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POWERCO – SUBMISSION ON WELLINGTON ELECTRICITY'S CPP TO DPP DRAFT DECISION

Powerco welcomes the opportunity to comment on the Commerce Commission's draft decision on Wellington Electricity's transition from its CPP to the 2020-2025 DPP.

We are interested in the Commission's approach to Wellington's transition off a CPP because if we don't apply for another CPP we will transition to the 2020-2025 DPP from 1 April 2023. We:

- Support the choice of a building blocks approach to re-set Wellington's revenue
- Encourage the Commission to choose historical reference periods that best reflect Wellington's circumstances
- Recommend the Commission consider the appropriateness and internal consistency of forecasts made for future periods given the impact and uncertainty of Covid19
- Encourage the Commission to align the transition process and decision requirements to each EDB's circumstances

Attachment 1 provides Powerco's detailed feedback. If you have any questions on this submission, please contact Nathan Hill (Nathan.Hill@powerco.co.nz).

Yours sincerely

Andrew Kerr
Head of Policy, Regulation, and Markets

Attachment 1: Discussion on specific issues

Building blocks approach appropriate

The Commerce Act provides the Commission with flexibility in its approach to setting prices for a CPP/DPP transition. The approach taken is dependent on the particular circumstances facing a distributor and its consumers. In exercising this judgement, the Commission must do so in a manner that best meets the purpose of Part 4 of the Commerce Act (as set out in s 52A) and the purpose of DPP/CPP regulation (as set out in s 53K).

The Commission's draft decision is to set a FY22 starting price using a building blocks (BBAR) approach. An alternative approach is to leave the starting price unchanged – implicitly set at the last year of Wellington's CPP. As with other transition settings, the merits of each approach need to be assessed. We think the BBAR approach is appropriate in this instance and meets the Commerce Act requirements because:

- BBAR takes account of a distributor's current and projected costs which limits a distributor's ability to extract excessive profits
- BBAR is a low-cost approach. The DPP3 BBAR mechanism and supporting models already exist, so it is low cost to update with more recent information
- BBAR is based on current and projected profitability. This helps match expenditure allowances with expenditure requirements
- BBAR provides appropriate scrutiny of costs which promotes the maintenance of incentives to innovate and invest

Use flexibility (discretion) to make customer/EDB-centric decisions

We support the Commission's use of discretion to consider the particular circumstances facing a distributor and its consumers when deciding on CPP/DPP transitions. In doing this, we think the key questions to answer are: what is sensible and what will best meet the statutory purpose?

Review cost inflation forecasts and sources

The draft decision uses August 2020 cost inflation forecasts sourced from NZIER to determine capex and opex allowances. These forecasts are made during a time of extraordinary and extreme economic impact and uncertainty due to Covid19. The forecasts should be scrutinised for how well they characterise the costs/inflators relevant to Wellington Electricity and to meet the statutory objective. For example, the cost inflators are dramatically different to those from a year ago and made during a period of considerable *known* uncertainty about the future.

We support the Commerce Commission engaging with NZIER about the composition of the forecasts and if there are any changes to their approach which affects their relevance to Wellington Electricity's costs. A fall-back option is to use the DPP forecasts.

Review insurance costs

The draft decision has excluded known insurance costs. Because distributors are in the best position to manage risks, including the risk of catastrophic events, the Commission should consider whether constraining Wellington's risk management options is the best interest of its consumers. The absence of alternative risk mitigation options that are cost-effective means the likely outcome of not funding these costs is that risk will transfer to consumers who have a limited ability to manage it. We think this outcome would be bad for consumers and would be inconsistent with the Part 4 purpose to promote the long-term benefit of consumers.

Use discretion to right-size historical reference periods for consumers' best interests

The Commission used a seven-year historical reference period for forecasting capex in the DPP3 final decision. For Wellington, the Commission has extended the historical reference period to eight years. This extension is consistent with the Commission's comments in its DPP3 final decision reasons paper that its preference is to use as long a historical reference period as possible to manage capex volatility.[1]

In setting capex allowances post-CPP, the Commission's choice needs to balance the benefits of reference period length against the potential for misalignment between costs and revenues. We agree that using longer reference periods can help manage volatility. But perpetually increasing the length of the historical reference period isn't feasible because there will be a point where historical expenditure is no longer meaningful in determining future expenditure allowances. So, judgement is required about an appropriate period – and it's not arbitrary.

The outcome we are seeking is that the Commission uses its discretion to select a shorter historical reference period when there are good reasons to do so. This would require the Commission to consider the particular circumstances of a distributor, and to determine whether increases in expenditure during a CPP are a short-term spike or a more enduring step change. Our expectation is that this would require little additional effort by the Commission as this is already contemplated when making decisions on CPP/DPP transitions.[2] Proportionate scrutiny of these costs will ensure the best outcomes for consumers.

In concept, the benefits of using taking a more tailored approach to setting expenditure allowances applies equally to all price-quality path resets, not just CPP/DPP transitions. However, we recognise that the scope for tailoring is limited under a DPP due to its default and low-cost nature. This limit on tailoring a DPP was one of the reasons Powerco proposed the idea of moving large distributors on to an individual price-quality path (IPP) regime in our submission on the Electricity Price Review.[3] Applying a higher degree of scrutiny to large distributors would improve the transparency and efficiency of expenditure forecasts for distributors that serve the most consumers.

Timing of process and decision needs to consider EDB circumstances

The timing of the process and decision appears to be appropriate in this instance. This is because a second CPP from Wellington was unnecessary – its CPP was needed for a short-term spike in

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[1] DPP3 – final decision reasons paper, paragraph B91

[2] Paragraph 2.10 of the Wellington CPP/DPP transition draft decision reasons paper states that the Commission considers whether a CPP was for a temporary spike in expenditure. Paragraph 3.27 of the Orion CPP/DPP final reasons paper states that the approach taken to a CPP/DPP transition should be dependent on the particular circumstances facing an EDB and its consumers.

[3] Powerco submission on the Electricity Price Review First Report, 23 October 2018

expenditure to undertake earthquake resilience work required by a government policy statement (and probably some on-going impacts on operating expenditure).

If a distributor's circumstances suggest a second CPP is an option, the Commission's process and decision should occur earlier so they can make an informed choice and an efficient (lower cost) process to assess the options. Options include

- Industry-wide guidelines for how the Commission would assess the process, including analysis of costs and drivers to inform how the Commission uses its discretion to reflect their impacts on allowable post-CPP expenditure.
- Including guidance about transition in an EDB's CPP determination.
- Issuing a draft decision more than one-year in advance of a possible successive CPP application proposal due date[4]

These options aren't mutually exclusive.

We support the Commission's observations and awareness of the interface between the DPP/CPP models and the IRIS mechanism. It's essential that these tools are able to operate seamlessly. For example, there is a need for clarity about how the capex IRIS model handles DPP/CPP transitions.

[4] For example, for Powerco this draft determination date would be early 2021 to allow consultation to support and submission on 10 July 2022, then a second CPP commencing 1 April 2023.