

Proposed amendments to input methodologies for Electricity Distribution Services

Consultation paper

Amendments proposed to be made under s 52X of the Commerce Act 1986 to the input methodologies for electricity distribution services.

Date: 24 June 2014

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CONTENTS

CHAPTER 1: INTRODUCTION	4
PURPOSE OF THIS PAPER.....	4
DETERMINATIONS AFFECTED BY THE AMENDMENTS	4
MATERIAL RELEASED ALONGSIDE THIS PAPER	4
OVERVIEW OF PROPOSED AMENDMENTS.....	4
CHAPTER 2: PROPOSED AMENDMENTS	5
AMENDING THE DEFINITION OF NOTIONAL DEDUCTIBLE INTEREST TO REFLECT A MID-YEAR CASH FLOW TIMING ASSUMPTION	5
CORRECTING THE DOUBLE DEDUCTION OF THE TERM CREDIT SPREAD DIFFERENTIAL ALLOWANCE	6
CORRECTING THE DEFINITION OF AMORTISATION OF INITIAL DIFFERENCES IN ASSET VALUES	6
CHAPTER 3: HOW YOU CAN PROVIDE YOUR VIEWS AND NEXT STEPS	8
HOW YOU CAN PROVIDE YOUR VIEWS	8
<i>Address for responses</i>	8
<i>Requests for confidentiality</i>	8
NEXT STEPS.....	8

Chapter 1: Introduction

Purpose of this paper

1. The purpose of this paper is to consult with interested persons on proposed amendments to the input methodologies for electricity distribution services.

Determinations affected by the amendments

2. We are consulting on proposed amendments to the determination *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26. The amendments primarily relate to changes to the input methodologies relevant to default price-quality paths, but also include consequential amendments to:
 - 2.1 information disclosure regulation; and
 - 2.2 customised price-quality path regulation.
3. The amendments proposed in this paper focus on changes that, if implemented, will primarily affect the structure of the financial model. We may use the financial model to set starting prices based on the current and projected profitability of each supplier.

Material released alongside this paper

4. We intend to undertake separate consultation on other proposals to amend the input methodologies. These include proposed amends to the IRIS mechanism.
5. Also released with this paper is an updated version of the financial model showing how we expect the model would implement the input methodology amendments proposed in this paper. The input worksheet contains additions and revisions to the input assumption estimates contained in version 2.1.

Overview of proposed amendments

6. We propose to amend the input methodologies to:
 - 6.1 reflect a mid-year cash flow timing assumption in the relevant definitions of notional deductible interest for the treatment of taxation;
 - 6.2 correct the double deduction of the term credit spread differential allowance when calculating the regulatory tax allowance; and
 - 6.3 correct the amortisation of initial differences in asset values.
7. Chapter 2 explains each of these matters in further detail. Chapter 3 outlines how you can provide your views.

Chapter 2: Proposed amendments

8. This chapter discusses the amendments we are proposing, including the draft methodologies required to implement the changes.

Amending the definition of notional deductible interest to reflect a mid-year cash flow timing assumption

9. We propose to amend the definition of notional deductible interest used in the treatment of taxation input methodologies to apply a mid-year cash flow timing assumption to the calculation of notional interest amounts. The current input methodologies assume year-end payments rather than payments being made during the year.
10. Mid-year timing assumptions recognise that suppliers will pay interest during the year, and the amount paid will be less than if payments were to be made at year-end. An amendment would also align the timing assumptions for the interest tax deductions with the mid-year timing assumptions adopted for other cash flows within the input methodologies.
11. To give effect to the mid-year timing assumptions, we propose an amendment to the formula for the calculation of notional deductible interest in the input methodologies applying to information disclosure, default price-quality paths, and customised price-quality paths. Table 1 below sets out these amendments.

Table 1: Revised formula for calculating notional deductible interest amounts

Determination clause	Current definition	Proposed definition
Clause 2.3.4(2)	<i>(regulatory investment value x leverage x cost of debt) + term credit spread differential allowance</i>	<i>((regulatory investment value x leverage x cost of debt) + term credit spread differential allowance) / √(1 + cost of debt)</i>
Clause 4.3.3(2)	<i>(opening investment value x leverage x cost of debt) + term credit spread differential allowance</i>	<i>((opening investment value x leverage x cost of debt) + term credit spread differential allowance) / √(1 + cost of debt)</i>
Clause 5.3.16(2)	<i>((regulatory investment value + RAB proportionate investment) x leverage x cost of debt) + term credit spread differential allowance</i>	<i>((regulatory investment value + RAB proportionate investment) x leverage x cost of debt) + term credit spread differential allowance) / √(1 + cost of debt)</i>

12. The formulas above assume interest payments are to be made continuously through the year at a constant rate (which would be closely equivalent to a single interest

payment being made at mid-year) and the interest payable amount is discounted using the cost of debt prescribed by the input methodologies. The mid-year timing assumption improves the accuracy of the annual notional deductible interest amount.

13. The proposed change is identical to the amendments made by *Gas Pipeline Services Input Methodologies Determination Amendment (No. 1) 2013* [2013] NZCC 3 to:
 - 13.1 clauses 2.3.4(2), 4.3.3(2) and 5.3.16(2) of *Gas Distribution Services Input Methodologies Determination 2012* [2012] NZCC 27 in respect of gas distribution services; and
 - 13.2 clauses 2.3.1(5), 4.3.4(1) and 5.3.13(5) of *Gas Transmission Services Input Methodologies Determination 2012* [2012] NZCC 28 in respect of gas transmission services.

Correcting the double deduction of the term credit spread differential allowance

14. We propose to amend the definition of regulatory profit / (loss) before tax in Part 4 of the input methodologies to correct a double deduction of the credit spread differential allowance when calculating the regulatory tax allowance for default price-quality regulation.
15. The term credit spread differential is included as a deduction in the definitions of both the regulatory profit / (loss) before tax and the regulatory tax adjustments and clause 4.3.1 uses these two terms to derive the regulatory tax allowance. As a result, the term credit spread differential allowance is incorrectly deducted twice when calculating the regulatory tax allowance.
16. To give effect to the amendment we propose to delete the reference to the term credit spread differential in the formula for 'regulatory profit / (loss) before tax' in clause 4.3.1(4).
17. The proposed change is identical to the amendments made by *Gas Pipeline Services Input Methodologies Determination Amendment (No. 1) 2013* [2013] NZCC 3 in respect of clause 4.3 and clause 5.4 for the input methodologies relating to gas distribution services and gas transmission services respectively.

Correcting the definition of amortisation of initial differences in asset values

18. We propose to amend the definition of amortisation of initial differences in asset values for default price-quality path regulation to be the value for the base year disclosed by suppliers in accordance with information disclosure determinations.
19. Clause 4.3.3(3) of the input methodologies defines the 'amortisation of initial differences in asset values' for each disclosure year as the 'initial differences in asset values' divided by the 'weighted average remaining useful life of relevant assets'.

However, this does not take account of changes to the initial differences that occur after the first day of the disclosure year 2010 such as the aging, sale or acquisition of assets.

20. A more accurate calculation is provided by clause 2.3.5 of the input methodologies which defines the 'amortisation of initial differences in asset values' for each disclosure year as the 'opening unamortised initial differences in asset values' divided by the 'weighted average remaining useful life of relevant assets'. This definition *does* take account of the changes in initial difference values that result from the age, sale and acquisition of relevant assets.
21. We propose to adapt the clause 2.3.5 value for the base year and for subsequent years of a default price-quality path. To give effect to the amendment we propose to:
 - 21.1 replace clause 4.3.3(3) with "For the purpose of subclause (1), 'amortisation of initial differences in asset values' is determined in accordance with Part 2 as of the **base year**";
 - 21.2 delete clause 4.3.3(5);
 - 21.3 renumber clause 4.3.3(6);
 - 21.4 change the reference in the clause 1.1.4(2) definition of the amortisation of revaluations from "clause 4.3.3(6)" to "clause 4.3.3(5)"; and
 - 21.5 remove paragraph (b) of the clause 1.1.4(2) definition of initial differences in asset values, and renumber paragraph (c).

Chapter 3: How you can provide your views and next steps

22. This chapter sets out the process for making submissions on this paper and provides details on the next steps in the amendments process.

How you can provide your views

23. Submissions on the proposed draft methodology are due by 5pm, Friday 18 July 2014.

Address for responses

24. You should address your responses to:

Brett Woods (Senior Analyst, Regulation Branch)

c/o regulation.branch@comcom.govt.nz

25. It would be helpful to include in the subject heading Submission on Proposed Electricity Distribution Services IM Amendments June 2014.
26. We would appreciate receiving responses in both MS Word and PDF file formats.

Requests for confidentiality

27. While we discourage requests for non-disclosure of submissions, we recognise that there may be cases where parties that make submissions wish to provide information in confidence. We offer the following guidance.
28. If it is necessary to include confidential material in a submission, the information should be clearly marked. Both confidential and public versions of the submission should be provided.
29. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
30. We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be 'locked'. This is because we intend to publish all submissions and cross-submissions on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Next steps

31. Following receipt of submission and cross-submissions, we intend to make final decisions on the proposed amendments by 30 September 2014. As indicated in our notice of intention on 29 April, we intend to consult alongside the DPP draft decision on 'second types' of amendment that focus on changes that primarily affect aspects of the default price-quality paths other than the financial model.