ena electricity networks aotearoa™

3 October 2024

Ben Woodham
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Commerce Commission
Wellington 6140

By email to: infrastructure.regulation@comcom.govt.nz

Dear Ben,

Submission to the Commerce Commission (Commission) on *the proposed amendments to input methodologies for electricity distribution businesses, gas pipeline businesses and Transpower relating to insurance entitlements, other compensatory entitlements, and other regulated income*

Electricity Networks Aotearoa (ENA) appreciates the opportunity to make a submission to the Commission on its consultation paper on the *proposed amendments to input methodologies for electricity distribution businesses, gas pipeline businesses and Transpower relating to insurance entitlements, other compensatory entitlements, and other regulated income.* We also thank the Commission for the extension provided, which has allowed us to propose a solution to issues we identified through our review of the Commission's proposed amendments.

ENA is the industry membership body that represents the 29 electricity distribution businesses (EDBs) that take power from the national grid and deliver it to homes and businesses (refer Appendix A for list of members). EDBs employ 10,000 people, deliver energy to more than two million homes and businesses and have spent or invested $8 billion in the last five years. ENA harnesses members' collective expertise to promote safe, reliable and affordable power for our members' customers.

1.1 ENA supports the intent of the proposed amendments

ENA welcomes the Commission's proposal to make changes to the input methodologies (IMs) to correct for unintended consequences of the current treatment with regards to insurance and other compensatory entitlements.

However, in this submission we are proposing an alternative way to apply the change, which we think offers several key benefits:

- It isolates the solution to price-quality (PQ), as it is a PQ-only problem – this reduces the burden on exempt EDBs, who would otherwise also have to make significant changes to their information disclosure (ID) under the Commission's currently proposed solution.
- It is a less complex and administratively burdensome approach for all parties.
- Our proposed changes to the thresholds for the catastrophic event reopener make it more accessible to EDBs and offers more opportunities for the Commission.

1.2 Incentive problem

The Commission has identified an incentive problem in the IMs regarding the treatment of compensatory entitlements. These may include insurance payments for asset damage and related operating costs following a major event, insurance for third-party liability claims, or recoveries from third parties for damaged assets.

The problem arises for non-exempt EDBs subject to PQ regulation because:

- Compensatory payments are recorded as other regulated income, and therefore, the benefit of the payments is fully passed through to consumers through the revenue cap wash-up
- The additional capex and opex incurred in response to an event is only partly passed on to consumers under the sharing properties of the Incremental Rolling Incentive Scheme (IRIS).

This disincentivises prudent insurance coverage, which is in the long-term interests of consumers. It also exacerbates the cash flow consequences of a major event for an EDB needing to respond to the event and repair or replace assets.

1.3 Commission's proposed solution

The solution proposed in the Draft Reasons Paper[1] is to apply an offsetting approach for compensatory entitlements. That is, the payments are to be offset against the capex and opex incurred for both information disclosure (ID) regulation and PQ regulation.

Specifically:

- asset remediation or replacement insurance entitlements will be offset against the costs of bringing the assets back to service or replacing damaged assets, reducing the value of the commissioned assets in the regulatory asset base (RAB)
- opex compensatory entitlements will be offset against the corresponding opex in the year that the opex is incurred, up to the maximum value of the additional opex. This also applies to compensation for third-party liability claims
- insurance entitlements, compensatory entitlements and third-party liability entitlements will be excluded from other regulated income in the year received unless they are not fully offset against expenditure, as described above
- IM definitions for insurance entitlements and compensatory payments will be introduced.

These changes will apply under Part 2 of the IMs for ID regulation, and Parts 3, 4 and 5 of the IMs for PQ regulation. Accordingly, the proposed changes will impact both exempt and non-exempt EDBs.

1.4 Consequences of the proposal

The proposal is a departure from NZ GAAP, and therefore will involve additional compliance costs for all EDBs (including exempt EDBs not subject to PQ regulation). The offsetting approach is not adopted under NZ GAAP because it makes it harder for users of financial statements to understand

[1] Commerce Commission, Proposed amendments to input methodologies for electricity distribution businesses, gas pipeline businesses and Transpower relating to insurance entitlements, other compensatory entitlements and other regulated income, 3 September 2024

the reporting entity's financial performance.[2] For example, under NZ GAAP, compensation payments for asset repairs or replacements are treated as separate economic events and accounted for separately from the cost of the asset restoration or replacement.[3] This also recognises that compensatory payments may not always align with the subsequent expenditure undertaken.

The transparency objective adopted for NZ GAAP is consistent with the statutory purpose of ID, which is to provide sufficient information to allow interested persons to assess the performance of regulated suppliers. In our view, the proposal makes it more difficult to understand the performance of EDBs because neither the cost nor the insurance impacts of an event will be evident in financial disclosures.

There are also practical problems with the proposal, including the following.

- As compensatory entitlements often take time to process, they may be received and recorded in financial statements in instalments across multiple periods and after the expenditure has been incurred. Entitlements can also only be recognised as revenue once the assumed economic benefit is 'virtually certain' and, therefore, may be recorded as contingent assets for a period prior to settlement of a claim.[4] This means that under the proposed IM amendments:
  - Separate assets with negative values will be created when there is a mis-timing between the asset spend and the compensation. This adds complexity to the RAB and future RAB management, including asset allocation, depreciation, disposals and the tax RAB. It is also unclear what occurs when the compensation does not align with the asset remediation undertaken, as negative notional assets may be created that do not align with actual assets.
  - Prior year opex may be restated once compensatory entitlements are recorded as revenue under NZ GAAP. Any prior year restatement will flow through multiple regulatory disclosures, including profit, return on investment, expenditure and related party disclosures. It will require auditing and certifying. The restated opex also will not have been reflected in prices for exempt EDBs who are not subject to the price cap.
- Because the compensatory entitlements that are associated with opex are capped at the amount of opex incurred, there is an asymmetry between capex, which allows for negative assets, and opex, which does not allow for negative opex.
- There is a divergence between the definition of disposals under the IMs and NZ GAAP. Some RAB assets may not be disposed of, even when they are treated as a disposal for NZ GAAP, or when a replacement asset is constructed with an as-new expected life. This creates complexity under the offsetting approach, given there will be multiple assets in the RAB with different depreciation profiles, and the assignment of the compensatory entitlement needs to be determined.
- The value of gains or losses on disposals will be impacted, which flows through other regulated income, potentially double counting the impact of the entitlements.

[2] NZ IAS 1 (paras 32 - 33)
[3] NZ IAS 16 (paras 65 - 66)
[4] NZ IAS 37 (paras 31 - 35)

We therefore do not support the proposed amendments. Instead, we propose a simple targeted solution that directly addresses the incentive problem, as follows.

1.5 Alternative solution

For ID regulation

- Record compensatory payments as other regulated income in the year recognised under NZ GAAP – i.e. retain the current IM approach. Additional capex, commissioned asset values, and opex are recorded at gross value in the year incurred, consistent with NZ GAAP and the current IMs. This avoids attempting to match compensatory payments and expenditures for IDs.

For PQ regulation

- Reduce the value of compensatory payments by the retention factor percentage when specifying the value of forecast and actual other regulated income for price-path compliance.
- Additional commissioned asset values and opex are recorded at gross value in the year incurred for the purpose of IRIS, consistent with the current IMs and ID.

As consumers have funded insurance premiums, it is appropriate that they share in any compensation that is received following an event. Non-exempt EDBs should also share in the benefits, because they share the cost consequences through IRIS.

To give effect to this solution, the required IM amendments would therefore be:

- include definitions for **insurance entitlements, compensatory entitlements and third-party liability entitlements**, as proposed in the Draft Reasons Paper
- include a definition for **retained entitlements** that applies the retention factor to insurance entitlements, compensatory entitlements and third-party liability entitlements
- modify the definition of **other regulated income** to exclude retained entitlements for the purpose of PQ regulation (i.e. Parts 3, 4 and 5 of the IMs)
- modify the definition of **retention factor** so that it may be applied in the determination of retained entitlements as well as the capex incentive amount for IRIS, for the purpose of PQ regulation.

Suggested mark-ups to the IMs are attached in Appendix B. These are mark-ups to the IM Review Amendment Determination 2023, noting that similar mark-ups will be required for existing IMs.

For the avoidance of doubt, the proposed amendments to the following clauses as set out in the consultation papers are not required under our alternative proposal:

- Clause 1.1.4(2) Definition of operating cost
- Clause 2.2.11 Value of commissioned assets
- Clause 2.3.9 Regulatory tax asset value
- Clause 4.2.5 Forecast aggregate value of commissioned assets
- Clause 5.3.11 Forecast value of commissioned assets
- Schedule E Capital and operating expenditure - regulatory templates

1.6 Catastrophic event reopener

The Draft Reasons Paper also proposes amendments to the IM provisions for catastrophic event reopeners, including the threshold for defining the reopener event and the amendments that may be made to the price path. The proposed amendments are consistent with the offsetting approach and the proposed new entitlement definitions.

We propose an alternative IM amendment that we consider is more consistent with the policy intent. This is because it is currently extremely difficult to meet the thresholds for a catastrophic event reopener in practice, as follows:

- The expenditure threshold is expressed net of any insurance entitlements, and these are typically not known at the time the expenditure is incurred and may not be known within the regulatory period. Accordingly, this threshold may not be available in practice.
- The revenue threshold is expressed as forecast net allowable revenue, which ignores the impact of other regulated income on the wash-up and IRIS penalties that may arise in the following regulatory period. In addition, even if there are major capex consequences from an event leading to significant IRIS penalties, the threshold may not be met because capex does not significantly impact net allowable revenue within the regulatory period.

We therefore propose that the expenditure threshold is expressed gross, not net, of any compensatory entitlements. This would allow significant expenditure events (over $2.5m for most non-exempt EDBs, and over $5m for Vector and Powerco) to be assessed. Currently, major events with significant financial impact may not be considered at all, because of how the thresholds are specified. As the High Court ordered in 2013, a CPP should not be the only remedy available to a regulated supplier subject to a DPP following a major event. [5]

We also propose that when amending a DPP or CPP in response to the catastrophic event reopener, the Commission should consider how compensatory entitlements are shared with consumers under the price path.

This would give the Commission the opportunity to understand the full impacts of the event when considering price-path amendments, including total allowable revenue in the current and future regulatory periods. Importantly, it also allows for the consideration of the actual net impacts on EDBs, including uninsured impacts.

1.7 Implementation

The Draft Reasons Paper proposes that the IM amendments apply from the beginning of the current disclosure year, i.e. for 2025 disclosures. This would impact price-path compliance for the final assessment period of DPP3, and for future DPPs. The Draft Reasons Paper explains that the reason that this amendment is possible within the current regulatory period is that the proposed

[5] Wellington International Airport Ltd & Others v Commerce Commission [2013] NZHC 3289, '*Our essential point of difference with the Commission, and where we agree with Vector, is that given the nature of the trigger events (being quite beyond the control of the affected supplier or suppliers and objectively defined and measurable), providing for automatic reopening is materially better than invoking the CPP pathway*' [1907]

amendments do not change the DPP3 price path, i.e. the allowable revenue for the remaining years of the regulatory period is unchanged.[6]

Our alternative IM amendment proposal to adjust other regulated income for PQ regulatory compliance purposes also does not change allowable revenue for the remaining years of DPP3, and therefore it can also be implemented for the 2025 year. This is important for Unison, and possibly other EDBs, who are in the process of settling insurance arrangements following Cyclone Gabrielle and other major events.

We note that our proposal requires no change to ID for 2025, which is consistent with regulatory precedent, where changes to IDs are determined prior to the beginning of the first relevant disclosure period.

If you have any questions about ENA's submission please contact Gemma Pascall, Regulatory Manager ( ).

Yours sincerely

Gemma Pascall

Regulatory Manager

[6] Draft Reasons Paper, para 3.18

Appendix A: ENA Members

Electricity Networks Aotearoa makes this submission along with the support of its members, listed below:

- Alpine Energy
- Aurora Energy
- Buller Electricity
- Centralines
- Counties Energy
- Electra
- EA Networks
- Firstlight Network
- Horizon Networks
- Mainpower
- Marlborough Lines
- Nelson Electricity
- Network Tasman
- Network Waitaki
- Northpower
- Orion New Zealand
- Powerco
- PowerNet (which manages The Power Company, Electricity Invercargill, OtagoNet and Lakeland Network)
- Scanpower
- Top Energy
- The Lines Company
- Unison Networks
- Vector
- Waipa Networks
- WEL Networks
- Wellington Electricity
- Westpower

Appendix B: Proposed IM drafting amendments

Clause 1.1.4(2)

compensatory entitlement means, for the purposes of–

(a) Part 2, money or the monetary value of other consideration relating to an event, other than an insurance entitlement or capital contribution, that is received or receivable from consumers or other parties, for any of the following purposes:

(i) restoring damaged assets to the same operating condition and location as prior to the event;

(ii) relocating assets if required; and

(iii) compensating for damaged or destroyed assets;

(b) Parts 4 and 5, money or the monetary value of other consideration relating to an event, other than an insurance entitlement or capital contribution, that is received or receivable from, or forecast to be received or receivable from, consumers or other parties, for any of the following purposes:

(i) restoring damaged assets to the same operating condition and location as prior to the event;

(ii) relocating assets if required; and

(iii) compensating for damaged or destroyed assets;

insurance entitlement means, for the purposes of–

(a) Part 2, money or the monetary value of other consideration relating to an event, that is received or receivable from a 'licensed insurer' as that term is defined in the Insurance (Prudential Supervision) Act 2010, in respect of a contract of insurance that insures against damaged or destroyed assets or operating costs arising from damaged or destroyed assets, excluding business interruption insurance or third-party liability entitlements; and

(b) Parts 4 and 5, money or the monetary value of other consideration relating to an event that is received or receivable from, or forecast to be received or receivable from, a 'licensed insurer' as that term is defined in the Insurance (Prudential Supervision) Act 2010, in respect of a contract of insurance that insures against damaged or destroyed assets or operating costs arising from damaged or destroyed assets, excluding business interruption insurance or third-party liability entitlements;

third-party liability entitlement means, for the purposes of-

(a) Part 2, money or the monetary value of other consideration relating to an event, that is received or receivable from a 'licensed insurer' as that term is defined in the Insurance (Prudential Supervision) Act 2010, in respect of a contract of insurance that insures against third-party liability; and

(b) Parts 4 and 5, money or the monetary value of other consideration relating to an event, that is received or receivable from, or forecast to be received or receivable from, a 'licensed insurer' as that term is defined in the Insurance (Prudential Supervision) Act 2010, in respect of a contract of insurance that insures against third-party liability;

other regulated income for the purpose of–

(a) Part 3, means income associated with the supply of electricity distribution services, including gains and losses on disposed assets, but excluding -

(i) income through prices;

(ii) investment-related income;

(iii) capital contributions;

(iv) vested assets;

(v) income associated with the assets that are funded under large connection contracts;

(vi) retained entitlements

(b) Parts 4 and 5, means income associated with the supply of electricity distribution services, including gains and losses on disposed assets, but excluding -

(i) income through prices;

(ii) investment-related income;

(iii) capital contributions;

(iv) vested assets;

(v) income associated with the assets that are funded under large connection contracts;

(vi) retained entitlements

as determined by the Commission;

retained entitlements for the purpose of-

(a) Part 3, means retention factor x (insurance entitlements + compensatory entitlements + third-party liability entitlements)

(b) Parts 4 and 5, means retention factor x (insurance entitlements + compensatory entitlements + third-party liability entitlements)

as determined by the Commission;

retention factor means the percentage amount determined by the Commission in a CPP determination or DPP determination for the purpose of calculating:

(a) the capex incentive amount; and

(b) retained entitlements

Clause 4.5.4 Catastrophic event

(1) A 'catastrophic event' is an event-

(a) […]

(b) […]

(c) […]

(d) for which-

(i) action required to rectify its adverse consequences cannot be delayed until a future regulatory period without quality standards under the DPP being breached;

(ii) remediation requires capex, opex, or both;

(iii) the full remediation costs are not provided for in the DPP; and

(iv) the costs of remediation ~~net of any insurance or compensatory entitlements~~ exceeds one of the thresholds specified in subclause (2).

Clause 4.5.15 Amending DPP after reconsideration

[…]

(3) The Commission will not amend-

(a) the price path more than is reasonably necessary to mitigate the effect of the reopener event on the DPP; and

(b) the price path more than is reasonably necessary to take account of the change resulting from the reopener event net of any ~~insurance or compensatory~~ retained entitlements; and

Clause 5.6.4 Catastrophic event

(1) A 'catastrophic event' is an event-

(a) […]

(b) […]

(c) […]

(d) for which-

(i) action required to rectify its adverse consequences cannot be delayed until a future regulatory period without quality standards under the CPP being breached;

(ii) remediation requires capex, opex, or both;

(iii) the full remediation costs are not provided for in the CPP; and

(iv) the costs of remediation ~~net of any insurance or compensatory entitlements~~ exceeds one of the thresholds specified in subclause (2).

Clause 5.6.13 Amending CPP after reconsideration

[…]

(2) The Commission will not amend-

(a) the CPP more than is reasonably necessary to mitigate the effect of the reopener event on the CPP; and

(b) the price path more than is reasonably necessary to take account of the change in costs net of any ~~insurance or compensatory~~ retained entitlements