4 October 2024

Commerce Commission
Te Komihana Tauhokohoko
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Tēnā koutou

PROPOSED AMENDMENTS TO THE INPUT METHODOLOGIES – INSURANCE ENTITLEMENTS

Executive summary

1 We support the Commission's objectives in amending the Input Methodologies (**IMs**) currently in force and commencing 1 April 2025. We agree the current treatment of insurance proceeds is unclear and, to the extent insurance is recorded as Other Regulated Income (**ORI**), this exposes EDBs to IRIS penalties and distorts prices to consumers in a manner that does not best achieve the Part 4 purpose.

2 However, the Commission's proposed solution, while a step forward, does not fully resolve the issues we have encountered in trying to manage insurance claims in the context of a price-quality path. In particular, the Commission's solution does not deal well with the high likelihood that insurance proceeds will be recognised one or more disclosure years after the expenditure is incurred due the time it takes to finally resolve insurance claims for significant events.

3 The Commission also appears to assume that insurance proceeds will never meet the definition of a capital contribution. As we explain in this submission, where insurance provides for reinstatement of assets, that will meet the definition of a capital contribution. That is an approach we would prefer to see preserved in the amended IMs.

4 We have also reviewed ENA's submission and agree that the solution proposed in that submission is simpler, easier to implement and deals with the timing issues identified above. The downside of that approach – and we think this is a significant problem – is that EDBs do not get the cashflow benefits of holding insurance. When planning for the risk of a catastrophic event, it is important that EDBs can use insurance cover to manage the financing challenge of the response to a natural disaster/catastrophic event. ENA's solution assumes that EDBs will always have debt headroom to finance the response.

5 We understand that Transpower effectively has the option to treat insurance proceeds as income or to net proceeds off expenditure. In our view, a solution that provides EDBs this choice is preferable. Given both approaches are neutral in NPV terms, there seems to be little downside in:

a. allowing EDBs the flexibility to use insurance proceeds to reduce disclosed expenditure, thereby enjoying the cashflow benefits of insurance and avoiding IRIS penalties; or
b. to disclose insurance as other regulated income but net of IRIS retention factors.

6 The only difference in the approaches is the timing of cashflows and, given neither expenditure nor income associated with a catastrophic event is factored into the default price-quality path, it is essentially neutral in terms of the prices that consumers actually pay.

7 As between the Commission's proposal and ENA's proposal, on balance we agree that the simplicity of ENA's approach is preferable, but subject to retaining the ability to treat insurance proceeds for reinstatement of assets as a capital contribution.

Problem definition and objectives for amendments

8 Unison, in common with a number of North Island EDBs, incurred significant costs responding to Cyclone Gabrielle.

9 Unison seeks to insure its assets for material damage and business interruption to the extent cover is available and economically viable. We have made claims on our insurance to cover operating costs and capex associated with responding to Cyclone Gabrielle and reinstating damaged or destroyed major assets. Our claim is still proceeding and will take some time to finally resolve. Our insurer has progressively advanced cash (in the form of a progress payment) prior to the claim being finally determined. Those proceeds are not recognised under GAAP unless and until the income is "virtually certain", which means that, while the costs were principally incurred in RY2023 and early RY2024, we recognised some insurance proceeds in RY2024 and will recognise further amounts in RY2025. It is not yet clear when the claim will be finally determined.

10 We agree with the Commission that the current treatment of insurance proceeds is both uncertain and leads to perverse outcomes. Unison agrees with the Commission that Part 4 is not met by a regulatory regime that disincentivises EDBs from holding insurance and restricts EDBs from utilising insurance received in the long-term interests of consumers. That includes balancing EDBs cashflow concerns against consumer benefit, particularly to efficiently restore the provision of *"services at a quality that reflects consumer demands"*[1] after a significantly adverse event.

11 Under the current IMs:

a. insurance proceeds treated as other regulated income are effectively passed straight through to consumers, meaning EDBs have little financial incentive to hold prudent levels of insurance cover;
b. the impact on the washup account will substantially reduce the price consumers pay in two years' time and then the consumers will see a significant increase in the third year when the price returns to 'normal';
c. the Commission has retained the base–step–trend approach to forecasting opex. Cyclone Gabrielle occurred in RY2023, and the substantial additional opex incurred in RY2023 will not be included in the base year RY2024. It is, therefore, not reflected in DPP4 funding entitlements;
d. the IMs don't deal with the high likelihood that 'event expenditure' and recognition of an insurance entitlement will occur in different years;
e. EDBs do not enjoy the cashflow benefits of holding insurance, which is a significant concern in the context of substantial unforecast expenses incurred in response to a catastrophic event;
f. insured expenditure is subject to the IRIS and therefore incur IRIS penalties even if insured. The consequence is that, for every dollar of insured opex or capex, consumers get the benefit of a dollar of other regulated income and only bear a share of the cost in prices; and
g. we understand the catastrophic event allowance mechanism was intended to remedy the adverse regulatory consequences, including consequent IRIS penalties and an inadvertent negative wash-up adjustment, of catastrophic events. However, Unison is unable to meet the threshold as at 4 October 2024, given the threshold is measured in terms of the impact on the price path (BBAR impact), net of insurance entitlements. Our first insurance claim is not settled and we cannot determine the price path impact 'net of any insurance entitlements'. The threshold also excludes the IRIS incentives from the thresholds because those incentives will not be applied to the price path until the next DPP period.

12 In our view the IMs amendments should aim to promote Part 4 by:

a. incentivising EDBs to hold prudent levels of insurance where it is efficient to do so by:
    i. protecting against IRIS penalties for insured expenditure; and
    ii. enabling EBDs to enjoy the cashflow benefits of holding insurance;

[1] Commerce Act 1986, s 52A(1)(b).

   b. providing a streamlined mechanism for dealing with timing differences between when expenditure is incurred and insurance proceeds are ultimately recognised (which may be one or more disclosure years after the year in which expenditure is incurred); and
   c. in general balance simplicity with effectiveness from a disclosure perspective (including clarity for the benefit of EDBs, auditors and the Commission).

13 We also think the Commission should take into account the fact that EDBs, including Unison, are currently in the process of recognising and disclosing insurance proceeds related to Cyclone Gabrielle and other significant insured events that have occurred over the past two years. That means any solution:
   a. needs to ensure an appropriate treatment of insurance proceeds that will be recognised in this disclosure year or in subsequent disclosure years, including where those proceeds relate to expenditure incurred prior to the RY2025; and
   b. should account for delays (including up to multiple disclosure years) between when insured expenditure is incurred and disclosed in ID and when insurance proceeds are able to be recognised.

Treatment of insurance proceeds as capital contributions

14 There is one point relating to the status quo that requires clarification. The Commission says that "*capex entitlements do not fall within the definition of 'capital contributions', as applies to EDBs and GPBs, because their purpose is to compensate businesses for damage to assets. They are not payments for the purposes of asset construction, acquisition or enhancement.*"[2]

15 Subsequently the Commission says, "*there may be grants or other compensatory payments intended to facilitate reinstatement or construction of assets, which under the existing definitions must also be treated as ORI and passed on to consumers if they do not meet the definition of 'capital contributions'*".[3]

16 Whether insurance proceeds are properly treated as capital contributions or other regulated income will depend on the terms of the policy.

17 Other regulated income is defined as "*income associated with the supply of electricity distribution services, including gains and losses on disposed assets, but excluding… capital contributions*".

18 Capital contribution is defined as "*money or the monetary value of other consideration charged to or received from consumers or other parties for the purposes of asset construction, acquisition or enhancement*".

19 We agree that insurance income recognised and attributable to opex constitutes other regulated income.

20 The treatment of insurance income recognised in relation to damaged or destroyed assets depends on the terms of the insurance contract. If the insurance income is "*received… for the purposes of asset construction, acquisition or enhancement*" then it will constitute capital contributions. Otherwise, it will constitute other regulated income.

21 Broadly speaking, the distinction is whether the insurance income compensates for the loss or diminution of the value of existing commissioned assets or whether the income compensates Unison for the costs of replacing or repairing those assets (i.e. commissioning new assets). In the former case we think the income is properly treated as other regulated income because the insurance recovers the costs of existing investments. In the latter case the income is properly treated as capital contributions because it is received for the purposes of constructing/commissioning new assets.

22 Unison's MDBI policy includes a Reinstatement Memorandum, which provides that the basis of amounts payable in respect of insured property that is lost or damaged is the cost of reinstatement of that property. The Reinstatement Memorandum therefore insures against the

[2] Paragraph 3.9.
[3] Paragraph 3.11.

cost of constructing *new* assets, rather than compensating for the loss associated with damage to, or destruction of, existing assets.

23 The Memorandum further provides that, in the event Unison chooses not to reinstate the assets, no payment is to be made beyond the amount that would have been payable absent the Memorandum. In that case, Unison would be entitled to an indemnity payment reflecting the loss of the existing assets, rather than the costs of a replacement asset.

24 Given the insurance income recognised relates to construction of new assets, rather than indemnifying Unison for the loss or diminution in value of the existing assets, that income was received "*for the purposes of asset construction, acquisition or enhancement*" and is therefore properly treated as capital contributions. We consider this provides a balanced implementation of Part 4, ensuring there are genuine incentives to invest in replacement assets[4] after a significant event (as opposed to compromising on quality outcomes because of the failure of the regulation to address cashflow). We can share further details of the analysis supporting this treatment if the Commission considers that would be useful.

Options to address

25 The Commission's proposed solution introduces new definitions of "compensatory entitlement" and "insurance entitlement" and provide that amounts that meet those definitions are netted off operating costs or commissioned asset values for disclosure and price-quality purposes.

26 We have seen the alternative proposal from Electricity Networks Aotearoa, which is to leave the current definitions largely unchanged and instead to provide that insurance proceeds that meet the definition of other regulated income are disclosed net of an amount equal to the present value of the IRIS penalties associated with the insured expenditure.

27 We support the intent of both approaches. Unison's circumstances following the catastrophic event of Cyclone Gabrielle present a useful test case to ensure a balanced regulatory solution that will promote Part 4.

There are pros and cons to each approach

28 There are pros and cons to each approach. In terms of the objectives outlined above:

a. Both the Commission's solution and ENA's solution relieve EDBs of IRIS penalties associated with insured expenditure. ENA's solution is preferable from Unison's perspective because it deals with insurance proceeds recognised in RY2025 that relate to insured expenditure incurred in earlier disclosure years. On our reading of the Commission's approach, it is not clear how insurance proceeds recognised in this disclosure year would be treated if they relate to expenditure in prior years because the Commission's approach relates to how expenditure is disclosed and the relevant expenditure in Unison's case has already been disclosed in a prior year.

b. As regards cashflow, the Commission's approach is more beneficial in principle in that it allows EDBs to use insurance to manage the financing risks associated with the response to significant insured events. A key benefit of insurance is that it compensates EDBs immediately for the – on occasion substantial – unforecast costs of responding to a majored insured event. ENA's approach allows EDBs to retain insurance proceeds only up to the present value of IRIS penalties. That approach therefore assumes that EDBs have sufficient debt headroom to finance the response to catastrophic events. We prefer a solution that at least enables EDBs the option to use insurance to manage these financing risks.

c. It may not be apparent to the Commission how significantly delayed the recognition of insurance may be. Unison will recognise significant insurance payments in this disclosure year that relate to expenditure incurred in response to Cyclone Gabrielle in RY2023. In our view the IMs amendments should offer a practical and streamlined solution to these timing differences. In that regard the ENA proposal is preferable. We understand the Commission's proposed approach would deal with timing differences by: (i) allowing for restatement of operating costs in ID, and (ii) requiring adjustments to insurance proceeds attributable to capex to be addressed via additional positive or negative notional assets.

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[4] Commerce Act 1986, s 52A(1)(a).

d. In general, ENA's solution appears simpler to implement and account for in regulatory disclosures. We understand it is also more closely aligned to GAAP.

Summary of pros and cons

Objective	Commission solution	ENA solution
Protect against IRIS penalties	**Partial**	✓
Enable EDBs to enjoy cashflow benefits of insurance	✓	X
Address timing differences	X	✓
Simple to implement / aligned to GAAP	X	✓

29 We also understand that Transpower effectively has an option whether to disclose insurance proceeds as income or net proceeds off the relevant costs. We think that flexibility has some merit and should be considered for EDBs as well. In principle, an EDB needs flexibility to address the nature of the challenges an event has caused and the scale. Unison accepts that the Commission may wish to seek additional disclosures where insurance proceeds are netted off. Provided those are clear for EDBs and auditors, that approach is supported.

Our preferred approach

30 We would prefer an approach that, like Transpower, allowed EDBs to elect whether to treat insurance proceeds as other regulated income (net of IRIS penalties) or subtract insurance proceeds from insured expenditure for disclosure purposes. A mechanism needs to be developed for expenditure incurred in one year and insurance proceeds recognised in a later year (which doesn't naturally fit a 'netting off' approach). Importantly, either approach is neutral in terms of overall cost recovery and achieves a fair balance between EDB and consumer interests. Having the flexibility to elect the approach will cater for the particular circumstances of an insured event.

31 As between the Commission's proposal and ENA's proposal on balance our view is:

a. ENA's approach is preferable; but

b. subject to retaining the flexibility to treat insurance proceeds for reinstatement of assets as capital contributions (as is currently the case).

32 The simplicity of ENA's approach is a substantial advantage, particularly as it avoids the need to make subsequent adjustments to disclosed expenditure to address adjustments to insurance proceeds. It also avoids the need to deal with timing differences between when expenditure is incurred and when proceeds are recognised. It offers a clear solution for those EDBs that, like Unison, will recognise insurance proceeds in RY2025 relating to expenditure in prior years. It is not clear to us how we would disclose RY2025 insurance proceeds under the Commission's approach given the intended commencement of those amendments.

33 However, if ENA's solution is preferred, it should be implemented alongside retention of the current definition of capital contributions. Our view allows for reinstatement capex to be treated as a capital contribution and netted off asset values. We would support retaining this option as it allows EDBs to retain at least some of the cashflow benefits of holding insurance. We reiterate that a key benefit of insurance is protecting against the financing risks of a major event which may compromise consumers long-term interests (and insurance directly responds to).

Comments on the Commission's proposed amendments

34 If the Commission decides to retain the approach proposed in its draft decision, then there are some adjustments required to make it workable:

a. The Commission's approach only applies to opex "*arising from damaged or destroyed assets*". That assumes that only opex arising from damaged or destroyed assets is insured and therefore eligible for this treatment. A wider definition that captures all insured opex is more appropriate given the policy objectives of the amendments.

b. The amendments to the clauses providing for value of commissioned assets only apply to "*an asset that replaces an asset*" in respect of which insurance was received. Again, a broader definition is more consistent with the Commission's policy objectives. We propose this should instead refer simply to "*an asset in respect of which insurance was received*".

c. The Commission’s solution to timing differences between when opex/capex is incurred and when insurance is received/recognised is to allow for: (i) restatement of opex, and (ii) recording additional positive/negative asset values. The former seems do-able but is administratively complex and may not work if the delay between incurring opex and recognising insurance is too great. We do not understand how disclosing separate ‘adjustment’ assets will deal with the capex IRIS. Given the IRIS is calculated annually based on annual forecasts of commissioned assets it would appear that adjusting assets in subsequent years would not deal with retention factors in relation to insured assets commissioned in earlier years.

Nāku noa, nā

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[redacted]