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20074

16/10/2020

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Commerce Commission
Wellington

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

Dear Dane

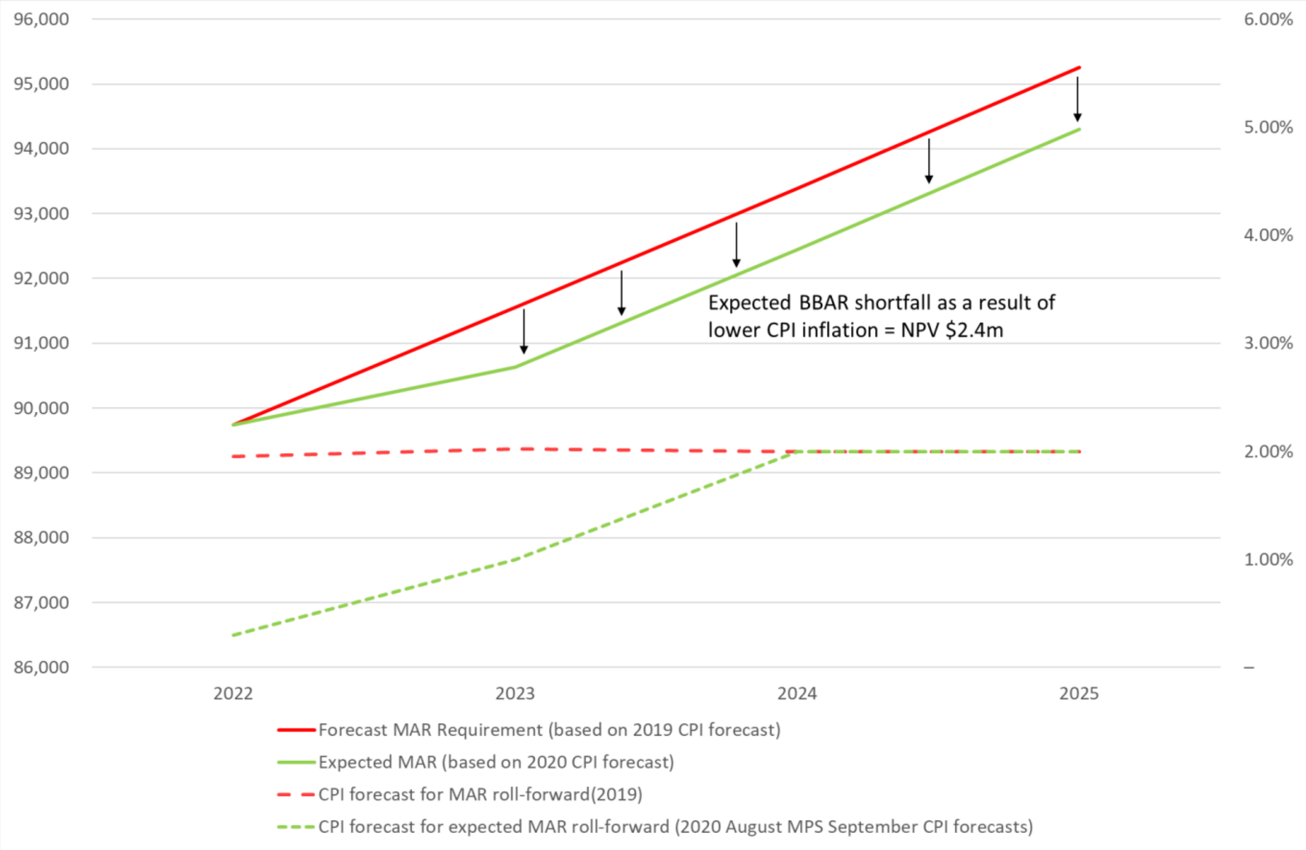
WELLINGTON ELECTRICITY DPP DRAFT DECISION

This letter represents Unison's submission on Wellington Electricity's DPP draft determination. We have contributed to ENA's submission and agree with its conclusions and recommendations.

As highlighted in the ENA's submission, the industry is extremely concerned that the mixed approach to inflation projections will lead to Wellington Electricity not expecting to achieve real financial capital maintenance (ex ante) in its shortened DPP regulatory period. As we understand it, the Commission is unable to update the CPI forecast used to convert the BBAR to the MAR as it is constrained by the IMs, but conversely, it has updated the input price inflation forecasts for the different components of costs that make up the BBAR. Accordingly, if CPI turns out lower as expected in the August 2020 CPI forecasts, then the Commission is effectively double-allowing for the reduction in input price inflation (once by specifically adjusting the input price inflation forecasts, and twice by not adjusting the CPI for converting the BBAR to MAR, so the expected MAR track is below the forecast MAR track).

We have sought to model the impact on Wellington Electricity using the Commission's financial model, and conclude that Wellington Electricity would therefore expect before the start of the regulatory period to fail to be able to recover its BBAR by an NPV (in 2021) of around $2.4m. This is highlighted in the following chart, (adopting the RBNZ's August 2020 CPI forecasts as illustrating the current inflation forecast):

Figure 1: Shortfall in achievement of required BBAR



Another way to think about this issue is to recognise the inherent hedge in using the CPI forecast to escalate the MAR. When CPI inflation is lower, expected input price inflation is also likely to be lower, so the revenue track automatically adjusts to a lower level of nominal expenditure: expected real financial capital maintenance is preserved. However, by updating the calculation of the BBAR for lower expected input inflation, but not the CPI for converting the BBAR to MAR, breaks this inherent hedge as no allowance is made for the known expected reduction in CPI.

Absent the constraint caused by the IMs which prevents the Commission from aligning the CPI forecast to the current CPI forecast, clearly the most appropriate approach would be to ensure that all inflation forecasts (CPI for converting the BBAR to MAR and input price inflation) are consistent (i.e., underpinned by the same economic environment). With the constraint of the IMs on updating the CPI forecast for converting the BBAR to MAR, the Commission needs to adopt one of the solutions identified in the ENA's submission to ensure internal consistency in the financial model and to meet the standard of expected real financial capital maintenance. We think the Commission needs to reconsider whether the IM needs to be adjusted to allow for the CPI used to convert the BBAR to MAR to be the forecast applicable at the time, as this is a different issue to the consistency of the CPI forecast used for revaluations and WACC. For the time-being, however, the Commission must use one of the solutions proposed by the ENA.

Unison also strongly agrees with ENA that the Commission should allow for Wellington Electricity's known increase in insurance costs. It seems wholly unreasonable for the Commission to force Wellington Electricity to reduce the level of cover to achieve the level of premium provided for in the draft decision, which would seem to be its only option, given

Wellington Electricity should have reasonable ability to earn the regulated WACC. It would seem unlikely that it would be efficient for Wellington Electricity's consumers to bear a higher proportion of any repair costs following an earthquake, given consumers would already be experiencing their own high costs of recovery. We note the Commission's reasoning and desire for consistency with its stated reasons for not providing for increased insurance costs in resetting the DPP in 2019. However, the magnitude of the increase confronting Wellington Electricity is exceptional and absent an adjustment to Wellington Electricity's opex allowances would likely drive an outcome not in the interests of consumers.

Yours sincerely

Nathan Strong
GENERAL MANAGER BUSINESS ASSURANCE