

Reconsideration of customised price-quality paths of Powerco Limited and Wellington Electricity Lines Limited following change to weighted average cost of capital

Consultation paper

Date: 5 March 2020

Associated documents

Publication date	Reference	Title
7 October 2016	978-1-869455-33-0	Orion New Zealand's transition to the 2015-2020 default price-quality path – Final report
20 December 2016	978-1-869455-48-4	Input methodologies review decisions – Topic paper 4: Cost of capital issues
28 March 2018	1178-2560	Powerco Limited Electricity Distribution Customised Price-Quality Path Determination 2018 [2018] NZCC 5
28 March 2018	978-1-869456-32-0	Powerco's customised price-quality path – Final decision
28 March 2018	1178-2560	Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018 [2018] NZCC 6
28 March 2018	978-1-869456-33-7	Wellington Electricity's customised price-quality path – Final Decision
25 September 2019	1178-2560	Cost of capital determination for electricity distribution businesses' 2020-2025 default price-quality paths and Transpower New Zealand Limited's 2020-2025 individual price-quality path [2019] NZCC 12
29 January 2020	978-1-869457-85-3	Electricity Distribution Services Input Methodologies Determination 2012 [2012] NZCC 26

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Executive Summary

We seek interested parties' views on our draft amendments to two customised price-quality path determinations

- X1 This consultation paper seeks interested parties' views on our draft determinations to amend under section 52Q of the Commerce Act 1986 (**Act**):
- X1.1 the *Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018* [2018] NZCC 6 (**Wellington Electricity CPP**); and
- X1.2 the *Powerco Limited Electricity Distribution Customised Price-Quality Path Determination 2018* [2018] NZCC 5 (**Powerco CPP**).
- X2 We propose these draft amendment determinations after reconsidering the Powerco CPP and the Wellington Electricity CPP under clause 5.6.7(1)(a) and (2)(e) of the *Electricity Distribution Services Input Methodologies Determination 2012* [2012] NZCC 26 (**EDB IMs**). This clause lets us reconsider a CPP after we have determined and published the weighted average cost of capital (**WACC**) for a new default price-quality path (**DPP**) regulatory period (**WACC change**). The purpose and policy intent of this clause, combined with clause 5.6.8(5) of the EDB IMs, is to remove the perverse incentive for an EDB to apply (or not to apply) for a CPP because of a material difference in the CPP and DPP WACC rate.¹
- X3 On 25 September 2019, we determined and published a WACC change for the DPP that will apply for the period 1 April 2020 to 31 March 2025 (**DPP3**).²
- X4 When a WACC change triggers our reconsideration of a CPP, clause 5.6.8(5)(a) of the EDB IMs requires us to determine for the remaining disclosure years of the CPP regulatory period:
- X4.1 the series of maximum allowable revenue (**MAR**) after tax; and
- X4.2 any consequential changes to the forecast net allowable revenue (**FNAR**).

¹ Commerce Commission, *Input methodologies review decisions – Topic paper 4: Cost of capital issues*, 20 December 2016, at paras 607, 616, and 622, available at: https://comcom.govt.nz/_data/assets/pdf_file/0021/60537/Input-methodologies-review-decisions-Topic-paper-4-Cost-of-capital-issues-20-December-2016.pdf.

² See Commerce Commission, *Cost of capital determination for electricity distribution businesses' 2020-2025 default price-quality paths and Transpower New Zealand Limited's 2020-2025 individual price-quality path* [2019] NZCC 12 (25 September 2019), available at: https://comcom.govt.nz/_data/assets/pdf_file/0022/177034/2019-NZCC-12-Cost-of-capital-determination-EDBs-and-Transpower-25-September-2019.PDF.

- X5 Our draft amendment determinations give effect to the requirements of clause 5.6.8(5)(a) of the EDB IMs and to the policy intent of that clause and clause 5.6.7(1)(a), (2)(e) of the EDB IMs.

We also seek interested parties' views on the first part of our proposed solution for dealing with the impact of a problem relating to clause 5.6.8(5)(a) of the EDB IMs

- X6 After a WACC change reconsideration under the EDB IMs, clause 5.6.8(5)(a) does not provide for us to make consequential changes to a CPP's actual net allowable revenue (**ANAR**) to reflect the WACC change. As we explain in this paper, this is problematic because, if a CPP's ANAR does not reflect a WACC change, this can lead to the relevant electricity distribution business's (**EDB**) prices not reflecting that WACC change.
- X7 This paper describes the problem in more detail and consults on the first part of our proposed three-part solution for dealing with its impact.³ The first part of our proposed solution is to reduce the FNAR for the remaining disclosure years⁴ of the Wellington Electricity CPP and Powerco CPP to the before-tax MAR value that would reflect the DPP3 WACC change.
- X8 In this paper we invite you to provide your written views on the draft amendment determinations and the first part of our proposed solution within the following timeframes:
- X8.1 Submissions are due by **5pm, Thursday 19 March 2020**; and
- X8.2 Cross-submissions on matters raised in submissions from other parties are due by **5pm, Thursday 26 March 2020**.

Next steps

- X9 After considering submissions and cross-submissions, we propose to make and publish our final decision on the first part of our proposed solution, including the draft amendment determinations, before 1 April 2020. This would ensure that any changes to the two CPPs' FNAR for the 2020/21 disclosure year are made before that disclosure year begins.

³ As this paper explains, at this stage, we do not seek interested parties' views on the second and third parts of our proposed solution. Rather, this paper's coverage of the second and third parts of the proposed solution is intended to signal our current thinking on those parts, and alert interested parties that we will consult on them at later points.

⁴ As explained in paras 5.3 and 5.4 of this paper, the first part of our proposed solution would apply to all remaining disclosure years of the Wellington Electricity CPP and the Powerco CPP, except for Powerco's 2022/23 disclosure year, for which we propose to reduce the FNAR:

(a) to reflect the DPP3 WACC change; and

(b) to offset the effect of the inflated wash-up amount for the 2020/21 disclosure year.

1. Introduction

We propose to amend two CPP determinations

- 1.1. Under clause 5.6.7(1) and (2)(e) of the EDB IMs, we may reconsider a CPP after we have determined and published a WACC change. As outlined above, the purpose and policy intent of clauses 5.6.7(1), (2)(e), and 5.6.8(5) of the EDB IMs is to remove the perverse incentive for an EDB to apply (or not apply) for a CPP because of a material difference in the CPP and DPP WACC rate.⁵
- 1.2. Under the relevant definition in clause 5.6.7(4) of the EDB IMs, a ‘WACC change’ occurred on 25 September 2019, because:
 - 1.2.1. we determined and published the 67th percentile estimate of WACC for the DPP that will apply for DPP3;⁶ and
 - 1.2.2. DPP3 will overlap with the regulatory periods of:
 - (a) the Wellington Electricity CPP; and
 - (b) the Powerco CPP.
- 1.3. When a WACC change triggers our reconsideration of a CPP, clause 5.6.8(5)(a) of the EDB IMs requires us to determine for the remaining disclosure years of the CPP regulatory period:
 - 1.3.1. the series of MAR after tax; and
 - 1.3.2. any consequential changes to the FNAR.
- 1.4. Under clause 5.6.7(1)(a) and (2)(e) of the EDB IMs, we have reconsidered the Wellington Electricity CPP and the Powerco CPP. As required by clause 5.6.8(5)(a) of the EDB IMs, we now propose under section 52Q of the Act to amend the MAR after tax and FNAR for the remaining disclosure years of the two CPP determinations. We consider the draft amendment determinations give effect to the purpose and policy intent of the provisions noted above.
- 1.5. Under section 52Q(1) of the Act, this consultation paper seeks interested parties’ views on our draft amendment determinations.⁷

⁵ See above n 1.

⁶ See above n 2.

⁷ Alongside this consultation paper, we have published on our website:

(a) our draft section 52Q amendment determinations for the Wellington Electricity CPP and the Powerco CPP; and

We also seek interested parties' views on the first part of our proposed solution for dealing with the impact of a problem relating to clause 5.6.8(5)(a) of the EDB IMs

- 1.6. This consultation paper also outlines a problem we have identified in clause 5.6.8(5)(a) of the EDB IMs that affects the allowable revenue under the Wellington Electricity CPP and the Powerco CPP.
- 1.7. The problem is that, following a WACC change reconsideration under the EDB IMs, clause 5.6.8(5)(a) does not permit us to make consequential changes to a CPP's ANAR to reflect the WACC change. Under the EDB IMs and the CPPs, the ANAR for a disclosure year forms part of an EDB's forecast allowable revenue for a subsequent disclosure year, which is the basis on which the EDB sets its prices.⁸ If ANAR does not reflect a WACC change, this results in a forecast allowable revenue that also does not reflect the WACC change,⁹ which in turn can result in prices that do not reflect the WACC change.
- 1.8. This paper describes the problem in more detail and consults on the first part of our proposed three-part solution for dealing with the impact of it.¹⁰ Consistent with clause 5.6.8(5)(a) of the EDB IMs, the first part of our proposed solution is two draft amendments under section 52Q of the Act to the FNAR:
- 1.8.1. under Schedule 1.3 of the Wellington Electricity CPP; and
- 1.8.2. under Schedule 1.3 of the Powerco CPP.
- 1.9. We seek interested parties' views on the first part of our proposed solution and the two draft amendment determinations intended to give effect to it.
- 1.10. This paper also outlines:
- 1.10.1. the second part of our proposed solution: adjusting the starting prices of Wellington Electricity Lines Limited (**Wellington Electricity**) and Powerco Limited (**Powerco**) under section 53X(2) of the Act when they transition from their respective CPPs to DPP3.¹¹ We do not intend to consult on this part of

(b) our reconsideration models demonstrating our application of the components listed in clause 5.6.8(5)(b) of the EDB IMs to determine the series of MAR after tax and the consequential changes to the FNAR for the remaining disclosure years of the two CPPs.

⁸ Clause 3.1.1(1) of the EDB IMs.

⁹ For ease of reference in this paper, we refer to:

- (a) ANAR that does not reflect a WACC change as 'unintended ANAR';
- (b) forecast allowable revenue that does not reflect a WACC change as 'unintended forecast allowable revenue'; and
- (c) a wash-up amount that does not reflect a WACC change as an 'unintended wash-up amount'.

¹⁰ As explained in paragraphs 1.10.1 and 1.10.2 and, we do not seek interested parties' views on the second and third parts of our proposed solution at this stage. Rather, this paper's coverage of the second and third parts of the proposed solution is intended to signal our current thinking on those parts, and alert interested parties that we will consult on them at later points.

¹¹ Under section 53X(4) of the Act, once their CPPs end, Powerco and Wellington Electricity may apply in accordance with section 53Q for another CPP.

the solution at this point. Instead, we intend to consult on it when Wellington Electricity and Powerco respectively transition to DPP3,¹² and

1.10.2. the third part of our proposed solution, which is likely only to apply to Powerco in the context of the DPP following DPP3 (**DPP4**).¹³ Under the wash-up mechanism in the EDB IMs, the effects of the unintended ANAR and forecast allowable revenue will extend beyond DPP3 for Powerco. In setting DPP4, we will have more options for addressing these effects than under clause 5.6.8(5)(a) of the EDB IMs or section 53X(2) of the Act. We do not propose to consult on these options at this stage, but rather to inform interested parties that the final part of our proposed solution involves:

(a) assessing our options at the DPP4 reset; and

(b) engaging with interested parties on our preferred option in that context.

If at the end of DPP3 we decide to proceed with the third part of our proposed solution, we would most likely consult on it in the DPP4 reset.

1.11. As with the first part of our proposed solution, our objective behind the second and third parts of our proposed solution would be to give effect to the purpose and policy intent of the regime for reconsidering a CPP after a WACC change.¹⁴

Submissions

1.12. We seek your written views on the first part of our proposed solution, including the draft section 52Q amendment determinations to the Wellington Electricity CPP and the Powerco CPP, within the timeframes set out below:

1.12.1. Submissions are due by **5pm, Thursday 19 March 2020**; and

1.12.2. Cross-submissions on matters raised in submissions by other parties are due by **5pm, Thursday 26 March 2020**.

1.13. You should address your responses to:

Matthew Lewer (Manager, Regulation Development)
c/o regulation.branch@comcom.govt.nz

1.14. Please include “Reconsideration of CPPs – WACC change” in the subject line. We prefer responses to be provided in a file format suitable for word processing, in addition to PDF file format.

¹² We consulted on setting Orion Group Limited’s (**Orion** – or Orion New Zealand Limited as it was then) starting prices under section 53X of the Act in Orion’s transition from its CPP to the default price-quality path applying from 1 April 2015 to 31 March 2020: <https://comcom.govt.nz/regulated-industries/electricity-lines/projects/orions-20142019-cpp/orions-transition-to-the-dpp>.

¹³ It is possible that, if we refine our proposed solution for Wellington Electricity, we may find it necessary to apply the third part of our proposed solution to Wellington Electricity.

¹⁴ Above n 1.

Requests for confidentiality

- 1.15. While we discourage requests for non-disclosure of submissions so that all information can be tested in an open and transparent manner, we recognise that there may be cases in which parties that make submissions wish to provide information in confidence. We offer the following guidance:
- 1.15.1. If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.
 - 1.15.2. If commercial sensitivity is asserted, submitters must explain why publishing the relevant information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information.
 - 1.15.3. Both confidential and public versions of the submission should be provided.
 - 1.15.4. 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.¹⁵
 - 1.15.5. 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 on our website. Where relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Next steps

- 1.16. After considering submissions and cross-submissions, we propose to make and publish our final decision on the first part of our proposed solution, including the draft section 52Q amendment determinations, before 1 April 2020. Publishing our final decision and amendment determinations before that date would ensure that any changes to the two CPPs' FNAR for the 2020/2021 disclosure year are made before that disclosure year begins.

2. Background

Under the EDB IMS, we may not amend a CPP's ANAR after a WACC change

- 2.1. While clause 5.6.8(5)(a) of the EDB IMs requires us to make consequential changes to a CPP's FNAR following a WACC change reconsideration, it does not permit us to make consequential changes to the CPP's ANAR. As a result, a consequential change

¹⁵ Parties can also request that we make orders under section 100 of the Act in respect of information that should not be made public. Any request for a section 100 order must be made when the relevant information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on section 100 orders if requested by parties. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. Any section 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

to the FNAR would, as intended, initially alter an EDB's prices under a CPP. However, this effect would be subsequently washed up, as it would not be accounted for in the CPP's ANAR.

- 2.2. The wash-up would negate any WACC change in present value terms over time. In the present context – a reduction of the WACC¹⁶ – the wash-up process would increase an EDB's forecast allowable revenue two years after each CPP wash-up amount is incurred.¹⁷ The amount by which the EDB's forecast allowable would increase would therefore be the increased wash-up amount, plus time value of money for the two-year period. The increase in the EDB's forecast allowable revenue represents an unintended windfall gain that the EDB would be able to recover in its prices.
- 2.3. Currently, the inability to amend a CPP's ANAR under clause 5.6.8(5)(a) of the EDB IMs will materially increase Powerco and Wellington Electricity's forecast allowable revenue and prices following a wash-up under their respective CPPs for subsequent disclosure years.

3. Reconsideration framework

The statutory framework for reconsidering and amending a CPP after a WACC change

- 3.1. This chapter sets out the statutory context and legal framework under which we may reconsider and amend a CPP after a WACC change.
- 3.2. CPPs are determined on an *ex ante* basis and apply for a regulatory period of 5 years,¹⁸ though we may set a shorter period than 5 years if we consider doing so would better meet the purpose of Part 4 under section 52A of the Act. In any event, we may not set a regulatory period of less than 3 years.¹⁹
- 3.3. Once determined, a CPP may not be reconsidered (or reopened) within a regulatory period except in limited circumstances,²⁰ which include the identified circumstances in which they may be reconsidered under the input methodologies made under section 52T(1)(c)(ii) of the Act.
- 3.4. As required under section 52T(1)(c)(ii) of the Act, we determined input methodologies identifying the circumstances in which a CPP may be reconsidered within a regulatory period in Subpart 6 of Part 5 of the EDB IMs.

¹⁶ In our cost of capital determination of 25 September 2019 (see above n 2), we reduced the vanilla WACC for EDBs in DPP3, and for Transpower New Zealand Limited under its 2020-2025 individual price-quality path, from 7.19% to 4.57%.

¹⁷ Whether the wash-up increases or decreases an EDB's forecast allowable revenue depends on whether the WACC change is a decrease or an increase in the WACC.

¹⁸ Section 53W(1) of the Act.

¹⁹ Section 53W(2) of the Act.

²⁰ Sections 52T(1)(c)(ii) and 53ZB of the Act.

- 3.5. Under clause 5.6.7(1) and (2)(e) of the EDB IMs, one of the circumstances under which we may reconsider a CPP is if there has been a WACC change (**WACC change reopener**).
- 3.6. When amending a CPP after a reconsideration, clause 5.6.8(2) and (3)(a) of the EDB IMs requires us to, respectively:
- 3.6.1. take into account the expenditure objective in determining the extent of any amendment to the price path;²¹ and
- 3.6.2. not amend the price path more than is reasonably necessary to take account of the change in costs net of any insurance or compensatory entitlements.

Our policy intent behind the WACC change reopener

- 3.7. In our decisions resulting from the 2016 review of the input methodologies,²² we outlined the problem the WACC change reopener sought to address:²³

Divergence between the revised WACC that applied to CPPs and a supplier's WACC under a DPP may create perverse incentives for a supplier to either apply or not apply, for a [CPP].

- 3.8. In terms of resolving the identified problem, we explained that aligning the CPP WACC with the DPP WACC:²⁴

[would] significantly [limit] the incentive problems that can occur when application of a CPP coincides with significant differences between the CPP and DPP WACC rate. Fluctuations in interest rates [for example] will, therefore, no longer be a significant consideration in whether a supplier applies for a CPP or not....

...We consider the most practical approach that minimises the risk of applications that are not in the long-term interests of consumers is to apply DPP WACCs to CPPs.

Consequential changes to the MAR and FNAR following a WACC change

- 3.9. Under clause 5.6.8(5)(a) of the EDB IMs, if a WACC change triggers our reconsideration of a CPP, we must for the remaining disclosure years of the CPP regulatory period after the WACC change, determine the series of MAR after tax and determine any consequential changes to the FNAR for the remaining disclosure years of the CPP regulatory period.

²¹ Under clause 1.1.4(2) of the EDB IMs, 'expenditure objective' means "objective that **capital expenditure** and **operating expenditure** reflect the efficient costs that a prudent **non-exempt EDB** would require to-
(a) meet or manage the expected demand for **electricity distribution services**, at appropriate service standards, during the **CPP regulatory period** and over the longer term; and
(b) comply with applicable regulatory obligations associated with those **services**".

²² Documents relating to our process, consultation, decisions and determinations from the 2015/16 review of the input methodologies are available at: <https://comcom.govt.nz/regulated-industries/input-methodologies/projects/201516-im-review>.

²³ Above n 1, at para 607.

²⁴ Above n 1, at paras 616 and 622.

- 3.10. In determining the series of MAR after tax and any consequential changes to the FNAR arising from the WACC change, we must use the components set out in clause 5.6.8(5)(b) of the EDB IMs.²⁵

4. Analysing the problem

The wash-up mechanism indirectly makes ANAR part of an EDB's forecast allowable revenue

- 4.1. Following a WACC change reconsideration, a consequential change to an EDB's FNAR for the remaining disclosure years of its CPP would initially align the EDB's forecast allowable revenue (and prices) with the WACC change.
- 4.2. However, because the WACC change reopener does not permit consequential changes to ANAR, the EDB's ANAR for the remaining disclosure years of its CPP will not reflect the WACC change. In the case of the DPP3 WACC change, this results in an inflated ANAR – that does not reflect the WACC change – for the remaining disclosure years of Powerco and Wellington Electricity's CPPs.
- 4.3. This is problematic because, under the EDB IMs, the wash-up mechanism makes ANAR part of the EDB's forecast allowable revenue (and prices) for disclosure years following a wash-up.
- 4.4. This occurs under the EDB IMs as follows:²⁶
- 4.4.1. under clause 3.1.3(4)(d), 'forecast allowable revenue' as specified in a CPP determination includes "the balance of the **wash-up account** available for draw down";
- 4.4.2. under clause 3.1.3(12), the 'wash up account' (referred to in paragraph 4.4.1) records, amongst other things:
- "....
- (c) ...any **wash-up amount** calculated in accordance with subclause (13)(b);
-
- (e) a time value of money adjustment in the **wash-up account**—

²⁵ Clause 5.6.8(5) of the EDB IMs is set out in full at Attachment A.

²⁶ The price setting and wash-up processes under the EDB IMs, including respective time-value-of-money adjustments, are based on the approach applicable to gas transmission businesses under the Gas Transmission Services Input Methodologies Determination 2012 [2012] NZCC 28 (**GTB IMs**). We discussed this approach in detail in our reasons paper on the 2017 gas pipeline businesses default price-quality path reset – see Commerce Commission, *Default price-quality paths for gas pipeline businesses from 1 October 2017* (31 May 2017), Attachment F.

Attachment F of that reasons paper includes at pages 163 to 164 a flowchart illustrating the price setting and wash-up processes under the GTB IMs.

- (i) using a rate equal to the **67th percentile estimate of WACC**; and
 - (ii) calculated by applying the method as specified in a **DPP determination** or **CPP determination**;
- 4.4.3. under clause 3.1.3(13)(b), the ‘wash-up amount’ means “**actual allowable revenue less actual revenue less revenue foregone for a disclosure year**”;
- 4.4.4. under clause 3.1.3(13)(e), ‘actual allowable revenue’ means, “for a **disclosure year**, an amount calculated in accordance with a **DPP determination** or **CPP determination**” that includes, amongst other things, ANAR; and
- 4.4.5. under clause 3.1.3(13)(h) and (i), ANAR means:
- (h) “for the first **disclosure year** of the **regulatory period**, the **forecast net allowable revenue** for that **disclosure year** as specified in clause 3.1.1(6)”;
 - (i) “for each **disclosure year** of the **regulatory period** after the first **disclosure year**, an amount calculated in accordance with a **DPP determination** or **CPP determination** by applying—
 - (i) the **actual net allowable revenue** for the preceding **disclosure year**;
 - (ii) the **CPI** in place of the **forecast CPI** to the extent that **forecast CPI** was applied in setting **prices** for the **disclosure year** in accordance with clause 3.1.1(7); and
 - (iii) the X factor that was used when the **forecast net allowable revenue** was originally determined for the **disclosure year** in accordance with clause 3.1.1(7)”.

The opening wash-up account balance under the CPPs

- 4.5. The CPP determinations of Powerco and Wellington Electricity apply the above EDB IM provisions and require the CPP parties to calculate opening wash-up account balances for each disclosure year.²⁷ The opening wash-up account balances are (in part) based on the ANAR from two disclosure years prior, and comprise part of the CPP parties’ respective forecast allowable revenues.
- 4.6. Under Schedule 1.6 of the Powerco CPP and the Wellington Electricity CPP, there is a two-year delay between calculating a wash-up amount and the disclosure year in which that amount becomes part of each CPP party’s forecast allowable revenue. The time value of money adjustment that is calculated under paragraph (2)(b) of Schedule 1.6 of both CPPs arises from this delay.

²⁷ See clauses 8.3, 8.4, Schedule 1.4 and Schedule 1.6 of Wellington Electricity CPP, and clauses 8.4, 8.6, Schedule 1.4 and Schedule 1.6 of the Powerco CPP.

- 4.7. In practice, this means that a wash-up amount (including ANAR) calculated in Year 1, for example, will not become part of a CPP party's forecast allowable revenue until Year 3.

ANAR in a transition from a CPP to a DPP

- 4.8. Under section 53X(1) and (2) of the Act, respectively:
- 4.8.1. when an EDB's CPP ends, the EDB is subject to the DPP that generally applies to other EDBs; and
 - 4.8.2. the EDB's starting prices at the beginning of the DPP are those that applied at the end of the CPP unless, at least 4 months before the end of the CPP, we set different starting prices for the EDB.
- 4.9. This means that if an EDB's starting prices at the end of its CPP are based on an unintended forecast allowable revenue, unless we adjust those prices under section 53X(2) of the Act, the EDB's starting prices under the DPP will also reflect the unintended forecast allowable revenue.

5. Our proposed solution

The first part of our proposed solution is to change the FNAR for the remaining disclosure years of both CPPs to reflect the DPP3 WACC change

- 5.1. After analysing the problem and the regulatory tools available to us, we consider that making appropriate changes to the FNAR for the remaining disclosure years of the Powerco and Wellington Electricity CPPs is the most viable first step to take.
- 5.2. To this effect, following a WACC change reconsideration, clause 5.6.8(5)(a) of the EDB IMs requires us to make consequential changes to a CPP's FNAR for the remaining disclosure years of the CPP.
- 5.3. Applying this clause, for each remaining disclosure year of the Powerco and Wellington Electricity CPPs (with one exception), we propose to reduce the FNAR to the before-tax MAR value that would reflect the DPP3 WACC change.
- 5.4. As we outline in more detail below, the exception noted above concerns the FNAR for Powerco's 2022/23 disclosure year, which we propose to reduce:
- 5.4.1. to reflect the DPP3 WACC change; and
 - 5.4.2. to offset the effect of the inflated wash-up amount²⁸ for the 2020/21 disclosure year.

Making consequential changes to the FNAR for Powerco's 2022/23 disclosure year

- 5.5. The FNAR we propose for Powerco's 2022/23 disclosure year would comprise Powerco's MAR before tax for the same disclosure year, calculated in the Powerco

²⁸ As described in chapter 4 above, the inflated wash-up amount for the 2020/21 disclosure year arises from the fact that the ANAR for this disclosure year (and the CPP's remaining disclosure years) would not reflect the DPP3 WACC change. Along with a time value of money adjustment, the inflated wash-up amount for the 2020/21 disclosure year would become part of the Powerco's forecast allowable revenue for the 2022/23 disclosure year.

reconsideration model accompanying this paper, *less* our estimate of the impact of the inflated wash-up amount for the 2020/21 disclosure year on the opening wash-up balance for the 2022/23 disclosure year.

- 5.6. This would produce a forecast allowable revenue for the 2022/23 disclosure year that is a reasonable estimate of the forecast allowable revenue that would apply absent the problem in clause 5.6.8(5)(a) of the EDB IMs.
- 5.7. We explain how this would work in practice as follows:

FNAR is a reasonable estimate of ANAR

- 5.7.1. The Powerco CPP's current FNAR for the 2020/21 disclosure year – \$290.852 million²⁹ – is a reasonable estimate of what the correct ANAR for this disclosure year would be without the WACC change.
- 5.7.2. To give effect to the WACC change, we would ideally set the ANAR for the 2020/21 disclosure year of the Power CPP equal to our proposed FNAR (given the WACC change) for that disclosure year, which is \$241.093 million.
- 5.7.3. As clause 5.6.8(5)(a) of the EDB IMs does not provide for us to do this, it follows that the impact of the problem with clause 5.6.8(5)(a) of the EDB IMs on the ANAR for the 2020/21 disclosure year is the difference between the above two values, ie, \$290.852 million - \$241.093 million, which is \$49.759 million.

How the ANAR for the 2020/21 disclosure year affects the forecast allowable revenue for the 2022/23 disclosure year under the Powerco CPP

- 5.7.4. Under paragraph (2)(b) of Schedule 1.5 of the Powerco CPP, the actual allowable revenue for the 2020/21 disclosure year is:

actual net allowable revenue + actual pass-through and recoverable costs + revenue wash-up draw down amount.

For the reason noted above in paragraph 5.7.3, the ANAR for the 2020/21 disclosure year will be \$49.759 million higher than it should be as it does not reflect the WACC change. This in turn means that the actual allowable revenue for the 2020/21 disclosure year will be \$49.759 million higher than it should be, absent the problem with clause 5.6.8(5)(a) of the EDB IMs.

- 5.7.5. Under paragraph (1) of Schedule 1.5 of the Powerco CPP, the wash-up amount must be calculated as:

actual allowable revenue – actual revenue – revenue foregone

As the actual allowable revenue will be \$49.759 million higher than it should be (and the problem with clause 5.6.8(5)(a) of the EDB IMs does not affect the other two components of this calculation), the wash-up amount for the 2020/21 disclosure year will be \$49.759 million higher than it should be.

- 5.7.6. Under paragraph (2)(b) of Schedule 1.6 of the Powerco CPP, the closing wash-up account balance for the 2021/22 disclosure year will be:

²⁹ See Schedule 1.3 of the Powerco CPP.

wash-up amount for the 2020/21 disclosure year $\times (1 + 67^{\text{th}}$ percentile estimate of post-tax WACC)²

This 67th percentile estimate of post-tax WACC for the 2021/22 disclosure year is set as 6.78% in Schedule 1.7 of the Powerco CPP. The impact of the problem with clause 5.6.8(5)(a) of the EDB IMs on the closing wash-up account balance for the 2021/22 disclosure year is therefore:

$$\$49.759 \text{ million} \times (1 + 6.78\%)^2 = \$56.735 \text{ million}$$

- 5.7.7. Under paragraph (1)(b) of Schedule 1.6 of the Powerco CPP, the opening wash-up account balance of the 2022/23 disclosure year is the closing wash-up account balance of the 2021/22 disclosure year. The opening wash-up account balance for the 2022/23 disclosure year will therefore be \$56.735 million higher than it should be.
- 5.7.8. Under paragraph (5) of Schedule 1.4 of the Powerco CPP, the forecast allowable revenue for the 2022/23 disclosure year is:

forecast net allowable revenue + forecast pass-through and recoverable costs + opening wash-up account balance.

At this point, we can neutralise the impact of the problem with clause 5.6.8(5)(a) of the EDB IMs by reducing the FNAR value for the 2022/23 disclosure year by \$56.735 million below the MAR before-tax value.³⁰ This would offset the opening wash-up account balance, which, for the reason noted above would be \$56.735 million higher than it should be.³¹

The first part of our proposed solution would give effect to the DPP3 WACC change and promote desired outcomes under section 52A(1) of the Act

- 5.8. Changing the FNAR in the manner we propose above would be ‘consequential’ to the DPP3 WACC change because:
- 5.8.1. the amended FNAR would properly reflect the effect of the DPP3 WACC change; and
- 5.8.2. it would properly give effect to our policy intent in creating the WACC change reopener—aligning a CPP’s WACC with the DPP WACC to reduce perverse incentives for an EDB to either apply or not apply, for a CPP.³²
- 5.9. We consider that, consistent with the desired outcomes under section 52A(1)(b) and (d) of the Act,³³ our proposed changes to the FNAR would:

³⁰ Under clause 5.6.8(5)(a) of the EDB IMs.

³¹ Clause 5.6.8(5)(a) of the EDB IMs does not affect the forecast pass-through and recoverable costs.

³² See above n 1.

³³ Under section 52A(1) of the Act, the purpose of Part 4 of the Act is to promote the long-term benefit of consumers in markets referred to in section 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

- 5.9.1. reduce incentives to apply for a CPP when it is not in consumers' long-term interests (ie, to seek higher revenue allowances based on differences in the applicable WACC)—which also gives effect to the policy intent behind the WACC change opener,³⁴
 - 5.9.2. direct incentives towards improving efficiency and providing services at a quality that reflects consumer demands, rather than pursuing higher revenue allowances from a higher WACC when costs have not changed; and
 - 5.9.3. limit the ability to extract excessive profits by aligning FNAR with the WACC intended to apply under the WACC change reopener.
- 5.10. In determining the series of MAR after tax and any consequential changes to the FNAR arising from a WACC change, we must:
- 5.10.1. use the components listed in clause 5.6.8(5)(b) of the EDB IMs,³⁵
 - 5.10.2. under clause 5.6.8(2) of the EDB IMs, take into account the expenditure objective in determining the extent of any amendment to the price path; and
 - 5.10.3. under clause 5.6.8(3)(a) of the EDB IMs, not amend the price path more than is reasonably necessary to take account of the change in costs net of any insurance or compensatory entitlements.
- 5.11. Regarding the requirements under clause 5.6.8(2) and (3)(a) of the EDB IMs, respectively, our proposed changes to the MAR after tax and FNAR for the remaining disclosure years of the Wellington Electricity CPP and the Powerco CPP:
- 5.11.1. take account of the expenditure objective by ensuring the forecast allowable revenue for the remaining disclosure years of the two CPPs reflects the DPP3 WACC change. In practical terms, this aligns the two CPPs' WACC with the lower DPP3 WACC, resolving unintended windfall effects. Specifically, we consider that amending the two price paths in the manner proposed would encourage the EDBs to make capital expenditure and operating expenditure decisions that reflect the efficient costs that a prudent non-exempt EDB would require to meet or manage the expected demand for electricity distribution services, at appropriate service standards, during the CPP regulatory period and over the longer term; and
 - 5.11.2. do not amend the price path more than is reasonably necessary to take account of the CPP parties' change in costs. Rather, by aligning (in practical effect) the CPPs' WACC with the DPP3 WACC, the proposed changes ensure the CPP parties do not benefit from a WACC that is higher than the DPP3

(d) are limited in their ability to extract excessive profits.

³⁴ See above n 1.

³⁵ As noted above, alongside this consultation paper and the draft amendment determinations for the two CPPs, we have published on our website our reconsideration models demonstrating our application of the components listed in clause 5.6.8(5)(b) of the EDB IMs to determine the series of MAR after tax and the consequential changes to the FNAR for the remaining disclosure years of the two CPPs.

WACC. Our draft amendments would reflect, *ex ante*, the estimated change in the CPP parties' capital costs.

Attachment B displays the effects on the two CPPs' forecast allowable revenue of applying, and of not applying, the first part of our proposed solution

- 5.12. The table in Attachment B sets out the FNAR, MAR, and wash-up amounts:
- 5.12.1. for the remaining disclosure year (2020/21) of the Wellington Electricity CPP;³⁶
 - 5.12.2. after applying the first part of our proposed solution to the remaining disclosure years (2020/21 to 2022/23) of the Powerco CPP; and
 - 5.12.3. without having applied the first part of our proposed solution to the remaining disclosure years (2020/21 to 2022/23) of the Powerco CPP.
- 5.13. The table in Attachment B also sets out our calculation of the proposed FNAR for the 2022/23 disclosure year of the Powerco CPP under the first part of our solution.
- 5.14. Alongside this paper, we have published on our website:
- 5.14.1. our draft section 52Q amendment determinations providing for the MAR after tax and consequential changes to the FNAR to the Wellington Electricity CPP and the Powerco CPP; and
 - 5.14.2. the reconsideration models demonstrating our application of the components listed in clause 5.6.8(5)(b) of the EDB IMs to determine the series of MAR after tax and the consequential changes to the FNAR for the remaining disclosure years of the two CPPs.
- 5.15. We would welcome interested parties' views on the first part of our proposed solution and the two draft amendment determinations intended to give effect to it.

The second and third parts of our proposed solution aim to resolve the delayed effects of unintended wash-up amounts in DPP3 and DPP4

- 5.16. Changing the FNAR in the manner we propose for the first part of our proposed solution would offset the inflated ANAR and prevent Powerco recovering an unintended forecast allowable revenue in their prices during the CPP regulatory period.³⁷ However, this would not resolve the delayed effects of unintended wash-up amounts:

³⁶ Under the first part of proposed solution, the FNAR, MAR, and wash-up amounts for the remaining disclosure year of Wellington Electricity's CPP are no different to what they would be if we did not apply the first part of proposed solution to Wellington Electricity. This is because the Wellington Electricity CPP will end before the wash-up mechanism applies the wash-up amount for the 2020/21 disclosure year to forecast allowable revenue for subsequent disclosure years.

³⁷ Under the wash-up mechanism in the EDB IMs, the unintended ANAR (and wash-up amount) for Wellington Electricity's 2020/21 disclosure year will not become unintended forecast allowable revenue during the CPP (which ends on 31 March 2021). Instead, the unintended wash-up amount will become unintended forecast allowable revenue in the 2022/23 disclosure year of DPP3.

5.16.1. accruing in the remainder of the CPP regulatory period and becoming part of the EDBs' forecast allowable revenue after their transitions to DPP3; and

5.16.2. in Powerco's case, continuing in DPP4.

The second part of our proposed solution involves adjusting the CPP parties' starting prices for DPP3

5.17. In Orion's transition from its CPP to the DPP, we set out our view that section 53X(2) of the Act gives us discretion to set starting prices in a way we judge best meets the purpose of Part 4 of the Act.³⁸

5.18. We consider that under section 53X(2) of the Act, we could adjust the CPP parties' starting prices for DPP3 by reducing their FNAR to offset the effects of the unintended wash-up amounts from the CPP regulatory period on the forecast allowable revenue for DPP3.

5.19. Adjusting the CPP parties' starting prices for DPP3 in this manner would give effect to the purpose of Part 4, in particular, by promoting the desired outcome under section 52A(1)(d) of the Act: limiting the CPP parties' abilities to extract excessive profits.

The third part of our proposed solution would address the remaining effects of Powerco's unintended wash-up amounts in the DPP4 reset

5.20. In setting DPP4, we will have more options for addressing the remaining effects of Powerco's unintended wash-up amounts than under clause 5.6.8(5)(a) of the EDB IMs or section 53X(2) of the Act. We do not propose to consult on these options at this stage, but rather to inform interested parties that the final part of our proposed solution will involve:

5.20.1. assessing our options at the DPP4 reset; and

5.20.2. engaging with interested parties on our preferred option in that context.

³⁸ Commerce Commission, *Orion New Zealand's transition to the 2015-2020 default price-quality path – Final report*, 7 October 2016, at para 2.4, available at: https://comcom.govt.nz/_data/assets/pdf_file/0021/63255/Orions-transition-to-the-2015-2020-DPP-Final-report-7-October-2016.PDF.

Attachment A: clause 5.6.8(5) of the EDB IMs

- (5) Where the **Commission's** reconsideration of the price-quality path was triggered by a **WACC change**, the **Commission** will for the remaining **disclosure years** of the **CPP regulatory period** after the **WACC change**:
- (a) determine the series of **maximum allowable revenue after tax** in accordance with clause 5.3.4(7) and determine any consequential changes to the **forecast net allowable revenue** for the remaining **disclosure years** of the **CPP regulatory period**; and
 - (b) for the purpose of (a), use-
 - (i) the **building blocks allowable revenue before tax** calculated in accordance with clause 5.3.2(1);
 - (ii) the revised **WACC** in clause 5.3.22(2), including where the **WACC** is used for present value calculations, and for timing factors in clause 5.3.2(4);
 - (iii) the **forecast CPI for DPP revaluation** for the new **DPP regulatory period** referred to in clause 5.6.7(4)(b), to calculate a revised **revaluation rate** in accordance with the method in clause 5.3.10(4);
 - (iv) the **cost of debt** for the new **DPP regulatory period** referred to in clause 5.6.7(4)(b), to calculate a revised notional deductible interest as specified in clause 5.3.16(2);
 - (v) subject to (ii) to (iv), the same input values as applied by the **Commission** in initially determining the **CPP** for all other input values in the calculation of **building blocks allowable revenue before tax**; and
 - (vi) a revised forecast regulatory taxable income to apply the changes in **building blocks allowable revenue before tax** resulting from (i) to (iii) in a revised forecast regulatory tax allowance.

Attachment B: effects on forecast allowable revenue of applying, and of not applying, the first part of our proposed solution

Wellington Electricity forecast allowable revenue for the remaining disclosure year of the CPP

<i>Disclosure year:</i>	<i>2020/21</i>
FNAR under the current CPP determination	109,531
MAR value before tax and after WACC change	91,697
Proposed FNAR value under draft CPP amendment determination	91,697
Wash-up amount estimate	17,834

Powerco forecast allowable revenue for the remaining disclosure years of the CPP – applying the first part of our proposed solution

<i>Disclosure year:</i>	<i>2020/21</i>	<i>2021/22</i>	<i>2022/23</i>
FNAR under the current CPP determination	290,852	296,750	302,685
MAR values before tax and after WACC change	241,093	245,981	250,901
Proposed FNAR values under draft CPP amendment determination	241,093	245,981	194,166
Wash-up amount estimate	49,759	50,769	108,519

Powerco forecast allowable revenue for the remaining disclosure years of the CPP – without applying the first part of our solution

<i>Disclosure year:</i>	<i>2020/21</i>	<i>2021/22</i>	<i>2022/23</i>
FNAR under the current CPP determination	290,852	296,750	302,685
MAR values before tax and after WACC change	241,093	245,981	250,901
Proposed FNAR values under draft CPP amendment determination	241,093	245,981	250,901
Wash-up amount estimate	49,759	50,769	51,784

Calculation of proposed FNAR for the 2022/23 disclosure year of the CPP under the first part of our solution

<i>Disclosure year:</i>	<i>2020/21</i>	<i>2021/22</i>	<i>2022/23</i>
Best estimate of ANAR for 2020/21 disclosure year, which is the FNAR for the 2020/21 disclosure year under Schedule 1.3 of the Powerco CPP determination	290,852		

	MAR value before tax and after WACC change for 2020/21 disclosure year	241,093	
less	Estimate of 2020/21 wash-up amount, perfect foresight for all forecasts	49,759	
=	opening wash-up account balance for 2022/23 disclosure year: wash-up amount for 2020/21 disclosure year plus 2 years' time value of money at 6.78%		56,735

Proposed 2022/23 disclosure year FNAR value under draft Powerco CPP amendment determination

	MAR value before tax and after WACC change for 2022/23 disclosure year	250,901	
less	wash-up amount for 2020/21 disclosure year plus 2 years' time value of money	56,735	
=	Proposed FNAR for 2022/23 disclosure year under draft CPP amendment determination	194,166	

Notes

- All amounts are expressed in \$000.
- Assessment periods tabled are the remaining periods in each of the CPPs.
- Wash-up amount estimates assume perfect foresight in forecasting CPI, pass-through and recoverable costs, and quantities of services supplied. All these wash-up amount estimates would collapse to nil in the absence of the problem with clause 5.6.8(5)(a) of the EDB IMs.
- The proposed FNAR value for the 2020/21 disclosure year of the Wellington Electricity CPP will not be affected by the two-year wash-up process because the 2020/21 disclosure year is the last year of the Wellington Electricity CPP.