

24 August 2020

**To:**

All suppliers of electricity distribution services that are subject to the *Electricity Distribution Services Default Price-Quality Path Determination* [2019] NZCC 21 (**DPP3**)<sup>1</sup>

**Treatment of in-year discounts offered by Electricity Distribution Businesses under DPP3**

1. As a result of our review of input methodologies in 2016, we changed the form of control for Electricity Distribution Businesses (**EDBs**) for DPP3 from a weighted average price cap to a revenue cap, including a wash-up for over- and under-recovery of revenue. The move to a revenue cap led to a change in the treatment of discounts offered by EDBs under the price path.
2. The Commission has received requests from several EDBs and the Electricity Networks Association to explain how in-year discounts (meaning discounts offered at a point in time after the start of the first assessment period of DPP3<sup>2</sup>) will be treated under the new rules in DPP3. Queries have included whether an EDB that offers an in-year discount will be able to recover the value of the discount in later years through the revenue DPP3 allows them to earn.
3. These requests have arisen in the context of some EDBs proposing to offer (or already having offered) further discounts to their prices in 2020 in order to mitigate some of the impacts of COVID-19 on their consumers. These further discounts are in the form of either an increase to a pre-existing discount or a new discount altogether.
4. Given the lack of certainty amongst industry stakeholders about how DPP3 applies to in-year discounts, we have decided to issue this guidance letter. The letter has two purposes:
  - 4.1 To outline how DPP3 treats increased or new discounts offered in-year by EDBs; and
  - 4.2 To inform stakeholders of our decision by way of enforcement discretion not to take action where we are satisfied that EDBs have contravened a price path requirement solely as a result of inputting a price into their wash-up amount calculation for the first assessment period of DPP3 that includes a

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<sup>1</sup> A consolidated version of DPP3 (as of 20 May 2020) can be found at this link:  
[https://comcom.govt.nz/data/assets/pdf\\_file/0025/216862/Electricity-distribution-services-default-price-quality-path-determination-2020-consolidated-20-May-2020-20-May-2020.pdf](https://comcom.govt.nz/data/assets/pdf_file/0025/216862/Electricity-distribution-services-default-price-quality-path-determination-2020-consolidated-20-May-2020-20-May-2020.pdf)

<sup>2</sup> The first assessment period of DPP3 runs from 1 April 2020 to 31 March 2021.

discount, and that the discount meets certain conditions (these conditions are explained below at paragraphs 20 and 21).

5. This decision not to pursue enforcement action has been reached on the basis that the revenue cap in DPP3 introduced a new framework for treatment of discounts, and that this has had effects which were not anticipated by the Commission or stakeholders at the time DPP3 was drafted. The urgent introduction of discounts by certain EDBs in response to COVID-19 has highlighted these effects.
6. We expect that the guidance set out in this letter will now give EDBs clarity as to how the provisions on in-year discounts operate, such that they will be in a position to comply with the price path for the remaining four years of the DPP3 regulatory period.

## **Background**

### *Discounts under DPP3*

7. Under DPP3, EDBs must set prices so that they can expect to recover revenue that complies with a 'revenue cap'. The revenue cap limits the total revenue that an EDB can recover from its consumers and allows some over- or under- recovered revenue to be carried forward to future allowed revenues via a 'wash-up' balance.
8. An EDB may offer a discount to any of its prices. However, it is only discounts with certain characteristics that will qualify under DPP3 as a reduction in the EDB's revenue (known as a 'qualifying discount'). What is considered a 'qualifying discount' for the purposes of DPP3 is important because it is only 'qualifying discounts' recognised under DPP3 whose value EDBs can recover in later years through the revenue DPP3 allows them to earn. The mechanism that allows EDBs to do this is called the wash-up mechanism.

### *The wash-up mechanism*

9. Clause 8.6 of DPP3 requires an EDB to calculate a 'wash-up amount' for each year<sup>3</sup> of DPP3 using the methodology specified in Schedule 1.6. The wash-up is intended to take account of any over-or-under recovered revenue by the EDB for the year (eg, where the EDB has under-recovered what it expected to earn as a result of offering discounts). The 'wash-up amount' is then accounted for in a wash-up balance that forms part of an EDB's 'forecast allowable revenue' in a subsequent year. The revenue is 'washed-up' by the EDB either collecting any under-recovered revenue from consumers through higher prices or returning any over-recovered revenue through lower prices.
10. Schedule 1.6(1) states that two components in the formula used to calculate the wash-up amount are 'actual revenue' and 'revenue foregone'. The meaning of both these components relies on the definition of 'actual revenue from prices'<sup>4</sup>, which is

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<sup>3</sup> A 'year' under DPP3 is called an 'assessment period'. As the regulatory period of DPP3 is five years, there are five assessment periods in DPP3.

<sup>4</sup> 'Actual revenue' is defined in clause 4.2 of DPP3 to mean "the sum of actual revenue from prices plus other regulated income", and the definition of 'revenue foregone' in clause 4.2 incorporates the 'revenue reduction

defined in clause 4.2 of DPP3 to mean “the sum of each price multiplied by each corresponding actual quantity” [Emphasis added]. Accordingly, what is considered a ‘price’ for the purposes of DPP3 is important for determining the EDB’s ‘actual revenue from prices’, and ultimately the EDB’s wash-up amount under Schedule 1.6.

#### ‘Qualifying’ discounts

11. ‘Price’ is defined in clause 4.2 to have the same meaning as given in the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26<sup>5</sup> (**EDB IMs**). ‘Price’ is defined in clause 3.1.1(9) of the EDB IMs as follows:

‘Prices’ means-

- (a) individual tariffs, fees or charges; or
- (b) individual components thereof,

in nominal terms exclusive of GST for the supply of an electricity distribution service, and must include a discount taken up by consumers.

[Emphasis added]

12. The definition of price provides that the individual tariff, fee or charge must include a ‘discount’ taken up by consumers. ‘Discount’ is defined in clause 3.1.1(11) of the EDB IMs as:<sup>6</sup>

‘discount’ means a discount to charges payable for the supply of electricity distribution services-

- (a) that is offered by an EDB;
- (b) the take-up of which is determined by consumers; and
- (c) that is included in the individual tariffs, fees, or charges (or individual components thereof) used to calculate forecast revenue from prices for the disclosure year that those individual tariffs, fees, or charges apply to.

13. Accordingly, a ‘qualifying discount’ is a discount that meets all of the requirements in clause 3.1.1(11) of the EDB IMs. If a discount meets all of these requirements, it can form part of a ‘price’ recognised under DPP3.
14. The policy intent of the definition of discount in the EDB IMs was to distinguish these discounts from ‘discretionary discounts’. While ‘discretionary discounts’ are more akin to the payment of a dividend to consumer-shareholders (able to be offered,

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percentage’ – which is a percentage that is calculated using the formula “1 minus (actual revenue from prices ÷ forecast revenue from prices”.

<sup>5</sup> A consolidated version of the EDB IMs (as of 20 May 2020) can be found at this link: [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0017/60542/Electricity-distribution-services-input-methodologies-determination-2012-consolidated-20-May-2020-20-May-2020.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0017/60542/Electricity-distribution-services-input-methodologies-determination-2012-consolidated-20-May-2020-20-May-2020.pdf).

<sup>6</sup> The definition of discount in clause 3.1.1(11) of the EDB IMs was amended in March this year. The amendment intended to correct an error in (what was then) limb (c) of the definition, which had the effect of preventing EDBs from including the value of discounts made after a DPP or CPP is determined when complying with that DPP or CPP. The amendment also intended to ensure EDBs have better certainty about how the rules should be applied. More information regarding this amendment can be found here: [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0020/213743/Amendments-to-EDB-input-methodologies-determination-and-EDB-DPP-determination-2020-Correction-to-definition-of-discount-Companion-paper-30-March-2020.PDF](https://comcom.govt.nz/_data/assets/pdf_file/0020/213743/Amendments-to-EDB-input-methodologies-determination-and-EDB-DPP-determination-2020-Correction-to-definition-of-discount-Companion-paper-30-March-2020.PDF).

varied, or removed at any time), the discounts recognised by the EDB IMs are non-discretionary in nature, in that they are 'locked in' once tariffs are set, and consumers are able to respond to them. In this way, a non-discretionary discount has the characteristics of a price.

### **How DPP3 treats increased or new discounts offered in-year by EDBs**

15. As set out at paragraph 12, limb (c) of the definition of discount in clause 3.1.1(11) of the EDB IMs provides that the discount must have been "*included in the individual tariffs, fees, or charges (or individual components thereof) used to calculate forecast revenue from prices for the disclosure year that those individual tariffs, fees, or charges apply to*". In other words, the discount must have been included in the tariffs used to calculate the EDB's 'forecast revenue from prices'<sup>7</sup> for the year those tariffs apply to. Under DPP3, an EDB must calculate its 'forecast revenue from prices'<sup>8</sup> before the beginning of each pricing year (i.e. before 1 April) for the purposes of demonstrating its compliance with the revenue cap.<sup>9</sup>
16. The effect of limb (c) is that, for EDBs that have offered (or intend to offer) non-discretionary discounts in a year of the DPP3 regulatory period:
  - 16.1 only discounts that are included in the tariffs used to calculate the EDB's forecast revenue from prices for the year, which must have occurred prior to 1 April, will satisfy the IM definition of discount. This is because any discounts not included within the tariffs used to calculate the EDB's forecast revenue from prices will not satisfy limb (c) of the discount definition; and
  - 16.2 only 'discounts' that meet the IM definition of discount are permitted to be included in the wash-up calculation under DPP3. This is because, as set out in paragraphs 11 to 13 above, the 'prices' that are taken into account to determine the 'actual revenue' and 'revenue foregone' components of the wash-up amount can only include 'discounts' that meet the IM definition of discount contained in clause 3.1.1(11).
17. Based on the above, and in response to the queries we received, we consider that DPP3 does not permit a non-discretionary discount offered in-year (ie, post-1 April), whether that be an increased discount<sup>10</sup> or a new discount, to be included in the EDB's wash-up calculation. In other words, the value of these discounts cannot be washed-up by the EDB in later years. This is because the in-year discount will not satisfy limb (c) of the EDB IM definition of discount, as the discount will not have

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<sup>7</sup> 'Forecast revenue from prices' is defined in clause 3.1.1(3) of the EDB IMs to mean for a disclosure year "the forecast revenue used by an EDB to set prices, where forecast revenue is the total of each price multiplied by each forecast quantity".

<sup>8</sup> Clause 4.2 of DPP3 provides that 'forecast revenue from prices' under DPP3 has the same meaning as given in the EDB IMs.

<sup>9</sup> See cls 8.3 and 8.4 of DPP3, which require that 'forecast revenue from prices must be no more than forecast allowable revenue', and cls 11.1(a) and 11.2(a), which require an EDB to report on whether or not they have complied with the cap prior to 1 April.

<sup>10</sup> Increasing the value of a pre-existing non-discretionary discount, above the amount previously notified.

been included in the tariffs used to calculate the EDB's forecast revenue from prices at the beginning of the year.

**Our enforcement response to certain in-year discounts offered by EDBs in the first assessment period**

18. We are aware that some EDBs have offered, or are proposing to offer, increased or new non-discretionary discounts to their consumers in order to mitigate some of the financial hardship resulting from COVID-19 and associated efforts to contain the virus. In accordance with the conclusions at paragraph 17 above, DPP3 does not permit these discounts to be included in the EDB's wash-up calculation for the first assessment period (which runs from 1 April 2020 to 31 March 2021).
19. However, we recognise that there has been a lack of certainty amongst industry stakeholders about how the new rules in DPP3 apply to in-year discounts. In addition, the urgent introduction of discounts has also highlighted effects of the new rules, which were not anticipated by the Commission or stakeholders at the time of drafting.
20. Accordingly, the Commission has decided to exercise its enforcement discretion and to refrain from taking action against an EDB who contravenes a DPP3 price path requirement where the Commission is satisfied that the contravention is solely as a result of inputting a price into the EDB's wash-up amount calculation for the first assessment period of DPP3 that includes a discount that does not meet the definition of 'discount' in clause 3.1.1(11) of the EDB IMs, although only where:
  - 20.1 the sole reason for the discount not meeting the definition of 'discount' is that it does not satisfy limb (c) of clause 3.1.1(11); and
  - 20.2 all of the requirements in paragraph 21 are met.
21. For the purposes of paragraph 20.2, the discount offered by the EDB must satisfy the following requirements:
  - 21.1 the discount must satisfy limbs (a) and (b) of the definition of 'discount' in clause 3.1.1(11) of the EDB IMs. In other words, the discount must still be non-discretionary, in that it is offered by the EDB to consumers in a manner that allows them to respond to it; and
  - 21.2 the discount must have been offered sometime between the date on which the EDB's annual price setting compliance statement for the first assessment period was prepared<sup>11</sup> and 31 March 2021 (the end of the first assessment period). A discount is considered to be 'offered' if it has been either 'publicly disclosed' or 'notified' in accordance with clauses 2.4.18-2.4.20 of the

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<sup>11</sup> This refers to the date the EDB must have stated in their annual price setting compliance statement for the first assessment period as the date the statement was prepared. Clause 11.1 of DPP3 required each EDB subject to DPP3 to provide the Commission with a written annual price-setting compliance statement in respect of price setting for the first assessment period before 1 April 2020. Clause 11.2(b) of DPP3 required that that annual price-setting compliance statement state the date on which the statement was prepared.

*Electricity Distribution Information Disclosure Determination 2012 (ID Determination)*.<sup>12</sup>

22. We have limited our enforcement discretion to the time period specified in paragraph 21.2, as we consider that EDBs will be in a position to offer new discounts in 2021 that satisfy the EDB IMs' definition of discount (eg, because they can be included in the EDB's calculation of forecast revenue from prices for 2021), and can therefore be washed-up in later years.<sup>13</sup>
23. Where we are satisfied an EDB has included a discount satisfying the conditions in paragraphs 20 and 21 within their wash-up calculation for the first assessment period, this will mean that:
- 23.1 the discount will be taken as having been included in the 'prices' that are used to calculate the EDB's 'actual revenue from prices' for the first assessment period; and
- 23.2 once the EDB has calculated its 'actual revenue from prices', the EDB may use that 'actual revenue from prices' to calculate the 'actual revenue' component and the 'revenue foregone' component of the formula for calculating the wash-up amount for the first assessment period, as set out in Schedule 1.6 of DPP3.
24. We also recognise that the wash-up amount calculation for the first assessment period will have flow-on impacts to other years under DPP3. Accordingly, we make the following comments:
- 24.1 Currently under DPP3, the 'prices' an EDB uses to calculate its wash-up amount for the first assessment period will be used to calculate the EDB's 'forecast allowable revenue' for the third assessment period and the fifth assessment period of DPP3.<sup>14</sup> Accordingly, if the 'prices' an EDB inputs into its

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<sup>12</sup> [2012] NZCC 22. Please note that, separate to this notice, the Commission has granted an exemption in respect of certain requirements under the ID Determination regarding price reduction notifications that may be relevant to increased or new discounts offered during the specified time period. A copy of the exemption letter can be found here: [https://comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0026/213848/ID-Exemption-All-EDBs-Notice-of-conditional-exemptions-from-electricity-distribution-services-information-disclosures-31-March-2020.pdf](https://comcom.govt.nz/__data/assets/pdf_file/0026/213848/ID-Exemption-All-EDBs-Notice-of-conditional-exemptions-from-electricity-distribution-services-information-disclosures-31-March-2020.pdf).

<sup>13</sup> This is because the discounts can be included in the tariffs the EDB uses to calculate their forecast revenue from prices for the second assessment period. Further, EDBs that wish to increase or introduce new discounts in-year during the second and subsequent assessment periods of DPP3 will have the opportunity to do so by reducing prices, should they also wish not to forego the associated reduction in revenue.

<sup>14</sup> Schedule 1.5(1) of DPP3 requires that, when an EDB sets its prices for an assessment period, it must calculate its 'forecast allowable revenue'. Schedule 1.5(5) states that a component of the formula for calculating 'forecast allowable revenue' is the 'opening wash-up account balance'. For the first and second assessment periods, the 'opening wash-up account balance' is nil (Schedule 1.7(1)(a)); however:

a) For the third assessment period, the 'opening wash-up account balance' is the closing wash-up account balance from the second assessment period (Schedule 1.7(1)(b)). The closing wash-up account balance for the second assessment period is calculated by using the wash-up amount calculated for the first assessment period (see formula provided in Schedule 1.7(2)). In this way, the 'prices' used in the calculation of the wash-up amount for the first assessment period will flow through to the calculation of the EDB's forecast allowable revenue for the third assessment period.

b) Further, for the fifth assessment period, the 'opening wash-up account balance' is the closing wash-up account balance from the fourth assessment period (Schedule 1.7(1)(b)), which in turn is calculated by using the wash-up amount from the third assessment period (Schedule 1.7(2)). In this way, the wash-up amount for

wash-up amount calculation for the first assessment period have included a discount in accordance with the conditions described in paragraphs 20 and 21, the Commission will not take enforcement action against an EDB who contravenes a DPP3 price path requirement if the Commission is satisfied that this has occurred solely as a result of using those 'prices' to calculate the EDB's 'forecast allowable revenue' for the third assessment period and the fifth assessment period of DPP3.

- 24.2 Clause 11.4(a) of DPP3 requires an EDB to prepare an 'annual compliance statement' in respect of the wash-up calculation for the first assessment period within 5 months after the end of the first assessment period. Clause 11.5(a)(i) requires that the annual compliance statement must state whether or not an EDB has complied with the requirements to calculate the wash-up amount in clause 8.6<sup>15</sup> for the previous assessment period (in this case, the first assessment period). The Commission will not take enforcement action against an EDB who states in its annual compliance statement for the first assessment period that it has not complied with the requirements to calculate the wash-up amount in clause 8.6, if the Commission is satisfied that the sole reason for that statement is because the EDB has included a discount within the calculation of the wash-up amount that meets the conditions described in paragraphs 20 and 21. As part of satisfying us that the conditions in paragraphs 20 and 21 apply, EDBs should include in their annual compliance statement the circumstances of the non-compliance. They should also keep records so that they are able to demonstrate to the Commission that the conditions described in paragraphs 20 and 21 did apply to the discount in question.
25. Any questions regarding the content of this guidance letter should be provided to Stephen Bass (Head of Compliance & Investigations, Regulation Branch) via email: [Stephen.Bass@comcom.govt.nz](mailto:Stephen.Bass@comcom.govt.nz). For more information on how the revenue cap works generally under DPP3, please see our recently released revenue cap guidance sheet, which is accessible via our website [here](#).

Yours sincerely



Elisabeth Welson  
Commissioner

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the third assessment period flows through to the calculation of the opening wash-up account balance for the fifth assessment period, and the calculation of the EDB's forecast allowable revenue for the fifth assessment period.

<sup>15</sup> As stated at paragraph 5 of this letter, clause 8.6 of DPP3 requires an EDB to calculate a 'wash-up amount' for each year of DPP3 using the methodology specified in Schedule 1.6.