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Value for customers is industry and regulators working together to provide proportionate solutions to non-controversial problems

What do customers and interested parties expect from a change in WACC on a CPP revenue path?

In Powerco's situation, it is three new annual revenue figures (FY21-23) with no other complication that requires deeper interrogation to understand. Essentially WACC went down, and revenue followed.

Looking deeper, a WACC change should create a new series of forecast net allowable revenue (FNAR) growing by forecast CPI each year. As now, our price-setting process would "washup" the impacts of differences between forecast and actual CPI. We agree with the Commission's approach to calculating the impact of the WACC change on FNAR and appreciate the constructive and collaborative approach of Commission staff over recent months.

But there's a catch. The formula for calculating the actual net allowable revenue (ANAR) in each year doesn't allow for the impact of the WACC change on revenue. This means the washup mechanism doesn't work as we all intended because there is a mismatch between FNAR and ANAR. The Commission's proposed approach to solve this is an adequate workaround to achieve the outcome, but it comes at a significant cost. There are a number of secondary impacts - some predictable and some not - which will impact our customers and us. The impact could be millions of dollars and many hours of unnecessary work out to 2025 (Attachment 1). This complex-looking solution to a simple problem does not inspire confidence or promote transparency and understanding. This can be avoided.

We think there's a better way. We recommend the Commission implement their "ideal solution" as discussed in the draft determination¹. This involves updating FNAR and ANAR in FY21 to reflect the WACC change – a bit like restarting the clock – which was how we all thought it would work when we adopted the 'split-WACC' approach. Attachment 2 has our view of some options for implementing this ideal solution so the effect of the WACC change can be properly reflected in our revenues.

Please contact Andrew Kerr (Andrew.Kerr@powerco.co.nz) if you have any questions about this submission.

Yours sincerely

A handwritten signature in blue ink, appearing to read "Stuart Marshall".

Stuart Marshall
General Manager - Regulation and Commercial

¹ 5.7.2 To give effect to the WACC change, we would ideally set the ANAR for the 2020/21 disclosure year of the Power CPP equal to our proposed FNAR (given the WACC change) for that disclosure year, which is \$241.093 million.

Attachment 1: Implications of adopting the Commission’s proposed solution

The list below summarises impacts of the Commission’s proposed solution. Given the time available, we expect this list won’t be exhaustive. We hope it is extensive enough to highlight the impacts on consumers, Powerco, and the Commission, that are created from not adjusting ANAR (the “ideal solution”). The combined effect of these impacts does not leave customers and Powerco neutral to the WACC change.

Cost impacts from estimating ANAR

Customers or Powerco bear the cost (potentially millions) of the mismatch between actual and forecast CPI hard-coded in the estimation of FY21 ANAR. The proposed solution requires the Commission to create a new term - “estimated ANAR”. This requires an estimate of CPI for 5 of the 8 data points from March 2020 to March 2021. Any difference between ANAR (using actual CPI) and “estimated ANAR” (using CPI estimates) will be passed to, or from customers to Powerco outside of the washup mechanism (which deals with differences between ANAR and FNAR).

Estimating CPI is difficult at the best of times and compounded with the potential impact of the COVID-19 situation on New Zealand’s economy. The assumed, known, and unknown CPI values can be summarised as:

- **CPI estimates used to derive ANAR.** Implicit in the Commission’s FY21 ANAR estimate are CPI values of 2.15% (FY20) and 2.10% (FY21). These are the Commission’s CPI estimates.
- **FY20 actual CPI.** The Commission’s CPI formula for FY20 is tracking at 1.62% to Dec ‘2019. Assuming similar CPI growth for the March 2020 quarter implies a CPI of around 1.84%.
- **FY21 actual CPI.** The looming impact of the coronavirus and a likely global recession make it difficult to forecast.

We have analysed the impact on FY21 ANAR of possible CPI outcomes to March 2021. The variance between the ANAR that would arise and the Commissions “estimated ANAR” is shown in the right hand column of the table².

Possible CPI outcomes to March 2021			
2020	2021	Implied FY21 ANAR value (\$m)	ANAR variance from ComCom FY21 “estimated ANAR”* (\$m)
Po1.84%	0%	\$284.1	(\$6.8)
	1%	\$286.9	(\$4.0)
	2%	\$289.7	(\$1.1)
	3%	\$292.6	\$1.7
	4%	\$295.4	\$4.5

* The estimated FY21 ANAR is \$290.852m (5.7.1 in the draft determination).

In simple terms, the only FY21 CPI outcome that leaves customers and Powerco indifferent is 2.4%. If CPI varies from this, Powerco will recover too much revenue from consumers (if CPI>2.4%) or too little (if CPI<2.4%). For example, if CPI in FY21 is 0%, Powerco will recover around \$6.8m (2.7%) less revenue in FY23 than would be expected. The impact is material, uncertain, and not able to be washed-up via the proposed solution. It would need a washup in a future regulatory period via a new mechanism.

If the ideal solution is implemented there is no need to estimate ANAR or incorporate a new term in any transition to a new revenue path. Customers and Powerco are indifferent to the level of CPI as they were prior to the WACC change, preserving simplicity.

² We’ve ignored time-value of money impacts to keep things simple. This adds about 14% to the numbers stated.

If the proposed solution is implemented, we recommend the Commission review the CPI assumptions used to derive FY21 ANAR to a central estimate based on the best information available. The Commission should provide consumers and Powerco confidence that the difference between estimated and forecast CPI will be passed back to the appropriate party in a future.

Reduced coherence and meaningfulness

Applying ~\$50m p.a. adjustments to FNAR over FY23-FY25 reduces the coherence and elegance of the forecast and actual revenue mechanisms as they have been, and are expected to apply.

- FY23 FNAR is no longer aligned with maximum allowable revenue, because it is reduced by around 20% to offset the estimated FY21 washup impact. This will potentially extend to future years.
- ANAR doesn't reflect actual net allowable revenue (it reflects a pre-WACC change allowable revenue). Or viewed another way, it would only have reflected a coherent ANAR if the WACC change impact aligned with Powerco's FY21-23 estimated WACC of 6.78% (post-tax, 67th percentile).

Reduced predictability

As noted in the Commission's paper, the proposed solution will require adjustments to Powerco over FY24/25 (DPP3), then again in FY26 (DPP4). These will be solely attributable to the proposed solution to ANAR. This reduces regulatory certainty because adjustments will be needed. We, and other sector investors, will need to predict them.

Adopting the proposed solution unnecessarily creates this uncertainty and is contra to how the regime is currently perceived internationally. For example, S&P Global³ revised the regulatory framework score from strong/neutral to strong in 2018, noting:

We now consider the framework to be more mature and predictable, as well as being stable, supportive, and transparent.

Favorable review of the building-block framework (input methodology) in December 2016. Under the framework, the regulator has set high-level rules for the next seven years, providing a transparent, efficient, and visible framework for the sector.

Regulatory focus on prudent and efficient cost recovery for the entities, while ensuring transparency and certainty of the process to maintain investor confidence.

Administrative burden

The proposed solution will create an administrative burden on the Commission and Powerco for several years and across two regulatory resets. For example, it requires the need to address the issue in phases 2 and 3 of the proposed solution and any specific consultation.

It will also create complicated and temporary explanations to customers and investors about the reasons for changes to revenue and pricing, including any comparisons to other EDBs. This is because adjusting Powerco's FNAR for the estimated ANAR removes the link between costs and revenues. Any discussion of revenue limits will require an adjustment and explanation eg in a Commission summary analysis⁴. Powerco's price-setting and compliance statements will need the same treatment.

³ Regulatory Framework Score For New Zealand Regulated Utilities Revised To Strong; Ratings On Three Entities Affirmed, S&P Global, April 22, 2018.

⁴ https://comcom.govt.nz/_data/assets/pdf_file/0023/63671/Profitability-of-Electricity-Distributors-Following-First-Adjustments-to.pdf

Revenue forgone calculations misaligned

There is a mismatch between the trigger and amount of revenue forgone in relation to the 20% limit on the revenue reduction percentage. A simplified version of the definitions in the CPP determination (pages 12-13) is:

1. The revenue reduction percentage = $1 - (\text{actual revenue from prices} / \text{forecast revenue from prices})$.
2. If RRP >20%, the revenue foregone is **actual net allowable revenue** x (RRP-20%) (emphasis added)

As highlighted in the Commission's paper, the proposed solution leaves ANAR at pre-WACC change levels. So in FY23, this could be around \$300m, materially higher than an ANAR based on WACC-adjusted revenues eg \$250m. Application of the calculation in [2] would overstate the revenue forgone because it would be applied to a figure which bears no resemblance to actual revenues (ie FY23 ANAR).

Attachment 2: Discussion of options

Context and problem to be solved

- Clauses 5.6.8(1) and (3) of the EDB IMs establish a general power for the Commission to amend a CPP Determination “to the extent reasonably necessary” to give effect to a list of reconsideration triggers identified in (3) – including a WACC Change
- Clause 5.6.8(5) also states specific aspects of the CPP Determination that the Commission will amend to give effect to the WACC Change
- In addition to the matters listed in clause 5.6.8(5) Powerco and the Commission staff have identified another aspect of the CPP Determination that it is “reasonably necessary” to amend in order to give effect to the WACC Change – the ANAR provisions
- There is no debate about the substantive outcome intended by all stakeholders from the WACC Change reconsideration, nor that the ANAR provisions need to be amended to achieve the outcome we all expected

Alternative option 1: Amend CPP Determination

- The simplest way forward is to use the general power under clauses 5.6.8(1) and (3) to amend the ANAR provisions in the CPP Determination as part of the WACC Change reconsideration.
- There is agreement that this change is “reasonably necessary” to achieve the outcome all stakeholders expected from the WACC Change reconsideration
- The regulatory expectation that informs “regulatory certainty” considerations is that the Commission will make the changes reasonably necessary to give effect to the various reconsideration triggers, including the WACC change
- This approach recognises (5) as declaring the minimum key changes to the CPP Determination that would be made as part of a WACC Change reconsideration. This approach also continues to give meaning to the general power provisions in (1) and (3) in this WACC Change context, consistent with both the wording of (3) and delivering the substantive outcome that all stakeholders expected
- A more restrictive view would be that the specific list of changes to be made to the CPP determination listed in (5) supplants the general power provisions in (1) and (3) to make changes that are reasonably necessary.
- But there is nothing in the text that compels that result (and in fact that approach doesn’t explain why (1) and (3) applies to the WACC Change). The “must” in (5) sets up the minimum set of key changes to be made to the CPP Determination. The “may” in (1) empowers other changes that are reasonably necessary to fully achieve an appropriate outcome from the reconsideration.
- This scheme makes sense – as we are discovering, regulation is complex and having a general power to make all changes reasonably necessary (but no more) is a useful part of the framework and an important part of delivering on regulatory certainty and predictability, giving the Commission and the EDB the ability to deliver the outcome stakeholders expect from the reconsideration.
- As a practical matter, not all the CPP Determination changes needed to deliver on a reconsideration could be identified upfront in the IMs. And indeed for most of the reconsideration triggers, none of the CPP Determination changes were signalled ahead of time and all of the work is done under the general power provisions. This doesn’t make the scheme lacking for regulatory certainty. Regulatory certainty is gained if the Commission delivers the substantive outcome that would be expected in response to a reconsideration trigger by making all changes to the CPP Determination that are reasonably necessary
- There is not textual or policy basis for the Commission to tie its hands and disavow the ability to make all changes reasonably necessary

- Importantly, the “reasonably necessary” condition supplies the key limiter on the Commission’s changes to the CPP Determination, which is what the sector expects.

Alternative option 2: Amend the IMs and CPP Determination

- The next most simple way forward is to amend the clause 5.6.8(5) of the EDB IMs to add an ability to amend ANAR as well as FNAR.
- Section 52X empowers the Commission to amend an IM; requiring the section 52V consultation process to do so
- Section 52Y clarifies that there is a difference between a section 52X amendment and an IM review. In short, the Commission has the discretion to amend an IM rather than wait for a 7 year review
- The framework for making an IM amendment is set out in the Commission’s current consultation paper on the definition of a discount:
 - Purpose of Part 4 (section 52A)
 - Purpose of the IMs (section 52R)
 - Important considerations of maintaining predictability and certainty
 - Lean in favour of considering incremental improvement and error correction rather than fundamental changes
- On its face, the proposal to amend the definition of a discount in the IMs for the purposes of the DPP looks close to the proposal to amend clause 5.6.8(5) to add ANAR. Such a change delivers the result stakeholders are expecting and avoids an unpredicted outcome, and it is in the nature of error correction not a change to the substantive nature of the price quality threshold that stakeholders expected from the WACC Change reconsideration
- As we understand it, the key question that arises in the CPP WACC Change reconsideration context is whether it matters that this would be an IM amendment that is then applied to a current section 52P determination
- There are possible legal and policy aspects to this question
- In relation to legal aspects:
 - Section 53ZB does not apply. Section 53ZB prohibits reopening an existing CPP on the grounds of a change in the IMs, except in limited circumstances.
 - The core intention here is to prevent the full detail of a 7 year IM review immediately flowing through into DPPs and CPPs. As a general matter, the fact of an IM Review or an IM change does not justify reopening a DPP or a CPP.
 - However in this process, the CPP Determination is already being reopened in response to the WACC Change, which is an outcome that all stakeholders were expecting. If the list of changes to be made in response to a WACC Change was amended to add the ANAR, there is no sense in which it could be said that the CPP Determination was being “reopened on the grounds of” that change to the IM. The CPP Determination is being reopened “on the grounds of” the WACC Change.
- In relation to policy aspects
 - It is important to check the concern of regulatory certainty and regulatory expectations as to how the IM / section 52P framework will be applied
 - In the current context:
 - The expectation is that there will be a WACC Change reconsideration
 - The expectation is that the WACC Change reconsideration will be implemented in full by changing the CPP Determination

- Changing the ANAR is important to ensure regulatory certainty and regulatory expectations are met as to how the IMs and the CPP Determination relate in this situation
- More generally, it is the usual case in a reconsideration exercise that changes are made to the CPP Determination that are not specified ahead of time in the IMs. This is what the general powers in clause 5.6.8(1) and (3) establish.
- This is not seen as creating the regulatory rules as they are applied but an essential part of the reconsideration exercise - delivering on the changes needed to give the outcome of the reconsideration that stakeholders expect.
- Regulatory certainty and credibility comes from delivering on the outcome stakeholders expect from the reconsideration.