analysis (CBA). MEUG and other submitters have discussed this in prior submissions, particularly in relation to the Powerco CPP application. The draft decision relies on "substantial unquantified benefits" along with quantified benefits to justify approving the proposed expenditure.[6] Setting aside the position by the Commission that it does not need to use CBA when considering CPP applications; the reliance on unquantified benefits appears to be contrary to the Commission's usual practice to make decisions on quantitative analysis. We would also suggest it would be helpful to all stakeholders for the Commission to:

   a) State its assessment of the credibility and reliability of the WELL's estimated quantified benefits;

   b) Describe the substantial unquantified benefits that it felt were delivered by the WELL CPP; and

   c) Outline how it combined and weighted the quantified and unquantified benefits in reaching its conclusion that the CPP was justified.

9. As a matter of principle if a regulated monopoly is proposing to charge consumers tens of millions of dollars in additional charges, the monopoly should be required to quantify the expected benefits consumers will receive.

10. The CBA used by WELL in support of its business case for the work is discussed in the next section.

WELL's CBA

11. MEUG asked NZIER to review the suitability of the cost benefit analysis included by WELL in its CPP application as a justification for the expenditure proposed under the CPP and to comment on how the CBA could be improved.

12. The WELL business case for its CPP application was based on a cost benefit analysis that clearly described the cost of additional resilience projects and the benefit to consumers as avoidance of lost load and valued at an estimated price per MWh based on analysis by the Electricity Authority. The cost benefit analysis methodology was used successfully to:

   a) Define the expected cost of outages without investment in resilience.

   b) Compare multiple options for improving the resilience of components of the network while avoiding double counting of benefits.

[4] MEUG has stated this previously, eg Refer MEUG submission to the Commerce Commission, Priorities for the electricity distribution sector for 2017/18 and beyond, 15 December 2017, paragraph 10, http://www.meug.co.nz/node/896.

[5] Commerce Commission email 16 February 2018.

[6] Draft decision paragraph 43.

c) Establish a cut-off for resilience investment that did not deliver net benefits to consumers.

13. However, NZIER also suggested that if the WELL business case method is to be applied to larger scale expenditure to improve resilience a more sophisticated analysis of how total load demand would change or shift between locations after an earthquake will be required. Scenarios for graduated responses by different groups of consumers to earthquake damage in general less reliable supply of electricity could easily be added into the CBA framework already applied by WELL and used as the basis for sensitivity analysis before an event.

The incentive mechanism

14. WELL and the Commerce Commission have in a range of documents described the proposed work as being needed urgently and as soon as possible.[7] The Government Policy Statement and GNS Science stress urgency given the proximity and recent occurrence of the Kaikoura earthquake on 14 November 2016, with that risk diminishing as time elapses.[8]

15. MEUG therefore recommends the resilience minimum index be phased to incentivise urgent implementation for the proposed works with material deviations treated as breaches. MEUG's proposed resilience minimum index compared to the draft decision are set out in the table below with an explanation for MEUG's indices in the paragraphs that follows.

CPP year Resilience Minimum Index:	2018/19	2019/20	2020/21
• Draft decision[9]	0	0	60
• MEUG proposal	50	72.5	95

16. Our assessment is that a large fraction of the work will be completed within the first year.[10] That should be the case if the basis for the proposal, being works are urgently needed, is true. Hence, we propose the first year of the CPP, 2018/19, should have a resilience minimum index of 50.

17. The proposal has been framed as the minimum necessary and hence we do not accept the final and third year, 2020/21, resilience minimum index of 60 is sufficient. Material changes from the highly detailed list of works to be approved totalling $31.2m should be subject to a breach enquiry and if appropriate follow-up enforcement process. We consider a material change is 5% based on that fraction being used in the NZX listing rules in the definition of "material information" and therefore familiar to businesses.[11] Therefore, the resilience minimum index for the last year should be 95.

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[7] For example, in the draft decision in paragraphs 14, 16 and 39.

[8] Refer Government Policy Statement – Resilience of Electricity Services in the Wellington Region, 18 September 2017, paragraph 5 with text in quote below underlined for emphasis by MEUG (https://gazette.govt.nz/notice/id/2017-go4910):

> "After the Hurunui and Kaikōura earthquakes on 14 November 2016, GNS Science issued updated information about the probability and severity of aftershocks in the areas surrounding the faults that ruptured. <u>The probability of a large earthquake or tsunami in Wellington</u> increased as a result of the Hurunui and Kaikōura earthquakes and <u>is expected to reduce from that elevated level over time</u>."

[9] Draft decision, table 2.5.

[10] Anecdotal discussions Commerce Commission and WELL.

[11] Refer NZX Limited, Main Board/Debt Market Listing Rules, 1 October 2017, Section 10 Disclosure of Information, found at https://www.nzx.com/regulation/nzx-rules-guidance/main-board-debt-market-rules

18. The resilience minimum index proposed by MEUG for the middle year of the CPP is the mid-point of our proposed first and third year indices.

19. MEUG notes that the resilience minimum indices have no bearing on the financial incentives for WELL to innovate. Rather the resilience minimum indices are the trigger at which a breach enquiry is commenced and the outcome of that enquiry can, but need not be, a financial penalty on WELL. At the least there will be a compliance cost to WELL to answer Commission questions on the breach and there may be some reputational cost. Even those least cost effects are good incentives on WELL to avoid breaching the resilience minimum indices.

20. There is also a broader policy design reason to lift the proposed resilience minimum indices so that it sends a clear signal to other parties that may seek to follow the path of this proposal, that claims for urgency will be considered but the be-spoke incentive mechanics will hold applicants accountable to deliver on their claimed need for urgency.

Other details

21. The consultation paper invited feedback on 2-other details:

    a) Feedback on the profile of the CPP price path, that is whether to tilt or not.[12] MEUG has no view at this stage but may, after viewing the submissions of other parties, take a view in the cross-submission phase.

    b) Payment to customers of the approximate $10m pass-through balance either in the first year of the CPP in 2018/19 (proposed in the draft determination) or paid out over the 3-years of the CPP.[13] MEUG prefers immediate payment rather than deferred payment because the longer payments are deferred the greater the misalignment between customers that overpaid and payment recipients.

22. Feedback was also sought last week on the proposed updated CPI assumptions as discussed in paragraph 7 above. MEUG agree with the proposed change.

23. We look forward to reading and cross-submitting on the views of other parties.

Yours sincerely

Ralph Matthes
Executive Director

[12] Draft decision paragraphs 57-59.

[13] Ibid paragraphs 64-66.