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Default price-quality paths for gas pipeline services from 1 October 2017

Implementing matters arising from proposed input methodologies changes

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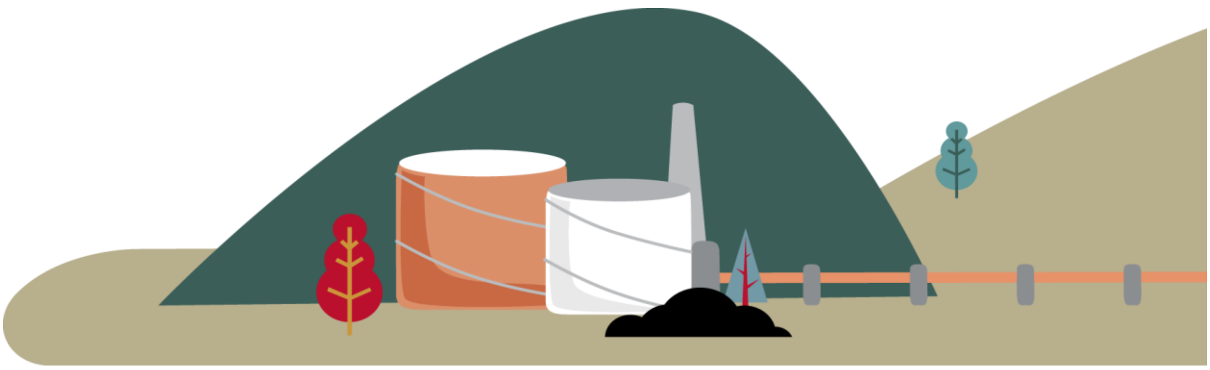

Associated Documents

Publication date	Reference	Title
28 February 2013	ISBN 978-1-869452-20-9	Setting Default Price-Quality paths for Suppliers of Gas Pipeline Services
28 February 2013	ISBN 978-1-869453-11-4	Gas Distribution Services Default Price-Quality Path Determination 2013
26 March 2014	ISBN 978-1-869453-60-2	Gas Transmission Services Default Price-Quality Path Determination 2013 (consolidating all amendments as of 26 March 2014)
16 June 2015	ISBN 978-1-869454-55-5	Input Methodology review: Invitation to contribute to problem definition
22 December 2015	-	Input methodologies review: Gas pipeline default price-quality path reset 2017: Gas stakeholder meeting - 8 December 2015: Summary of views
29 February 2016	ISBN 978-1-869454-96-8	Default price-quality paths for gas pipeline services from 1 October 2017: Process and issues paper
16 June 2016	ISBN 978-1-869455-08-8	Input methodologies review draft decisions: Summary paper
16 June 2016	ISBN 978-1-869455-09-5	Input methodologies review draft decisions: Introduction and process paper
16 June 2016	ISBN 978-1-869455-10-1	Input methodologies review draft decisions: Framework for the review
16 June 2016	ISBN 978-1-869455-11-8	Input methodologies review draft decisions: Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower

Publication date	Reference	Title
16 June 2016	ISBN 978-1-869455-18-7	Input methodologies review draft decisions: Topic paper 2 – CPP requirements
16 June 2016	ISBN 978-1-869455-12-5	Input methodologies review draft decisions: Topic paper 3 – The future impact of emerging technologies in the energy sector
16 June 2016	ISBN 978-1-869455-13-2	Input methodologies review draft decisions: Topic paper 4 – Cost of capital issues
16 June 2016	ISBN 978-1-869455-17-0	Input methodologies review draft decisions: Topic paper 7 – Related party transactions
22 June 2016	ISBN 978-1-869455-16-3	Input methodologies review draft decisions: Report on the IM review
22 June 2016	1178-2560	Draft amendments to *Gas Distribution Services Input Methodologies Determination 2012* [2012] NZCC 27
22 June 2016	1178-2560	Draft amendments to *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28

Regulation Branch, Commerce Commission

Wellington, New Zealand

Contents

Executive Summary

Purpose of this paper

X1 This paper sets out our preliminary views on how our input methodologies (IM) review draft decisions would, if confirmed, be implemented in the gas default price-quality path (Gas DPP) 2017 reset.

X2 Submissions are due by **5pm on 28 July 2016**. Cross submissions are due by **5pm on 11 August 2016**.

Legislative framework

X3 Under Part 4 of the Commerce Act 1986 (the Act) we are required to regulate the transportation of gas by pipeline where this qualifies as gas pipeline services under the Act.[1]

X4 The suppliers of gas pipeline services are all subject to price-quality regulation.[2] This means that we must set limits on each supplier's maximum price or revenue, as well as set minimum standards for service quality.

X5 When we determine how the price-quality regulation should apply to gas pipeline services, or the prices or quality standards for those services, we are required to apply the IMs, which are the upfront rules, processes and requirements of Part 4.[3]

Interaction with the input methodologies review

X6 This paper refers to the IM review draft decisions and explains how we propose to implement them in the Gas DPP 2017 reset. This paper should be read in conjunction with the IM review draft decisions and Report on the IM Review in order to get a full understanding of how the proposed IM draft decisions would, if confirmed, impact on the Gas DPP 2017 reset.

Implementing a new revenue cap for gas transmission businesses

X7 Our IM review draft decisions propose changing the form of control for gas transmission businesses (GTBs) from a 'lagged' revenue cap to a 'pure' revenue cap.

X8 To implement a pure revenue cap for GTBs we propose:

X8.1 a set of new provisions to give effect to a 'pure' revenue cap; and

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1 The meaning of gas pipeline services is set out in s 55A of the Commerce Act 1986. Specific pipelines are exempt under the definition. The list of exempt pipelines is contained in Schedule 6 of the Act.

2 Commerce Act 1986, s 55D.

3 Commerce Act 1986, s 52.

X8.2 a revenue wash-up process that occurs two years after the year in which forecasts apply.

X9 Stakeholders interested in our IM review draft decision to implement a pure revenue cap for electricity distribution businesses (EDBs) may also be interested in how we intend to implement a pure revenue cap for GTBs.

Pass-through and recoverable costs

X10 Our IM review draft decisions propose changes to:

X10.1 how the gas distribution businesses (GDBs) price-quality path treats pass-through and recoverable costs;

X10.2 allow GTBs to include compressor fuel costs as recoverable costs;

X10.3 introduce a capex wash-up recoverable cost for both GDBs and GTBs;

X10.4 introduce a revenue wash-up drawdown recoverable cost for GTBs; and

X10.5 change the scope of pass-through costs that can be specified at the start of a DPP period.

Draft financial model

X11 A description of the draft financial model, the impact of draft IM changes on the model, and an outline of other changes made since the 2013 Gas DPP model are included in Chapter 4 of this paper.

CHAPTER 1: Introduction

Purpose

1. This paper:

   1.1 sets out our preliminary views on how our draft decisions on the input methodologies (IMs) review would, if confirmed, be implemented in the gas default price-quality path (Gas DPP) 2017 reset;[4] and

   1.2 seeks feedback on our proposed implementation of these draft changes.

Interaction between the input methodologies and price-quality regulation

2. Part 4 regulatory control involves a two-step process which requires us:

   2.1 firstly, to determine, pursuant to section 52T of the Commerce Act 1986 (the Act), IMs that will be of general application in regard to particular regulated services; and

   2.2 secondly, to use those IMs to determine, pursuant to section 52P of the Act the actual regulatory controls to which each regulated supplier will be subject, including the price-quality paths for such suppliers.

3. IMs are the upfront rules, processes and requirements of Part 4 regulation.[5] Section 52C defines 'input methodology' as:

   > A description of any methodology, process, rule or matter that includes any of the matters listed in section 52T and that is published by the Commission under section 52W; and in relation to particular goods and services, means any input methodology, or all input methodologies, that relate to the supply, or to suppliers, of those goods or services.

4. The suppliers of gas pipelines services are subject to price-quality regulation (noting that some specific pipelines are exempt).[6] This means that we must set limits on each supplier's maximum price or revenue, as well as set minimum standards for service quality.

5. Section 52S of the Act provides that the IMs must be applied when we determine how the price-quality regulation should apply, or the prices or quality standards that should apply to regulated goods or services:

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4 Note: this paper sets out our preliminary views on how we propose implementing the IM review draft decisions, if confirmed, in resetting the Gas DPP. This paper is not a draft decision. We intend to publish our draft decision on the Gas DPP reset in February 2017.

5 Commerce Act 1986, ss 52R and 52C.

6 Commerce Act 1986, s 55D.

Every relevant input methodology relating to the supply of particular goods or services that is published under section 52W must be applied, … (b) in all cases, by every person entitled or required under this Act to recommend, decide, or determine – (i) whether or how regulation under this Part should apply to the goods or services; or (ii) the prices or quality standards applying to the goods or services.

6. Therefore, when we make the Gas DPP 2017 reset determinations we must also apply the relevant IMs. In order to apply the relevant IMs as they stand at the time of the reset, we must also make those amendments that are necessary to give effect to any changes to any relevant IMs since the current Gas DPP determinations were made. However, we recognise that as the IMs do not include all details necessary for their implementation, we will also have to apply our regulatory judgement.

7. This paper should be read in conjunction with the relevant IM review draft decisions topic papers, the draft amended IM determinations for gas distribution businesses (GDB) and gas transmission businesses (GTB), and the Report on the IM Review.[7] This paper is intended to support and extend your understanding of how the IM review draft decisions may affect the resetting of the Gas DPP.

Structure

8. Table 1.1 outlines the structure of each chapter.

Table 1.1

Chapter	Content
Chapter 1: Introduction	Context, scope and process
Chapter 2: Implementing a new revenue cap for GTBs	A new form of revenue cap for GTBs Objectives of the compliance assessment and wash-up processes Wash-up process Compliance process
Chapter 3: Pass-through and recoverable costs	Treatment of pass-through and recoverable costs for GDBs Treatment of compressor fuel costs as recoverable costs for GTBs Introduction of a capex wash-up for GDBs and GTBs Allowing for a new criteria-based pass-through cost
Chapter 4: Draft financial model	Description of the model Impact of IM changes on the financial model Other changes made since the 2013 Gas DPP model

7 Commerce Commission "Input Methodologies review draft decision: Report on the IM Review" (22 June 2016); Draft amendments to *Gas Distribution Services Input Methodologies determination 2012* [2012] NZCC 27; Draft amendments to *Gas Transmission Services Input Methodologies determination 2012* [2012] NZCC 28.

Context, scope and process

9. The Gas DPP 2017 reset is being consulted on in parallel with the IM review. We have identified interdependencies between these processes to make it clear to stakeholders where there are connections between decisions being made in each process.

10. At both the draft and final stages, decisions on the IM review will be made before decisions on the Gas DPP 2017 reset. As we need to apply the IMs to certain aspects of the DPP reset process, any changes to those IMs that might result from the IM review need to be made before the DPP reset can be finalised.

11. The IM review is intended to be completed by December 2016, and will be followed by draft decisions on the DPP reset in February 2017. The draft DPP decisions will be prepared in line with the updated IMs. See Table 1.2 for further information on expected timeframes.

Table 1.2

Publication/event	Intended timing
IM review draft decisions	16 June 2016
Report on the IM Review	22 June 2016
Draft amended GDB and GTB IM determinations	22 June 2016
Implementing matters arising from proposed input methodologies changes (this paper)	28 June 2016
Submissions due on this paper and IM review draft decisions papers	28 July 2016
Cross submissions due on this paper and IM review draft decisions papers	11 August 2016
Submissions due on the IM review draft amended IM determinations	11 August 2016
Policy paper for the Gas DPP 2017 reset (non-IM issues)	September 2016
Final decisions on the IM review	December 2016
Draft DPP decisions	February 2017
Technical consultation on the DPP determinations (if needed)	March/April 2017
Final DPP decisions	31 May 2017

12. Despite the interrelationship between the DPP reset and IM review, there are still necessary boundaries between the two processes. This is because they will result in separate determinations at different dates, and with different appeal rights attached to them.

13. This paper takes into account submissions received as a result of the gas pipeline stakeholder workshop held on 8 December 2015, the process and issues paper published on 29 February 2016, and relevant submissions from the IM review process to date.

14. Topics such as opex and capex forecasts, constant price revenue growth (CPRG), productivity, and the X-factor, which do not involve the application of IMs, are

outside the scope of this paper and will be discussed in the policy paper planned for release in September 2016.

15. As indicated in our 29 February 2016 Gas DPP Process and Issues Paper, we consider that any submission or material provided in relation to the Gas DPP 2017 reset that is relevant to the IM review, and received before the final IM review determinations are made, will also form part of the IM review record.

How you can provide feedback on this paper

16. We welcome your views on our proposed implementation of matters arising from proposed IM changes by the following dates:

    16.1 submissions are due by **5pm on Thursday 28 July 2016**; and

    16.2 cross submissions are due by **5pm on Thursday 11 August 2016**.

Address for responses

17. Responses should be addressed to:

    Tricia Jennings (Project Manager, Gas DPP 2017 reset)
    c/o regulation.branch@comcom.govt.nz

18. Please include '**Gas DPP 2017 reset**' in the subject line of your email. We prefer submissions in both a format suitable for word processing (such as Microsoft Word doc), and a 'locked' format (such as PDF) for publication on our website.

Requests for confidentiality

19. We encourage full disclosure of submissions so that all information can be tested in an open and transparent manner. However, we offer the following guidance where you wish to provide information in confidence.

    19.1 If you include confidential material in a submission, both confidential and public versions of the submission should be provided.

    19.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

CHAPTER 2: Implementing a new revenue cap for gas transmission businesses

Purpose of this chapter

20. This chapter explains how we propose to implement our IM review draft decision, if confirmed, on the form of control in the DPP reset, to change from a 'lagged' revenue cap to a 'pure' revenue cap for GTBs.[8]

21. To implement this pure revenue cap for GTBs we propose:

    21.1 a set of new provisions to give effect to a 'pure' revenue cap. These provisions would depend on forecasts of quantities and the consumer price index (CPI); and

    21.2 a revenue wash-up process that occurs two years after the year in which the forecasts apply, to wash up for any forecasting differences.[9]

22. The new provisions would result in a new price-setting process for the price-quality path for GTBs. The wash-up for forecast differences would result in a new recoverable cost for GTBs.

A new form of revenue cap for GTBs

23. Our IM review draft decisions propose that certain key parameters for the setting of the revenue cap, the application of compliance to the revenue cap, and the revenue wash-up be set in the GTB DPP 2017 determination.

24. As is set out in the Report on the IM Review,[10] the key features of the proposed amended IM for the specification of price for a GTB would be as follows.

    24.1 The cap on annual maximum revenues that may be recovered by a supplier would be specified in the GTB DPP determination.

    24.2 The revenue cap would require that the forecast revenues planned to be used by the GTB in its pricing be no more than a forecast allowable revenue amount specified by us. This would mean the point of compliance with the revenue cap would be after the GTB sets its prices but before those prices take effect.

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8 Commerce Commission "Input methodologies review draft decisions: Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016).

9 'Forecasting differences' refers to the difference between the forecast quantities and CPI values and the actual values of these parameters when the actual information becomes available.

10 Commerce Commission "Input methodologies review draft decisions: Report on the IM review" (22 June 2016), para 262.

24.3 A revenue wash-up mechanism would apply for each year of the regulatory period to take account of the actual and forecast revenue values after the end of the year. Suppliers would maintain a wash-up account and drawdowns of this account would result in a recoverable cost that would be applied in a future year. The wash-up process is intended to apply the *ex ante* Financial Capital Maintenance (FCM) principle.[11]

25. The IM review draft decisions would result in the following changes from the current regime:

25.1 removal of any reference in our compliance process to lagged quantities;

25.2 allowing for proceeds from any capacity auctions to be taken into account in the wash-up process; and

25.3 allowing for actual values of 'other regulatory income' to be taken into account in the wash-up process. Other regulatory income has previously been accounted for when setting starting prices. We propose that other regulatory income would not be taken into account in setting starting prices at the reset, so a forecast of such amounts would not be required.

Objectives of the compliance assessment and wash-up processes

26. Key objectives of the compliance process, and the method of achieving these objectives, are to:[12]

26.1 provide that the forecast revenue in each year be no more than the forecast allowable revenue;

26.2 limit price shocks to consumers by providing a cap on the increase in weighted average prices from one year to the next;

26.3 provide for an *ex ante* compliance test, so that suppliers will have sufficient information when setting prices to know that those prices will be compliant. This means the compliance test must be based on forecast quantities. A wash-up of actual revenues received will be subsequently provided for and will generally correct for outcomes differing from forecasts;

26.4 provide for a wash-up account, into which unders and overs of revenue may be accumulated, with the balance (be it positive or negative) being fully drawn down each year, subject to a possible cap and collar mechanism. The drawdown would convert some or all of the balance into a recoverable cost;

11 The FCM principle is explained in the framework paper for our draft decisions. See Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016).

12 Commerce Commission "Input methodologies review draft decisions: Report on the IM review" (22 June 2016).

26.5 provide for timely pass through of pass-through and recoverable costs. This is achieved through allowing forecasts of pass-through and recoverable costs to be built into prices, with the forecast differences being washed up through the wash-up process;

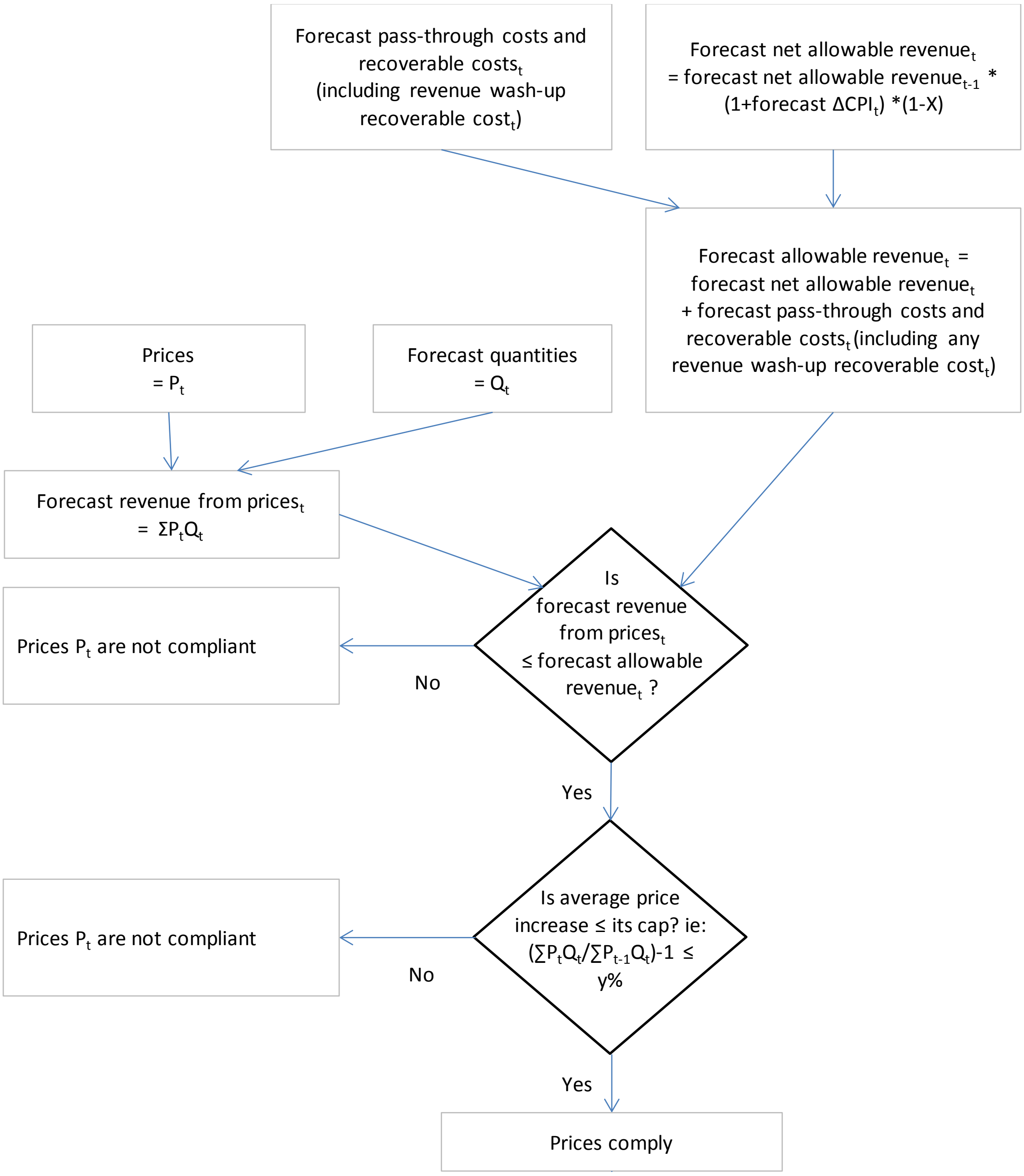
26.6 provide for risk sharing between suppliers and consumers in the event of a significant under-recovery, such as might result from a catastrophic event. This would be achieved through a cap on the amount of any under-recovery from a single year being accumulated into the wash-up account; and

26.7 limit price volatility arising from drawdown of the wash-up account. A cap on drawing down a positive balance would limit price increases while a collar on drawing down negative balances would limit price decreases.

Pricing compliance

27. Figure 2.1 below shows the compliance process that relates to the setting of prices after the wash-up drawdown has been calculated. It should be read in conjunction with Figure 2.2.

Figure 2.1 Assessing compliance for Year t



Forecast revenue from prices must be no more than forecast allowable revenue

28. The first compliance test in Figure 2.1 assesses forecast revenue from prices (forecast revenue) against forecast allowable revenue.

28.1 Forecast revenue is prices multiplied by forecast quantities for the year ahead. Suppliers will need to make a year-ahead quantity forecast as part of their price-setting processes. These forecasts must be demonstrably reasonable. We will further develop criteria for how suppliers would be required to demonstrate that their forecasts are reasonable. We invite stakeholder views on such criteria.

28.2 Forecast allowable revenue is the sum of:

- forecast pass-through and recoverable costs, which will be made by the supplier on a year-ahead basis and must be demonstrably reasonable; and
- forecast net allowable revenue (defined below).

29. The forecast pass-through and recoverable costs referred to in the previous paragraph include any recoverable cost that is a 'revenue wash-up recoverable cost'. This recoverable cost is discussed below, starting at paragraph 54.

30. Forecast net allowable revenue is a forecast of the allowable revenue net of recovery of pass-through and recoverable costs. An explanation of how it will be calculated is below.

30.1 In the first year of a regulatory period, the net allowable revenue would be set out in the GTB DPP determination. This will be the maximum allowable revenue (MAR) for the first year of the regulatory period, as calculated in the financial model for the DPP reset.

30.2 In each subsequent Year 't' of a regulatory period, the previous year's forecast net allowable revenue multiplied by $(1+{}_f\Delta CPI_t)(1-X)$ where ${}_f\Delta CPI_t$ is a forecast of the change in CPI to Year t and X is the X-factor as specified by us in the GTB DPP determination.[13]

31. The forecast revenue referred to in paragraph 28 above excludes revenues from capacity auctions and 'other regulatory income'. Actual revenues from these sources will be accounted for through the wash-up process.

32. This approach to 'other regulatory income' means that a forecast of this income will not be required when setting the MAR.[14]

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[13] The forecast net allowable revenue in the second year of a regulatory period will be based on the previous year's net allowable revenue as specified in the DPP determination, rather than a forecast value.

[14] The compliance process for the current regime compares notional revenue from prices with an allowable notional revenue that has had a forecast of other regulatory income netted off the amount otherwise allowable.

Cap on the forecast average price increase

33. Our IM review draft decision on the revenue cap for GTBs would allow for us to apply a cap on the forecast average price increase in each year's price-setting process. The draft GTB IM determination provides for us to apply such a cap through the GTB DPP determination.[15]

34. The second compliance test in Figure 2.1 applies a cap on the forecast average price increase in each year's compliance assessment process. This forecast average price increase must be no more than the cap (y%).

35. Previous EDB DPP reset decisions have considered both 5% and 10% as the maximum average price increase before consideration is given to mitigating price shocks.[16]

36. We invite submissions on whether such a cap should apply, and, if so, what percentage value should apply. We are also interested in your views on any GTB-specific factors that might need to be considered.

37. The wash-up mechanism means that any reductions in revenue arising from this cap will be returned to suppliers (subject to the cap on the wash-up amount). The amount returned will include an adjustment for the time value of money in future years, including if the amount returned is in the next regulatory period.

Wash-up process

38. The wash-up process is intended to apply the *ex ante* FCM principle,[17] with the exception of the cap on the wash-up amount (x%) that may be added to the wash-up balance in the wash-up account.[18] This will be achieved through a revenue unders and overs account (the wash-up account) to ensure under-recoveries and over-recoveries of revenue are returned to suppliers or consumers respectively.

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15 Draft amendments to *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28, cl 3.1.1(3).

16 The resetting of the default price path for EDBs in 2012 set a threshold on real price increases of 10%. The rationale for this is discussed in Chapter 6 and Attachment J of the Reasons paper for the 2010-15 price reset, published November 2012. See Commerce Commission "Resetting the 2010-15 Default Price-Quality Paths for 16 Electricity Distributors" (30 November 2012).
The resetting of the default price path for EDBs in 2014 set a threshold on real price increases of 5% before adjustments to the X-factor were made to smooth price increases over the regulatory period. The X values from this process allowed annual real price increases of up to 11%. This is discussed in Chapter 4 and Attachment C of the Main Policy Paper for the 2015-20 EDB reset. See: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020" (28 November 2014).

17 As noted earlier, the FCM principle is explained in the framework paper for our IM review draft decisions. See Commerce Commission "Input methodologies review draft decisions: Framework for the IM review" (16 June 2016).

18 This cap is discussed in paragraph 48.

39. A wash-up of any under- or over-recovery of revenues cannot proceed until sufficient information is available. This will be two years after the year in which the under- or over- recovery arose. The wash-up balance would be rolled over from year to year in the wash-up account until the amount is drawn down from the account and applied to prices in accordance with rules that would be set out in the GTB DPP determination.

40. A new type of recoverable cost would arise from our draft decision to apply this revenue wash-up mechanism to GTBs.

41. Figure 2.2 shows the wash-up process, which should be read in conjunction with Figure 2.1.

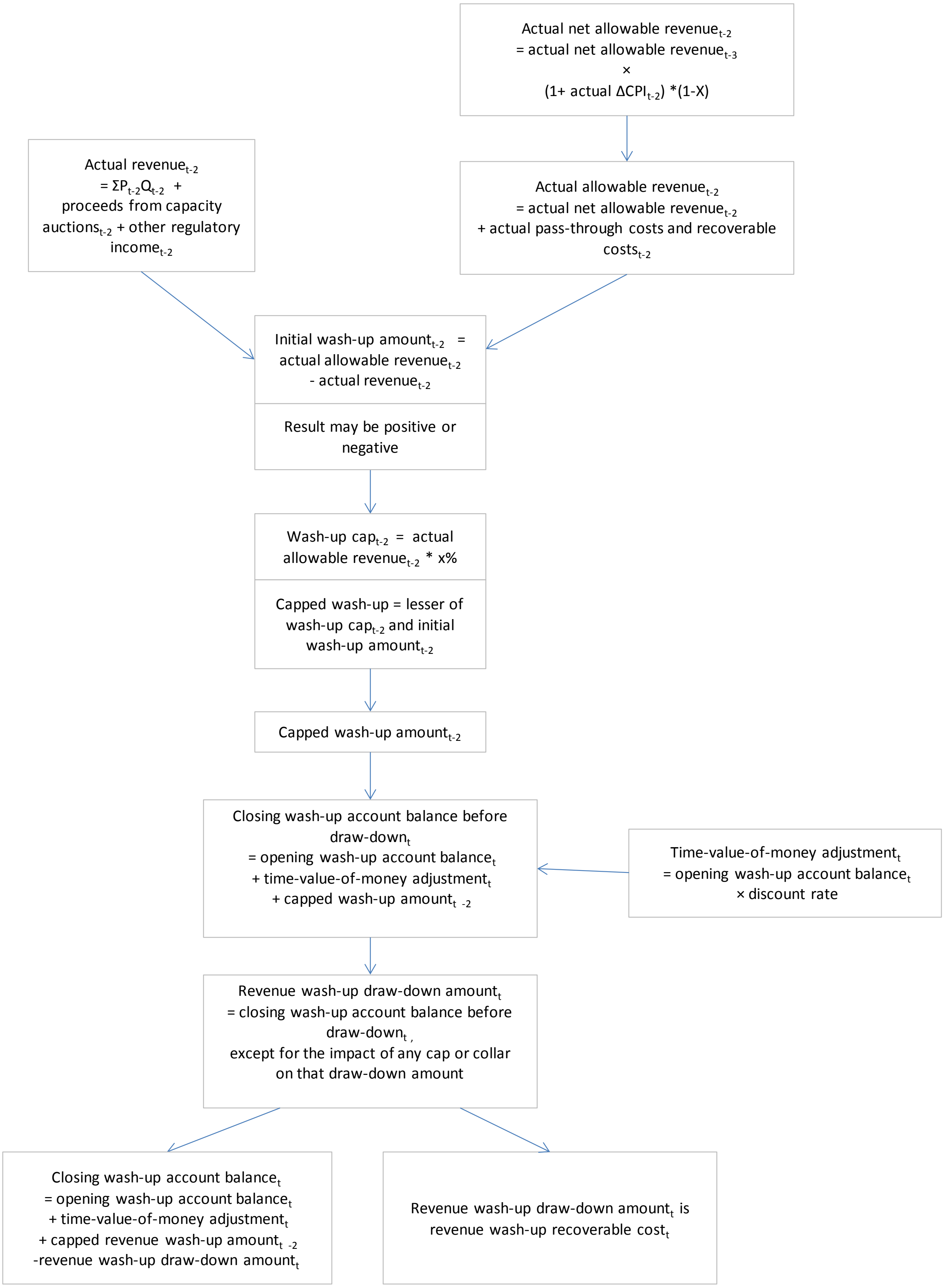
42. This wash-up process would not commence until setting prices for the 3rd year of the regulatory period commencing 1 October 2017. This will be for the year ending 30 September 2020, ie, when t = 2020. When setting prices for the years ending 30 September 2018 and 30 September 2019, the revenue wash-up recoverable cost will be nil.

43. The flow charts in Figure 2.1 and Figure 2.2 contain variables with subscripts 't' and 't-2'. In both charts, 't' is the year for which prices are to be set.[19] In practice, the overall price-setting process (except for the setting of prices for the years ending 2018 and 2019) will first involve the wash up calculations relating to the year two years prior, which will provide the revenue wash-up recoverable cost.

44. This recoverable cost will, soon after it is calculated, be available for use in setting the prices for Year t.

[19] In Figure 2.2 and generally in this paper, the subscript 't' refers to the year in which the relevant period ends, not the year in which it begins.

Figure 2.2: Determining the revenue wash-up recoverable cost to be taken into account in Year t pricing, based on actual revenues for Year t-2



The "closing wash-up account balance before draw-down$_t$ arising from the Year t-2 pricing will be able to be *calculated by each supplier shortly before setting prices for Year t. The recoverable cost will therefore be able to be taken into account in the Year t price setting process.*

Calculating the revenue unders and overs

45. The 'initial wash-up amount' referred to in Figure 2.2 would be the actual allowable revenue less the actual revenue. These amounts (actual revenue and actual allowable revenue) are discussed below.

46. The actual revenue will be the revenue from prices ($\sum P_t Q_t$) plus any proceeds from capacity auctions and any 'other regulatory income'.

47. The 'actual allowable revenue' has two components, being the actual net allowable revenue and the actual pass-through and recoverable costs. These components are explained below.

    47.1 The actual net allowable revenue in the first year of a regulatory period will be the forecast value previously discussed at paragraph 30.1.

    47.2 In subsequent years, the actual net allowable revenue will be calculated as the previous year's actual net allowable revenue multiplied by $(1+\Delta CPI_t)(1-X)$. This will be the same process as previously discussed in paragraph 30.2, except that actual CPI values will be used, rather than forecast CPI values.

    47.3 The actual pass-through and recoverable costs will be an update of the forecast pass-through and recoverable costs used in the price-setting process, and will reflect the actual costs.

A cap on the wash-up amount

48. A cap on the wash-up amount that may be recorded in the wash-up account may apply, and would reflect any underlying risk-sharing principle.[20]

49. Our IM review draft decisions propose to allow such a cap to be set by us in the GTB DPP determination as a cap on the wash-up amount that could be added to the wash-up account balance.[21]

50. If such a cap was determined by the Commission in the GTB DPP determination, it could be set as a percentage of the 'actual allowable revenue' (see Figure 2.2).

51. The risk-sharing nature of this cap means that any reduction in revenues would be a permanent loss to the supplier, and would therefore not be recovered in future years.

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[20] Commerce Commission "Input methodologies review draft decisions: Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), para 129.

[21] Consider, for example, a cap on the wash-up amount set at 20%, an actual net allowable revenue calculated during a wash-up process of $10m, and an initial wash-up amount (ie, actual allowable revenue less actual revenue) of $2.5m. The cap would be $10m x 20% = $2m. The cap would bind ($2.5m > $2.0m), so the capped wash-up amount would be $2.0m. It is this amount by which the wash-up balance would be increased. $0.5 million is lost permanently by the supplier in this example.

52. We invite submissions on whether such a cap should apply, what the percentage threshold might be under such a cap, and whether there are any GTB-specific factors that might need to be considered in applying such a cap on wash-up amounts.

Wash-up account

53. Each supplier will be required to maintain a wash-up account to track the cumulative balance of wash-up amounts added, the time value of money added, and drawdown amounts.

54. Our IM review draft decisions propose that the amount drawn down from the wash-up account would be specified according to rules to be set out in the GTB DPP determination.[22]

55. Our IM review draft decisions propose to give the Commission the ability to determine a cap or collar on the amount that may be drawn down from the wash-up account and applied in setting prices.

56. We envisage that a DPP determination would set any cap as a positive amount and any collar as a negative amount.

    56.1 If the wash-up account balance before drawdown is positive, then the cap may apply, ie, if the balance before drawdown is greater than the cap, then the drawdown amount would be equal to the cap.

    56.2 If the wash-up amount balance before drawdown is negative, then the collar may apply, ie, if the balance before drawdown is less than (more negative than) the collar, then the drawdown amount would be equal to the collar.

    56.3 If the wash-up amount balance before drawdown were to be between the positive cap amount and the negative collar amount, then drawdown would be the wash-up amount balance. The wash-up balance after drawdown in this case would be nil.

57. This cap and collar could provide a means of addressing future pricing volatility. We are aware this is an issue of significant concern to some major gas users.[23] We are therefore interested in views on whether this smoothing mechanism is needed in the gas sector, and what stakeholders consider the amount of a cap and collar should be.

58. Each drawdown amount shall be a recoverable cost, and will therefore be reflected in future revenues.

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[22] Draft amendments to *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28, cl 3.1.3(11)(f).

[23] MGUG "Submission on the Gas DPP process and issues paper" (30 March 2016).

59. The discount rate to be used for all time value of money calculations will be the 67th percentile of the post-tax weighted average cost of capital (WACC) as set for the DPP.

Compliance process

60. We propose that each supplier provide its compliance report for each assessment period after prices have been set, but prior to the prices taking effect at the commencement of that period. Our proposed process would allow each supplier to set its prices with certainty that they comply with the DPP determination.

61. *Ex ante* submission of compliance reports, rather than the current *ex post* requirement, would allow any non-compliant pricing to be addressed more quickly. We envisage that compliance reports will be required to demonstrate compliance with the determination and to set out all wash-up account entries and balances. Providing the wash-up account information will allow us to check compliance with that part of the process.

62. Any pricing issues that arise during an assessment period, such as price restructures, would automatically contribute to the wash-up amounts because they will affect actual revenue, and should not require any particular compliance actions.

63. We are particularly interested in stakeholder views of the practicality of this approach and any problems that may arise.

CHAPTER 3: Pass-through and recoverable costs

Purpose of this chapter

64. This chapter explains how we propose to implement our IM review draft decisions on pass-through costs and recoverable costs, if confirmed, in the Gas DPP 2017 reset.

65. Our IM review draft decisions propose to:

    65.1 change how the GDB price-quality path treats pass-through and recoverable costs;

    65.2 allow GTBs to include compressor fuel costs as recoverable costs;

    65.3 introduce a capex wash-up recoverable cost for both GDBs and GTBs; and

    65.4 change the scope of pass-through costs that can be specified at the start of a DPP period.

66. The proposed introduction of a revenue wash-up drawdown recoverable cost for revenue wash-ups in the implementation of the GTB revenue cap is explained above in Chapter 2.

Treatment of pass-through costs and recoverable costs for GDBs

67. Our IM review draft decisions propose changes to the way we approach pass-through costs and recoverable costs for GDBs, moving from the current 'ascertainable' approach, to a 'pass-through balance' approach.[24] This would align the GDB DPP with the current EDB DPP approach used with the weighted average price cap. It would also change the way suppliers demonstrate compliance with the price-quality path.[25]

Compliance

68. Compliance with the price path would be assessed against two components of the price path:

    68.1 the portion of prices attributed to pass-through costs and recoverable costs (to be referred to as 'pass-through prices'); and

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[24] Commerce Commission "Input methodologies review draft decisions: Topic paper 1 – Form of control and RAB indexation for EDBs, GPBs and Transpower" (16 June 2016), paras 197-198.

[25] For a detailed description of how this approach to price-path compliance would work, see: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020 – Compliance requirements", Chapter 3. We note that if EDBs move to a revenue cap from 2020 as proposed in the IM review draft decisions, the pass-through balance approach would no longer be necessary for EDBs.

68.2 the balance of prices (to be referred to as 'distribution prices').

69. Suppliers would need to demonstrate that 'distribution prices' do not exceed the weighted average price cap during an assessment period.

70. For 'pass-through prices', suppliers would report annually on the running balance of the disparity in their recovery of pass-through costs and recoverable costs, which may result in either a positive or a negative value. The value of the disparity will depend on whether the actual pass-through cost or recoverable cost has been under- or over-recovered relative to the forecast values used in setting prices.

71. This running balance would be referred to as the 'pass-through balance'. The pass-through prices used in calculating the pass-through balance would comprise:

71.1 a demonstrably reasonable allowance for forecast pass-through costs and forecast recoverable costs relating to the current period; and

71.2 any recovery (or pay-back) of all, or part of, the most recent pass-through balance.

72. Implementing these changes would require a change to the 'allowable notional revenue' formula in the GDB DPP determination, and the inclusion of an additional Schedule in that determination specifying the treatment of pass-through prices. We anticipate that these would be drafted in a similar way to the current EDB DPP determination.[26]

Treatment of compressor fuel costs as recoverable costs for gas transmission businesses

73. Our IM review draft decisions propose to allow GTBs to include compressor fuel costs as a recoverable cost when this is cheaper than a balancing gas transaction (already a recoverable cost) that has the same effect on the operation of the pipeline.[27]

74. This change has been proposed to ensure that GTBs are not penalised for choosing the lowest cost option when deciding between balancing gas transactions or running compressors.

75. The proposed change would impact on how we forecast opex allowances in the GTB DPP 2017 reset, and would prevent double-counting and double-recovery of these costs.

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26 *Electricity Distribution Services Default Price-Quality Path Determination 2015* [2014] NZCC 33, Sch 3B and Sch 5.

27 Commerce Commission "Input methodologies review draft decisions: Report on the IM review" (22 June 2016), paras 311-316.

76. If the IM review draft decisions are confirmed, we would need to remove these costs from our GTB DPP forecasts, where these costs have been included either as opex in previous information disclosure (ID) data, or as forecast opex in asset management plans (AMPs). Historic compressor fuel costs are currently disclosed as a line item under ID, so we intend to use these amounts as the basis for any adjustment to opex forecasts.

77. We propose that the recovery of these costs will remain subject to compliance requirements and a Commission approval process, which we will set out in the GTB DPP determination.[28]

Introduction of a capex wash-up for gas distribution and transmission businesses

78. Our IM review draft decisions propose a recoverable cost that accounts for the revenue effect of the difference between forecast and actual commissioned capex for the period from the end of the DPP 'base year' to the start of the DPP regulatory period. This adjusts for the fact that when a DPP determination is made, we will base it on an estimated opening regulatory asset base (RAB) that uses forecast commissioned capex from the preceding year.

79. This change has been proposed to ensure that suppliers are not unduly rewarded or penalised for differences between forecast and actual values of commissioned assets, and that the price-quality paths allow for the expectation of a normal return at the start of the new regulatory period. This change would bring the GTB and GDB IMs into line with the approach in the current EDB IMs.

80. The introduction of this recoverable cost would not affect the way we set starting prices for the DPP resets. However, it does relate to the DPPs in two ways.

    80.1 It would mitigate the risk of using a forecast of commissioned capex for the final year of the current regulatory period when determining the opening RAB for the current regulatory period.

    80.2 We would use the final version of the financial model to calculate the value of this recoverable cost for suppliers for compliance purposes.[29]

Allowing for new criteria-based pass-through costs

81. Our IM review draft decisions provide for any cost which meets the criteria set out in the IMs to be specified as a pass-through cost in a GDB or GTB DPP determination,

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[28] *Gas Transmission Services Input Methodologies Determination* 2012 [2012] NZCC 28, cl 3.1.3(2).

[29] For an example of how this may work in practice, see the model "EDB capex wash-up adjustment recoverable cost calculation sheet – 11 December 2015" (11 December 2015). Available at: http://www.comcom.govt.nz/regulated-industries/electricity/electricity-default-price-quality-path/default-price-quality-path-from-2015 under the heading "2015-2020 DPP guidance: capex wash-up adjustment".

rather than just 'levies' as allowed at present.[30]

82. The IMs currently include a list of pass-through costs and a process for specifying new pass-through costs through a DPP or customised price-quality path (CPP) determination, where a cost meets certain criteria set out in the IM (ie, criteria-based pass-through costs).

83. Currently these criteria-based pass-through costs can only be specified during the regulatory period. They must be reasonably unforeseen at the time the DPP or CPP was set.

84. Our IM review draft decisions propose to change the IMs to allow these costs to be specified in a DPP or CPP determination at the time the DPP or CPP is set, as well as during the regulatory period.

85. We do not consider that any new types of costs meet the criteria for inclusion as additional pass-through costs. However, we are open to submissions from stakeholders as to any potential costs which they think ought to be specified as pass-through costs.

30 Commerce Commission "Input methodologies review draft decisions: Topic paper 2 – CPP requirements" (16 June 2016), paras 121-126.

CHAPTER 4: Draft financial model

Purpose of this chapter

86. This chapter provides a description of an early exposure draft of the financial model (draft model), the impact of our IM review draft decisions (if confirmed) on the model, and an outline of other changes made since the 2013 Gas DPP model.[31]

87. We are releasing this draft model to help interested parties understand and submit on the model. Our ongoing review procedures will involve further testing to gain assurance on the robustness of the model.

88. The input data to this draft model is mostly data from the previous reset, and will not be the data used for the final decision on the Gas DPP reset. Accordingly, the outputs from this draft model are for illustrative purposes only and bear no relationship to the starting prices that will apply from 1 October 2017.

89. The draft model will be released again as part of our draft decision in February 2017, providing interested parties another opportunity to submit their views.

Description of the model

90. The draft model is an Excel workbook that calculates a 'building blocks allowable revenue' (BBAR) for each of the BBAR periods that make up the five-year regulatory period.[32] It calculates the total of the present values of the BBARs as at the start of the regulatory period.

91. This total present value of allowable revenue for the entire regulatory period is used to determine a price path with equal present value. The starting price for this price path is adjusted to achieve this present value equivalence. The price path comprises a set of five MARs with each of these having a 30 September year-end.

Impact of IM changes on the calculation methodology in the financial model

92. As discussed in Chapter 2, our IM review draft decisions propose a change in the form of control for GTBs from a revenue cap with lagged quantities to a pure revenue cap. This change in the form of control would, if confirmed, require a change in the calculations in the financial model from the financial models used in the 2013 Gas DPP.

93. Two rows of calculations that might otherwise be required at the very end of the 'MAR' sheet calculations would not be required when starting prices for GTBs are

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[31] The draft model is not associated with a draft decision on the GPB DPP reset.

[32] A BBAR period is a period entirely within the regulatory period that is either 12 months long and with the same year-end date as disclosure years, or a part year at the beginning or end of the regulatory period such that the BBAR periods in aggregate cover the whole of the regulatory period.

being calculated. These rows are those that relate to the ‘ΔD’ term. ‘ΔD’ allows for a conversion between MAR for the first year of a regulatory period to the allowable notional revenue for the same year. The ΔD term is the factor by which we forecast allowable revenues to increase over the two years of the lag, ie, the average growth in quantities to the first year of the regulatory period from the quantities applying two years prior.

94. Our IM review draft decisions propose a change to the way in which ‘other regulatory income’ is accounted for. In setting the current EDB and GPB DPPs, we accounted for ‘other regulatory income’ by having forecast amounts of this income set out in the relevant financial model, and the starting prices were adjusted accordingly. Changes to the IMs proposed in our IM review draft decisions would result in ‘other regulatory income’ being accounted for in the wash-up part of the compliance process, with the result that the financial model would not need to account for this income.

95. We do not consider that any other of our IM review draft decisions, if confirmed, would require changes to the calculation methodology of the draft model.

Other changes since the 2013 gas default price-quality path model

96. There are two significant changes from the Gas DPP model used in 2013. The first is that the layout of the calculations has changed. In the 2013 model, there was a workbook sheet for each business, and all the calculations specific to a business were done on that business’ sheet. The revised layout allows the calculations to be divided across a number of functional sheets. This improves workbook structure with the focus of the entire workbook on just one business at a time. The business is user-selectable on the ‘GPB data’ sheet.

97. The second change from the 2013 model is to deal with the different year-ends used by the businesses for ID in a more structured way. The ID year-ends are now entered as business-specific input data, rather than being hard-coded into the model. The form of control for each business may be selected in a similar manner.

98. The draft model sets out the calculations in the same format as the 2015 EDB model, which we consider has a better structure than the earlier Gas DPP model.

Changes that affect information used for the gas default price-quality path resets

99. Our IM review draft decisions propose a number of changes that may affect the information used for the Gas DPP 2017 reset. In particular, our IM review draft decisions propose amendments to IMs that apply to ID, which are in turn referenced in the IMs for Gas DPP resets.

100. Examples include proposed amendments to the application of the term 'finance leases' for the purposes of the RAB rules in the IMs (IM decision AV05);[33] and a proposed change to the revenue materiality threshold which would affect the cost allocation approach suppliers use to allocated shared costs between regulated and non-regulated services (IM decision CA03). [34]

101. As discussed in the Report on the IM Review,[35] we are interested in your views on the timing for IM amendments coming into effect. Taking into account the approaching Gas DPP 2017 reset, we want to know whether you think transitional arrangements would need to be introduced for any particular provisions. In particular, we seek your views on whether certain changes to the IMs for ID should be drafted to take effect, for the purposes of Part 4 of the IMs, from the next regulatory period commencing 1 October 2022 to maintain the timing alignment between the IMs for both ID and price-quality regulation.

102. This is relevant for the Gas DPP 2017 reset because our final decisions on the IM review are planned for December 2016, and the final sets of disclosures under the ID requirements we will use for the reset will be received in January 2017 (Vector and First Gas) and March 2017 (Powerco). This would be too late for these suppliers to have implemented any IM changes that result from the IM review. However, we note that we are not dependent on ID data and can seek IM-compliant information using our s 53ZD powers.

103. We welcome your views on this timing issue.

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[33] Commerce Commission "Input methodologies review draft decisions: Report on the IM review" (22 June 2016), paras 86-91.

[34] Even though a change is being proposed, it does not necessarily affect allocated costs, but we would be interested in whether the proposed change would have such an effect on any GPB.

[35] Commerce Commission "Input methodologies review draft decisions: Report on the IM review (22 June 2016).