



MAJOR ELECTRICITY USERS' GROUP

28 November 2017

Matt Lewer
Manager, Price-Quality Regulation
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Matt

Wellington electricity earthquake resilience

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission discussion paper, "Our proposed approach to assessing Wellington Electricity's proposal for additional expenditure to improve its resilience and response to a major earthquake", 14 November 2017 (the "WELL proposal").¹ MEUG appreciates assistance by staff of WELL and the Commission to meet with us and our advisors at short-notice to brief us, answer questions and provide additional information to assist in preparing this feedback.
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. This feedback is to assist the Commission:
 - a) Confirm or not the view in the discussion paper (paragraph 20) that exceptional circumstances exist to warrant a "streamlined" CPP; and
 - b) If the answer to a) above is that exceptional circumstances do exist then what factors need to be considered to design a streamlined CPP process?

Are the circumstances sufficiently exceptional?

4. The answer to the question "are the circumstances sufficiently exceptional to warrant a new stream-lined CPP process just for approving WELL's proposed earthquake readiness stage 1 expenditure to be recovered from its customers?", is perhaps yes.
5. We have not answered unequivocally yes and instead added the qualifier "perhaps" because, while intuitively it may feel obvious to spend \$32 million for stage 1, we think it would be imprudent to support development of a new process until a robust quantitative Cost-Benefit-Analysis (CBA) was available for potentially such a material sum.

¹ Document URL <http://www.comcom.govt.nz/dmsdocument/15910> at <http://www.comcom.govt.nz/regulated-industries/electricity/cpp/cpp-proposals-and-decisions/wellington-electricitys-2018-2021-potential-cpp/>.

6. There are challenges to testing resilience expenditure options such as those proposed by WELL using CBA techniques. We discuss those later in paragraphs 13 to 17. While challenging to prepare a CBA to test if a streamlined CPP process is worth developing, at the least such an analysis would provide an order of magnitude of the benefit relative to other options. Currently we have no analysis justifying even on a back-of-the-envelope basis an investment by the Commission and the industry including customers on developing a new process.
7. MEUG is concerned that the Commission may feel compelled to rush decisions on deciding whether to develop a streamlined process, then design a process and finally implement with determinations issued by 31 March 2018 in order that WELL can recover costs from regulated income from 1 April 2018. As noted above undertaking a CBA on whether to develop a streamlined CPP process will be challenging and that alone could make it unrealistic, even with the most efficient process and no unexpected speed bumps, to achieve a determination by 31 March 2018. MEUG believes there is no need to rush or circumvent a robust CBA being prepared when there is an option that WELL can choose to invest in stage 1 earthquake readiness expenditure now not canvassed in the discussion paper.
8. MEUG believes WELL has 3 options as listed below. The first two are mentioned in the discussion paper. The third is not mentioned but we believe is feasible:
 - a) WELL can choose to wait and include provision for stage 1 earthquake readiness expenditure in the next Default Price-Quality Path (DPP) reset that will come into effect on 1 April 2020;
 - b) WELL can lodge an application for a standard Customised Price-Quality Path (CPP); or
 - c) WELL can proceed at their own cost to deploy emergency assets ahead of either a) or b) above being implemented.

MEUG believes this is a feasible option because in workably competitive markets businesses do assess the cost of spending resources on emergency assets in the near-term, even at the expense of lowering short-term dividends to shareholders, to protect existing revenue streams over the near and longer-terms from being affected by unexpected events. We see no barrier to WELL considering the same in this instance.

The experience of Orion with the 2010-11 Canterbury earthquakes is also informative. Orion's shareholders lost lines income when damaged assets were unable to deliver line services. WELL will also be aware that if the same occurred now in Wellington it also would be out of pocket for lost line revenue. This is a business choice that WELL can take itself to self-insure income protection before any Commission approvals in the next DPP, a CPP or yet to be decided possible decision on a yet to be designed streamlined CPP process. WELL has had this choice to self-insure the risks to its near-term income stream, given the precedent set in the Orion CPP, since the Commission's Orion CPP decision in November 2013.

9. In comparing the proposal to develop a streamlined CPP process and the options above a material factor is likely to be the diminishing probability of a major post-Kaikoura earthquake affecting Wellington. We mention this factor again in paragraph 14 in the next section.

What factors need to be considered in designing a streamlined CPP process

10. The first and foremost factor to be considered in designing a new streamlined CPP process is the expected outcome must have a positive CBA and that must be higher than the expected outcome of any other alternative streamlined CPP process. This is a variation on the CBA discussed in the preceding section where that CBA must test whether a streamlined process is warranted in the first place. The CBA and the factors discussed below are relevant in choosing which streamlined CPP process is best.
11. As well as having the highest Net Present Value of all options in a CBA, the best streamlined CPP process would provide a win-win-win for:
 - a) WELL customers;
 - b) The owners of WELL; and
 - c) All other regulated Electricity Distribution Businesses (EDB) and Gas Pipeline Businesses (GPB) and their customers in terms of precedents set.
12. The following sections discuss:
 - Aspects of preparing a CBA for resilience investments to be considered;
 - The appropriate regulated Weighted Cost of Capital (WACC) that should apply for a return on capital for capital expenditure approved under a new streamlined CPP process to be recovered from WELL customers;
 - Specifying quality dimensions;
 - Is the increase in revenue due to changing from weighted average price cap (WAPC) to pure revenue cap a legitimate benefit to WELL or a windfall? and
 - Precedent risks and benefits.

CBA and resilience investments

13. Deciding the benefits and costs of alternative resilience investments for any sector or particular business entity of the economy including life-line utilities is challenging. Sometimes a second-best approach (or a different perspective to complement a CBA estimate) is to compare the relative benefits of alternative resilience investments by considering their cost efficiency and cost effectiveness.
14. In terms of effectiveness, the Government Policy Statement – Resilience of Electricity Services in the Wellington Region, issued 18 September 2017 (the “GPS”²) specifically refers to regulated electricity suppliers in Wellington responding to new information³ about hazards not considered at the time a price path was determined. For example –

² This submission has been prepared without the benefit of viewing the Cabinet paper or reports from officials considered by Ministers ahead of the decision to gazette the GPS. MBIE are considering a request by MEUG for those papers.

³ The vulnerability of Wellington roads to earthquake is not new. Although the term ‘7 islands’ is a new description of the loss of connectivity the concept and possible solutions have been discussed for some time as indicated in reports such as ‘13-03-23-Transport-Access-full-project-report-FINAL-corrected’ available at

<http://www.gw.govt.nz/assets/Emergencies--Hazards/Lifelines/13-03-23-Transport-Access-full-project-report-FINAL-corrected.pdf>

and ‘Lifeline Utilities Restoration Times for Metropolitan Wellington Following a Wellington Fault Earthquake, November 2012’ available at

<http://www.gw.govt.nz/assets/Emergencies--Hazards/Emergency-Planning/12-11-13-WeLG-report-to-CDEM-Joint-Committee-restoration-times-FINAL.pdf>

This second report also includes a brief discussion of actions being taken by WELL and Transpower to improve resilience (pages 29 to 30) and the effect of regulation on WELL investment in resilience (page 43).

“The probability of a large earthquake or tsunami in Wellington increased as a result of the Hurunui and Kaikoura earthquakes that is expected to reduce from that elevated level over time.”⁴

15. WELL need to explain how they have assessed the increase in threat and subsequent tailing-off of that threat and to what extent the increase then decrease in threat is addressed by the proposed resilience expenditure. This should be explained for the proposed stage 1 expenditure of \$32 million and any subsequent requests for additional expenditures in stages 2 and 3.
16. The efficiency and effectiveness of the proposed resilience expenditure will be affected by how well it is matched or co-ordinated with the resilience expenditure and disaster recovery planning of:
 - a) Other life-line infrastructure providers including particularly Transpower, tele-communications providers, water services etc
 - b) Major users of the infrastructure lifelines (to assess when WELL supply of electricity becomes a binding constraint on their capacity to operate).
17. Customers need a clearer explanation from WELL about how the proposed expenditure meets the tests set out in the GPS particularly with respect to responding to new information and ensuring the resilience expenditure is efficient.

Is WACC the same for the proposed streamlined CPP and a standard CPP?

18. The discussion paper canvases in detail the costs of the proposal WELL is likely to lodge to gain Commission approval to recover from customers. It appears the request and approval will be very specific unlike the wide price path envelope of a standard CPP. In effect, this is a carve-out of a particular project, indeed a highly specific list of assets, that would normally have been part of an overall suite of projects for the entire business lodged under a standard CPP. In a standard CPP there is no requirement to invest in assets or undertake operating expenditure as proposed (or at the timing proposed) once the CPP is granted. Hence the CPP is a revenue cap with quality standards giving the regulated monopoly an incentive to meet the quality standards as efficiently as possible with final decisions on actual investment and operating expenditure at the discretion of the monopoly.
19. In contrast, the stage 1 earthquake readiness expenditures are highly defined and they must be spent. They are specific project expenditures.
20. The paper does not consider whether the use of a streamlined CPP process might lead to a material change in the risk that accrues to the owners of WELL and hence the return on capital appropriate for these ring-fenced earthquake readiness assets being less than that for a standard CPP. For example, we suggest the Commission needs to consider if assets purchased for the stage 1 earthquake readiness phase are subject to the risk of stranding or need an uplift on WACC as an incentive to invest and innovate. We think there is a case whereby approved stage 1 earthquake readiness expenditures can be assumed as fixed in terms of both cost and timing. There they are not subject to stranding, do not have discretion by WELL to elect to choose a materially different set of assets and operating costs or when those might be spent. Hence expenditures for the proposed streamlined CPP process have a lower risk profile than that of a standard CPP determination and a lower WACC should apply.
21. Another consideration for the appropriate WACC is to ensure there is no fortuitous arbitrage by WELL using a WACC based on historic settings when actual current costs may be lower.

⁴ Refer GPS, paragraph 5.

Quality dimension of a CPP approved under a new streamlined process

22. The paper does not mention any quality dimensions linked to the incremental price path associated with an approved streamlined CPP. Incremental changes to the existing DPP SAIDI and SAIFI measures are not appropriate. Therefore, other measures of performance should be included otherwise there will be no accountability on WELL to deliver what it proposes to deliver for \$32 million in stage 1. Those measures of performance are likely to be project milestone type measures; reinforcing the view noted above that this is akin to a be-spoke project not a CPP price path arrangement.

Change to revenue cap leading to helpful or windfall increased revenues?

23. A quantitative CBA would assist untangle whether the \$1 million to \$2 million pa increase in receipts to WELL from changing to a revenue cap discussed in paragraph 51 of the discussion paper is a legitimate and beneficial outcome complimentary to earthquake readiness expenditure or a wind fall. If the latter then it should be netted out either voluntarily by WELL or an urgent change made to the Input Methodologies.

Precedent risks and benefits

24. There is a risk of precedents being set to incentivise other be-spoke streamlined CPP proposals to be sought. Hence it is important the above factors need to be considered otherwise, for example, a decision to allow streamlined CPP expenditure to have a return on capital including the 67th percentile uplift will be an invitation for WELL, other EDB and GPB to use that route again because it reduces risk but maintains high returns relative to a standard CPP. On the other hand, carefully assessing the appropriate WACC for one-off project approval requests will give EDB, GPB and the Commission another option in the regulatory tool-box to accommodate circumstances where a DPP hinders efficient investment and therefore harms the long-term benefit of consumers.
25. Finally, there is a risk of rushing a streamlined CPP process in place without adequate stress testing of possible unintended consequences and that will leave either or both customers and WELL worse off. That risk is also a factor in the broader CBA in paragraphs 4 to 9 above considering the question of whether a streamlined CPP process is warranted.

Yours sincerely



Ralph Matthes
Executive Director