

Wellington Electricity Lines Limited's transition to the 2020-2025 default price-quality path

Reasons paper

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Executive Summary

Purpose of this reasons paper

- X1 This reasons paper explains our decision to amend the 2020-2025 default price-quality path (DPP) to provide for the transition by Wellington Electricity Lines Limited (Wellington Electricity) from its 2018-2021 customised price-quality path (CPP) to the 2020-2025 DPP (DPP3).
- X2 Wellington Electricity will move from its CPP to DPP3 on 1 April 2021. This means that Wellington Electricity will be subject to DPP3 for only the last four years of the five-year regulatory period. The DPP3 currently applies to 15 other electricity distribution businesses (EDBs).

Setting Wellington Electricity's starting prices for when its CPP ends is the focus of our decision

- X3 The focus of our decision is on setting starting prices when Wellington Electricity moves onto DPP3. When we set the DPP3 in November 2019, we specified the rate of change and the quality standards that will apply to Wellington Electricity when it moves to the DPP3.¹

Decision on starting prices

- X4 Our decision is to use a “building blocks” approach to set starting prices for Wellington Electricity.
- X5 Under s 53X(2) of the Commerce Act, we have a choice of rolling over the prices that applied at the end of Wellington Electricity's CPP, or setting different starting prices.
- X6 The building blocks approach provides a way to take account of the current and projected profitability of each distributor to set starting prices. The approach is the same as that used for each of the other EDBs subject to DPP3, but uses some updated figures including information from Wellington Electricity's latest information disclosure.
- X7 Accordingly, we have set the 2022 forecast net allowable revenue at \$91.109 million. This is 0.6% lower than the 2021 forecast net allowable revenue that was set as part of Wellington Electricity's CPP and reflects a reduction in operating costs which Wellington Electricity has recently achieved.

¹ For more detail on the treatment of Wellington Electricity in the DPP3 refer to: Commerce Commission “Default price-quality paths for electricity distributors from 1 April 2020: Reasons paper” (27 November 2019), Attachment I.

- X8 In making our decision we are exercising our discretion under s 53X, while being guided by ss 52A and 53K. In particular, we consider that our decision:
- X8.1 maintains Wellington Electricity's incentives to innovate and invest (s 52A(1)(a));
 - X8.2 limits Wellington Electricity's ability to extract excessive profits (s 52A(1)(d)); and
 - X8.3 reflects a relatively low-cost approach to the transition (s 53K).
- X9 We also consider that our decision is consistent with s 53P because it is based on Wellington Electricity's current and projected profitability, does not seek to recover excess profits from the prior period, and is not derived from comparative benchmarking.

Chapter 1 Introduction

Purpose of this reasons paper

- 1.1 This reasons paper explains our decision for Wellington Electricity’s transition from its 2018-2021 CPP to the DPP3.

Wellington Electricity’s CPP and the DPP3 applying to 15 electricity distributors

- 1.2 Wellington Electricity applied for a CPP following the November 2016 Kaikoura earthquakes and a Government Policy Statement (GPS) that noted the increased likelihood of a large earthquake occurring. The GPS highlighted the importance of key “lifeline” utilities in Wellington, including Wellington Electricity, taking action to ensure they were well prepared for such an event.²
- 1.3 On 28 March 2018, we determined a CPP to apply to Wellington Electricity between 1 April 2018 and 31 March 2021.³
- 1.4 Wellington Electricity has entered the third year of its three-year CPP. One requirement of its CPP determination is for it to prepare and disclose an annual compliance statement. This includes agreed measures that demonstrate the progress of its procurement and installation programme and the effectiveness of the seismic strengthening building works that were approved under the CPP. Statements to date show that in 2019 and 2020 Wellington Electricity outperformed its CPP resilience quality standard, and that it appears to be on track to comply in 2021.
- 1.5 On 27 November 2019, we set the default price path (DPP) applying to 15 EDBs for the five-year period from 1 April 2020 to 31 March 2025 (ie, DPP3).⁴ The DPP3 determination specified the rate of change in revenues and the quality standards that would apply to Wellington Electricity when it transitioned to the DPP on 1 April 2021, but did not determine its starting prices.⁵ In the associated reasons paper we noted our intention to determine Wellington Electricity’s starting prices once more up-to-date information became available.⁶

² “Government Policy Statement — Resilience of Electricity Services in the Wellington Region” (21 September 2017) 97 New Zealand Gazette 4910 at 53.

³ *Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018* [2018] NZCC 6, 28 March 2018.

⁴ *Electricity Distribution Services Default Price-Quality Path Determination 2020* [2019] NZCC 21, 27 November 2019.

⁵ For more detail on the treatment of Wellington Electricity in the DPP3 refer to: Commerce Commission “Default price-quality paths for electricity distributors from 1 April 2020: Reasons paper” (27 November 2019), Attachment I.

⁶ *ibid*, at para I15.

- 1.6 Wellington Electricity will move from its CPP to the DPP3 on 1 April 2021. Once it moves, we expect that Wellington Electricity will be subject to the DPP3 for four years unless it applies for another CPP.

In making our decision we considered submissions received

- 1.7 On 25 September 2020 we published our draft DPP3 amendment determination and draft reasons paper. We received submissions on 16 October and cross-submissions on 23 October.
- 1.8 We would like to thank all of those who provided the submissions and cross-submissions that helped inform our decision. Submissions were received from Aurora Energy, the Electricity Networks Association (ENA), the Major Electricity Users' Group (MEUG), Powerco, Unison, and Wellington Electricity. Cross-submissions were received from Orion and Wellington Electricity.

Structure of this paper

- 1.9 In this paper, we explain:
- 1.9.1 the legal framework relevant to Wellington Electricity's transition to the DPP3 (Chapter 2);
 - 1.9.2 our decision on Wellington Electricity's starting prices when it transitions to the DPP3 (Chapter 3); and
 - 1.9.3 how we propose to implement Wellington Electricity's transition to the DPP3 (Chapter 4).

Chapter 2 Legal framework

Purpose of this chapter

- 2.1 This chapter sets out the legal framework relevant to our decision for Wellington Electricity's transition from its CPP to the DPP3.

Section 53X

- 2.2 Section 53X of the Commerce Act 1986 governs the transition of regulated suppliers from a CPP to a DPP. It provides:

53X What happens when customised price-quality path ends

- (1) When the customised price-quality path of a supplier of goods or services ends, the supplier is subject to the default price-quality path that is generally applicable to other suppliers of those goods or services.
- (2) The starting prices that apply at the beginning of the default price-quality path are those that applied at the end of the customised price-quality path unless, at least 4 months before the end of the customised price-quality path, the Commission advises the supplier that different starting prices must apply.
- (3) The supplier remains subject to the default price-quality path until—
 - (a) the end of the period for which it applies to other suppliers; or
 - (b) a new customised price-quality path begins to apply to the supplier.
- (4) To avoid doubt, a supplier who is or was subject to a customised price-quality path may apply in accordance with section 53Q for another customised price-quality path.

Making the supplier subject to the DPP – section 53X(1)

- 2.3 Section 53X(1) requires that, when Wellington Electricity's CPP ends, it be made subject to the DPP that is "generally applicable" to the other EDBs. In this case, this is the DPP3 that is set out in the DPP3 determination.
- 2.4 Clause 3.4 of the DPP3 determination provides that the DPP3 determination does not apply to Wellington Electricity until the expiration of Wellington Electricity's CPP determination. Wellington Electricity's CPP determination expires on 31 March 2021 and, as such, the DPP3 determination applies to Wellington Electricity from 1 April 2021 onwards.
- 2.5 However, some amendments to the DPP3 determination are required to make Wellington Electricity subject to the DPP that is "generally applicable" to the other EDBs. Without these amendments, Wellington Electricity would be on a materially different DPP to the other EDBs. We explain what these necessary amendments are in Chapter 4 on "Implementation".

Setting the transitioning supplier's starting prices – s 53X(2)

- 2.6 We have previously considered how we should set a transitioning supplier's starting prices under s 53X(2) when Orion New Zealand Limited transitioned from its CPP to the EDB DPP for the last year of the 2015-2020 regulatory period. Our Final Report set out the key considerations for this task, which we summarise below.⁷
- 2.7 We have a discretion in setting starting prices under s 53X(2). This discretion involves:
- 2.7.1 choosing between rolling over the prices that applied at the end of the CPP or setting different starting prices; and
 - 2.7.2 if we choose to set different starting prices, deciding on the prices that apply.
- 2.8 In exercising our discretion under s 53X(2), we must do so in the manner we judge best meets the purpose of Part 4 of the Commerce Act (as set out in s 52A⁸) and the purpose of DPP/ CPP regulation (as set out in s 53K⁹). However, the s 52A purpose provides the primary objectives and considerations that we must give weight to when exercising our judgement.
- 2.9 Of particular relevance to our s 53X(2) discretion are:
- 2.9.1 the s 52A(1)(a) outcome relating to incentives to innovate and invest and the s 52A(1)(b) outcome that suppliers are limited in their ability to extract excessive profits; and
 - 2.9.2 under the s 53 K purpose, the desirability of keeping the cost and complexity of the transition low, including our approach to setting starting prices.
- 2.10 In deciding whether to roll over the prices that applied at the end of the CPP, or to set different starting prices, the primary consideration will be which option will better promote the objectives in the s 52A purpose. If, for example, rolling over the

⁷ Commerce Commission "Orion New Zealand's transition to the 2015-2020 default price-quality path – Final Report" (7 October 2016), at 2.2-2.14.

⁸ Section 52A provides that "The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in s 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".

⁹ Section 53K provides that "The purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances".

prices that applied at the end of the CPP would be inconsistent with limiting the supplier's ability to extract excessive profits, this would weigh in favour of setting different starting prices. This could be the case where, for instance, a CPP was required for a temporary spike in expenditure. If the prices that applied at the end of the CPP were rolled over in this instance, the prices would not reflect the lower level of future expenditure and the supplier may extract excessive profits.

- 2.11 Exercising our discretion consistent with s 52A and s 53K purposes means that the length of the DPP regulatory period remaining when a supplier transitions from a CPP is relevant to our decision on setting starting prices. A shorter period remaining may weigh in favour of a lower-cost exercise, such as rolling over the prices that applied at the end of the CPP or a relatively simple approach to setting different starting prices. This is because the costs involved in a more complex exercise may outweigh any associated incremental gains in accuracy.
- 2.12 On the other hand, a longer period remaining may weigh in favour of a relatively higher-cost approach to setting prices, such as more detailed modelling of the costs the supplier is likely to incur.
- 2.13 If we decide to set different starting prices, s 53P is a relevant consideration. Relevantly, s 53P requires that starting prices:
- 2.13.1 be based on the current and projected profitability of the supplier (if prices are being reset);
 - 2.13.2 must not seek to recover any excessive profits made during any earlier period; and
 - 2.13.3 must not be derived from comparative benchmarking.
- 2.14 We have some flexibility in how we set prices based on the current and projected profitability of the supplier. In particular, we are not required to undertake a full 'building blocks' analysis. Nor are we required to accommodate all of a supplier's specific circumstances, given the low-cost nature of DPP regulation.

Section 52Q

- 2.15 Any amendments to the DPP determination must be made under s 52Q of the Commerce Act. Section 52Q(1) requires the Commission to consult with interested parties on any material amendments to the DPP determination.
- 2.16 We satisfied our obligation to consult with interested parties through inviting submissions on our draft DPP3 amendment determination and draft reasons paper.

Chapter 3 Our decision

Purpose of this chapter

- 3.1 This chapter explains our decision on Wellington Electricity's DPP starting prices as it moves to the DPP3. Specifically, it addresses:
- 3.1.1 our decision to set Wellington Electricity's starting prices based on a building blocks approach;
 - 3.1.2 our decision not to use updated cost inflators to project Wellington Electricity's operating expenditure (opex) and capital expenditure (capex) cost requirements;
 - 3.1.3 our decision to allow part of Wellington Electricity's request for an adjustment to its base year opex;
 - 3.1.4 MEUG's submission on electricity demand reductions; and
 - 3.1.5 how the existing building blocks models have been used to calculate Wellington Electricity's starting prices.

Setting Wellington Electricity's starting prices on a building blocks approach rather than rolling over the CPP prices

- 3.2 As noted in paragraph 2.7, we can choose between rolling over the prices that applied at the end of the CPP or setting different starting prices.
- 3.3 Our decision is to set different starting prices rather than rolling over the CPP prices, and to base those different starting prices on a building blocks approach. Submissions generally supported this approach.¹⁰ The building blocks approach was used to set the starting prices of the other EDBs subject to the DPP3. In applying the building blocks approach to Wellington Electricity, we have used more recent data than was available when we set the DPP3.
- 3.4 We consider that our decision best meets the Part 4 purpose as set out in s 52A. We also consider the decision meets the purpose of default/customised price-quality regulation as set out in the s 53K purpose.

¹⁰ See Wellington Electricity, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision" (16 October 2020) at p. 2; Aurora Energy, "Submission – Draft Decision on Wellington Electricity Lines Limited's Transition to the 2020-2025 Default Price-Quality Path" (16 October 2020, at para 4; MEUG, "Wellington Electricity CPP to DPP draft decision" (16 October 2020), at para 3(a); Powerco, "Submission on Wellington Electricity's CPP to DPP draft decision" (16 October 2020), at p. 1.

Reasons for our decision

3.5 We consider that our decision:

- 3.5.1 maintains Wellington Electricity's incentives to innovate and invest (s 52A(1)(a));
- 3.5.2 limits Wellington Electricity's ability to extract excessive profits (s 52A(1)(d));
- 3.5.3 reflects a relatively low-cost approach to the transition (s 53K); and
- 3.5.4 is consistent with s 53P.

Maintaining Wellington Electricity's incentives to innovate and invest

3.6 Our decision to use a building blocks approach and update the models used for the DPP3 with more recent data allows us to better match expenditure allowances with expenditure requirements. To assess Wellington Electricity's capital expenditure requirements, we applied the same series of reliability tests to Wellington Electricity's asset management plan (AMP) forecasts that we applied when we assessed the capex requirements of the other 15 EDBs. We consider that appropriate scrutiny of costs helps to promote the maintenance of Wellington Electricity's incentives to innovate and invest.

Limiting Wellington Electricity's ability to extract excessive profits

- 3.7 In our reasons paper for the decision on the DPP3, we noted that Wellington Electricity's CPP would "not be a suitable base for future revenue allowances". This was because of Wellington Electricity's unique CPP circumstances whereby the 2015-2020 DPP was extended and an increment applied to allow for resilience investments.
- 3.8 By taking into account Wellington Electricity's current and future profitability, the decision to use a building blocks approach takes account of Wellington Electricity's current costs to help lock in place the recent operating cost savings that Wellington Electricity has made. This approach best promotes the s 52A outcome of limiting a supplier's ability to extract excessive profits.

A relatively low-cost approach to Wellington Electricity's transition

- 3.9 Our decision is a relatively low-cost way of managing Wellington Electricity's transition to the final four years of the DPP3.
- 3.10 When we set the DPP3, we modelled an indicative price path for Wellington Electricity. The existence of that indicative modelling provides us a relatively low-cost opportunity to apply a building blocks approach.

- 3.11 Given that Wellington Electricity will be subject to the DPP3 for four years, we consider the benefits of adopting a building blocks approach to be justified.
- 3.12 In our draft reasons paper, we noted that it is not clear how a roll-over could be implemented for a price path that contains an IRIS mechanism. In its submission, Aurora Energy raised a concern that this might preclude the Commission from choosing to roll over prices. While we consider that, on this occasion, setting different starting prices best meets the Part 4 purpose, we agree that, for future transitions, s 53X(2) provides the Commission with a discretion to choose between rolling over prices or setting different starting prices. This may be considered when we next review the input methodologies (IMs).

Consistent with s 53P

- 3.13 Section 53P is a consideration when setting starting prices using a building blocks approach. It requires that starting prices be based on the current and projected profitability of the supplier, must not seek to recover any excessive profits made during any earlier period, and must not be derived from comparative benchmarking.
- 3.14 We consider that we have been consistent with s 53P because we have followed the DPP3 approach, and we considered that approach produced outcomes consistent with s 53P.

Cost inflators

How the draft determination treated cost inflators

- 3.15 The projections of each EDB's opex and capex cost requirements in the DPP3 determination are calculated from three cost inflation forecasts: the labour cost index (all industries); producers' price index (input—all industries); and the capital goods price index (all groups). These are abbreviated, respectively, to LCI, PPI and CGPI. The forecasts used for the DPP3 determination were provided by the New Zealand Institute of Economic Research (NZIER) and reflect those in its September 2019 Quarterly Projections publication.
- 3.16 In the draft amendment determination, we used updated cost inflation forecasts provided by NZIER in September 2020.
- 3.17 As required by the EDB IMs, we calculated the maximum allowable revenue by using September 2019 forecasts of Consumer Price Index (CPI) inflation, rather than more recent forecasts of CPI inflation. The IMs require that the CPI forecasts are taken from the Monetary Policy Statement last issued by the Reserve Bank of New Zealand

prior to when the applicable estimate of the Weighted Average Cost of Capital (WACC) was determined.¹¹

What submissions said on cost inflators

3.18 A number of submissions discussed the use of cost inflators in the draft decision. Submissions noted the impact of using updated cost inflators, and older CPI forecasts, on Wellington Electricity’s building blocks allowable revenue (BBAR) and therefore on the price path. Wellington Electricity noted:

“Applying the new operating expenditure cost inflators and capital expenditure cost inflators has resulted in a ~\$5.5m and ~\$0.1m respective reduction in BBAR (across a four-year regulatory period) compared to applying the August 2019 cost inflators from the Final DPP3 Decision.”

3.19 All submissions received from suppliers and the ENA expressed concern with the updated forecasts for cost inflators, including the interaction with the use of an older CPI forecast. In its submission, Wellington Electricity summarised the concerns with the forecasts as follows:

3.19.1 The recent forecasts of cost inflation do not reflect the circumstances facing the electricity sector which continues to operate at pre-Covid-19 levels and has not been as exposed to the pandemic and recession as some other sectors have been;

3.19.2 The August 2020 cost inflation forecasts are not fit for purpose due to the elevated uncertainty of Covid-19, the current recession and the general election; and

3.19.3 The forecasts of cost inflation are inconsistent with the CPI forecast used elsewhere in the draft amendment determination.

3.20 According to submissions, these concerns would mean that Wellington Electricity is not returned to a DPP that is generally available to other EDBs. Submissions said that Wellington Electricity would not be expected to recover its projected capex and, more materially, its projected opex requirements. In its submission, Aurora Energy concluded, “[i]n our view, the Commission’s draft decision to use re-forecast escalators conflicts with its preference to ensure that Wellington Electricity is not on a ‘materially different DPP to the other DPPs’”.¹² Wellington Electricity’s cross-submission concluded, “[t]he current draft decision knowingly sets maximum

¹¹ Commerce Commission *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC26 (Consolidated at 20 May 2020), clauses 3.1.1(7)–3.1.1.(8).

¹² Aurora Energy, “Submission – Draft Decision on Wellington Electricity Lines Limited’s Transition to the 2020-2025 Default Price-Quality Path” (16 October 2020, at para 14.

allowable revenue (MAR) at a level that Wellington Electricity isn't realistically expected to achieve a real return. The statutory purpose of s 52A(1)(a) is therefore not being met".¹³

- 3.21 We understand that there are two distinct issues raised by submitters. The first issue relates to the extent of uncertainty in the 2020 price index forecasts and the associated concern that the forecasts may not reflect conditions facing EDBs. The second issue arises from the mechanics of the model, which must use the 2019 forecast CPI to set the starting price, and the potential inconsistency if 2020 forecast cost inflators are used for the opex and capex components of BBAR. We summarise submissions on these two issues below.

Electricity industry circumstances and Covid-19 uncertainty

- 3.22 The concerns Wellington Electricity raises in its paragraphs 3.19.1 and 3.19.2 relate to macroeconomic uncertainty and the specific circumstances of the electricity industry.
- 3.23 Aurora, ENA, Powerco, Wellington Electricity and Orion (in its cross-submission) all note differences in the impact of Covid-19 on individual sectors of the economy, with media and communication, tourism, hospitality and arts particularly affected.
- 3.24 Wellington Electricity submitted charts of Statistics New Zealand PPI and LCI historical figures to June 2020 weighted by sector. Wellington Electricity concluded that the change in the economy-wide indices between 2019 and 2020 did not reflect changes in the costs confronting EDBs. In particular, Wellington Electricity stated, "the significant fall in the all industries PPI is not reflected in the EGWW [electricity, gas, water and waste] sector which showed a small increase in PPI" since September 2019, and "there has been virtually no change in the [EGWW] sector index in the [March and June 2020] quarters, a direct contradiction to the all industries index which has declined markedly".¹⁴
- 3.25 ENA, Powerco and Wellington Electricity noted that the 2020 inflation forecasts were made during a period of extraordinary and extreme economic impact and uncertainty due to Covid-19. Wellington Electricity quoted from NZIER's September 2020 Quarterly Projections publication:¹⁵

¹³ Wellington Electricity, "Cross-submission to the Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision" (23 October 2020) at p. 8.

¹⁴ Wellington Electricity, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision" (16 October 2020) at pp. 7–8

¹⁵ Wellington Electricity, "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision" (16 October 2020) at p. 4.

“NZIER continues to forecast an uneven recovery for the economy, with the effects of the COVID-19 outbreak expected to persist well into 2023. An extremely high degree of uncertainty remains over the growth outlook, given the rapidly changing conditions”.

- 3.26 Wellington Electricity also noted that in its September 2020 pre-election economic and fiscal update, Treasury reported three alternative forecast scenarios as well as its main forecast for the economy. Significant uncertainties considered in these scenarios included an earlier recovery in exports of services, an extended period of border controls, and a resurgence in community transmission.

CPI and price inflator consistency

- 3.27 The concern Wellington Electricity raises in paragraph 3.19.3 of its submission relates to potential inconsistencies between the use of updated cost inflation forecasts and the intended operation of DPP mechanisms. These mechanisms include the use of:

3.27.1 the 2019 CPI forecast to set Wellington Electricity’s 2022 starting price,^{16 17} and

3.27.2 actual CPI outturns to calculate the remaining price path.¹⁸

- 3.28 This concern was also reflected by the ENA, Unison and Orion. The ENA stated that “in resetting Wellington Electricity’s revenue allowance, the Commission is now constrained to use the WACC and CPI forecasts from 2019, which creates an issue in ensuring that there is logical consistency with the input price inflation forecasts affecting opex and capex”.¹⁹

- 3.29 The ENA, in its submission, states:²⁰

“One of the advantages of escalating the revenue allowance at the rate of actual CPI inflation over the regulatory period is that it inherently provides a degree of hedge against changes in out-turn input price inflation. If CPI turns out to be less than forecast, then it would be expected that nominal wage inflation would also reduce, as would other input price inflation outturns.”

¹⁶ The CPI forecasts used for revaluing assets and setting the starting price of a DPP and a CPP are defined in clause 3.1.1(8) of the IMs. To be consistent with investor expectations associated with the WACC, the IMs require that they are calculated using the forecast in the Reserve Bank Monetary Policy Statement last issued before the date for which the WACC was determined.

¹⁷ Wellington Electricity’s starting price is specified in the amended determination as the forecast net allowable revenue for the assessment period commencing 1 April 2021 and ending on 31 March 2022.

¹⁸ The ‘actual net allowable revenue’ is specified in the Schedule 1.6 of the amended determination and follows a ‘CPI-X’ path. In the DPP3 ‘X’ is zero for all non-exempt EDBs (Schedule 1.2).

¹⁹ ENA, “Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision” (16 October 2020), at p. 3.

²⁰ *ibid*, at p. 3.

- 3.30 Unison argues that applying an updated cost inflation forecast to the DPP mechanisms in the draft determination will result in Wellington Electricity not expecting to achieve real financial capital maintenance.²¹

“Accordingly, if CPI turns out lower as expected in the August 2020 CPI forecasts, then the Commission is effectively double-allowing for the reduction in input price inflation (once by specifically adjusting the input price inflation forecasts, and twice by not adjusting the CPI for converting the BBAR to MAR, so the expected MAR track is below the forecast MAR track).”

Proposed resolutions

- 3.31 In its submission, the ENA recommended:²²

“Given the constraints on the Commission’s use of 2019 CPI forecasts, this problem could be addressed in potentially one of two ways:

“1. Adopt the 2019 input price inflation forecasts so that there is logical consistency in the expected revenue allowance (which will be lower than the stated MAR track) and the expected compensation for expenditure requirements (which will be lower than the stated forecast expenditure requirement); or

“2. Take the 2020 input price inflation forecasts, deflate these by the 2020 CPI forecast and then re-inflate these using the 2019 CPI forecasts. In that way, the real component of the input price inflation forecasts is consistent with current economic conditions and the nominal component of the input price inflation forecasts is consistent with the inflation assumption used elsewhere in the DPP reset (and in particular the conversion of BBAR to MAR).

“We consider option 1 to be the easier solution to implement and its low cost is consistent with the overall DPP approach.”

- 3.32 Wellington Electricity supported the first of the ENA’s recommendations, and Unison supported the recommendations in their entirety.

Our decision on cost inflators

- 3.33 We considered the two concerns raised in submissions and the proposed solutions. The first solution proposed by the ENA would adopt the forecasts for cost escalators used in the DPP3 and therefore eliminate both concerns raised in submissions. The other solution focuses on the second concern only; it would take the 2020 cost escalators and adjust these for the relative change in the CPI forecast. The effect of this would be to adopt the profile of the 2020 cost escalators relative to the 2020 CPI forecast and apply it to the 2019 CPI forecast.

²¹ Unison, “Wellington Electricity DPP Draft Decision” (16 October 2020), at p. 1.

²² ENA, “Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision” (16 October 2020), at p. 3.

- 3.34 Our decision is not to use the updated LCI, PPI and CGPI forecasts and to revert to the forecasts that were used to set the DPP3 capex and opex projections for all other EDBs. This decision:
- 3.34.1 avoids the inconsistency that arises from the mechanics of the model; and
 - 3.34.2 is a low cost way of setting a price path for Wellington Electricity that uses readily available data and recognises the limited remaining time to set different starting prices under s 53X (ie, by the end of November 2020).
- 3.35 While we would prefer to reflect information about current economic conditions in our decision, we recognise the considerable uncertainty inherent in current forecasts and, in particular, the extent to which they may reflect temporary differences in conditions in different sectors.

Other submissions on cost inflators

- 3.36 Some submitters have suggested that, in the longer term, the Commission:
- 3.36.1 should employ a refined approach when forecasting escalators. This would involve selecting only relevant cost categories within LCI, PPI and CGPI, and applying an appropriate weighting to those relevant cost categories. Such an approach would produce a more defensible result and would not be so onerous as to compromise the relatively low-cost nature of DPP regulation required by s 53K of the Act;²³
 - 3.36.2 needs to reconsider whether the IM needs to be adjusted to allow for the CPI used to convert the BBAR to MAR to be the forecast applicable at the time, as this is a different issue to the consistency of the CPI forecast used for revaluations and WACC.²⁴
- 3.37 Before each DPP reset we consider and consult on indices appropriate for projecting the opex and capex requirements.²⁵ It is appropriate that the suggestion raised in paragraph 3.36.1 be raised at that time.
- 3.38 We note the second suggestion and may reconsider it when we next review the IMs.

²³ Aurora Energy, "Submission – Draft Decision on Wellington Electricity Lines Limited's Transition to the 2020-2025 Default Price-Quality Path" (16 October 2020), at para 15.

²⁴ Unison, "Wellington Electricity DPP Draft Decision" (16 October 2020), at p. 2.

²⁵ For example, see Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2015 to 31 March 2020 — Low cost forecasting approaches" (28 November 2014), Attachment C; Commerce Commission "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision — Reasons paper (27 November 2019)", Attachments A & B.

Wellington Electricity's request for increments to the base year opex

3.39 In a letter to us on 26 August 2020,²⁶ Wellington Electricity requested that the base year opex figure we use in our modelling be increased from the amount disclosed in Wellington Electricity's 2020 information disclosure. The reason cited by Wellington Electricity was that its ongoing earthquake readiness and insurance costs are not well reflected in actual expenditure in the 2020 base year.

What we said in the DPP3 reasons paper about opex step changes

3.40 Under the building blocks approach used to set the starting prices in the DPP3 determination, each EDB's total opex cost is projected, based on the total opex costs reported in the EDB's most recent information disclosure (the base year cost). Some adjustments have been made to, for example, reflect a change in accounting standards or recognise an additional charge faced by most EDBs. Such adjustments can be implemented by adjusting the base year cost or by adjusting the amount projected for each year. These adjustments can have a material impact on distributors' revenue, and EDBs have an incentive to seek the inclusion of as many positive adjustments as possible.

3.41 In the DPP3 reasons paper, we set out a test for considering whether to accept opex step changes.²⁷ The test was that each of the following criteria needed to be met for a step change in opex to be approved:

3.41.1 significant;

3.41.2 robustly verifiable;

3.41.3 not captured in other components of our projection (base year, trend factors, capex or recoverable costs);

3.41.4 largely outside of the control of distributors; and

3.41.5 be applicable to most, if not all distributors.

3.42 In submissions made on the DPP3 decision, Wellington Electricity raised concerns in regard to its ongoing earthquake readiness costs and its increasing insurance costs.²⁸

²⁶ Letter from Scott Scrimgeour (Commercial and Regulatory Manager, Wellington Electricity) to Robert Gordon (Chief Adviser, Commerce Commission) on Wellington Electricity DPP3 allowance calculation – preparation (26 August 2020).

²⁷ Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2020: Reasons paper" (27 November 2019), paragraph A35.

²⁸ Wellington Electricity "Submission on EDB DPP reset draft decisions paper" (18 July 2019), ss 3 and 5.

3.43 In our DPP3 reasons paper, we noted that:

3.43.1 in relation to the ongoing earthquake readiness costs, we would review Wellington Electricity's situation when it transitioned to the DPP3.²⁹

3.43.2 in relation to the increasing insurance costs, existing insurance costs may be included in the opex baseline, but that the insurance costs in Wellington Electricity's submission were "not sufficiently significant" to be added to the base year.³⁰

Our decision on ongoing earthquake readiness costs

3.44 Our decision is to add an increment of \$0.330m to Wellington Electricity's base year opex figure to allow the building blocks projection of Wellington Electricity's operating costs to reflect expected ongoing earthquake readiness operating expenditure.

What we said in the draft reasons paper about ongoing earthquake readiness costs

3.45 In our draft decision, we added an increment of \$0.287m to Wellington Electricity's base year opex in relation to ongoing earthquake readiness costs. This amount reflected the 2021 earthquake readiness expenditure approved in the CPP determination.

3.46 The draft decision recognised that Wellington Electricity's request for an increment relating to ongoing earthquake readiness costs did not satisfy the step change criteria set out in paragraph 3.41. In particular, these costs are not applicable to most EDBs.

3.47 However, we recognised that the earthquake readiness component of Wellington Electricity's 2018 CPP was approved to allow Wellington Electricity to properly respond to a GPS on the Resilience of Electricity Services in the Wellington Region.³¹ That statement highlighted the importance of key "lifeline" utilities in Wellington (including Wellington Electricity) taking action to ensure they are well prepared for a large earthquake event. The GPS states:

²⁹ Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2020: Reasons paper" (27 November 2019), paragraph A78.

³⁰ Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2020: Reasons paper" 27 November 2019, Table A4.

³¹ "Government Policy Statement — Resilience of Electricity Services in the Wellington Region" (21 September 2017) 97 New Zealand Gazette 4910 at 53.

It is Government policy that lifeline utilities that are regulated under Part 4 of the Commerce Act should be able to recover reasonable costs arising from their duties under the CDEM Act, including costs arising from actions taken in response to new hazard information, to the extent allowed by law. The ability to recover prudent resilience costs promotes the purpose of the CDEM Act and the purpose of Part 4 of the Commerce Act.

- 3.48 Under s 26 of the Commerce Act, the Commission is required to have regard to the GPS in exercising its powers.
- 3.49 The increment to base year opex that Wellington Electricity has requested in its 26 August 2020 letter is for ongoing opex that is directly related to the earthquake readiness component of Wellington Electricity's CPP.³²
- 3.50 As such, in this limited circumstance, our draft decision proposed to include this opex in the base year, despite not satisfying our criteria for accepting opex step changes.

What submissions said on ongoing earthquake readiness costs and our response to those submissions

- 3.51 Wellington Electricity's submission on the draft decision requested the additional \$0.043m difference between the \$0.287m increment we added for the draft decision and the \$0.330m increment we have added for the final decision. Wellington Electricity wrote to us on 16 September 2020, detailing the additional \$0.043m and providing documentation for ongoing opex contracts it had recently concluded. We did not have sufficient time prior to the release of the draft decision to take the letter into account for that decision. Given the amount falls within the scope of the GPS and is of the same type and nature as the expenditure already included in the CPP, we have included it in the base year opex for Wellington Electricity's DPP.
- 3.52 In its submission on the draft decision, MEUG disagreed with the draft decision to add an increment of \$0.287m to the base year opex in relation to ongoing earthquake readiness opex. MEUG submitted that the problem was of Wellington Electricity's making, having not sought "a full CPP knowing full well that the DPP regime had no capability to cover opex before the next all-of-EDB DPP reset". MEUG also submitted that adding the increment to the base year opex would create undesirable precedents.

Our response

- 3.53 We do not agree with MEUG's submission that an increment should not be added to the base year opex amount, or that allowing it will create an undesirable precedent. The expenditure in question is covered by the GPS (reasonable costs relating to the duties of a lifeline utility under the Civil Defence Emergency Management Act) and is of the same type and nature as expenditure allowed under the Wellington Electricity

³² Commerce Commission "Wellington Electricity's customised price-quality path – Final Decision" (Reasons paper, 28 March 2018).

CPP. We do not agree that Wellington Electricity's use of a streamlined CPP process rather than a full CPP application is relevant to allowing the additional opex as the GPS relates to the recovery of costs generally under Part 4, including when transitioning to a DPP.

Our decision on insurance costs

3.54 Our decision is not to approve an adjustment to Wellington Electricity's base year opex figure to reflect Wellington Electricity's increasing insurance premiums.

What we said in the draft reasons paper about higher insurance costs

3.55 Our draft decision was not to approve an adjustment to Wellington Electricity's base year opex figure that would allow the building blocks projection of Wellington Electricity's insurance costs to reflect Wellington Electricity's 2021 insurance premiums instead of the insurance premiums in the 2020 base year.

3.56 Our draft decision acknowledged that Wellington Electricity had provided evidence of the growth in its insurance premiums between 2017 and 2021. Notably, its insurance costs increased by 26 percent in the year to 2020, and would increase by a further 37 percent in the year to 2021 despite a decrease in the coverage of the policy (reflecting the insurer's current willingness to offer cover).

3.57 However, our draft decision noted that the expected increases in insurance costs:

3.57.1 were not approved for the other EDBs as part of the DPP; and

3.57.2 do not relate to the matters addressed in the CPP and do not directly relate to improvements in Wellington Electricity's network.

3.58 We referred to our consideration of the treatment of insurance in the 26 November 2019 IM amendments. Our concern was whether insurance should be treated as a recoverable cost. In deciding that insurance should not be treated as a recoverable cost, we commented:³³

Furthermore, allowing all insurance costs to be passed through to consumers, who have no control over the risks would be contrary to the risk allocation principle we apply when making decisions within the Part 4 regime. While, as the ENA points out, distributors do not have full control over the premiums they face, they are better able to control these costs and manage their exposures than consumers are.

³³ Commerce Commission "Amendments to Electricity Distribution Services Input Methodologies Determination, Reasons paper" (26 November 2019), at para 3.97.

- 3.59 We did not consider it appropriate to make insurance an exception to the criteria set out in paragraph 3.41. In implementing a building blocks approach to setting supplier starting prices, insurance did not appear to be fundamentally more deserving of being singled out for special treatment than other controllable costs affecting individual EDBs.
- 3.60 Our draft decision was therefore not to increase Wellington Electricity's base year opex to reflect the expected increase in its insurance costs in the last year of its CPP.

What submissions said on insurance

- 3.61 A number of parties submitted on insurance costs. MEUG agreed with our draft decision, but the ENA and four EDBs, including Wellington Electricity, disagreed for two broad reasons:³⁴
- 3.61.1 There was a known and significant increase in insurance costs for Wellington Electricity to levels that were well above those allowed for in the DPP. For example, Wellington Electricity submitted that "without the funding, it will have to consider reducing its insurance coverage",³⁵ and
- 3.61.2 If Wellington Electricity reduced its further coverage this would transfer risk to consumers and it was unlikely to be efficient for consumers to bear a higher proportion of repair costs following an earthquake given consumers would already have their own high costs of recovery.
- 3.62 In support of these points, some submitters referenced the approach in the Orion CPP decision and in the 2010-2015 DPP decision in light of higher insurance costs following the Canterbury earthquakes.

Our response

- 3.63 Our decision is not to make a greater allowance for higher insurance costs. This is for essentially the same reasons as advanced in the draft decision (and set out above at paragraphs 3.55 to 3.60).
- 3.64 In terms of the criteria for making step changes to opex under the DPP (as set out at paragraph 3.41), we do not consider this increase to be significant to Wellington Electricity, and it is not applicable to most distributors (and if it were, it could not be

³⁴ MEUG "Wellington Electricity CPP to DPP draft decision" (16 October 2020) at 2. WELL "Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision" (16 October 2020) at 11–14. Unison "Wellington Electricity DPP Draft Decision" (16 October 2020) at 2–3. Aurora Energy "Submission – Draft Decision on Wellington Electricity Lines Limited's Transition to the 2020-2025 Default Price Quality Path", (16 October 2020) at 3. Powerco "Submission on Wellington Electricity's CPP to DPP Draft Decision" (16 October 2020) at 2–3. Orion "Cross Submission on Wellington Electricity Lines (WELL) CPP to DPP draft decision" (23 October 2020) at 11–17.

³⁵ Wellington Electricity, "Cross-submission to the Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision" (23 October 2020) at p. 11.

addressed when transitioning Wellington Electricity to a DPP). Where a regulated firm faces an increase in one cost item, like firms facing workable competition, it should seek to manage its costs by reviewing its other activities to find offsetting savings. Where a regulated firm cannot do so, it can choose to seek a CPP. Wellington Electricity has not sought a CPP at this time.

- 3.65 We do not accept that our decision necessarily transfers risk to consumers. Wellington Electricity can continue its level of insurance cover (subject to insurer's willingness to provide cover), albeit at higher cost.

Electricity demand reductions resulting in expenditure reductions

- 3.66 In its submission on the draft decision, MEUG recommended that we review demand growth projections and reduce starting prices to reflect our latest views of Covid-19 on electricity demand. MEUG calculated that "for every 5% decrease in operating costs and capital expenditure" the NPV of MAR would reduce by \$6.293m, and \$0.741m respectively. MEUG submitted that these amounts are material.³⁶
- 3.67 The scope of MEUG's analysis appears to be to establish the rate of revenue reduction for every 5% reduction in opex and capex. If the purpose were to establish that the impact of Covid-19 should result in material reductions in MAR then a three step analysis would be required. An estimate of electricity demand reduction would be the first step, with an estimate of opex and capex reductions arising from the demand reduction being the second step. The MEUG analysis would then provide the third step, which would be to establish the MAR adjustment required.
- 3.68 We note from the Ministry of Business, Innovation and Employment "Energy fact sheet" for 19 – 25 September 2020 that national electricity demand was at 101% of historical demand for the week and a chart on the fact sheet indicates demand generally above historical levels since mid-May 2020.³⁷ This does not reflect any reduction in demand relative to historical levels.
- 3.69 In its submission on the draft decision, Wellington Electricity said that electricity demand for Wellington quickly recovered to normal levels following the national Covid-19 lockdown and it provided evidence of this.
- 3.70 In its cross-submission, Wellington Electricity included an extensive discussion on "adjusting capex and opex forecasts to reflect the effects of Covid-19". The cross-submission indicates that Wellington Electricity does not expect to reduce its

³⁶ Major Energy Users' Group, "Wellington Electricity CPP to DPP draft decision" (16 October 2020) at p. 2.

³⁷ MBIE Energy Fact Sheet, <https://www.mbie.govt.nz/assets/2020-09-30-energy-fact-sheet.pdf>. (Viewed on 10 November 2020).

maintenance and replacement and renewal programmes, as these relate to maintaining supply quality.

- 3.71 The cross-submission also confirmed that network growth investments will not change because the economic consequences of Covid-19 include:
- 3.71.1 new sub-divisions and continuing housing shortages
 - 3.71.2 high growth in new connections
 - 3.71.3 decarbonisation initiatives.
- 3.72 The cross-submission contained a table of 11 key network growth work programmes, with the table including programme details and continuing drivers for each programme.
- 3.73 Having considered all the matters arising from MEUG’s recommendation as discussed above, we have decided not to reduce the starting price for reasons of reduced electricity demand.

Modelling methodology and results

- 3.74 To set Wellington Electricity’s starting prices we have revised the opex and capex models that were used for the draft decision. We have not modified the financial model, but its results have changed as a result of the different inputs from the opex and capex models.
- 3.75 As discussed in the “cost inflators” section above, we have used the economy-wide inflators forecast by NZIER in 2019 as inputs to the opex and capex models, rather than the updated forecasts that we used for the draft decision. Accordingly, the opex and capex models link to the DPP3 inflator model, rather than to the modified inflator model used for the draft decision. This modification to the opex and capex models adds \$1.313m to the 2022 MAR, i.e. the starting price.
- 3.76 We have also modified the capex model in response to a submission from Wellington Electricity suggesting that a formula in the capex model should use data for the full period of 2021 to 2025, rather than the draft decision model’s use of 2021 to 2024.³⁸ This modification to the capex models adds \$0.012m to the 2022 MAR, i.e. the starting price.

³⁸ The formula is at cell E28 on the sheet ‘Calculations – Gating’. The formula used for the draft decision reflected the DPP3 model approach, but data for 2025 has been disclosed since the DPP3 decision, allowing the period referenced to be extended. See Wellington Electricity, “Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft Decision” (16 October 2020) at pp. 15–16.

- 3.77 We modified the opex model to include the additional \$43,000 in the base year opex, as discussed above at paragraph 3.51.
- 3.78 In its submission on the draft decision, Powerco submitted on the eight year historical reference period for forecasting capex for the draft decision. Powerco submitted that we should use our “discretion to select a shorter historical reference period when there are good reasons to do so”. In its cross-submission, Wellington Electricity agreed with the Powerco submission that shorter reference periods may be more appropriate.
- 3.79 Neither the Powerco nor the Wellington Electricity submission recommended a particular length of reference period for the Wellington Electricity CPP to DPP transition. We have considered the issue and do not consider that there are good reasons for selecting a shorter historical reference period for the transition. The historical reference period for the capex model is therefore the same as it was for the draft decision.
- 3.80 To set Wellington Electricity’s starting prices we revised four of the models that were used in 2019 to set the DPP3: the financial model, the capex projections model, the opex projections model and the input cost inflators model.
- 3.81 The purpose of the revisions is to:
- 3.81.1 modify the building blocks and maximum allowable revenue modelling to set a four-year price path for Wellington Electricity, rather than the five-year price path for the other EDBs;
 - 3.81.2 modify the capex projections and opex projections models to project costs for a four-year price path rather than a five-year price path;
 - 3.81.3 incorporate Wellington Electricity’s most recent annual information disclosures of historical opex and capex;³⁹
 - 3.81.4 incorporate Wellington Electricity’s 2020 AMP forecast of capital expenditure, rather than its 2019 AMP forecast;⁴⁰ and
 - 3.81.5 include adjustments to the base year opex, as discussed above at paragraphs 3.44 to 3.53.

³⁹ Wellington Electricity, 2020 information disclosure report.
<<https://www.welectricity.co.nz/disclosures/network-information/document/225>>.

⁴⁰ Wellington Electricity, 2020 asset management plan data, at
<https://www.welectricity.co.nz/disclosures/asset-management-plan/document/213>

- 3.82 Information about the modifications made to each model is available in the 'Description' sheet of the model. The models can be downloaded from the Commission's website.
- 3.83 There are a number of feeder models that provide inputs to these four models. These feeder models have not been updated for the reasons set out in the table below.

Model	Reason for not updating
Econometric	The elasticities determined with the econometric model are expected to be relatively stable, so we do not consider the resource requirements for updating this model justify an update in the relatively low-cost DPP context.
Disposals	The disposals projection extrapolates an historical average level. For Wellington this has been less than \$3,000 pa over the last six years which we consider is immaterial.
CPI	<p>The IMs specify which Reserve Bank forecast we must use in establishing 'forecast CPI'. This results in 'forecast CPI' not being updated since the DPP3 CPI model was prepared and published.</p> <p>CPI is an input to the capex model, and this use is not constrained by the IMs. Updating this CPI forecast would have no impact on the capex projection.⁴¹</p>
Operating lease	An operating lease model was prepared for the DPP3 decision, based on s 53ZD information. We have not repeated the s 53ZD information request as we did not consider the significant effort and cost for Wellington Electricity and us to be justified, as the projections made in the DPP3 process were likely to be adequate for the transition to the DPP3.
Household growth	An update to the household growth model would require an updated population growth projection from Statistics New Zealand. No updated projection is available since the DPP3 decision.
Circuit length	We tested the sensitivity of the opex projections compared to an update of the model and found an update, on average, would increase the opex allowance by less than 0.05%.

⁴¹ The CPI is used to determine whether an EDB passes one of the capex scrutiny tests: "Gate 3 – Asset replacement and renewals". Wellington Electricity passes this gate by a wide margin, and any CPI update would not change its pass result for this gate.

Modelling results

3.84 The starting price is calculated in the models as the 2022 MAR. It appears in the determination as forecast net allowable revenue for the assessment period ending 31 March 2022. The model calculates Wellington Electricity's forecast net allowable revenue in 2022 to be \$91,109,000. The forecast allowable revenue remains at the same level, in constant real terms, throughout the DPP3 regulatory period.

3.85 We can compare this value to:

3.85.1 The MAR values in the DPP3 financial model used to reset the DPP for 15 EDBs in November 2019 (indicative MAR). These reflect a best estimate of the price path Wellington Electricity would have been on if it had not moved to its CPP.

3.85.2 The 2020/21 MAR set for Wellington Electricity's CPP earlier this year in the WACC change amendment to its CPP determination.

3.86 The values are compared in this table:

<i>All values \$'000</i>	2021	2022
DPP3 indicative MAR	91,407	93,190
CPP final year MAR	91,697	
CPP to DPP final decision: 2022 MAR		91,109

3.87 The decision value reflects a 0.6% reduction in net allowable revenue relative to the current year's CPP value.

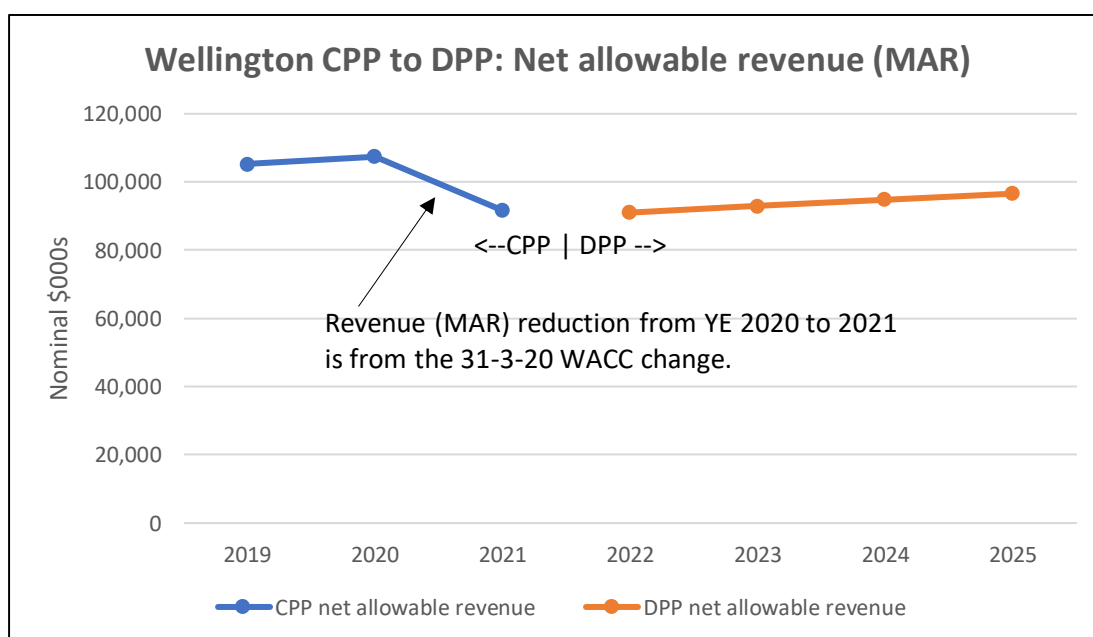
3.88 Figure 3.1 and Figure 3.2 chart the net allowable revenue and the opex and capex amounts respectively for Wellington Electricity for disclosure years 2019 to 2025 inclusive.

3.89 All amounts of revenue quoted in this section and in the charts refer to *net* revenue, not the total revenue that Wellington Electricity may charge to fund its network operation. Pass-through and recoverable costs may be recovered from consumers, as well as the net revenues. Recoverable costs include Transpower's charges and IRIS amounts, which can be significant.

3.90 In Wellington Electricity's 2021 price setting compliance statement,⁴² for example, the total forecast allowable revenue (which includes forecast pass-through and recoverable costs) was \$146.2m while the forecast net allowable revenue was \$91.7m, so the forecast net allowable revenue was 63% of total forecast allowable revenue.

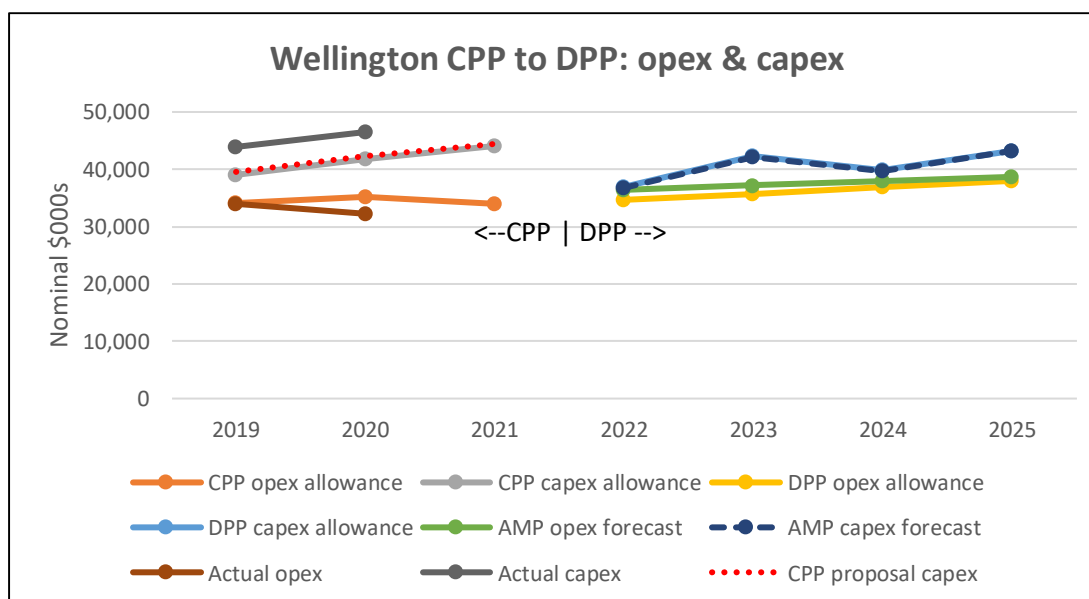
3.91 Figure 3.1 below is a chart of net allowable revenue and Figure 3.2 is a chart of opex and capex revenue. The charts show values for both the CPP period and the DPP3 period.

Figure 3.1 Net allowable revenue



⁴² Wellington Electricity, 2021 price-setting compliance statement, at <https://www.welectricity.co.nz/disclosures/price-quality-path-annual-compliance-statements/document/210>

Figure 3.2 Opex and capex



Submissions not immediately applicable to the CPP to DPP transition decision

3.92 We received two submissions on topics that may be relevant to future processes for setting a price path or to amending the IMs rather than being applicable to setting s 53X starting prices for Wellington Electricity. We have not responded to these submissions in this decision. They are summarised in the table below.

Submitter	Submission
ENA, Powerco	Guidelines on how CPP to DPP transitions are expected to occur are encouraged and would give stakeholders greater confidence.
Powerco	If a distributor's circumstances suggest its CPP could be followed by a second CPP, the Commission's processes should occur earlier. For example, for Powerco's transition off its current CPP, a draft determination date early in 2021 would be required to allow for consultation and the submission of a CPP application on 22 July 2022 would be required for a second CPP commencing 1 April 2023.

Chapter 4 Implementation

- 4.1 The DPP3 amendment determination, published alongside this reasons paper, sets out the way we propose the starting prices be implemented.⁴³

Pass-through balance allowance

- 4.2 Paragraph 5 of Schedule 1.5 of the 2019 DPP3 determination provides a formula for EDBs to calculate their 'forecast allowable revenue'. It includes the term 'PTBA' (pass-through balance allowance) which is defined in clause 4.2 of the DPP3 determination.
- 4.3 That definition relies on the values of the 'pass-through balance' and 'ePTB' (an estimate of the pass-through balance). These are also defined in clause 4.2.
- 4.4 For the year ended 31 March 2020, Wellington Electricity was not subject to the DPP3 determination⁴⁴ that is referred to in the clause 4.2 definition of pass-through balance. Unlike the other EDBs, Wellington Electricity will therefore not have values for 'pass-through balance' and 'ePTB'.
- 4.5 The residual pass-through balance from when Wellington Electricity was subject to the 2015-2020 DPP has been dealt with in the Wellington Electricity CPP. There is now no need for any further transitional requirements for a pass-through balance.
- 4.6 A workable outcome requires the pass-through balance allowance for Wellington Electricity to be defined as nil for all assessment periods of the DPP3. Alternatively, the term 'pass-through balance allowance' could be removed from the formula for 'forecast allowable revenue' and 'actual allowable revenue'. Our decision is to adopt the former of these two options.
- 4.7 The pass-through balance is also used in the DPP3 schedule 1.6(2)(a) formula for 'actual allowable revenue'. In the DPP3 amendment determination, the schedule provides a formula for only Wellington Electricity which makes no reference to a pass-through balance.

Ensuring the 2019/20 wash-up amount is taken into account

- 4.8 For EDBs other than Wellington Electricity and Powerco, 2020 was before the revenue cap applied and no wash-up amount applied in that year. However, for Wellington Electricity, a 2020 wash-up amount does apply as the revenue cap applied, and it needs to be taken into account. This requires changes from the DPP3 determination drafting in both schedules 1.6 and 1.7.

⁴³ *Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016* [2016] NZCC 19.

⁴⁴ *Electricity Distribution Services Default Price-Quality Path Determination 2015* [2014] NZCC 33.

- 4.9 The calculation of ‘actual allowable revenue’ in the DPP3 determination does not provide for taking a 2020 wash-up amount into account, so we have in the DPP3 amendment determination added a new paragraph (4) to schedule 1.6 to set out the methodology for Wellington Electricity.
- 4.10 Schedule 1.7(1)(a) defines the ‘opening wash-up account balance’ for 2022 (i.e. the second assessment period in DPP3) as nil. That is problematic as Wellington Electricity will have calculated a ‘wash-up amount’ for 2020 which should, from a policy intent perspective, be taken into account for pricing two years later, i.e. in pricing for 2022. The DPP3 drafting would result in the wash-up from 2020 not ever being taken into account.
- 4.11 The DPP3 amendment decision determination schedule 1.7 has been amended from the DPP3 text to achieve the policy intent.

Actual net allowable revenue for 2022

- 4.12 From a policy perspective, we would expect that the DPP3 amendments determination would specify the 2022 actual net allowable revenue as a numerical value. That value will have been produced from the financial model for the CPP to DPP3 transition.
- 4.13 IM clause 3.1.3(13)(i) effectively requires the 2022 value to be the previous year’s value increased by CPI–X. That is different from simply specifying a numerical value as the 2022 actual net allowable revenue.
- 4.14 To comply with the IM requirement, and to also apply a known numerical value to the 2022 actual net allowable revenue, we have drafted the DPP3 amendment determination to effectively back-calculate a 2021 actual net allowable revenue. The back-calculation is such that, when it is rolled forward at CPI–X to a 2022 value, the calculated result is equal to the known numerical value.
- 4.15 We used a very similar approach earlier in 2020 for Wellington Electricity and Powerco, which were both on CPPs and were subject to a ‘WACC change’.⁴⁵
- 4.16 A complication arises with the CPI values for the CPI–X adjustment not being available until after the end of the 2022 year. This complication has been resolved in the DPP3 amendment determination by using a formula, instead of numerical values, to specify the 2021 forecast net allowable revenue.

⁴⁵ Further information on the WACC change decision is available on our Wellington Electricity CPP webpage at <<https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-customised-price-quality-path/wellington-electricitys-20182021-cpp>>.

- 4.17 To comply with IM 3.1.1(13)(h), the 2021 actual net allowable revenue is specified through a reference to the 2021 forecast net allowable revenue. The reason for this is that IM 3.1.1(13)(h) defines the actual value in terms of the forecast value.

IRIS amounts and Innovation allowance

- 4.18 Schedule 2.2 of the DPP3 amendment determination contains tables of specified amounts for the IRIS. The amounts are sourced directly from the opex projections model and the capex projections model.
- 4.19 Schedule 5.3 of the DPP3 amendment determination contains a table showing the innovation project allowance for the DPP regulatory period. As for the 15 other EDBs in the DPP3 determination, Wellington Electricity's allowance is based on the total annual forecast net allowable revenue.