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Dear Mr Gunnell

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 submission 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 the final DPP3 decision reasons paper "*Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision*" published on 27 November 2019. This submission refers to this as the "**Final DPP3 Decision**".

This submission has two main points of focus. The first is on the selection of the cost inflation forecasts used to calculate the starting MAR. The Draft Decision uses August 2020 cost inflation forecasts while retaining the CPI inflation forecasts that reflect the 7 August 2019 RBNZ Monetary Policy Statement. Under normal economic conditions, using inconsistent inflation forecasts would not have a material impact on an Electricity Distribution Network's (EDB's) ability to earn a real return. However, the August 2019 CPI and August 2020 cost inflation assumptions now reflect very different economic conditions. The August 2020 economy wide NZIER forecast cost inflators reflect abnormal levels of uncertainty due to Covid-19 and are unlikely to represent the circumstances facing our sector for the remaining DPP3 period. This submission will show that other sectors unrelated to the energy sector (like tourism and hospitality) are driving the reduction in the inflation forecasts. This has resulted in operating and capital cost allowances that are unlikely to be representative of the actual costs.

Using inconsistent cost and CPI inflation forecasts that were derived in very different economic conditions also results in a MAR that is knowingly set at a level that is not expected to be achieved and at a level that WELL will not earn a real return. The BBAR has been updated with August 2020 cost inflators reflecting an expectation of lower cost inflation. However the price path calculation retains the older, higher inflation forecast. Accepting the latest lower cost inflation forecasts are correct, it is unlikely WELL will be able to achieve the MAR price path over that period.

This submissions second point of focus is that WELL believes that the increase in insurance premiums should be included in WELL's operating cost allowances. WELL believes it is consistent with the Commission's policy intent regarding catastrophic risk to include the additional insurance cost. The additional insurance allowance will allow WELL to continue to prudently manage the risk associated with catastrophic events on behalf of, and for the long term benefit of Wellington consumers.

2. Selection of transition method

WELL supports the Draft Decision to reset starting prices at the end of the CPP period using the 'building blocks' approach. As highlighted in the Draft Decision and in the Final DPP3 Decision, the DPP2 price-quality path was used as a base for WELL's revenue path for the 'streamline' CPP with an incremental adjustment for the modest CPP earthquake readiness programme. We agree with the Commission's assessment that it would not be appropriate to carry forward the CPP price path by extrapolating the underlying building blocks that were initially set in 2015.

WELL's CPP only overlaps the current DPP3 regulatory period by a single year, at the beginning of DPP3. WELL agrees with the Commission that the short interval means that the DPP3 methods and inputs are relevant for when WELL transitions to the DPP one year later. This approach also allows WELL to align itself with the other 15 non-exempt EDBs for the majority (four of the five years) of the DPP3 period.

WELL notes that while the Commission has broadly used the DPP3 approach to calculate WELL's starting price in the Draft Decision, section 53X(2) of Part 4 of the Commerce Act provides discretion as to how starting prices are set following a CPP. Additional discretion exists even when applying the DPP approach, as while certain inputs are specified in the Input Methodologies (**IMs**), other inputs and assumptions are at the Commission's discretion. This provides the Commission with the ability to make adjustments to WELL's starting price calculation to provide outcomes which better meet the statutory purpose, while retaining the relatively low-cost approach to setting DPPs.

3. Lower prices from cost saving initiatives

WELL notes that the Commission have updated the DPP3 model with the latest operating expenditure and Regulatory Asset Base (**RAB**) from WELL's 2020 Information Disclosures. This has resulted in a reduction in WELL's revenue allowances. The reduction is a result of cost efficiency initiatives that will provide Wellington customers with lower distribution prices. As noted by the Commission, the draft decision to calculate the starting price using the DPP3 building block calculation allows these cost efficiencies to be shared with customers.

4. Cost inflation

The Draft Decision uses August 2020 cost inflation forecasts sourced from NZIER to determine operating cost and capital cost allowances for the four-year DPP regulatory period applying to WELL. CPI inflation forecasts used elsewhere in the Draft Decision are the same as those applied in the Final DPP3 Decision, reflecting the 7 August 2019 RBNZ Monetary Policy Statement CPI forecast. Consistent with the IMs, forecast CPI is aligned to the WACC estimate derived prior to the start of the five-year DPP regulatory period.

The consequence of this approach is that the August 2020 input cost inflation assumptions reflect a very different economic outlook to the August 2019 general inflation assumptions assumed elsewhere in the building block model. This fundamental inflation inconsistency in the revenue building blocks leads to a revenue path which is unreasonably low, because the recent NZIER forecasts reflect abnormal levels of uncertainty and they do not represent the circumstances facing our utility sector. This draft price path, if implemented, means that WELL does not have a reasonable expectation of earning normal returns, which is inconsistent with the statutory purpose.

Applying the new operating expenditure cost inflators and capital expenditure cost inflators has resulted in a ~\$5.5m and ~\$0.1m respective reduction in BBAR¹ (across a four-year regulatory period) compared to applying the August 2019 cost inflators from the Final DPP3 Decision.

The August 2020 NZIER cost inflation forecasts were made at a time of extreme and unusual economic uncertainty. The June 2020 quarter saw the largest quarterly drop in economic activity since records began². Gross Domestic Product (GDP) fell by a record 12.2 percent in the June 2020 quarter compared to the March quarter. The response to the Covid-19 pandemic, including the various levels of lockdown and border controls, contributed to this large drop.

However, not all sectors were impacted uniformly. Electricity demand, like the share market, was back to its pre-Covid levels once the Level 4 lockdown was eased and has remained at or slightly above the levels seen at similar points of time in 2019, reflecting the essential service nature of electricity supply as businesses in Wellington transformed to a “working from home” model.

Accordingly, WELL does not believe that the August 2020 input cost inflation forecasts included in the Draft Decision are fit for purpose and that the 2019 forecasts applied in the Final DPP3 Decision should be retained. Specifically:

- The August 2020 cost inflation forecasts are not fit for purpose due the elevated uncertainty of Covid-19, the current recession and the general election.
- The forecasts do not reflect the circumstances facing the electricity sector which continues to operate at pre-Covid-19 levels and has not been as exposed to the pandemic and recession as some other sectors have been.
- The forecasts are inconsistent with the CPI forecast used in the BBAR.
- The cost inflator forecasts are inconsistent with the CPI forecast used to set MAR.

This submission addresses each of these points in turn.

4.1. The forecasts are not fit for purpose due the elevated uncertainty of Covid-19, the current recession and the general election

Economic forecasting is uncertain, and forecasts depend on multiple variables, however forecasting in the current Covid-19 environment is substantially more uncertain than usual. NZIER acknowledges this in their September 2020 quarterly predictions report, as follows.

¹ BBAR before tax in year-end terms

² <https://www.newshub.co.nz/home/money/2020/09/in-the-eye-of-the-storm-quarterly-gdp-falls-to-record-12-2-percent-new-zealand-officially-in-recession.html>

“NZIER continues to forecast an uneven recovery for the economy, with the effects of the COVID-19 outbreak expected to persist well into 2023. An extremely high degree of uncertainty remains over the growth outlook, given the rapidly changing conditions³”.

and

“Second wave of COVID-19 brings added uncertainty⁴”

How economic activity and therefore inflation evolves over time will depend on factors such as how long the border closures remain in place, the trajectory of commodity prices in response to the global economic recession, monetary policies of central banks in response to Covid-19 and the timing and scale of fiscal stimulus in New Zealand. These factors were not present at the time the DPP3 was set in November 2019 for other non-exempt EDBs.

The heightened level of uncertainty in producing economic forecasts in the current environment was also highlighted by Treasury in its September 2020 Pre-election Economic and Fiscal Update⁵:

“In addition to our main forecast, this Update provides three alternative forecast scenarios for the economy to reflect the continued uncertainties about the outlook. These scenarios include an earlier recovery in exports of services than assumed in our main forecast, an extended period of border controls and a resurgence in community transmission. The scenarios help illustrate the nature of the economic challenges ahead and the potential range of outcomes against which the public finances can be assessed.”

There is also an additional layer of uncertainty with the upcoming general election. This is because households, businesses, local government and other economic stakeholders tend to take a pre-election wait and watch approach, as the election outcome can change the economic and policy environment in which investments are made. This uncertainty is expected to reduce after the election once the make-up of the new government is known.

4.2. The forecasts do not reflect the circumstances facing the electricity sector which continues to operate at pre-Covid-19 levels and has not been as exposed to the pandemic and recession as some other sectors have been

The pandemic, border closure and resulting economic recession have affected some sectors (e.g. media and communication, tourism, hospitality and arts) much more than others. We understand that excess capacity in the economy (i.e. how actual economic output compares with potential output) is reflected in NZIER’s August 2020 PPI and LCI forecasts. The significant decline in these indices since the beginning of 2020 reflects the extra capacity that now exists in the New Zealand economy due to the economic impacts of Covid-19. These reflect border closures, business shutdowns and the emerging recession.

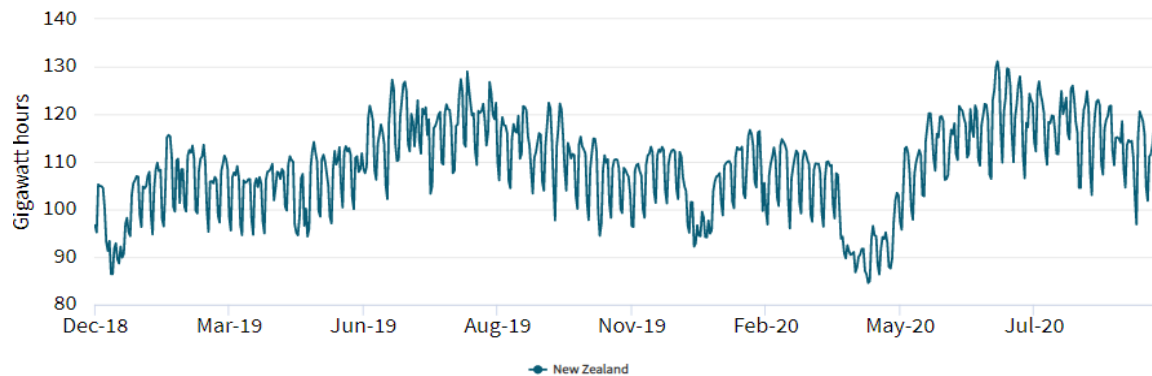
³ Leung, C., Gamperle, D., Isack, E. (2020), *Quarterly Predictions September 2020*. NZIER, page 2

⁴ Leung, C., Gamperle, D., Isack, E. (2020), *Quarterly Predictions September 2020*. NZIER, page 2

⁵ The Treasury, Pre-election Economic and Fiscal Update. (September 2020). Page 3
<https://www.treasury.govt.nz/system/files/2020-09/prefu20.pdf>

The energy sector however, is an essential industry and has been largely operating under a business as usual environment since the pandemic began and will continue to do so for the remainder of the DPP3 period. Although there were some limitations on activity during Level 4 resulting in a reduction in electricity demand, these have now been removed and electricity demand has recovered to at least prior-year levels, as illustrated in Figure 1 below.

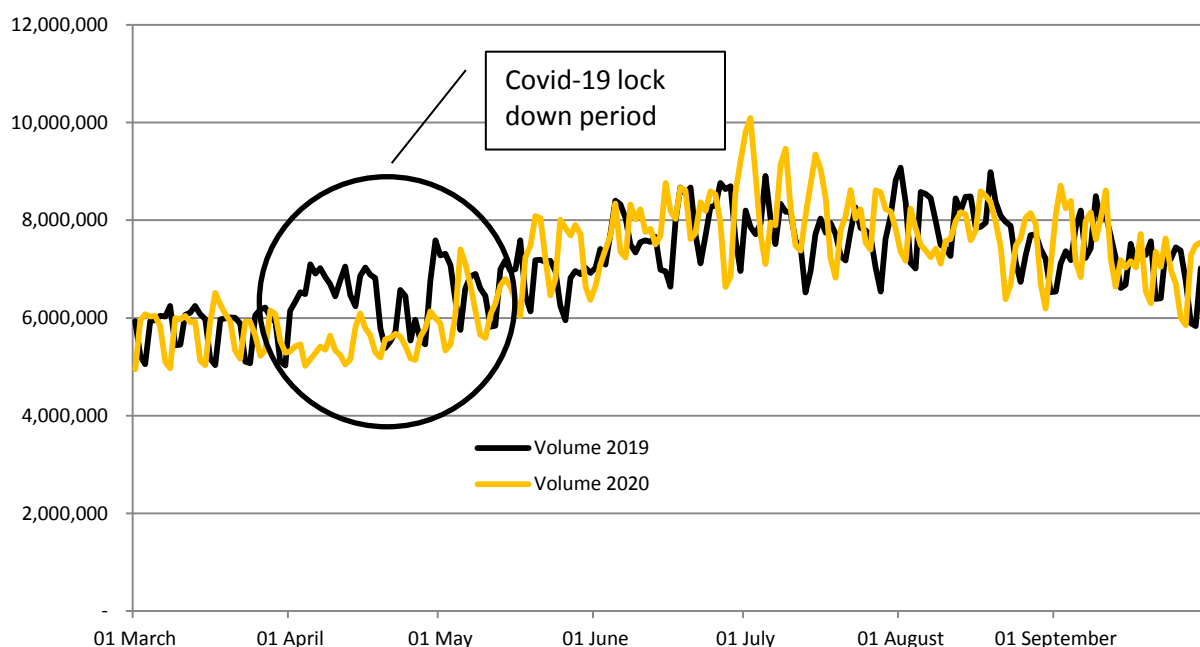
Figure 1: Daily Electricity national grid demand



Source: Electricity Authority

In line with the trend in national energy use shown in Figure 1, energy use in Wellington also quickly recovered back to normal levels following the national Covid-19 economic lockdown. Figure 2 compares energy use in 2019 and 2020 and shows energy use in 2020 has returned to 2019 levels.

Figure 2: Energy use in Wellington (KW)



Source: Wellington Electricity's grid exit point energy use data

As highlighted in the Energy News Article 'Lines companies keep lights on in pandemic – Woods', the Minister of Energy recognised the performance of the electricity sector during the Governments Covid-19 lock down period, highlighting electricity as an essential service and the importance of

providing a reliable and continuous supply. A reliable supply of electricity remained important during the lock-down period as workers in Wellington transitioned from the office environment to working from home. While some non-essential tasks were temporarily delayed, most network operation tasks continued. Those non-essential tasks that were delayed will be 'caught up' during the regulatory year to ensure maintenance on the network is completed and network reliability is maintained.

The utility sectors skilled workers were retained through the Covid-19 lockdown period unlike the Tourism & Hospitality sectors which closed businesses and dismissed their employees. Additional labours costs were incurred during the lockdown period as the network control room was run from two locations simultaneously to ensure the network would continue operating in the event of a Covid-19 outbreak at either control room.

Labour cost index

Extra capacity in the labour market, which is reflected in NZIER's recent LCI forecasts, is not capacity which is relevant for our business as it largely reflects service industries and relatively unskilled labour.

*"According to findings in a recently released Hays Construction & NZIOB Salary Guide for 2020, 69% of employers say it is 'very difficult' or 'hard' to recruit Senior Managers. This is followed closely by Project Managers and Construction Managers (both 66%), Estimators (56%), Quantity Surveyors (55%), Site Managers (52%) and Project Engineers (50%)."*⁶

Many of these skills are required by the electricity sector which continues to experience difficulty in finding skilled labour. Transpower's recent report⁷ notes that:

"There needs to be sufficient workforce capability and capacity to deliver the investments required to enable the transformation. Already, Transpower and its service providers are struggling to recruit the skilled workers needed to make current levels of investments."

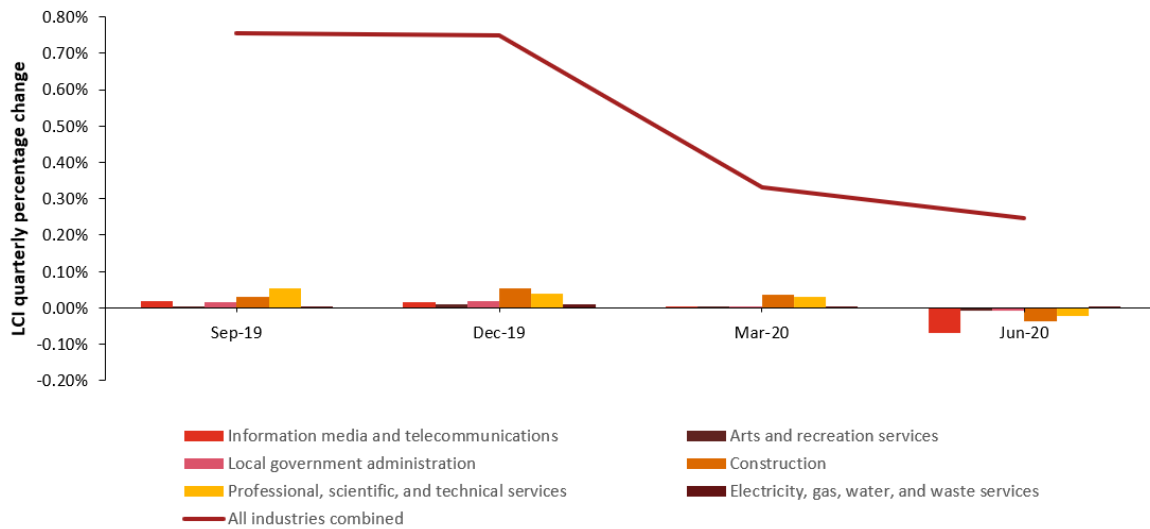
WELL regularly recruits specialised engineering, control room and project management staff from overseas because of difficulty in finding local recruits. In the last four years, WELL has recruited five employees (WELL has approximately 70 staff members) from outside of New Zealand. The Covid-19 Boarder restrictions is making overseas recruitment difficult and is likely to make recruitment of specialised staff even more challenging.

Figure 3 below shows the LCI movement over the last four quarters, i.e. since the input cost inflation was determined for the Final DPP3 Decision.

⁶The most sought-after Construction Skills in New Zealand. (28 September 2020). Scoop Business. <https://www.scoop.co.nz/stories/BU2009/S00492/the-most-sought-after-construction-skills-in-new-zealand.htm>

⁷ Transpower, Whakamana i Te Mauri Hiko - Empowering our Energy Future, March 2020

Figure 3: Quarterly LCI percentage change (weighted by sector)



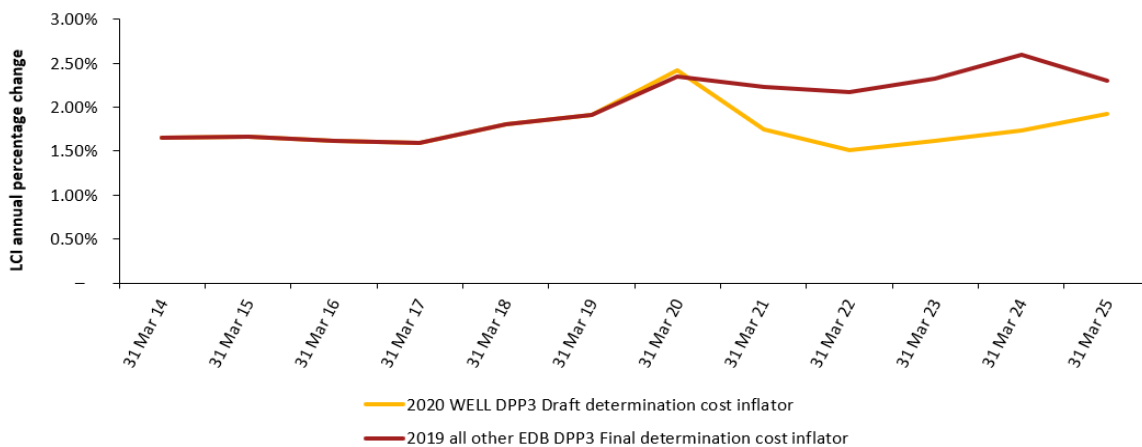
Source: Statistics New Zealand, LCI by industry, June 2020 quarter

Figure 3 above also shows the LCI movement for the Electricity, Gas, Water and Waste (EGWW) sector over the same period compared to the all industries index. As illustrated there has been virtually no change in the sector index in the final two quarters, a direct contradiction to the all industries index which has declined markedly.

The recent reduction in the all industries LCI forecasts illustrated in Figure 4 below therefore do not adequately reflect the capacity constraints in the electricity sector compared to the rest of the economy.

Accordingly, the LCI forecast in the Draft Decision will generate opex allowances which are too low because the labour inflation forecasts reflect abnormal labour market conditions in sectors of the economy which are less relevant to our business.

Figure 4: Annual LCI actual and forecast difference between August 2019 and August 2020

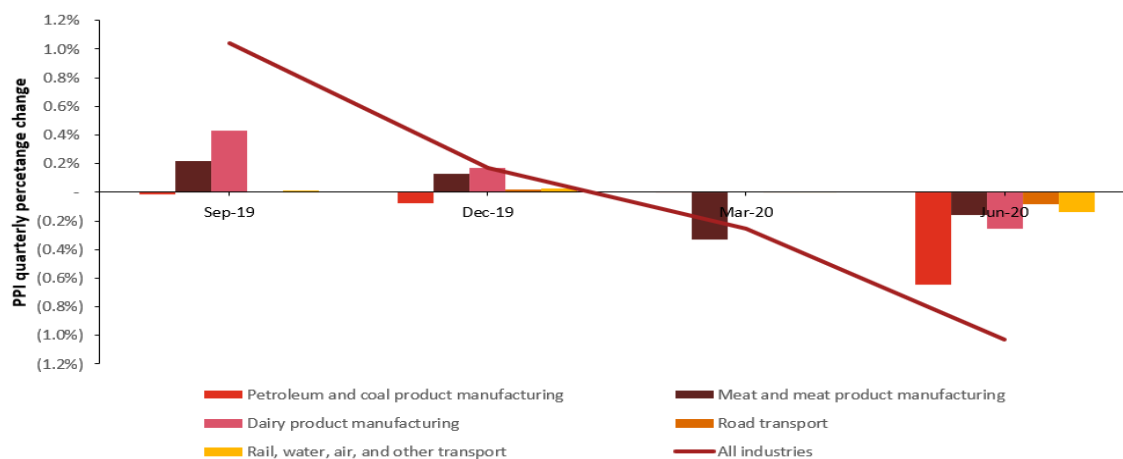


Source: Commerce Commission input cost inflator models (2019 & 2020)

Producers Price Index

The PPI has declined sharply over the past year, particularly in the June 2020 quarter as shown in Figure 5 below.

Figure 5: Quarterly PPI percentage change (weighted by sector)



Source: Statistics New Zealand, PPI by industry, June 2020 quarter

The last quarter shows the impact of the pandemic, with significant reduction in PPI due to decrease in demand for fuel driven by the aeronautical and road transport sectors.

Figure 6 below shows the sectors which have had the most influence on the fall in the all industries PPI during the June 2020 quarter and for comparison purposes the EGWW sector change. As demonstrated, the significant fall in the all industries PPI is not reflected in the EGWW sector which showed a small increase in PPI during this period.

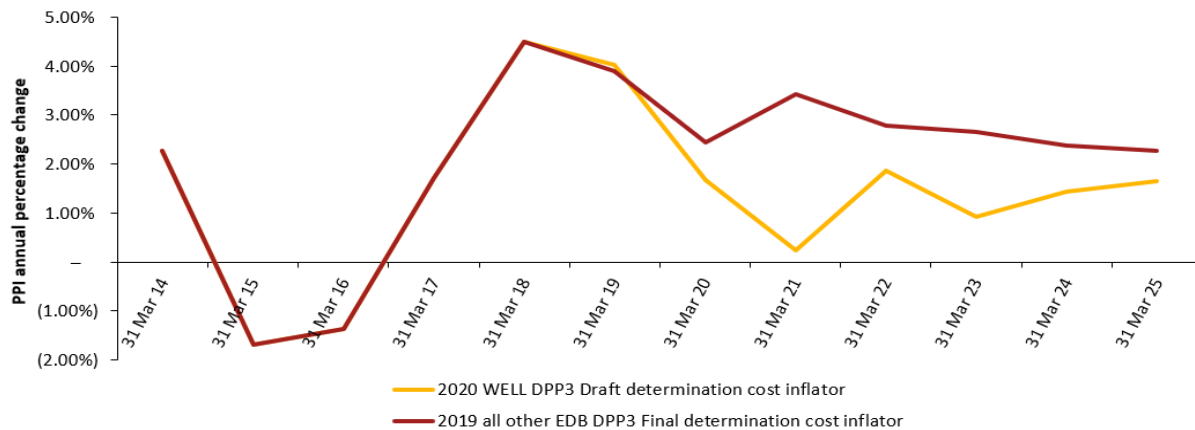
Figure 6: June 2020 Quarter PPI percentage change by industry group

Industry group	June PPI index % change	June PPI index % change (All industry weighted)
Petroleum and coal product manufacturing	(34.0%)	(0.6%)
Meat and meat product manufacturing	(4.3%)	(0.2%)
Dairy product manufacturing	(4.1%)	(0.3%)
Road transport	(4.5%)	(0.1%)
Rail, water, air, and other transport	(6.8%)	(0.1%)
Electricity and gas supply	4.2%	0.1%

Source: Statistics New Zealand, PPI by industry, June 2020 quarter

Figure 7 shows how the 2019 PPI forecasts compare with the August 2020 forecasts. Like the LCI forecasts the PPI forecast index has fallen considerably since the 2019 forecast used in the Final DPP3 Decision.

Figure 7: Annual PPI actual and forecast difference between August 2019 and August 2020



Source: Commerce Commission input cost inflator models (2019 & 2020)

As for LCI, the reduction in the all industries PPI forecasts illustrated in Figure 7 above do not adequately reflect the electricity sector when compared to the rest of the economy.

Accordingly, the PPI forecast in the Draft Decision will generate opex allowances which are too low because the inflation forecasts reflect excess capacity in sectors of the economy which are less relevant to our business.

WELL is continuing to collect evidence on the differences between economy wide and sector specific forecasts and will provide any new information during the cross submission period.

4.3. The forecasts are inconsistent with the CPI forecast used in the BBAR

The economy wide inflationary environment has changed considerably since the Final DPP3 Decision was set. The safeguards which exist in the regulatory framework for inflation forecasting risk apply to CPI. They do not apply to the input cost inflation used for DPP opex and capex allowances. As NZIER’s August 2020 PPI/LCI/CGPI forecasts are linked to their August 2020 CPI forecasts the proposed approach to setting the DPP for WELL one year after the DPP was set for other non-exempt EDBs is internally inconsistent. This means that if applied, WELL does not have a reasonable expectation of earning normal returns. Under normal economic conditions, using inconsistent inflation forecasts would not have a material impact on an EDB’s ability to earn a real return. However, the CPI and cost inflation assumptions now reflect very different economic conditions.

WELL is continuing to collect evidence on how the LCI, PPI and CGPI inflation forecasts are indexed to the CPI forecast and will provide any new information during the cross submission period.

4.4. The cost inflator forecasts are inconsistent with the CPI forecast used to set MAR

The Draft Decision is also inconsistent in how it uses CPI and cost inflation in the allowance calculations. The Draft Decision uses August 2020 PPI and LCI cost inflators which updates BBAR with an expectation of lower cost inflation. However, the Draft Decision retains the higher 2019 CPI inflation forecast for the price path calculation. This will lead to annual price changes from smoothing MAR which are inconsistent with the expected changes in nominal expenditure – the

inconsistencies reflecting that the two inflation forecasts were derived at different times and under very different economic conditions. WELL will be exposed to a different price escalation path to that reflected in the expected nominal expenditure.

Using consistent inflation forecasts provides a natural hedge against differences between forecast cost inflation and actual cost inflation. For example, and assuming the inflation forecast is representative of the sector, if actual cost inflation is less than forecast then actual operating expenditure will be less and there will be savings to offset the lower nominal revenue allowances. However, under the Draft Decision, operating expenditure allowances have been reduced to reflect lower inflation but the MAR price path still reflects the older inflation forecast which WELL will not achieve – the savings that would provide a natural hedge have already recognised in the lower nominal operating expenses. WELL would not earn a real return.

Accepting the lower inflation expectations of the latest CPI forecasts, it is unlikely that WELL will be able to achieve the MAR price path over the regulatory period. The MAR is knowingly set at a level that is not expected to be achieved and at a level that WELL will not earn a real return. WELL estimates this would have an approximate impact to the allowable revenue of \$600k less per annum.

We note that the CPI forecast used in the asset revaluation building block is intrinsically linked to WACC so that a real return can be maintained. This relationship is not the case for the CPI used to set MAR.

Maintaining consistent forecast cost inflation and CPI inflation for annual price changes ensures the cost inflation included in the BBAR is consistent with the final MAR price path. WELL understands that the IMs do not allow the Commission to apply an updated CPI forecast. However, we consider a practical solution for addressing the inconsistency between the inflation forecast is to revert to the cost inflators used for the 2019 forecast in the Final DPP3 Decision. This will provide 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). The proposed solution also maintains a low cost approach as the Commission already have the alternative inflation inputs.

4.5. Addressing the inflation inconsistencies

WELL submits that the Commission should apply the same input cost inflation forecasts to WELL's DPP as applied in the November 2019 Final DPP3 Decision, which it applies to other non-exempt EDBs. This will align the inflation forecasts and correct the inflation forecast inconsistencies which are exacerbated by the current economic conditions. This solution relies on information already available, and therefore it can be readily implemented, and ensures consistent treatment for all EDBs subject to the DPP. It also achieves internal consistency in the underlying inflation expectations within the DPP building blocks. This inconsistency has been exacerbated because of the pandemic and the subsequent recession which have occurred since the Final DPP3 Decision. However, these effects have not impacted the EGWW sectors (as demonstrated above). The extra capacity in the economy which is reflected in the latest all industries forecasts is not evident or expected to emerge for the energy sector.

This approach will, in our view:

- provide a more stable forecast, suitable for a four-year regulatory period;
- correct the inconsistency between the underlying CPI which is inherent in the most recent input cost inflation forecasts and the CPI used in the BBAR and MAR;
- maintains the integrity of the IRIS, by ensuring the base year actual expenditure is used;
- recognise the highly abnormal economic circumstances which have emerged over the past year, particularly since March 2020 (which is the end of the base year for WELL's DPP reset);
- recognise that the current economic situation and outlook differs between sectors. Some sectors have been particularly negatively impacted, but lifeline utilities such as energy have not been impacted in the same way;
- reflect that electricity demand is expected to continue to grow, even in a recession, due to the increasing electrification of transport and industrial processes which are core parts of New Zealand's environmental sustainability objectives. This could result in cost increases as resources become scarce as de-carbonisation related work programmes increase; and
- ensure the cost inflation included in the BBAR is consistent with the final MAR price path.

The proposed solution provides the outcome expected when moving between Price Paths and will allow WELL to earn real financial capital maintenance. The proposed solution will help maintain investor confidence in the CPP process.

5. Insurance

WELL disagrees with the Draft Decision to exclude known insurance cost increases. The 37% increase in insurance premiums is an actual increase (not a projection as noted in the Draft Decision). The recent article in Energy News titled '*Power to the insurers*'⁸ provides a good overview of the reasons insurance costs are increasing in the energy sector.

Under the low cost DPP3 methodology there is flexibility to set appropriate expenditure allowances based on actual expenditure information pertaining to individual EDBs, including when transitioning from a CPP to a DPP. WELL has provided evidence verifying the increase in actual insurance costs so that the Commission can maintain the low cost approach to the DPP.

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. Without the funding, WELL will have to consider reducing its insurance coverage and transfer the risk to consumers who have a limited ability to manage those risks.

Due to the non-linear nature of insurance premiums⁹, reducing insurance coverage to a level that aligns with the allowances provided in the Draft Decision would mean WELL would need to reduce:

1. The number of core assets insured from the 89 core assets to only the 28 zone substations
2. The percentage coverage for each asset

⁸ <https://www.energynews.co.nz/news-story/insurance/58017/column-power-insurers>

⁹ Due to the first dollar of capacity (insurance value) being the most expensive, when reducing total insurable value (and therefore the capacity required) the premium rate and final total premium will fall at a lower rate.

WELL also has Business Interruption insurance which would also reduce to any change in coverage. Business Interruption allows WELL to recoup from insurers any revenue losses resulting from damage to its core assets.

The view that suppliers are best placed to manage the risks associated with catastrophic events has been strongly endorsed by the Commission to date. Including the additional insurance costs in WELL's allowances will allow the Commission to maintain its policy intent which was clarified in Orion's final CPP decision¹⁰, as follows:

B3 In our view, the financial impact of the earthquakes should be shared between Orion and its consumers. Imposing the entire financial impact of the earthquakes on consumers is not consistent with the Part 4 purpose because:

B3.1 it is unusual for consumers to bear all the costs and risks of catastrophic events in a workably competitive market. Workably competitive markets tend to manage risks efficiently, by allocating identified risks to the party best placed to manage them;

B3.2 regulated suppliers (and their investors) are generally better placed to manage the risks of catastrophic events than consumers;²⁴⁴ and

B3.3 from a forward-looking perspective, allocating all the costs and risks of catastrophic events to consumers would reduce the incentives for suppliers to manage these risks efficiently (ie, create a moral hazard).²⁴⁵

²⁴⁴ *Investors are able to limit their risks through diversification. Suppliers can manage risks associated with catastrophic events through a combination of measures, including insurance, self-insurance and investment in network strengthening/resilience. Consumers, on the other hand, have a relatively limited ability to manage the risks of damage to electricity distribution networks due to catastrophic events and are likely to be facing significant other costs from the catastrophic event.*

²⁴⁵ *A moral hazard is a situation where a party will have a tendency to take risks because the costs that could result will not be felt by the party taking the risk.*

And

B26 Orion's CPP proposal highlighted that suppliers are able to mitigate the risks of catastrophic events in multiple ways. For example, Orion insures all of its key substations at full estimated replacement cost.²⁶¹ Orion also spent \$6m on seismic protection prior to the Canterbury earthquakes.²⁶² Consumers, on the other hand, have a relatively limited ability to manage the risks of damage to electricity distribution networks due to catastrophic events.

Like Orion, WELL has mitigated the risk associated with catastrophic events, specifically earthquakes:

- WELL insures the 89 core assets which have been identified as critical to network operations (i.e. most other assets feed off these assets and rely on them to maintain supply). This includes 28 zone substations, 9 GXP points of supply and 52 distribution substations, load control sites or other specified sites. WELL's approach balances the cost and affordability of insurance, the appetite of the insurance market to provide the required level of coverage and the prudent mitigation of key risks associated with the network assets.

¹⁰ Commerce Commission, Final decision for setting the customised price quality path of Orion New Zealand Limited, 29 November 2013

- Under the DPP revenue cap the wash-up mechanism provides some protection against any revenue shortfall arising from network disruption following a catastrophic event. WELL's Business interruption insurance allows WELL to recoup revenue losses from insurers resulting from damage to its core assets. The recovered revenue is offset against the wash up mechanism to protect consumers from these circumstances.
- WELL is in the final stages of completing its \$31.4m earthquake readiness programme which provides WELL with an improved ability to respond quickly following a catastrophic event. The programme includes emergency communication system, seismic strengthening of key buildings and two mobile zone substations able to maintain an emergency supply level during repairs to critical assets.
- WELL continues to make non-CPP approved investments in improving the networks ability to withstand an earthquake. The most recent programme included strengthening the Newtown zone substation and a number of others in response to Council Initial Evaluation Procedures (IEPs) assessments and Government earthquake strengthening requirements.
- In conjunction with the Wellington Lifelines Utilities, WELL have developed a proposed work programme to further improve the resiliency of the Wellington network to major earthquakes. WELL is considering how this additional programme of resilience investment will be funded.

We note that the final 2010-2015 DPP Decision included additional allowances for insurance following the Canterbury earthquakes, consistent with its policy decision for suppliers to manage catastrophic risk on behalf of consumers, and in recognition of the changes to the insurance market following the earthquakes. The final decision states¹¹:

C2 To forecast each supplier's opex, we first modelled the impact of changes in the main factors that affect opex, and then made an additional adjustment to reflect increases in insurance costs that are attributable to natural disasters. This adjustment is appropriate as the increase in insurance costs is largely outside the control of all suppliers, is significant, and is not fully captured in our original forecast.

Adjustment for insurance costs

C40 We have included an adjustment for increased insurance costs resulting from the Canterbury earthquakes and other natural disasters. We consider that this adjustment is appropriate because the costs:

C40.1 are largely outside the control of suppliers;

C40.2 are significant;

C40.3 affect all suppliers in the industry; and

C40.4 are unlikely be captured in our original forecast of each supplier's opex.

The final 2010-2015 DPP Decision also recognised that insurance cost increases for some networks were higher than others, reflecting different levels of regional risk, as follows¹²:

C43 We have accepted all suppliers' forecasts of insurance expense. We requested and assessed further evidence from a small number of suppliers that forecast unusually large increases in insurance expenditure. Following on from this, we saw no justification for disallowing any of the proposed increases.

¹¹ Commerce Commission, Final determination, 2010-2015 DPP Reset, 30 November 2012

¹² Commerce Commission, Final determination, 2010-2015 DPP Reset, 30 November 2012

Wellington does have a higher risk of earthquakes than most other regions which is being reflected both in the higher cost of insurance premiums and some insurers electing to exclude Wellington from their coverage portfolio in favour of other New Zealand centres and regions. It would be reasonable to expect prices and therefore allowances in Wellington to mitigate the risk associated with catastrophic events to be higher than other networks areas.

The final decision also said that the Commission would not expect to need to apply similar adjustments in the future. WELL agrees that similar adjustments were not needed to reflect the insurance impact of the Christchurch earthquake. However, the Kaikoura earthquake in 2016 has resulted in further increases that weren't captured in the 2010 adjustment. A similar adjustment is required to adjust WELL's 2020 insurance premium. WELL also disagrees with allowances not being provided because they only apply to individual EDBs and are not applied across all EDBs. Wellington customers are exposed to unique risk and WELL should be able to mitigate those specific risks on behalf of its customers.

The Draft Decision includes a number of specific reasons to not include the additional earthquake costs. Figure 8 below responds to each of these reasons.

Figure 8: Summary of the reasons for the draft insurance decision

Reasons for the Draft Decision	WELL's response
Costs provided by Wellington Electricity in their submission are not sufficiently significant.	The actual increase in insurance premiums is 37% or \$470k. This is significant, representing 1.5% of WELL's operating allowances. This is equivalent to annual operating cost inflation or around a third of WELL's vegetation programme.
Insurance does not appear to be fundamentally more deserving to be singled out for special treatment than other controllable costs affecting individual EDBs.	As outlined above, Wellington does have a higher risk of earthquakes than most other regions which is reflected in the higher cost of insurance premiums and reduction in market participants willing to place cover for the region. Insurance was singled out in the DPP1 decision following the Canterbury earthquakes to reflect the policy intent for catastrophic risk. It is reasonable to allow WELL to mitigate Wellington specific risks on behalf of its consumers following the Kaikoura earthquakes.
Additional allowances were not approved for other EDBs as part of the DPP.	The Commission have more discretion when transitioning an EDB from a CPP. WELL has specific earthquake circumstances, heightened following the 2016 Kaikoura earthquakes, and directly reflected in WELL's insurance premiums.
Do not directly relate to matters addressed in the CPP and do not directly relate to improvements on WELL's network.	<p>The CPP programme and the increase in insurance premiums have the same purpose - to allow WELL to manage the risk of a catastrophic event. They are also both in response to the Kaikoura earthquake and share a common cause.</p> <p>As outlined above, to diversify the risks of a catastrophic event, EDB's provide multiple levels of protection to consumers. The CPP programme is one of the mitigations provide by WELL and insurance is another. The level of insurance relates directly to the reasons the CPP improvements were made – to mitigate the risks of a catastrophic earthquake. Without the funding to maintain insurance premiums, WELL's coverage may reduce further, directly offsetting the benefits the CPP programme provides.</p>

6. CPP costs not included in the base

WELL requested that the Commission include CPP earthquake readiness costs in the operating cost allowances not captured in the base year. The draft decision accepts that the 2021 earthquake readiness operating expenditure reflects an ongoing annual cost of maintaining WELL's new earthquake readiness capability. The Commission are seeking further assurance from WELL about the incremental adjustment.

WELL has provided signed contracts and invoices which provide for the on-going operating costs where they have been finalised. Some costs are in the last stages of procurement and draft contracts have been provided. The evidence supports the actual on-going costs not captured in the base year. The detailed review of operating costs shows that \$330k of the CPP annual operating costs have not been captured in the base year (RY20). If needed, WELL can also provide Chief Executive or Director Certification of the information provided.

Figure 9 provides the actual/forecast CPP on-going operating costs and compares this to the CPP allowances for the readiness spend that was approved for the CPP.

Figure 9: Actual CPP operating costs compared to CPP allowances

	2018/19	2019/20	2020/21	Total
Operating expenditure from the CPP determination ¹³	228	395	605	1,228
Incremental operating expenditure allowance	228	167	210	605
Actual/forecast operating expenditure	0	188	518	705
Incremental actual/forecast expenditure	0	188	330	518
Difference between allowance & actuals	228	207	87	522
Difference between incremental allowances & actuals	228	-21	-120	87

The CPP allowances provided for an additional \$167k of operating costs for RY20 and \$210k for RY21. However, due to rescheduling of some services (specifically the radio network) more of the incremental CPP readiness operating costs fall into the last year of the CPP, RY21. Therefore these on-going costs are not captured in the base year. As illustrated in Figure 9, WELL will outperform the CPP operating cost allowance by \$87k overall. Basing the adjustment on the original allowance profile will result in \$120k allowance shortfall of WELL's on-going committed costs.

7. Application of Capex gates

The DPP3 model has been updated with the latest capital expenditure forecast from WELL's 2020 Asset Management Plan (AMP). The capex gates from the Final DPP3 Decision have also been applied.

¹³ The operating costs are from the Commission's financial model for the Wellington Electricity Customised Price-Quality Path Final Determination 28 March 2018.

WELL believes an error has been made in applying the 'Gate 1 – Consumer Connections' to the latest connections forecast provide in WELL's AMP. The calculation is provided in the 'Calculations – gate' worksheet in the 'Capex-projections-model-WELL-DPP3-draft-determination-25-September-2020.xlsx' workbook. The 'Forecast compound annual connection growth (2020 - 2024)' calculation in cell 'E28' (and the alternative calculation in cell 'F28') include the 2020 year in the forecast (which is an actual year) and does not include the 2025 year (which is a forecast year in the 2020 AMP). Updating the formula in cells E28 and F28 so that they reflect the 2021 - 2025 forecast period, derives a lower 'Forecast compound annual connection growth' of 1.25%. This results in the Gate being passed, and is consistent with the approach adopted in the DPP3 Final Decision for other non-exempt EDBs.

This is supported by the "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision"¹⁴ paper which states:

We note that we have used the period forecast 2020-2024 because EDBs only forecast this information out five years, so we are unable to assess the DPP3 period itself. As this test is a check of the quality of the forecast itself, rather than the expenditure per se, we consider this reasonable.

The relevant period forecast for WELL would be the 2021 -2025 forecast from the 2020 AMP.

WELL has provided the 'Capex-projections-model-WELL-DPP3-draft-determination-25-September-2020.xlsx' workbook with the corrected formula.

8. Closing

WELL appreciates the opportunity to provide a 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

¹⁴ Commerce Commission, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision, 27 November 2019