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## **Wellington Electricity's customised price-quality path**

### **Final Decision**

**Date of publication:** 28 March 2018

## Associated documents

	Reference	Title
28 March 2018	1178-2560	<i>Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018 [2018] NZCC 6</i>
28 February 2017	1178-2560	<i>Electricity Distribution Services Input Methodologies Determination 2012 (consolidating all amendments as at 28 February 2017)</i>
9 July 2015	978-1-869454-593	<i>Electricity Distribution Services Default Price-Quality Path Determination 2015 (consolidating all amendments as of 9 July 2015)</i>

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## Executive summary

### Purpose of this Paper

- X1 This paper sets out our final decision on, and reasons for, setting a customised price-quality path (CPP) for Wellington Electricity Lines Limited (WELL).

### WELL submitted an application to increase prices

- X2 WELL owns and operates the electricity distribution network in the Wellington, Hutt Valley and Porirua regions. Its network provides electricity lines services to approximately 166,000 homes, businesses and government.
- X3 As a monopoly supplier of distribution services, WELL is regulated under Part 4 of the Commerce Act. We set maximum revenues it can earn from its customers and set the minimum standards its services must meet under a price quality path. WELL is currently subject to the default price-quality path (DPP) set in 2014 which applies to 16 electricity distributors across New Zealand.<sup>1</sup>
- X4 WELL considers the DPP no longer meets its needs and submitted a CPP application to us on 5 December 2017. The application requested an increase in prices to allow for \$31.2m of additional expenditure over a three year period to better prepare its network for an earthquake.<sup>2</sup>

#### Key features of WELL's CPP proposal

- WELL proposed to spend an additional \$31.2m of expenditure (primarily capital) over the next three years to better prepare its network for a major earthquake.
- To recover this expenditure, WELL proposed an initial increase in its maximum allowable revenue, after which its revenue would be indexed to inflation for the remainder of the CPP period.
- WELL proposed to keep its quality standards the same as under the current DPP.

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<sup>1</sup> For more information on the DPP for electricity distributors please visit <http://comcom.govt.nz/regulated-industries/electricity/electricity-default-price-quality-path/>

<sup>2</sup> All references to expenditure allowances in this paper, except as otherwise indicated, are expressed in real 2018 dollars.

## **Our framework for assessing WELL’s application**

- X5 Our starting point for determining WELL’s CPP is the purpose of Part 4 of the Commerce Act (the Act) – to promote the long term benefit of consumers.<sup>3</sup>
- X6 The Commerce Act requires us to set rules and processes for CPPs – these rules and processes are referred to as input methodologies (IMs).
- X7 The IMs we have previously set relating to CPPs include the requirements that must be met by the applicant for information, verification, audit and consumer consultation, as well as the criteria that we must use to evaluate a CPP proposal.<sup>4</sup>

## **WELL’s CPP has been approved under a ‘streamlined’ process**

### *Increased risk of a major earthquake in Wellington since the Kaikoura earthquakes*

- X8 The November 2016 Kaikoura earthquakes caused extensive damage to the surrounding regions. Wellington escaped major damage but widespread minor damage highlighted the region’s vulnerability and that Wellington is not as prepared as it could be for a large earthquake.
- X9 Following the earthquake a Government Policy Statement (GPS) was issued noting the increased likelihood of a large earthquake occurring and highlighting the importance that key ‘lifeline’ utilities in Wellington, including WELL, take action to ensure they are well prepared for such an event.<sup>5</sup>
- X10 In response WELL has identified \$31.2m of expenditure that it can undertake in the short-term in order to increase its network’s resilience to a significant earthquake and enable it to more quickly restore supply to customers faced with outages (for the purposes of this paper we have referred to these improvements as ‘resilience’).

### *Exceptional circumstances warranted the use of flexibility in our regime*

- X11 WELL’s exceptional circumstances, highlighted in the GPS, warranted the use of the flexibility in our regime and allows for a ‘streamlined’ CPP to ensure that WELL can recover the cost of undertaking this important expenditure as soon as possible.

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<sup>3</sup> Commerce Act 1986. S 52A.

<sup>4</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, Part 5.

<sup>5</sup> “Government Policy Statement — Resilience of Electricity Services in the Wellington Region” (21 September 2017) 97 *New Zealand Gazette* at 53.

- X12 This compares with normal circumstances where suppliers must follow the full set of processes in the IMs if they are to apply for a CPP.
- X13 We considered that a streamlined CPP, in this instance, would promote the long-term benefit of consumers, as it was the best possible way to ensure that WELL could recover the cost of undertaking the urgent short-term resilience expenditure.
- X14 The streamlined process utilised revenues already approved or likely to be approved under the DPP revenue setting process and added to it revenue associated with the additional resilience expenditure.

### Our decision

- X15 We have decided to allow WELL's proposed \$31.2m of expenditure to prepare its network for a major earthquake. Our decision allows WELL to deliver a more resilient network that is less susceptible to earthquake damage and provide a reduced risk of prolonged interruptions following an earthquake.
- X16 WELL will earn a return on, and of, this capital investment during the three year revenue path we have set and in future pricing periods.
- X17 The resulting maximum allowable revenue (MAR) of \$105.2m for the initial year of the CPP represents a 5.1% increase relative to forecast allowable revenue under the DPP.<sup>6</sup>
- X18 We estimate the impact on the typical consumer's monthly electricity bill of \$185 to be around \$1.70. This represents a 0.9% increase.
- X19 Table X.1 shows the MAR for each year of the CPP.

**Table X.1: Nominal maximum allowable revenue before tax**

Maximum allowable revenue (\$m)	2018/19	2019/20	2020/21
WELL proposed MAR	107.4	109.6	111.8
CPP MAR – final decision	105.2	107.4	109.5

<sup>6</sup> Maximum allowable revenue represents the revenue WELL is allowed to recover prior to pass-through and recoverable costs.

- X20 The increase in MAR is a result of the allowed resilience expenditure and from WELL transitioning from the DPP to a CPP.
- X21 Our CPP MAR final decision amends what was proposed by WELL as it applies an estimate of the DPP allowable revenue that we decided is more reflective of what WELL would earn under the DPP.
- X22 We are satisfied that our decision is consistent with the evaluation criteria and it promotes the long-term benefit of consumers.

*WELL transitions from a DPP to a CPP*

- X23 By transitioning to a CPP WELL moves from a weighted average price cap to a revenue cap. This means WELL is no longer exposed to demand forecast variances.
- X24 Under WELL's existing default price path it was unable to fully recover its MAR, due to lower demand than expected when we set it. WELL forecasts that under the default price path its actual allowable revenue would be 2.6% lower, in 2018/19, as a result of lower than forecast demand. By transitioning to a CPP this reduction is avoided.

*Quality standards for reliability and delivery of resilience improvements*

- X25 Our decision is that WELL will be subject to the same reliability quality standards and incentives that applied under the DPP we set for WELL in 2014.
- X26 We have also set additional quality requirements that incentivise WELL to meet the objectives of the additional resilience expenditure.
- X27 WELL is required to deliver a minimum level of the resilience improvements set out in its CPP proposal. If WELL fails to meet this minimum resilience level, WELL will breach its quality path and we may take enforcement action.
- X28 Under the revenue linked quality incentive, if WELL does not deliver the resilience improvements, as outlined in its proposal, its revenue will be proportionately reduced in the next regulatory period.

## Chapter 1 Introduction

### Purpose of this paper

1. This paper sets out our decisions on, and reasons for, setting a customised price-quality path (CPP) for Wellington Electricity Lines Limited (WELL) that promotes the long-term benefit of consumers.
2. This chapter explains why we have made changes to the normal process for setting CPPs, to allow WELL to make this application.
3. It also explains the process that we followed to reach our final decision, and how we have structured the remainder of this paper.

### WELL has submitted an application to increase its prices

4. WELL owns and operates the electricity distribution network in the Wellington, Hutt Valley and Porirua regions. Its network provides electricity lines services to approximately 166,000 homes, businesses and government.
5. As a monopoly supplier of distribution services, WELL is regulated under Part 4 of the Commerce Act. We set maximum revenues it can earn from its customers and set the minimum required standards its services must meet under a price quality path. WELL is currently subject to the default price-quality path (DPP) set in 2014 which applies to 16 electricity distributors across New Zealand.<sup>7</sup>
6. WELL considered that the DPP no longer met its needs and submitted a CPP application to us on 5 December 2017. The application requested an increase in prices to allow for \$31.2m of additional expenditure over a three year period to better prepare its network for an earthquake.

### Context for this application – a “streamlined” customised price-quality path

7. WELL explained that the purpose of its CPP proposal is to:<sup>8</sup>

...seek regulatory approval for the additional funding required to implement a number of readiness initiatives, which will improve response and restoration times following a major earthquake.

We are seeking approval to invest \$31.24 million (Opex and Capex) over the next three years to improve our readiness to respond to a major earthquake. Approval of this proposal will

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<sup>7</sup> For more information on the DPP for electricity distributors please visit <http://comcom.govt.nz/regulated-industries/electricity/electricity-default-price-quality-path/>

<sup>8</sup> Wellington Electricity “Earthquake Readiness Customised Price-Quality Path Proposal” (5 December 2017), p 6.



allow us to implement relatively low cost readiness measures, which in the event of a major earthquake will result in Wellington communities and businesses avoiding significant social and economic welfare losses.

*Increased risk of a major earthquake in Wellington since the Kaikoura earthquakes*

8. The November 2016 Kaikoura earthquakes caused extensive damage to the surrounding regions. Wellington escaped major damage but widespread minor damage highlighted the region's vulnerability and that Wellington is not as prepared as it could be for a large earthquake.
9. Following the earthquake a Government Policy Statement (GPS) was issued noting the increased likelihood of a large earthquake occurring and highlighting the importance that key 'lifeline' utilities in Wellington, including WELL, take action to ensure they are well prepared for such an event.<sup>9</sup>

*Identified investment to improve resilience of WELL's network*

10. WELL has considered the resilience of its network to a major earthquake based on analysis it has undertaken over the past two years including through its ongoing participation in the 2017 Wellington Region resiliency modelling project. This project commenced in response to the Kaikoura earthquakes and required Wellington Lifelines Group members to consider the full interdependencies between lifeline utilities in the region.
11. As a result of this work WELL has identified \$31.2m of expenditure that it can undertake in the short-term in order to increase its network's resilience to a significant earthquake (ie, ability to maintain supply) and enable it to more quickly restore supply to customers faced with outages (resilience).<sup>10</sup>
12. WELL's position is that it could not fund the significant increase in expenditure under the existing default price-quality path (DPP) allowances.<sup>11</sup> WELL also considered reprioritising expenditure from maintenance to resilience, but deemed it inappropriate as it would likely affect the quality of supply of service provided to WELL consumers.

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<sup>9</sup> "Government Policy Statement — Resilience of Electricity Services in the Wellington Region" (21 September 2017) 97 *New Zealand Gazette* at 53.

<sup>10</sup> Throughout this paper we use the term 'resilience' to refer to both the resilience of WELL's network to earthquakes, as well its ability to restore electricity supply following an earthquake.

<sup>11</sup> Under Part 4 of the Commerce Act we set a DPP for WELL and 15 other electricity distribution businesses (EDBs). The current DPP runs from 1 April 2015 until 30 March 2020. DPPs take a one-size-fits-all approach to setting allowable revenues with limited tailoring for individual EDBs. Where the DPP does not suit a specific EDB's circumstances, it has the opportunity to apply for a CPP, which is tailored for that specific EDB.

13. WELL was not in a position to submit a full CPP application (consistent with the relevant rules and requirements) in time to address the immediate concerns arising from the increased earthquake risk. This meant that a different option was needed to provide for the additional expenditure.

*Government policy statement – government supports additional resilience expenditure*

14. On 18 September 2017, a GPS was issued supporting prudent, efficient and timely resilience-related expenditure by WELL.<sup>12</sup>

**Government policy statement – key points**

- Lifeline utilities should be able to recover reasonable costs arising from their duties under the Civil Defence and Emergency Management Act (CDEM), to the extent allowed by law. The ability to recover those costs promotes the purposes of both the CDEM Act and Part 4 of the Commerce Act.
- The national significance of Wellington’s disaster resilience should be given due consideration by lifeline utilities and by the Commission when performing its functions under Part 4. In particular, the Commission should consider options consistent with the Part 4 purpose which, in respect of regulated suppliers of lifeline services in the Wellington region, will:
  - allow those suppliers to recover prudent, efficient and timely resilience-related expenditure that was not anticipated when existing s 52P price-quality path determinations were made;
  - provide certainty to those suppliers in relation to how any additional prudent, efficient and timely resilience-related expenditure may be recovered, where relevant amendments to a s 52P determination may not be made in advance of that expenditure being incurred; and
  - allow the Commission to consider amending requirements that might normally apply to those suppliers relating to information, verification, or consultation on proposed expenditure.

15. After we received the GPS we consulted on a proposed approach to “streamline” the CPP process using the flexibility afforded to us under the IMs and legislation.<sup>13</sup>

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<sup>12</sup> The Commerce Act requires us to have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister (ie, via a GPS). The GPS is not a direction by Government; however we must have regard to it, subject to our overall requirement to promote the long term benefit of consumers under s 52A of the Act.

<sup>13</sup> As discussed further in the document: Commerce Commission “Our proposed approach to assessing Wellington Electricity’s proposal for additional expenditure to improve its resilience and response to a major earthquake Discussion Paper” (6 December 2017), paras 36-37.

*We decided to allow for a one-off ‘streamlined’ CPP for WELL*

16. Taking into account submissions, we decided that WELL’s exceptional circumstances, highlighted in the GPS, warranted the use of the flexibility in our regime and to allow a ‘streamlined’ CPP to ensure that WELL can recover the cost of undertaking this important expenditure as soon as possible.<sup>14</sup>
17. In making this decision, we considered whether this approach would promote the purpose of Part 4 of the Commerce Act, and we had regard to the GPS.<sup>15</sup>
18. We considered that a streamlined CPP, in this instance, would promote the long-term benefit of consumers, as it was the best possible way to ensure that WELL could recover the cost of undertaking the urgent short-term resilience expenditure.<sup>16</sup>
19. Further discussion of the changes we have made to the normal process is set out in Chapter 3.

### **WELL’s customised price-quality path proposal**

20. On 5 December 2017 WELL submitted its CPP application.

#### **Key features of WELL’s CPP proposal**

- WELL proposed to spend an additional \$31.2m of (primarily capital) expenditure over the next three years to better prepare its network for a major earthquake.
- In order to fund this expenditure, WELL requested that we allow it to recover this expenditure from its customers. WELL proposed this would be recovered via an initial increase in its maximum allowable revenue, after which its revenue would be indexed to inflation for the remainder of the CPP period.<sup>17</sup>
- WELL proposed to keep its quality standards the same as under the current DPP.

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<sup>14</sup> Commerce Commission, “Wellington Electricity Customised Price-Quality Path – Process paper” (6 December 2017).

<sup>15</sup> Commerce Act 1986, s 52A.

<sup>16</sup> We consider that WELL’s urgent and exceptional circumstances justify a streamlined CPP in this case (ie, the heightened earthquake risk following the Kaikoura earthquake and the government issuing the government policy statement). However we are unlikely to adopt this approach in the future, unless similar exceptional circumstances were to arise.

<sup>17</sup> This increase does not factor in that WELL was not fully recovering its maximum allowable revenue under the DPP, under its weighted average price cap.

21. We published WELL's CPP proposal for consultation on 6 December 2017, and we received submissions on the proposal in December 2017.<sup>18</sup>

### **In making our decision we considered submissions received**

22. We published a discussion paper on our proposed approach to assessing WELL's additional resilience expenditure on 17 November 2017 and received submissions on that paper later in November.
23. On 6 December 2017 we published a paper outlining the process we intended to follow. We received submissions on this paper and WELL's proposal in December 2017.
24. On 1 February 2018 we published our draft decision for consultation and published a supplementary paper on 16 February 2018 outlining a change from our draft decision. We received submissions on the draft decision in February and early March 2018.<sup>19</sup>
25. We have not specifically addressed all submissions in this paper though we have responded to submissions where appropriate.

### **Structure of this paper**

26. The remainder of this paper is set out into three key parts:
- 26.1 **Chapter 2: Our decision** sets out the price path, expenditure forecasts and quality standards that make up our decision. It also acts as a road map pointing to where more detailed reasons for the decisions can be found in the paper.
  - 26.2 **Chapter 3: Our process for setting WELL's price path** outlines the streamlined process we followed to make our decisions.
  - 26.3 **Chapter 4: Our evaluation** explains the high level framework we applied to evaluate WELL's CPP proposal.
  - 26.4 **Attachment A: Revenue impact explanation**
  - 26.5 **Attachment B: WELL's resilience expenditure**
  - 26.6 **Attachment C: WELL's BAU expenditure**

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<sup>18</sup> WELL's CPP Proposal and submissions in response are available at: <http://comcom.govt.nz/regulated-industries/electricity/cpp/cpp-proposals-and-decisions/wellington-electricitys-2018-2021-potential-cpp/>

<sup>19</sup> Our consultation papers and submissions on them can be found at <http://comcom.govt.nz/regulated-industries/electricity/cpp/cpp-proposals-and-decisions/wellington-electricitys-2018-2021-cpp/>

26.7 **Attachment D: Resilience quality standard assessment**

26.8 **Attachment E: IM variations**

## Chapter 2 Our decision

### Purpose of this chapter

27. This chapter sets out our decision on WELL's CPP including:
  - 27.1 the expenditure allowances that we have provided for;
  - 27.2 WELL's price path – the maximum revenues that WELL will be able to recover; and
  - 27.3 the quality standards that will apply to WELL.
28. It also explains where you can find further discussion of these decisions in this paper.

### Summary of our decision

29. We have decided to allow for WELL's proposed \$31.2m of expenditure to prepare its network for a major earthquake. Our decision allows WELL to deliver a more resilient network that is less susceptible to earthquake damage and provide a reduced risk of prolonged interruptions following an earthquake.
30. WELL will earn a return on and of this capital investment during the three year revenue path we have set and in future pricing periods.
31. We are satisfied that the expenditure is needed and has been costed appropriately to ensure Wellington's network is better prepared to withstand a major earthquake.
32. The resulting CPP maximum allowable revenue (MAR) of \$105.2m for the initial year of the CPP represents a 5.1% increase relative to allowable revenue under the DPP in the same year.<sup>20</sup>
33. We estimate the impact on the typical consumer's monthly electricity bill of \$185 to be around \$1.70.<sup>21</sup> This represents a 0.9% increase.<sup>22</sup>

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<sup>20</sup> The MAR represents the allowable revenue WELL was allowed to recover prior to pass-through and recoverable costs (including wash-ups).

<sup>21</sup> The impact on consumer's electricity bills are based on a WELL's typical consumer's annual electricity bill of \$2,222, including \$402 of annual distribution charges.

<sup>22</sup> Over the CPP period WELL anticipates consumers will pay lower line charges when expected reductions in pass through and recoverable costs (such as transmission costs) are taken into account, offsetting the effect of the increased CPP MAR.

34. In the years following the CPP period, we expect the resilience capex investment will place continued upwards pressure on prices as the full value of the investments enters the regulatory asset base.

#### Key features of our final decision

We have decided to determine WELL's CPP price path, as outlined in our previous process paper:<sup>23</sup>

- for the first two years of the CPP WELL will be able to recover the revenue allowed for under a DPP,<sup>24</sup> as well as revenue associated with the additional resilience expenditure; and
- in the third year of the CPP WELL will be able to recover allowable revenue determined consistent with a DPP revenue setting process (using forecast opex and capex), as well as revenue associated with the additional resilience expenditure.

We have decided to:

- allow for WELL's proposed \$31.2m of expenditure to prepare its network for a major earthquake (resilience expenditure);
- allow for WELL's proposed base expenditure for the third year of the CPP period, being \$30.9m of opex and \$35.8m of capex;
- approve maximum allowable revenue of \$105.2m in the first year of the CPP, and CPI increases for subsequent years of the CPP period;
- retain the same quality standards and incentives for electricity outages as WELL had under its default price-quality path; and
- introduce new quality standards and incentive for WELL to improve its network's ability to respond to a major earthquake.

35. The increase in allowable revenue is a result of the approved resilience expenditure and from WELL transitioning from a weighted average price cap (WAPC) to a revenue cap.
36. Attachment A explains in further detail the reasons for the increase in allowable revenues.

#### We consider that our decision promotes the purpose of Part 4 of the Commerce Act

37. The purpose of Part 4 of the Commerce Act is to promote the long-term benefit of consumers in regulated markets by promoting outcomes consistent with outcomes produced in competitive markets.<sup>25</sup>

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<sup>23</sup> Commerce Commission, "Wellington Electricity Customised Price-Quality Path – Process paper" (6 December 2017)

<sup>24</sup> DPP allowable revenue determined consistent with the DPP but excluding the impact of demand forecast variances – this is consistent with our IM Review decision to move EDBs to a revenue cap.

38. We consider that our decision meets the purpose of Part 4. In reaching this conclusion we have considered, in particular the outcome in s 52A(a) – that suppliers have incentives to innovate and invest. We consider it important that WELL is incentivised to undertake the investment that is needed to better prepare the network to respond to a major earthquake. We are also satisfied that our decision limits WELL’s ability to extract excessive profits in line with s 52A(d).

**We consider our decision is consistent with the evaluation criteria**

39. We consider that our decision on WELL’s CPP is consistent with the CPP evaluation criteria. This includes an assessment of WELL’s capex and opex forecasts against the expenditure objective.<sup>26</sup>

**We consider a full CPP is necessary for any further resilience expenditure**

40. We have undergone a streamlined process to reach our decision on WELL’s CPP. This has involved using WELL’s DPP revenues as a base, and allowing for additional resilience expenditure.<sup>27</sup>
41. We have allowed for this unique process, to address the urgent need for WELL to improve its ability to respond to an earthquake – as highlighted by the increased risk following the Kaikoura earthquakes, and supported by a GPS encouraging the urgent consideration of measures to increase WELL’s resilience.
42. It is the unique nature of WELL’s situation that has created the need for the streamlined CPP. Allowing for a streamlined process for WELL does not create a precedent for other CPP applicants.
43. WELL’s customised price-quality path will last for three years, during which time our decision allows for significant investment in improving its networks’ ability to respond to an earthquake.
44. We consider that there is sufficient time for WELL to fully consider any further resilience investments required and, if needed, plan for and apply for a full CPP under the normal process.

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<sup>25</sup> Commerce Act 1986, s52A.

<sup>26</sup> We discuss our assessment of WELL’s CPP against the evaluation criteria in ‘Chapter 4 – Our evaluation approach’.

<sup>27</sup> This streamlined process is explained in more detail in ‘Chapter 3 – Our approach to setting WELL’s price path’.



## WELL's resilience expenditure

45. We have allowed for WELL's proposed resilience expenditure of \$30.1m capex and \$1.2m opex.
46. We used Strata Energy Consulting (Strata) to assist in our review of WELL's resilience expenditure. This included an initial review of the proposed resilience expenditure to identify any potential issues. Strata identified a number of issues which we discussed with WELL. Ultimately we concluded, consistent with Strata's recommendation, that there was no reason to decline or adjust the CPP application, based on the issues identified.
47. Strata did note that there were some areas where WELL could better articulate its quantitative analysis of the costs and benefits of the proposed expenditure. MEUG, in its submission on the draft decision, also noted that "... if the WELL business case method is applied to larger scale expenditure to improve resilience a more sophisticated analysis ... will be required."<sup>28</sup>
48. We consider that the substantial unquantified benefits along with the quantified benefits, justify the proposed resilience expenditure as prudent to meet appropriate service standards. We also consider that the proposal represents the efficient costs of achieving these service standards.
49. Based on the findings outlined in the Strata report and our review of the issues identified, we are comfortable the proposed resilience expenditure meets the expenditure objective.
50. Our reasons are explained in more detail in Attachment B, including further discussion of the unquantified benefits of the expenditure that we have considered in making our decision.
51. We have previously published, alongside our draft decision, the report from Strata that outlines its assessment of WELL's CPP resilience expenditure.

## WELL's base expenditure for the third year of the CPP

52. As outlined above our decision is to use, for the third year of the CPP, revenue determined consistent with a DPP approach as our base (using forecast opex and capex).<sup>29</sup>
53. This section outlines how we have determined the appropriate business-as-usual (BAU) capex and opex for the base revenue of the third year of the CPP.<sup>30</sup>

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<sup>28</sup> Major Electricity Users' Group, *Wellington Electricity CPP draft decision* (22 February 2018) page 3

<sup>29</sup> We have not determined opex and capex forecasts for the first two years as the streamlined CPP is based off revenues already set under the 2015-2020 DPP.

### **BAU capital expenditure for year 3**

54. We have allowed for \$35.8m of BAU capital expenditure (capex) for the third year of the CPP, consistent with what was proposed by WELL. WELL has proposed BAU capex for the third year of the CPP consistent with the forecast outlined in its 2017 asset management plan.
55. We used Strata to review WELL's 2020/21 capex, and to recommend an appropriate expenditure allowance (for BAU activities) that year.
56. Strata assessed WELL's proposed BAU capex for the third year of the CPP by comparing disaggregated expenditure forecasts against historical expenditure and other metrics, and then investigating any anomalies.
57. After discussing the anomalies with WELL, Strata recommended we accept the expenditure.
58. We are comfortable WELL's third year BAU expenditure meets the expenditure objective. This decision is supported by the recommendations from Strata and our review of Strata's findings.

### **BAU operating expenditure for year 3**

59. We have allowed for \$30.9m BAU operating expenditure (opex), consistent with what was proposed by WELL.
60. WELL has proposed base opex for the third year of the CPP consistent with its forecast opex as outlined in its 2017 asset management plan.
61. We modelled base and trend projections of WELL's opex forecast and used this forecast as a cross-check against WELL's proposed opex forecast.
62. Based on this modelling we determined that WELL's forecasts were in line, with our expectations and accordingly met the expenditure objective.

### **Application of expenditure objective to base expenditure is consistent with DPP approach**

63. In applying the expenditure objective to our assessment of WELL's BAU expenditure for year three of its CPP we have not applied the same level of scrutiny that we usually would under a CPP. Rather, we have applied a level of scrutiny more consistent with the approach applied in our recent gas distribution DPP decision.<sup>31</sup>

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<sup>30</sup> BAU expenditure is the appropriate level of expenditure excluding the additional resilience expenditure.

<sup>31</sup> Further details on the recent Gas distribution reset can be found at <http://comcom.govt.nz/regulated-industries/gas-pipelines/gas-default-price-quality-path/2017-2022-gas-dpp/>

64. We consider that this approach was warranted in the context of WELL's streamlined CPP, taking into account WELL did not propose a significant uplift in BAU expenditure compared with historical expenditure, and the urgency with which we have undertaken this process.
65. Ultimately, we consider that this approach promotes long term benefits to consumers by ensuring that WELL's CPP can be determined urgently in order to enable the important improvements to WELL's network.
66. As signalled throughout this process, we are unlikely to adopt this approach for future CPPs.

### **WELL's price path**

67. We have allowed WELL a MAR of \$105.2m in the first year of the CPP period. WELL will then be able to increase revenue by CPI for each subsequent year of the CPP period.<sup>32</sup>
68. In making our decision we have assumed that an increase in prices of less than \$2 a month at the beginning of the CPP period is unlikely to be a price shock for consumers. This increase could also, potentially, be offset by other factors, such as reductions in transmission charges, anticipated by WELL. As such, we have decided not to tilt WELL's price path.

### **WELL's BAU revenue is based on revenues they would likely receive under a DPP**

69. In determining WELL's CPP price path we have aligned base revenue for the first two years to that which WELL would receive under the current DPP but excluding the impact of demand forecast risk. This amount takes into account actual CPI, and where actual CPI is not available updated forecast CPI projections. Using updated CPI is aligned with how allowable revenue would be determined under WELL's DPP.<sup>33</sup>
70. Using actual CPI to determine the BAU revenue was different to how we initially determined our draft decision. An explanation of the change is outlined in more detail in our paper we published subsequent to the draft decision.<sup>34</sup>
71. Both MUEG and WELL, in their submissions on the draft decision, supported our decision to apply the actual CPI to the base revenue calculation.

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<sup>32</sup> This figure is defined as 'actual net allowable revenue' and 'forecast net allowable revenue' in the CPP determination.

<sup>33</sup> Commerce Commission, *Electricity Distribution Services Default Price-Quality Path Determination 2015 (consolidating all amendments as of 9 July 2015)* schedule 3B

<sup>34</sup> Commerce Commission, *Wellington Electricity's proposal to customise its price path to better prepare its network for an earthquake – Change from the draft decision* (16 February 2018)

### **Pass-through and recoverable costs for the CPP period**

72. The categories of pass-through costs and recoverable costs that WELL may recover in its prices (and that are not included in the BBARs, MARs or the setting of the price path) are defined in the IMs. Although these additional costs increase the amounts payable by consumers, they are not reflected in our estimated initial MAR increase.
73. We are, however, required to specifically determine certain pass through and recoverable costs amounts in the CPP determination.
74. We have specified in our determination that WELL may recover the costs of having its CPP proposal audited – \$71,396.05.
75. We have also specified the amount of the capex wash-up adjustment as discussed in Attachment E.
76. Other pass through and recoverable costs include costs (set out in the IMs) that are outside the control of WELL (such as electricity lines service charges payable to Transpower), financial incentives and wash-ups from prior periods.

### **WELL's pass-through balance moving off the DPP**

77. WELL has forecast a negative 'pass-through balance' of approximately \$10m as at 31 March 2018. This is the amount that WELL owes consumers for the past over-recovery of pass-through and recoverable costs.
78. We have decided that the pass-through balance should be returned to customers evenly over the CPP period, to reduce the likelihood of price volatility.
79. Our draft determination provided for this amount to be paid back to consumers in the first year of WELL's CPP. However, we noted that this could create volatility in prices.
80. In its submission on our draft decision, MEUG noted its preference for immediate payment rather than deferred payment: "because the longer payments are deferred the greater the misalignment between customers that overpaid and payment receipts".<sup>35</sup>
81. WELL, however, requested it be allowed to smooth the return over the CPP period, at its discretion, to address the potential "saw tooth" impact of returning the balance in a single year, which it considered would create pricing instability over the CPP period.

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<sup>35</sup> Major Electricity User Group, *Wellington Electricity CPP draft decision* (22 February 2018) page 4

82. In its cross-submission MEUG highlighted that smoothing the balance could reduce visibility, and hence accountability, for non-routine line charge credits or one-off increases.
83. In general, we consider that smoothed prices are preferable to the extent practicable as this gives consumers the benefit of greater stability and certainty as to their power bill during the regulatory period. We consider that this benefit outweighs any additional transparency that more volatile pricing may provide.
84. We did not see any compelling reason to allow WELL discretion to determine how the pass-through balance is spread and therefore we have decided on an even recovery over the three years.
85. We have applied an adjustment to account for the 'time value of money', meaning that spreading the repayment of the balance will be neutral in 'net present value' terms.
86. We consider smoothing of prices to be more beneficial to customers than the potential misalignment between customers that overpaid and payment receipts, which is consistent with our treatment of a number of other wash-ups, both positive and negative.
87. We have agreed to an associated variation to the IMs to enable the balance to be smoothed in the way described.

**MEUG suggested that we should apply a different WACC to WELL's resilience expenditure**

88. We have applied to the resilience expenditure investments the standard weighted average cost of capital (WACC) that is specified in the IMs and applicable to all RAB assets.
89. MEUG, in its submission on our discussion paper, suggested the standard CPP weighted average cost of capital might be excessive relative to the resilience expenditure investment risks and that we should consider adjusting the WACC applied in this instance.<sup>36</sup>
90. We did not consider adjusting the WACC because the IMs specify the WACC we must apply and this WACC is designed to apply to a portfolio of investments with varying risk levels.
91. The consideration of applying alternative WACC's to specific scenarios would be most appropriately addressed as part of an IM Review process.

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<sup>36</sup> Major Electricity User Group, *Wellington Electricity earthquake resilience* (28 November 2017) page 4

## WELL's reliability quality requirements

92. WELL will be subject to reliability quality standards and incentives for planned and unplanned interruptions over the CPP period, consistent with the standards and incentives set under WELL's DPP. We have also set the same standards and incentives for the third year of WELL's CPP, which was not set under the DPP.
93. We consider this appropriate as WELL's additional resilience investments are unlikely to have strong linkages with reliability.
94. WELL's reliability quality standard, measured through the System Average Interruptions Frequency Index (SAIFI) and System Average Interruptions Duration Index (SAIDI), restricts the frequency and duration of interruptions allowed on WELL's network. If WELL fails to meet reliability quality standard, WELL will breach its quality path and we may take enforcement action.
95. The revenue linked quality incentive that was in operation under the DPP will also apply to WELL's CPP. Under this incentive each year WELL will stand to gain or lose up to 1% of the forecast net allowable revenue, depending on how it performs against its SAIFI and SAIDI targets.
96. This will provide WELL with incentives to improve network reliability beyond that required by the reliability quality standard where it is cost-effective to do so.
97. Consistent with the DPP, when measuring SAIDI and SAIFI, planned interruptions will be weighted at half that of unplanned interruptions. This recognises that planned interruptions are needed to maintain WELL's network and that they are less disruptive to end consumers than unplanned outages.
98. Key reliability metrics for WELL's reliability quality path are set out in the tables below.

**Table 2.2: SAIDI Limit, SAIFI Limit, SAIDI unplanned boundary value, and SAIFI unplanned boundary value for the CPP regulatory period 1 April 2018 – 31 March 2021**

Wellington Electricity	2018/19	2019/20	2020/21
SAIDI limit (minutes)	40.630	40.630	40.630
SAIDI unplanned boundary value (minutes)	2.103	2.103	2.103
SAIFI limit (outages)	0.625	0.625	0.625
SAIFI unplanned boundary value (minutes)	0.031	0.031	0.031

**Table 2.3: SAIDI quality incentive measures for the CPP regulatory period  
1 April 2018 – 31 March 2021**

<b>Wellington Electricity</b>	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>
SAIDI target (minutes)	35.4358	35.4358	35.4358
SAIDI collar (minutes)	30.2414	30.2414	30.2414
SAIDI cap (minutes)	40.6302	40.6302	40.6302

**Table 2.4: SAIFI quality incentive measures for the CPP regulatory period  
1 April 2018 – 31 March 2021**

<b>Wellington Electricity</b>	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>
SAIFI target (outages)	0.5465	0.5465	0.5465
SAIFI collar (outages)	0.4682	0.4682	0.4682
SAIFI cap (outages)	0.6248	0.6248	0.6248

99. Further details on WELL’s quality standard are set out in the determination which we have published alongside this paper.

### **WELL’s resilience quality requirements**

100. We have included new quality standards and an incentive for resilience improvements as part of WELL’s CPP (resilience quality mechanism).
101. Given that we are specifically providing for expenditure to improve the resilience of WELL’s network to an earthquake, we consider it appropriate to include a quality mechanism that incentivises WELL to meet the objectives of the additional expenditure (ie, ensuring that it is better placed to maintain and return supply following a major earthquake).
102. We explain how WELL’s resilience is measured in more detail, including implementation changes from our draft decision and further discussion of submissions, in ‘Attachment D – Resilience quality standard assessment’.

### **Current quality requirements not sufficient to address resilience expenditure improvements**

103. The current reliability quality requirements are not sufficient to ensure the delivery of resilience improvements, as improved earthquake resilience is not expected to be reflected in SAIDI and SAIFI.

### **Resilience quality requirements to incentivise WELL to deliver on CPP objectives**

104. We have decided to introduce resilience quality standards, requiring WELL to deliver a minimum level of the resilience improvements set out in its CPP proposal. This will be measured by a resilience index which will run from 0 to 100 and, at a high level will measure the extent to which:<sup>37</sup>

104.1 WELL's key substations are adequately seismically strengthened;

104.2 WELL has capability to replace certain amounts of cable damaged in an earthquake;

104.3 WELL has capability to replace a substation at short notice, in both the CBD and the Hutt regions; and

104.4 WELL is suitably prepared to maintain data and communication links in the case of an earthquake.

105. In submissions on our draft decision MEUG and Transpower supported the introduction of a resilience quality standard. Transpower submitted:<sup>38</sup>

we consider the requirement for additional service quality measures, coupled with revenue-at-risk, is a reasonable and prudent requirement to help ensure consumers get the benefits of the proposed additional expenditure.

106. WELL, however, noted its concerns that this type of standard had not been implemented previously by the Commission:<sup>39</sup>

To date, the Commission has focussed on reliability as the core quality standard in prior CPP determinations. We note that the Commission can apply additional quality standards at its discretion under a CPP, but there has never been an indication of including deliverability quality standards in previous IM reviews or CPP decisions.

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<sup>37</sup> For the avoidance of doubt, a resilience value of 100 does not represent a fully resilient network – rather it represents the fully delivery of the resilience improvements that we expect over the CPP period.

<sup>38</sup> Transpower, *Wellington Electricity CPP network resilience draft decision* (22 February 2018)

<sup>39</sup> Wellington Electricity, *Submission on the Commerce Commission's 'Wellington Electricity's proposal to customise its prices to better prepare its network for an earthquake' draft decision* (February 2018) page 5



107. While, to date, EDB DPP quality standards have been based on historical reliability, WELL has elected to propose a CPP in order to gain additional revenues to fund specific resilience improvements. These improvements will not have a clear impact on reliability so we consider it necessary to introduce a quality standard and incentive that ensure that WELL delivers the improvements to resilience that have been provided for.

*Minimum resilience improvements that WELL must deliver*

108. We have decided to require WELL to deliver a minimum level of resilience improvements in every year of the CPP.
109. Each year WELL will assess the resilience improvements it has delivered in order to determine its performance on the resilience index.
110. A resilience index value of 100 represents the full delivery of the resilience outcomes, whereas an index value of 0 would mean that WELL had delivered none of these resilience improvements.
111. If WELL fails to meet the minimum resilience levels set out in the table below, WELL will breach its quality path and we may take enforcement action.

**Table 2.5: Resilience minimum for the CPP regulatory period 1 April 2018 – 31 March 2021**

<b>Wellington Electricity</b>	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>
Draft Resilience Minimum	0	0	60
Final Resilience Minimum	20	40	60

112. Submitters provided opposing views on the level and timing of the minimum resilience standards. These are discussed further in Attachment D. We amended our draft decision after considering these submissions.

*WELL will be subject to a revenue linked incentive*

113. WELL will be subject to a revenue linked incentive, relating to its progress in meeting its resilience objectives. To the extent that WELL does not deliver the resilience improvements, as outlined in its proposal, its revenue will be proportionately reduced through the 'quality incentive adjustment' recoverable cost in the next period.

### *Quantum of revenue at risk*

114. WELL could have its future revenues reduced by up to \$5.2m for non-delivery of resilience improvements in the CPP period. This amount represents what WELL would stand to gain, if it did not undertake any of the expenditure allowed for delivering resilience improvements.<sup>40</sup>
115. We discuss WELL's submission on the quantum of the incentive, and why we have retained our draft decision in 'Attachment D - Resilience quality standard assessment'.

### **WELL incentivised to deliver resilience improvements efficiently**

116. WELL is still incentivised to deliver these improvements efficiently and will share with consumers any efficiencies achieved in delivering the resilience improvements, through the capex incentive.<sup>41</sup>

### **Resilience quality incentives**

117. Key metrics for WELL's resilience incentive are set out in the tables below:

**Table 2.6: Resilience quality incentive measures for the CPP regulatory period 1 April 2018 – 31 March 2021**

<b>Wellington Electricity</b>	<b>2018/19</b>	<b>2019/20</b>	<b>2020/21</b>
Resilience target	100	100	100
Revenue at risk			\$5.185m

118. WELL's resilience target represents the full delivery of the resilience improvements expected from the resilience investment. If WELL fully delivers these improvements then there will be no incentive adjustment under this mechanism.
119. WELL's assessed resilience index value will be capped at the 100, and collared at 0, meaning that the incentive will apply to any possible value that WELL attains on the resilience index.

<sup>40</sup> This amount takes into account the impact of the capex incentive applying to WELL. This is discussed in more detail in Attachment D.

<sup>41</sup> See: *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, Part 3, Section 3 of the EDB IMs.

**Reporting on resilience improvements**

120. WELL will be required to report its progress against the resilience index on an annual basis through its annual compliance statement.
121. Reporting is to include supporting evidence, demonstrating how WELL has determined its compliance.
122. The annual compliance statement is also required to be certified and audited, consistent with the compliance and audit requirements applicable to SAIDI and SAIFI.

**IM variations**

123. We have varied the IMs to allow WELL's revenue path to be calculated consistent with the 'streamlined CPP' approach and to allow financial incentives and wash-ups to apply as intended under the varied approach.
124. We have varied the IMs consistent with what WELL proposed in its CPP proposal, except for the proposed opex IRIS variation.
125. We have also made variations to the IMs to correct a drafting error in the opex IRIS, address an issue with the revenue wash-up mechanism and to provide for the smoothing of WELL's pass through balance.
126. Attachment E outlines each of the IM variations, WELL's reasons for proposing them and our reasons for our final decision.

## Chapter 3 Our process for setting WELL's price path

### Purpose of this chapter

127. This chapter outlines how we set WELL's price path and how the CPP process has been tailored to align with the unique nature of WELL's CPP proposal. The chapter also outlines how we have modified and varied the IMs to allow for the streamlined CPP process.

### The IMs set out how regulated suppliers price paths are set

128. The Commerce Act required us to set rules and processes for CPPs – these rules and processes are referred to as input methodologies (IMs).<sup>42</sup>
129. The IMs we have previously set relating to CPPs include the requirements that must be met by the applicant for information, verification, audit and consumer consultation, as well as the criteria that we must use to evaluate a CPP proposal.<sup>43</sup>

### What we are trying to achieve – key elements of the streamlined WELL CPP

130. We considered that the best way to enable WELL to undertake its necessary resilience expenditure was to enable the submission of a 'streamlined' CPP proposal, exempting WELL from many of the usual requirements for submitting and determining a CPP. This required us to alter, for the purpose of WELL's CPP, the IMs.
131. The regime provides scope for us to modify and vary the IMs, to allow us to accept, evaluate and determine a streamlined CPP proposal. Given the particular circumstances of WELL's proposal we have made use of this flexibility.
132. The key features of the streamlined CPP include:
- 132.1 The CPP starts on 1 April 2018 and runs for three years, under a revenue cap which will apply for the three year period;
- 132.2 The allowable revenue in the 2018/19 and 2019/20 years consist of existing allowable revenues applicable under the existing DPP excluding the impact of demand quantity risk,<sup>44</sup> plus allowable revenue for additional resilience expenditure;

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<sup>42</sup> As required by the Commerce Act 1986, s 52T.

<sup>43</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, Part 5.

<sup>44</sup> Existing revenues applicable under the existing DPP excluding the impact of demand quantity risk has been applied to align WELL's CPP with our IM Review decision to transfer EDB's from a weighted average price cap to a revenue cap

- 132.3 The allowable revenue in 2020/21 consists of allowable revenue based on forecast BAU expenditure (determined using the existing DPP BBAR calculation) plus allowable revenue for the additional resilience expenditure;
- 132.4 Scrutiny, in detail, of the additional resilience expenditure;
- 132.5 Scrutiny of the BAU expenditure allowances already provided for in the 2018/19 and 2019/20 years of the DPP and the 2020/21 year forecast, to the extent necessary to confirm that the additional resilience expenditure was not already provided for under them (ie, confirming there is no “double-dipping”); and
- 132.6 Modified verification and audit requirements consistent with the streamlined CPP process.

*Use of modifications and exemptions*

- 133. In order to implement a streamlined CPP process, we exempted WELL from the information requirements for CPPs apart from the limited information we needed to determine a streamlined CPP.
- 134. The information we required included (among other things):
  - 134.1 an overview of the proposal;
  - 134.2 the business cases for the resilience expenditure and any associated models;
  - 134.3 WELL’s latest AMP;
  - 134.4 a financial model for the CPP period;
  - 134.5 a summary of feedback from the consumer consultation undertaken;
  - 134.6 director’s certification of the proposal;
  - 134.7 a limited scope audit report; and
  - 134.8 the proposed variations to the IMs for determining the CPP.
- 135. We also had the ability to request further information after the CPP proposal was submitted using our information gathering powers.<sup>45</sup> We requested further information from WELL, as needed, throughout the evaluation.

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<sup>45</sup> Under s 53ZB and s 98 of the Commerce Act 1986.

136. We modified the requirements for WELL to undertake verification, audit and consumer consultation, including:
- 136.1 removing the requirement for WELL to undertake verification. WELL has provided an independent engineer's report supporting the resilience expenditure as part of its application. We also used our own experts to help us verify the CPP application after it was submitted;
  - 136.2 modifying the audit requirements to ensure that the proposal could be audited in accordance with the streamlined process. This included limiting the scope of the audit to information required to set the streamlined CPP price path; and
  - 136.3 requiring WELL to provide a summary of feedback from the engagement that it had undertaken with key stakeholders, but we did not require specific consultation with consumers. We instead consulted with consumers ourselves on the proposed expenditure.
137. Although we modified WELL's consultation obligations, consumers had at least three opportunities to have their say on the streamlined CPP, including what the process would look like, the IM variations, and whether further information was needed to evaluate the CPP proposal. This included:
- 137.1 consultation on our proposal to undertake a streamlined CPP process;
  - 137.2 initial consultation on WELL's CPP proposal (as part of this consultation, consumers were able to see any modifications and exemptions that we agreed with WELL, and ask us to request further information from WELL if needed); and
  - 137.3 consultation on our draft CPP decision, including variations to the IMs.<sup>46</sup>
138. We do not think that modifying the IMs in this way detracted, in a way that is more than minor, from our ability to evaluate and determine the CPP or for interested persons to provide input in the particular special circumstances.

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<sup>46</sup> The consultation documents and submissions in response are available at:  
<http://comcom.govt.nz/regulated-industries/electricity/cpp/cpp-proposals-and-decisions/wellington-electricitys-2018-2021-potential-cpp/>

### *Use of variations to the IMs*

139. We decided to vary the IMs relating to the determination of the price path broadly consistent with the variations proposed by WELL as part of its CPP proposal and to correct other items identified during the assessment process.
140. The variations proposed by WELL and accepted by us include:
- 140.1 changing the IMs to allow for a three year price path;
  - 140.2 allowing a different approach to building the price path; and
  - 140.3 implementation matters (such as the application of the incremental rolling incentive scheme) to allow the IMs applicable to the streamlined CPP process to align with our policy intent.
141. As part of its submission on our draft decision WELL also proposed an additional variation to remove the double treatment of “other regulated income” in the revenue wash-up mechanism.
142. The variations are discussed in more detail in Attachment E of this paper.

### **We created a new submission window for WELL’s CPP application**

143. Applications are only able to be made in specific windows set out in the DPP determination. The CPP windows are intended to allow us to prioritise CPPs when more than three are received in a given year.
144. We amended the DPP determination in order to allow WELL to submit its CPP outside of the usual windows.<sup>47</sup> We do not consider that this is a material change, given that we did not expect any further CPPs, apart from Powerco’s, that year.

### **How we forecasted the third year of the CPP**

145. We decided that applying a similar approach to that taken in the recent gas DPP reset is an appropriate approach for determining the 2020/21 year base expenditure.
146. As part of the streamlined CPP we needed to determine WELL’s allowable revenue for the 2020/21 year, which is beyond the end of the current DPP. This meant we were not able to adopt a DPP allowance as the base for setting WELL’s revenue allowance for that year.

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<sup>47</sup> *Electricity Distribution Services Default Price-Quality Path (CPP Window) Amendment Determination November 2017 [2017] NZCC27*

147. We started by analysing WELL's AMP and then applied further scrutiny to expenditure that was not consistent with what we expected to be 'business-as-usual'. We then used these expenditure forecasts to build the allowable revenue for the third year of the CPP using a simple building blocks approach.<sup>48</sup>

**WELL will move to a revenue cap for the CPP**

148. WELL will move from a weighted average price cap to a revenue cap for the 2018/19 and 2019/20 years in line with the recently amended IMs.<sup>49</sup>
149. WELL, under the DPP, is subject to a weighted average price cap as its price control. Under a weighted average price cap supplier revenue is exposed to differences between forecast and actual demand.
150. As part of our IM Review last year, we decided that a revenue cap was a more appropriate form of control for EDBs as it would remove this forecasting risk for suppliers.

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<sup>48</sup> Building blocks approach uses the forecasts of various costs to a business, in order to determine the appropriate revenue for that business.

<sup>49</sup> Consistent with the recently amended IMs, a revenue cap would apply to WELL in 2020/21 irrespective of whether they are on a DPP or CPP.



## Chapter 4 Our evaluation approach

### Purpose of this chapter

151. This chapter explains the approach we have taken to evaluate WELL's CPP proposal and make our decision. It explains, at a high level, the framework that we have applied in order to make a decision that aligns with the unique nature of WELL's proposal while delivering long-term benefits to consumers.

### The Commerce Act guides our determination of WELL's CPP

152. Our starting point for determining WELL's CPP is the purpose of Part 4 of the Commerce Act – to promote the long-term benefit of consumers.<sup>50</sup>

#### The purpose of Part 4 of the Commerce Act

##### 52A purpose of Part 4

- (1) The purpose of Part 4 is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—
- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
  - (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
  - (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
  - (d) are limited in their ability to extract excessive profits.

### The CPP evaluation criteria

153. The criteria that we must use to evaluate a CPP are set out in EDB input methodologies.<sup>51</sup> These criteria are intended to ensure that our determination of a CPP promotes the long-term benefit of consumers.

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<sup>50</sup> Commerce Act 1986, s52A.

<sup>51</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 5.2

### **Evaluation criteria for customised price-quality path proposals**

The Commission will use the following evaluation criteria to assess each CPP proposal:

- a) whether the proposal is consistent with the input methodologies;
- b) the extent to which the proposal promotes the purpose of Part 4 of the Act;
- c) whether data, analysis, and assumptions underpinning the proposal are fit for the purpose of determining a CPP;
- d) whether the proposed capital and operating expenditure meet the expenditure objective;
- e) the extent to which any proposed variation to the existing quality standards better reflects what the applicant can realistically achieve, taking into account either or both: statistical analysis of past SAIDI and SAIFI performance; and the level of investment provided for in the proposal; and
- f) the extent to which the CPP applicant has consulted with consumers on its CPP proposal; and the proposal is supported by consumers, where relevant.

154. We briefly explain below each of the evaluation criteria and how they have been applied to the WELL streamlined CPP.

### **Assessment of WELL's CPP against evaluation criteria**

#### **Whether the proposal is consistent with the relevant input methodologies**

155. WELL's proposal must apply or adopt all relevant IMs.<sup>52</sup> The IMs establish the key rules, requirements and processes of regulation. As outlined in chapter three we have provided modifications and amendments to the IMs to allow for a streamlined CPP process.
156. Our evaluation of WELL's proposal included assessing whether the proposal was consistent with the IMs, following the WELL modifications and exemptions. This included an assessment, prior to accepting the proposal, of whether the proposal met the CPP process and content IM requirements; as well as an assessment of whether the proposal met the substantive IMs for determining a CPP.
157. On 15 December 2017 we determined that the CPP proposal was consistent with the IMs.

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<sup>52</sup> Commerce Act 1986, s53Q(2)(d).

#### **The extent to which the proposal will promote the purpose of Part 4**

158. To satisfy the evaluation criteria the proposal must promote the purpose of Part 4 of the Act, outlined above. The Act sets out objectives in s52A(1)(a)-(d) which are integral to promoting the long-term benefit of consumers, and reflect key areas of supplier performance that we would expect in markets with workable competition.

#### **Whether the information in the proposal is fit for purpose**

159. The information in a proposal must be sufficient in detail and quality to allow us to undertake our assessment.<sup>53</sup> The assumptions used must also be robust.
160. To enable a streamlined process we modified the information we required from WELL. For the most part WELL provided the required information in a way that was fit for purpose for evaluating its streamlined CPP proposal.
161. Where we considered further information was necessary to establish if it was fit for purpose, we requested this from WELL. Where we had doubts about the appropriateness or robustness of an assumption, we sought further explanation for the assumption or used a more appropriate assumption.

#### **Whether the proposed expenditure reflects the expenditure objective**

162. The expenditure objective was included in the IMs as a specific evaluation criterion for the assessment of capex and opex.<sup>54</sup>
163. The expenditure objective requires us to assess WELL's proposed capex and opex on the basis that it reflects the efficient costs that a prudent supplier subject to price-quality regulation would require to:
- 163.1 meet or manage the expected demand for electricity distribution services, at appropriate service standards, during the customised price-quality path regulatory period and over the longer term; and
- 163.2 comply with applicable regulatory obligations associated with those services.<sup>55</sup>
164. The assessment of forecast expenditure is not a mechanistic process – it necessarily involves the exercise of judgement supported by expert advice.

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<sup>53</sup> Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper* (22 December 2010), para 9.4.8.

<sup>54</sup> Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper* (22 December 2010), para 9.4.10.

<sup>55</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 1.1.4.

165. For the purposes of WELL's CPP the focus of our assessment against the expenditure objective has been on whether the resilience expenditure proposed by WELL reflects efficient costs a prudent supplier would incur to meet appropriate resilience service standards.
166. We also considered whether WELL's forecasts for the third year of its CPP met the expenditure objective.

#### **Whether any proposed quality standard variation is realistically achievable**

167. There was no proposed variation to the existing quality standards so we have not considered this evaluation criterion, in relation to WELL's reliability standard.<sup>56</sup>
168. We have, however, adopted an additional quality standard which is discussed in Chapter 2 and Attachment D.
169. While we are not required to consider this criterion, in relation to the resilience quality standards, we are satisfied that the standard we have set is realistically achievable.

#### **The extent of WELL's consultation with consumers and support from WELL's consumers**

170. A CPP path must promote the long-term benefit of consumers. While consumers are best placed to understand what they value in terms of price and quality trade-offs, we acknowledge that a supplier should have a better understanding of the required network investment to meet those preferences than its consumers. Accordingly, while consumer support for the network investment is taken into account, agreement to the proposed customised price-quality path is not required.<sup>57</sup>
171. When evaluating WELL's CPP proposal we have considered:
- 171.1 the need for WELL's network resilience as outlined in the government policy statement;<sup>58</sup>
  - 171.2 the extent of support by consumers for the resilience expenditure that was outlined by WELL in its proposal;<sup>59</sup> and
  - 171.3 submissions we received on our Process Paper, WELL's CPP proposal, and our draft decision.<sup>60</sup>

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<sup>56</sup> *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26, clause 5.4.5.

<sup>57</sup> Commerce Commission, *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper* (22 December 2010), para 9.4.16.

<sup>58</sup> "Government Policy Statement — Resilience of Electricity Services in the Wellington Region" (21 September 2017) 97 *New Zealand Gazette* at 53.

<sup>59</sup> Wellington Electricity, *Earthquake Readiness: Customised Price –Quality Path Proposal* (5 December 2017) section 5.1.

172. We have taken into account the nature of the resilience expenditure and the streamlined process, compared with usual CPPs, in determining the extent of WELL's consultation with consumers.

### **Our evaluation of WELL's proposal against the evaluation criteria**

173. The starting point for our assessment was the review of WELL's proposal by Strata. We have also considered the findings and recommendations outlined from the independent engineer's review provided by WELL.

### **WELL provided us an independent engineering report from Jacobs**

174. WELL sought an exemption to the requirement to obtain 'verification' under clause 5.1.3 of the IMs in favour of providing evidence of an independent engineering review of its earthquake readiness business case.
175. Jacobs were engaged to undertake the independent review. Jacobs is a global provider of technical, professional, and scientific services, including engineering, architecture, construction, operations and maintenance.
176. WELL used the feedback from the Jacobs review to revise its proposal. Revisions to the proposal changed the total proposed resilience expenditure from \$32.0m to \$31.2m.
177. Jacobs also provided a letter summarising the review and outlining key findings and recommendations. WELL responded to the findings and recommendations outlined by Jacobs in its submission.
178. We have taken account of the Jacob's report in reaching our decision, while recognising that Jacob's review process did not have the full independence safeguards in place as would an independent verifier.

### **We used Strata as our own independent expert to assist our evaluation of WELL's CPP proposal**

179. As explained in more detail in Attachments B and C, we engaged Strata to assist us in the evaluation of WELL's CPP proposal.
180. Strata produced two reports – with recommendations on appropriate levels of resilience expenditure and BAU expenditure – which we published alongside our draft decision.

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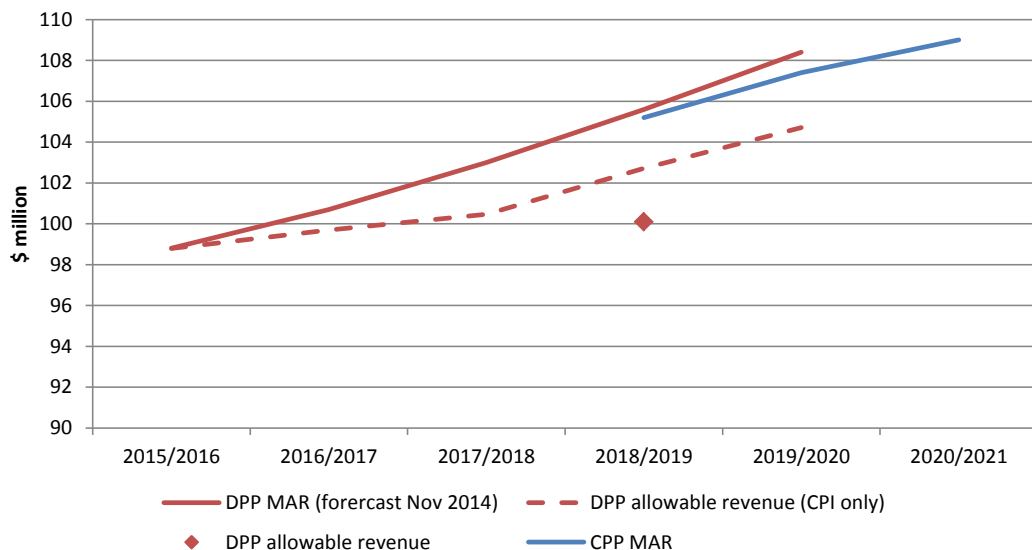
<sup>60</sup> The consultation documents and submissions in response are available at:  
<http://comcom.govt.nz/regulated-industries/electricity/cpp/cpp-proposals-and-decisions/wellington-electricitys-2018-2021-potential-cpp/>

181. We critically reviewed Strata's recommendations, with the assistance of Commission engineering experts, and concluded that Strata's recommendations are appropriate for the purposes of WELL's streamlined CPP.

## Attachment A Revenue impact explanation

182. This attachment explains the allowable revenue increase resulting from this CPP decision.
183. The increase in allowable revenue, relative to DPP allowable revenue, is a result of additional resilience expenditure and from WELL moving from a DPP to a CPP. By moving to a CPP WELL is no longer subject to demand forecast risk which has increased its base allowable revenue.
184. The below graph compares the CPP MAR with allowable revenue WELL is forecast to earn under a DPP. To provide context, the graph outlines the following:
- 184.1 DPP MAR – the maximum allowable revenue we forecast in 2014 as part of the DPP decision;
- 184.2 DPP allowable revenue – the revenue WELL would be able to recover under the DPP which takes into account updated CPI and demand quantities;<sup>61</sup>
- 184.3 DPP allowable revenue (CPI only) – the revenue WELL would be able to recover under the DPP but excluding the impact of demand forecast risk; and
- 184.4 CPP MAR – the maximum allowable revenue we forecast as part of this CPP decision.

**Figure A.1: Allowable revenue increase**



<sup>61</sup> DPP allowable revenue is different to the notional revenues that are used to confirm compliance under the DPP Determination.

*WELL was to earn less under the DPP than we forecast when setting the DPP*

185. WELL has been and is forecast to, for the rest of the DPP period, earn less than we initially forecast in 2014 when setting the DPP.
186. WELL's estimated allowable revenue under the DPP for 2018/19 was expected to be some 5.2% less than what we estimated in the DPP decision. Under the current DPP regime EDB's earn a return that is updated during the assessment period for actual CPI and demand quantities. Actual CPI and demand quantities during the DPP period have been lower than we forecast when setting the DPP.

*WELL's transition to a CPP removes their exposure to demand forecast risk*

187. In the 2016 IM Review we decided EDBs would move from a weighted average price cap to a 'pure' revenue cap, therefore removing EDBs exposure to demand forecast variances.<sup>62</sup> By transitioning to a CPP part way through the DPP period, WELL removes its exposure to the demand forecast earlier than the EDBs that remain on the DPP.
188. As outlined in our reasons paper to the IM Review decision, one of the three key problems identified in relation to the weighted average price cap for EDBs was that suppliers are exposed to demand forecasting risk. It was noted that when actual demand is higher than our forecast there will be a revenue gain for suppliers and if the opposite occurs and actual demand is lower than our forecast then there would be a revenue loss for suppliers.<sup>63</sup>
189. During the current DPP period, WELL's actual demand has been lower than our 2014 forecast which has reduced WELL's DPP allowable revenue for the 2018/19 year by 2.6%. By transitioning to a CPP the reduction created by demand forecast variances is avoided in 2018/19 and 2019/20.<sup>64</sup>

*Resilience expenditure also increases prices*

190. The additional resilience expenditure increases allowable revenue on average by 1.3% over the CPP period. As seen in Figure A.1, the observed increase in the CPP MAR relative to the DPP allowable revenue (CPI only) in the initial year is higher at 2.4%. The impact in the initial year is higher because the BAU revenue we

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<sup>62</sup> If WELL remained subject to a DPP it would transition to a revenue cap at the beginning of the next DPP period (2020/21).

<sup>63</sup> As discussed further in the document: Commerce Commission, *Input methodologies review decisions Topic paper 1: Form of control and RAB indexation of EDBs, GPBs and Transpower*, paras 28-40.

<sup>64</sup> This transition to a CPP and the early adoption of a revenue cap does not affect WELL's 2020/21 revenues as all non-exempt EDBs, including WELL, were to transition to a revenue cap in 2020/21.



determined for the final year (2020/21) is higher than the BAU revenue in the initial two years.

## Attachment B WELL's resilience expenditure

### Purpose of this attachment

191. This attachment explains our decision on the level of resilience expenditure that we have allowed for under WELL's CPP.

### Summary of our decision

192. WELL proposed \$31.2m of expenditure to prepare its network for a major earthquake (resilience expenditure) – \$30.1m of capex and \$1.2m of opex.
193. We consider that WELL's proposed expenditure is needed, and meets the expenditure objective. We have decided to provide for WELL's proposed resilience expenditure in our CPP decision.

### Our approach to assessing WELL's resilience expenditure

194. In order to determine an appropriate level of resilience expenditure, against the evaluation criteria, we engaged Strata to assist with the task from an engineering perspective.
195. Strata were generally satisfied with WELL's approach to the business case for its resilience expenditure, but identified a number of potential issues with some of its assumptions.
196. Commission staff and Strata subsequently met with WELL to discuss the potential issues and WELL provided further justification on a number of points.

#### *Strata's report and view on WELL resilience expenditure*

197. After meeting with WELL and reviewing further information provided by WELL, Strata concluded that there was no reason for the Commission to decline or adjust the CPP application based on the issues identified. This was on the basis that:
- 197.1 WELL provided satisfactory explanations for the issues identified, or
- 197.2 while quantification of resilience benefits could be refined and improved, the unquantifiable benefits were likely to be sufficiently significant to justify the expenditure.
198. Strata identified the risk that the full 91 building reinforcement projects proposed by WELL would not be completed in the proposed timeframes. Strata recommended that WELL's CPP should specify that the expenditure allowed for this work cannot be used for other projects.
199. We published Strata's report alongside our draft decision.

*Commission review of Strata's report*

200. We have critically reviewed Strata's approach and findings and consider that WELL's proposed resilience expenditure forecast is appropriate and meets the expenditure objective.
201. We have considered the concerns raised by the Major Energy Users Group (MEUG) that WELL's estimate of the benefits are overstated, because the counterfactual is not the status quo over the 20-year time frame used by WELL for its cost-benefit analysis. MEUG submitted that subsequent resilience work could shorten the recovery time used significantly.
202. We have considered MEUG's concerns and discussed the matter further with WELL. We are satisfied that the expenditure will deliver the proposed benefits, even once further resilience work is undertaken in the future.
203. In our draft decision we explained that while there are some areas where WELL could better articulate its quantitative analysis of the costs and benefits of the proposed expenditure, we agree with Strata that the substantial unquantified benefits along with the quantified benefits, justify the proposed expenditure and represents prudent steps to meet appropriate service standards (including resilience). We also consider that the proposal represents the efficient costs to achieve these service standards.
204. In its submission on our draft decision MEUG submitted that:
- The draft decision relies on "substantial unquantified benefits" along with quantified benefits to justify approving the proposed expenditure. Setting aside the position by the Commission that it does not need to use CBA when considering CPP applications; the reliance on unquantified benefits appears to be contrary to the Commission's usual practice to make decisions on quantitative analysis. We would also suggest it would be helpful to all stakeholders for the Commission to:
- a) state its assessment of the credibility and reliability of the [sic] WELL's estimated quantified benefits
  - b) Describe the substantial unquantified benefits that it felt were delivered by the WELL CPP; and
  - c) Outline how it combined and weighted the quantified and unquantified benefits in reaching its conclusion that the CPP was justified.
205. We were generally satisfied with the veracity and reliability of WELL's cost-benefit analysis. While there are areas where we consider the analysis could be improved, overall we considered that the analysis was generally fit-for-purpose, and that the majority of the expenditure would deliver net benefits to consumers, under the cost-benefit analysis.

206. WELL also explained a number of unquantified benefits in its proposal, and provided further information during our evaluation process with Strata. We agree with Strata and WELL that the expenditure will deliver significant unquantified benefits.
207. For example we consider that there will be substantial benefits in restoring supply to emergency services that will enable those services to assist people in need. We do not consider that these benefits are likely to be fully captured in the estimated value of lost load, which is based on the Electricity Authority's (EA) value of any expected unserved energy, set out in the 2010 Electricity Industry Participation Code, escalated by inflation.
208. We agree with Strata's conclusion that:
- Strata's conclusion Strata considers that, whilst in its opinion, sensitivity testing and calculation of quantifiable benefits could be refined and improved, the unquantified benefits will be significantly high enough to provide the justification to support the investment. Strata considers that it is the unquantified benefits that are the primary driver of resilience investment for catastrophic earthquake events. As Wellington Electricity list of unquantified benefits shows, these benefits will be sufficiently substantial to justify the proposed investments. Strata considers that there is no reason for the Commission to decline or adjust the CPP application based on this issue.
209. In reaching our decisions we were satisfied that the quantified benefits of the expenditure outweighed the costs under WELL's base assumptions, as well as most of those used for sensitivity testing. The unquantified benefits identified added weight to the quantitative case for approval, and given this we considered it appropriate to approve the expenditure.
210. As such, we have accepted WELL's proposed resilience expenditure of \$31.2m (\$30.1m of capex and \$1.2m of opex).
211. We have introduced a resilience specific quality standard that addresses Strata's concerns regarding the deliverability of WELL's seismic strengthening programme.

## Attachment C WELL's BAU expenditure

### Purpose of this attachment

212. This attachment explains our decision on the BAU level of expenditure provided for in the third year of WELL's CPP.

### Summary of our decision

213. In order to determine WELL's streamline CPP, we needed to set new BAU opex and capex forecasts for the final year of the CPP as we did not have DPP forecasts in this year to use as a base.<sup>65</sup>

### Year 3 BAU capex

214. Our decision is to allow for \$35.8m BAU capex for the third year of WELL's CPP, as proposed by WELL.
215. We identified issues with WELL's proposed consumer connection capex. However, taking into account the capital contributions that are netted off this forecast before entering the regulated asset base, the overstatement of this forecast was not material.

### Year 3 BAU opex

216. WELL proposed \$30.9m of BAU opex for the third year of its CPP. Our decision is to allow for \$30.9m BAU opex as proposed by WELL.

## Our approach to assessing WELL's proposed BAU capex for 2020/21

### *High level approach*

217. In order to determine an appropriate level of BAU capex, against the evaluation criteria, we engaged Strata to assist with the task from an engineering perspective. We developed an approach to assessing WELL's year three capex that took into account the urgent nature of the CPP. At a high level, we asked Strata to:

- 217.1 develop a dashboard to identify BAU expenditure based on a comparison against historical expenditure and other metrics (such as ICP numbers, line length, etc);
- 217.2 identify expenditure that falls outside what was deemed to be BAU;

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<sup>65</sup> By business-as-usual, we mean expenditure required, but not linked to the additional specific resilience expenditure proposed by WELL.

- 217.3 assess WELL's asset management plan to see if justification is provided for any non-BAU expenditure; and
- 217.4 make a recommendation on an appropriate level of capex for WELL in the 2020/21 year.

*Strata identified two outlying expenditure categories in dashboard assessment*

- 218. Strata assessed WELL's capex forecasts using the dashboard tool it created. It found two expenditure categories did not fit with what it would expect to be required as BAU:
  - 218.1 consumers connection capex; and
  - 218.2 system growth capex.
- 219. All other categories were consistent with what would be expected as BAU.

*Further justification from WELL's AMP*

- 220. Strata went on to consider if the non-BAU expenditure was justified in WELL's asset management plan:
  - 220.1 System growth – Strata found that the process that WELL undertook to determine system growth expenditure forecasts was sound and that the options assessment process was robust. They had no concerns with the planning criteria applied and thought that demand forecasts were appropriate. As such, Strata recommended that we accept WELL's forecasts for system growth expenditure.
  - 220.2 Consumer connections – Strata did not consider that consumer connections expenditure was supported, as the forecast was for a substantial increase above historical actual costs with no explanation in the AMP.
- 221. Strata initially recommended that we allow an amount of consumer connection capex in line with the historical average over the last 4 years of \$5.7m compared with \$7.1m, reducing the forecast total capex by \$1.44m.
- 222. However, capital contributions for consumer connections are netted off the consumer connection forecast before entering the price path. Taking this, and WELL's capital contribution forecasts, into account, we consider that any overstatement in consumer connection expenditure is not material.
- 223. We have previously published Strata's report alongside our draft decision.

*Commission review of Strata's report*

- 224. We have critically reviewed Strata's approach and findings and consider the approach and findings appropriate given the urgent nature of WELL's CPP.

### **Our approach to assessing WELL's proposed BAU opex for 2020/21**

225. We used a slightly different approach to determine whether WELL's forecast opex for year three of its CPP was appropriate.
226. In line with our streamlined approach we modelled our own base and trend projections of WELL's opex forecasts. These projections were relatively simple, in line with our streamlined approach to WELL's CPP. At a high level:
  - 226.1 we used opex models from the 2015 DPP reset as our base;
  - 226.2 we updated pricing inflators to include more recent information provided by NZIER, and to extend into the 2020/21 year; and
  - 226.3 we updated actual opex values for 2015/16 and 2016/17 years.
227. Using this forecast as a cross-check we compared our own forecast of WELL's opex, with WELL's forecast in its 2017 AMP. WELL's forecast was in line with our expectations. As such, we are satisfied that the amount of opex proposed by WELL is appropriate in these circumstances.
228. We have decided that WELL's opex forecast of \$30.9m is appropriate for the purposes of this CPP.

## Attachment D Resilience quality standard assessment

### Purpose of this attachment

229. This attachment explains, in greater detail, how we have implemented the resilience quality mechanism and responds to submissions on the resilience quality standard.

### We have developed an index to measure WELL's performance in delivering resilience improvements

230. In order to measure WELL's performance in increasing its networks resilience (ie, its ability to maintain and restore supply in the event of a major earthquake) we have developed a resilience index.
231. The resilience index runs from 0 to 100 and measures WELL's delivery of some of the outcomes WELL has proposed as part of its CPP, to improve its networks resilience to a major earthquake.
232. A resilience index value of 100 represents the full delivery of the resilience outcomes WELL proposed as part of its CPP submission, whereas an index value of 0 represents a case where WELL delivers none of these outcomes.
233. Throughout the period WELL's resilience will be assessed on the resilience index, by summing the values we have attached to each of the resilience outcomes. These values are weighted consistent with the level of capex that we have allowed for to deliver the resilience outcome.
234. For example, WELL's CPP proposal includes plans to ensure that it can return supply if key CBD substations are downed in an earthquake, by designing and deploying a mobile substation. This substation accounts for 6.55% of the resilience capex we have allowed for. When WELL has constructed a substation that meets the required resilience needs and it has been deployed in the CBD region, WELL will attain a resilience value of 6.55.
235. At a high level, the key resilience improvements we will measure are whether:
- 235.1 WELL's key substations are adequately seismically strengthened;
  - 235.2 WELL has capability to replace certain amounts of cable damaged in an earthquake;
  - 235.3 WELL has capability to replace a substation at short notice, in both the CBD and the Hutt regions; and
  - 235.4 WELL is suitably prepared to maintain data and communication links in the case of an earthquake.
236. The full list of resilience improvements and their associated values are set out in Schedule 9 of the CPP determination, which we have published alongside this paper.



### **WELL will be subject to a binding resilience quality standard**

237. Under the resilience quality standard, WELL will be required to deliver a minimum level of the resilience outcomes set out in its CPP proposal. In the case that WELL fails to meet this minimum resilience level (resilience index ratings of 20, 40 and 60 in first, second and third years of the CPP respectively), WELL will breach its quality path and we may take enforcement action.

### **WELL's resilience quality mechanism will have a revenue linked incentive**

238. WELL will also be subject to a revenue linked incentive, which will depend on its assessed value on the resilience index. To the extent that WELL does not deliver the improved resilience outcomes (represented on the resilience index) by the end of the CPP period, its revenue will be reduced through the 'quality incentive adjustment' recoverable cost in the next period.
239. WELL's resilience target represents the full delivery of the resilience improvements expected from the resilience investment. If WELL fully delivers these improvements then there will be no incentive adjustment under this mechanism.
240. WELL's assessed resilience index value will be capped at the 100, and collared at 0, meaning that the incentive will apply to any value that WELL attains on the resilience index.

### **Revenue at risk under the quality linked incentive**

241. The total revenue at risk will be the equivalent of 15% of the present value of the forecast commissioned asset values for the resilience assets. This is the present value of the "retention adjustment" per the capex incentive wash-up<sup>66</sup> that WELL would stand to gain, in the case that it did not undertake any of the expenditure allowed for delivering resilience improvements.
242. The forecast commissioned asset values in each of the three years of the CPP are \$8.3m, \$11.1m, \$11,8m respectively.<sup>67</sup> The present value is to be calculated as at 31 March 2021, as the recoverable cost is to apply to the year ending 2021.
243. The three values of forecast commissioned asset values are each deemed to occur at mid-year. The periods from mid-year to the end of 2020/21 will be 2.5, 1.5 and 0.5 years respectively for each of the 3 forecast amounts. The present value so discounted over these periods totals \$34.6m.<sup>68</sup>

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<sup>66</sup> Clause 3.3.12(1) of the Electricity Distribution Services Input Methodologies Determination 2012 (Consolidated version published 28 February 2017)

<sup>67</sup> These three values are expressed in nominal dollars.

<sup>68</sup> Discount rate used is the 2015 DPP WACC of 7.19%.

244. The revenue at risk with respect to completing the resilience works is therefore \$34.6m × 15%, or specifically \$5,185,000.

### **Measuring the resilience improvements to key substation buildings**

245. WELL's CPP proposal was to strengthen 91 key substation buildings to above 67% of the new building standards (NBS).
246. We have provided for the expenditure needed to undertake this work and our expectation is that WELL will now strengthen the identified buildings to above 67% of NBS as planned.
247. If, following more detailed analysis of the buildings, the criticality and the marginal cost of the strengthening do not justify improving the building to above 67%, then we have designed the resilience incentive, so that revenue provided for improving the buildings to that level will be reduced, in line with the actual level of resilience improvements that have been undertaken.
248. For example, if a building had an initial NBS rating of 47%, and WELL increased this rating to 57%, falling short of 67%, WELL would attain half of the maximum resilience performance value for that improvement.<sup>69</sup>
249. If WELL decides, based on criticality and marginal cost, that it is no longer appropriate to strengthen the building then the revenue provided for that outcome will be returned to customers through the resilience quality incentive.
250. Also, WELL is not prevented from doing more strengthening if prudent and efficient to do so.

### **Submissions on our draft decision to implement a reliance quality standard and incentive**

251. We received three submissions and two cross submissions on the reliance quality standard and incentive. MEUG and Transpower were supportive of including a resilience quality mechanism. WELL, while acknowledging our efforts to enforce the delivery of what it had undertaken to do, proposed alternative mechanisms to achieve the intended outcomes.
252. The remainder of this attachment outlines some of the key matters raised by submitters and our responses.

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<sup>69</sup> This mechanism is set out, in detail, in the CPP determination published alongside this paper.

### *Seismic strengthening flexibility*

253. In its submission on our draft decision WELL requested that we add greater flexibility to the seismic strengthening:

The Commission's proposed index requires each individual building to be strengthened to at least 67% of NBS. While this appears mathematically efficient, it will be difficult to administer identical performance measures against the range of uncertainties including geotechnical conditions, constructability and capital efficiency at each site. The buildings cover a range of designs, construction styles, locations and dimensions which by their nature require individual economic and condition based risk decisions.

...

It is important to note that the seismic strengthening program is in its early stages of delivery and there have been no designs undertaken as yet. We may have to make decisions on some buildings where the cost of strengthening to 60% (for example) is the most cost effective outcome. In other cases, strengthening above 67% may be prudent.

254. We have decided to provide some additional flexibility to the resilience quality mechanism compared to what we proposed in the draft decision. The additional flexibility allows for instances where it may not be feasible to strengthen a building to 67%. This flexibility incentivises WELL to strengthen a building even if it is not feasible to get to 67%.
255. We have not provided the full flexibility, of averaging the seismic strength of the whole portfolio of buildings when determining the incentive, as WELL recommended. We believe this has the potential to create perverse incentives that would not be in the long term best interest of consumers.
256. We acknowledge that the seismic strengthening programme for WELL is in the early stages of delivery and therefore there is likely to be some variation to the viability and costs of strengthening individual buildings. We expect WELL to manage these under and overs in delivering the programme of work. Should WELL decide to not deliver on the strengthening of individual buildings due to marginal costs then we see it appropriate that consumers be refunded, through lower prices in future periods, in line with the associated revenue that has been provided for those projects in the CPP period.

### *Quantum and symmetry of incentive*

257. In its submission on our draft decision WELL provided its views on the quantum of revenue at risk:

The proposed \$5.2 million penalty at 15% of spend is not symmetrical and is designed as a significant and absolute penalty at a single point in time. In this way it is significantly different from the IRIS incentive scheme which provides rewards and penalties proportionate to any over or under spends.

258. The total revenue at risk is what WELL would otherwise gain if it delivered none of the resilience improvements proposed in its CPP. In this sense, we consider it proportionate that the value of the incentive would remove this gain should WELL not deliver the proposal outcomes or proportionately if some outcomes are not delivered.
259. In terms of the symmetry of the incentive, in making the CPP decision we have provided for the full resilience expenditure in the price path. In this sense, WELL has already been ‘rewarded’ for the resilience improvements that have been proposed. Adding an additional reward for expenditure already provided for would be inappropriate and unnecessary.
260. In proposing symmetry to the resilience incentive regime, WELL proposed they be incentivised for improving the seismic strength above 67%. We note that WELL’s CPP proposal was for the buildings to be strengthened above 67% and we expect that WELL has already accounted for, in proposed costings, at least some of the buildings to be strengthened above 67%. Accordingly we do not believe it appropriate to provide an additional incentive for WELL to deliver on what has already been proposed.

#### *Resilience quality standard*

261. In our draft decision we set a resilience index value of 60 in the final year of the CPP as the minimum resilience that WELL must deliver.
262. MEUG’s submission on our draft decision suggested we should include minimum resilience standards for the first two years of the CPP as well, given the urgency of the work.<sup>70</sup>
263. WELL opposed MEUG’s suggestion in its cross-submission stating that it would “perversely threaten the efficiency with which we can deliver the program”.<sup>71</sup>
264. MEUG also submitted that the resilience requirements in the third year should be increased given WELL’s proposal has been framed as the minimum necessary investment required to prepare the network for an earthquake.
265. On balance, while we want to incentivise WELL to deliver the work urgently, we are concerned that setting standards too high or too soon, may create perverse incentives such as rushed investment in non-optimised assets.
266. We have set the minimum resilience standards at levels we have discussed with WELL and which we consider will limit potential perverse incentives.

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<sup>70</sup> Major Electricity User Group, *Wellington Electricity draft decision* (22 February 2018) para 14-20.

<sup>71</sup> Wellington Electricity, *Cross Submission on Submissions* (March 2018) para 6-8.

267. Our expectation is that WELL will exceed these minimum standards, and we will monitor its performance through its compliance statements during the CPP period.

## Attachment E IM variations

### Purpose of this attachment

268. This attachment outlines the IM variations we have made, or considered, to allow for the streamlined CPP.<sup>72</sup>

### Summary of our decision

269. We have accepted the IM variations proposed by WELL in its application, except for the proposed Opex IRIS variation.

270. The IM variations provide for the price path to be determined consistent with the streamlined CPP process. The variations include:

270.1 Definitions of “CPP regulatory period” and “next period”;

270.2 Definition of “building blocks allowable revenue before tax”;

270.3 Capex wash-up;

270.4 Works under construction;

270.5 Capex IRIS and the definition of ‘forecast value of commissioned assets’; and

270.6 Revenue wash-up calculation.

271. We have also made a variation to correct a drafting error in the Opex IRIS and allow the smoothing of WELL’s DPP pass-through balance over the CPP period.<sup>73</sup>

272. The remainder of this attachment outlines the purpose of the variations and our reasons for making them or rejecting them. It also outlines the reasons for any changes from our draft decision.

### Definitions of “CPP regulatory period” and “next period”

273. We have varied the definitions of “CPP regulatory period” and “next period”, to the proposed 3 year period, to rationalise the information required to be prepared by WELL and assessed by us when considering the CPP proposal. This variation aligns with us streamlining the CPP process for WELL.

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<sup>72</sup> Section 53V(2)(c) of the Commerce Act allows us in determining a CPP to vary the IMs with agreement of the supplier.

<sup>73</sup> The smoothing of WELL’s DPP pass-through balance is discussed further in ‘Chapter 2 – Our decision’.

274. We consider, in this instance, that limiting the calculations to the three year period of the streamlined CPP is appropriate given the urgency of this proposal.
275. Under the streamlined CPP, the analysis of allowable revenue and its components is limited to 2018/19 to 2020/21. However, the IMs require a number of items to be calculated for the duration of the “next period” or the “CPP regulatory period”.
276. The ‘next period’ is defined as from the regulatory year in which the CPP application is made until the regulatory year five years after the start of the CPP regulatory period.
277. The ‘CPP regulatory period’ is defined as five years long for the purposes of a CPP proposal, and can only be shorter once a CPP determination has been made. The variation amends these definitions.

### **Definition of “building blocks allowable revenue before tax”**

278. Under the streamlined CPP for WELL, allowable revenue is calculated by extending the current DPP by one year and then adding an increment each year related to earthquake readiness expenditure. This is a change to how the IMs currently provide for the determination of a CPP revenue path.
279. We have varied the definition of “building blocks allowable revenue” so it is consistent with the streamlined CPP approach. The variation provides for allowable revenue to be calculated by extending the current DPP by one year and then adding an increment each year related to earthquake readiness expenditure.
280. The variation proposed involves a variation to how BBAR before tax and the regulatory tax allowance is calculated.

### **Capex wash-up**

281. The capex wash-up corrects for differences in the revenues that EDBs could expect to recover during the regulatory period as a result of changes between the forecast and actual value of commissioned assets in the year prior to the start of the regulatory period.
282. WELL is currently in the process of recovering a capex wash-up amount, based on the RAB reset in 2015, when the current DPP was determined.<sup>74</sup> The recovery of the

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<sup>74</sup> The capex wash-up is the variance between 2014/15 actual capex and the 2014/15 capex used to set prices for the 2015-2020 default price-quality path.

wash-up amount is spread over 2016/17 to 2019/20 years (year's two to five of that DPP period).<sup>75</sup>

283. Also, the value of the capex wash-up is calculated assuming that the RAB used to determine allowable revenue would apply for five years before being reset.
284. Under the proposed 'streamlined' CPP approach to setting allowable revenue, WELL's RAB will be reset one year later than assumed when specifying the capex wash up.
285. As WELL's RAB is not being reset when it moves onto the streamlined CPP, it is appropriate that WELL continues to recover the unrecovered portion of the capex wash-up as specified in the DPP determination (ie, during the 2018/19 and 2019/20 years).
286. WELL proposed that the capex forecasting variance which is reflected in the DPP BBAR will continue for another year, and a capex wash-up can be included for 2020/21 to offset this variance.
287. The variation proposed involves a variation to IM clause 3.1.3(1)(p). Since the value of the wash-up can be calculated today, the CPP determination can specify the specific values, rather than just a formula.
288. As WELL's RAB will not be reset when it moves onto the CPP, WELL proposes there is no need for a capex wash-up related to a 2018 CPP determination.

#### *Our decision*

289. WELL will have recovered, during 2016/17 and 2017/18, a portion of the wash-up amount from the 2015 RAB reset but not the full amount. It is therefore appropriate for WELL to continue to recover the remaining amount during 2018/19 and 2019/20.
290. The capex wash-up amount determined in the 2015-2020 DPP assumed a regulatory period ending 2019/20. The proposed streamlined CPP extends the period the forecast variance impacts to 2020/21. Accordingly it is appropriate to include a capex wash-up amount in 2020/21 that reflects the effect of the 2014/15 capex variance on the rolled forward allowable revenue.
291. Our decision is also to not provide for a capex wash-up for the 2018 CPP determination, as proposed by WELL. In the streamlined CPP approach applied to WELL, the RAB is not being reset at the beginning of the regulatory period. Capex

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<sup>75</sup> The total wash-up amount and the annual recoverable cost values have been specified by the Commission, Commerce Commission "EDB capex wash-up adjustment recoverable cost calculation sheet – 11 December 2015" (10 December 2015)



wash-ups are only required when the RAB is reset which is most likely to be at the end of the proposed CPP period (FY21).

292. The capex wash-up amounts for the streamlined CPP period are outlined in the below table.

**Table D.1: Nominal capex wash-up amounts for recovery through CPP period**

\$m	2018/19	2019/20	2020/21
Capex wash-up amount	0.489	0.518	0.350 <sup>76</sup>

### Implementation of the IRIS

293. The Incremental Rolling Incentive Scheme (IRIS) is intended to ensure that suppliers subject to price-quality regulation have an incentive to achieve operating efficiencies that is relatively constant throughout the regulatory period.
294. WELL suggested an amendment to the IRIS in light of concerns about how it will operate in its particular circumstances as it transitions to the streamlined CPP. In its submission on the draft decision, WELL acknowledged that the existing IMs produce expected retention factors but noted it may create volatile cash flows.
295. We have modelled how the IRIS mechanism would operate under the existing IMs and WELL's proposal and do not believe the volatility identified by WELL is sufficiently material to justify an amendment to the IMs.
296. Our decision is therefore that the proposed variation is not required. Instead we propose to apply the existing IRIS mechanism.

### Works under construction

297. We have varied how works under construction is calculated consistent with WELL's proposal. The variation amends clause 5.3.12
298. The 'streamlined' CPP approach combines an existing DPP allowance with an increment for the earthquake readiness expenditure. While the CPP IMs define a "works under construction" roll-forward, the DPP IMs do not.

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<sup>76</sup> 2020/21 Capex wash-up amount has been determined using the methodology adopted in determining the previous year's capex wash-up amounts and applying the rolled forward assumptions applied in the WELL CPP financial model.

299. WELL's proposal limits the works under construction roll-forward to the earthquake readiness expenditure – incorporating the CPP IMs but maintaining the current DPP treatment.
300. The proposed amendment provides for the readiness expenditure to be recognised in the CPP BBAR calculation and excludes other expenditure already accounted for through the DPP BBAR calculation.

### **Capex incentive definition of forecast value of commissioned assets**

301. As with the Opex IRIS the method specified in the IMs for the Capex incentive involves a calculation using actual and forecast values. For the purpose of the 'streamlined' CPP these values include both DPP and earthquake readiness components.
302. The definition of 'actual' value of commissioned assets refers to Part 2 which implies that it includes both components. But the definition of forecast commissioned asset values for a CPP does not explicitly include the DPP component.
303. WELL proposes a variation to the definition of "forecast value of commissioned assets" for the purpose of the Capex incentive to incorporate both the DPP and readiness components.
304. Our decision is to vary the definition of "forecast value of commissioned assets" as proposed by WELL.
305. Amending the definition provides for the Capex incentive to be appropriately applied to forecast capex for each of the streamlined CPP years.
306. Our final decision also includes minor variations to the capex incentive IMs to allow the incentive to operate as intended with the customised building block definition.

### **Correction to Opex IRIS drafting**

307. We have amended the drafting of the Opex IRIS to allow the policy intent to apply as intended to WELL's CPP.
308. In 2016, as part of the IM Review, we made a change to the Opex IRIS. The policy change was to introduce a smoothing adjustment to spread the previously second year adjustment over the whole regulatory period.
309. The IM amendment implementing the policy change incorrectly referred to the DPP regulatory period rather than the regulatory period. A variation to the IMs is required to allow the Opex IRIS policy intent to appropriately apply under a CPP.
310. Clause 3.3.2 of the IMs is varied so that it refers to the regulatory period rather than DPP period. The same variation has been applied for the Powerco CPP.

## **Revenue wash-up calculation**

311. We have corrected the revenue wash-up calculation so it aligns with how other regulated income is factored into the MAR determination for WELL's streamlined CPP.
312. The revenue wash-up mechanism provides for the transfer of over or under recover of revenue between pricing years. Under normal CPP circumstances, the MAR is determined without taking into account other regulated income and it is the revenue wash-up mechanism that ensures it is eventually factored into prices.
313. Under the WELL streamlined CPP, however, we have provided for DPP allowable revenue which does take into account other regulated income. Accordingly, it is appropriate to amend the revenue wash-up account so that other regulated income is not considered twice within the regime.
314. Correction of the matter required variation to the IM's and the determination published in conjunction with our draft decision.
315. WELL, in its submission on our draft decision, recommend two alternative approaches to resolving the matter.
316. We decided that varying the revenue wash-up calculation was preferable to varying the MAR calculation as the MAR had already been consulted on as part of the draft decision.
317. We also deemed our variation to the revenue wash-up to be preferable to those proposed by WELL as it relied on fewer definitions and accordingly reduced the potential for misinterpretation.