Orion

23 October 2020

Dane Gunnell

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Commerce Commission

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

Dear Dane

Cross Submission on Wellington Electricity Lines (WELL) CPP to DPP draft decision (the Paper)

Introduction

1. Orion welcomes the opportunity to cross submit on the draft decision for Wellington Electricity's transition from a CPP to the DPP.

Summary

2. We agree with submitters that the Commission should retain internal consistency in its financial model as the current approach to forecasts will result in WELL not achieving a real FCM.
3. We agree with submitters that the known increase in WELL's insurance premiums should be reflected in their opex allowances.
4. The draft decision for WELL's transition from a CPP to a DPP, and the prevailing economic environment, has highlighted potential issues that should be addressed in the next IM Review.

Inconsistent forecasts in financial model- negative impact on real FCM

5. We agree with ENA that the Commission's use of inconsistent forecasts will result in WELL not achieving a real FCM during their four-year DPP period. As ENA submits *"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."*

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6. Unison puts it another way in their submission, "*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."*
7. In this instance the Commission is somewhat limited in its approach by the IMs. However, working within this constraint the Commission should continue to maintain internal consistency in the financial model and to meet the standard of expected real financial capital maintenance.
8. A further complication is the different impact that Covid has had on various sectors. Unlike tourism and hospitality, the electricity distribution sector, as local lifelines utilities, have not been impacted by the significant downturn in international travel. We continue to operate at normal levels, aside from a brief period during level 4 lockdown. There is an additional risk with applying updated LPI and PPI, in an uncertain environment, because they are not reflective of our sector's operational context.
9. As Aurora submits *"….the forecast indices are very likely to incorrectly supress Wellington Electricity's future labour costs, because LCI (as specified) will be skewed by the tourism, service and hospitality industries that have been heavily impacted by Covid-19."*
10. We agree with Aurora's submission that *"In our view, the Commission's draft decision to use reforecast escalators conflicts with its preference to ensure that Wellington Electricity is not on a "materially different DPP to the other DPPs"*

Allow increase in insurance costs

11. Orion agrees with submissions that the known increase in WELL's insurance premiums should be included in their opex expenditure allowance.
12. The Commission *"accept that the 2021 earthquake readiness opex expenditure reflects a continued annual cost of maintaining Wellington Electricity's new earthquake readiness capability for the remainder of the DPP3 regulatory period."*[1]

[1] Point 3.2.1 Wellington Electricity Lines Limited's transition to the 2020-2025 default price-quality path draft reasons paper Sept20

*13.*We agree with submitters that insurance costs are part of ongoing earthquake readiness costs (resilience preparedness). Resilience preparedness is the very reason for the initial CPP that WELL wish to transition from. As WELL submits *"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 Commission agreed with this in Orion's CPP decision when they stated that *"B23.2 suppliers can manage risks associated with catastrophic events through a combination of measures, such as insurance, self-insurance, and investment in network strengthening/resilience."*

14.The main reason the Commission states for not including the increase in WELL's insurance premiums is that the step change is not significant. As WELL submits *"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.*" We consider the step change in WELL's insurance premium to be significant.

15.We agree with Unison that *"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."*

16.When considering FENZ levies as a recoverable cost in the DPP3 decision the Commission said that *"there is no incentive benefit to exposing distributors to any difference between forecast and actual FENZ levies."*[2] FENZ levies are also a type of insurance and, in accordance with the opex step change test, the amount that WELL's premium will increase is robustly verifiable, not already captured in the base year and is largely outside of the control of WELL. Further, most EDBs are likely to experience these significant increases over time.

17.The transition from a CPP to a DPP provides an appropriate opportunity to reflect WELL's known insurance premium increases in allowances.

Considerations for the IM Review

18.The draft decision for WELL's transition from a CPP to a DPP, and the prevailing economic environment, has highlighted potential issues that should be addressed in the next IM Review.

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[2] Point 5.47 Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision Reasons paper Nov19

19.We agree with two points made by submitters that we suggest should be considered as part of the next IM Review.

(a) Aurora submits that *"Moving forward, we consider that the Commission should employ a refined approach when forecasting escalators. This would involve selecting only relevant cost categories within LCI, PPI and CGPI, and applying an appropriate weighting to those relevant cost categories. Such an approach would produce a more defendable result and would not be so onerous as to compromise the relatively low-cost nature of DPP regulation required by S53K of the Act."* and

(b) Unison submits that *"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."*

Concluding remarks

Thank you for the opportunity to provide this cross submission. We do not consider that any part of this submission is confidential. If you have any questions please contact Dayle Parris (Regulatory Manager), DDI 03 363 9874, email dayle.parris@oriongroup.co.nz.

Yours sincerely

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