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20 October 2023

To: Potential applicants of Catastrophic event reopener under Part 4 of the Commerce Act 1986

By e-mail only

Tena koutou,

Catastrophic Events: Response to queries relating to Cyclone Gabrielle and the Auckland Floods of 2023

1. This letter responds to questions from EDBs who are considering catastrophic event reopener applications to cover costs associated with Cyclone Gabrielle and the Auckland Floods of 2023. The letter updates potential applicants on our current thinking around requests for interpretation. It does not necessarily represent our final view. We remain open to further discussions and intend to outline our final interpretations in our response to applications.

2. We are grateful for the early engagement from EDBs in the months following these events. The immediate engagement was vital in informing amendments to our compliance statement and information disclosure requirements.[1] Subsequent engagement with EDBs over the following months on how a Catastrophic event reopener might work, including sharing indicative numbers and potential issues, has provided valuable input into this letter. This initial analysis will also assist us in assessing applications.

3. This letter responds to matters raised where we have information we can share. It is not exhaustive, as there are still matters that require further consideration. We have issued this letter so that potential applicants have clarity on matters we can provide clarity on.

4. The following matters are addressed in this letter:

    - the catastrophic event definition including the materiality assessment;

    - how costs are recovered through the reopener; and

[1] https://comcom.govt.nz/about-us/our-policies-and-guidelines/cyclone-gabrielle/updates-for-regulated-businesses

- other areas of clarification, including aspects which relate to both the materiality assessment and how costs are recovered through the reopener.

5. We note that how matters are treated in the materiality assessment do not necessarily determine how they are treated in the reopening of the price path.

Catastrophic event definition and materiality assessment

6. For an event to be deemed a Catastrophic event it needs to meet the definition set out in clause 4.5.1 of the EDB Input Methodologies (IMs).[2] This section discusses the matters raised that relate to that definition.

Does Cyclone Gabrielle meet the definition of a 'Catastrophic event'

7. The Catastrophic event definition includes aspects relating to the event and matters relating to each application. Our preliminary assessment of information available suggest Cyclone Gabrielle would likely meet the definition for some EDBs. However, each application must be assessed against the full criteria, including but not limited to:

   - whether an EDBs remediation costs can be delayed until the next regulatory period[3]; and

   - the materiality assessment.

The catastrophic event definition includes a materiality assessment

8. The purpose of the threshold is to provide a balance between the need to ensure that a supplier can seek a reconsideration if an event is so material in terms of financial effects that the existing path is no longer appropriate, and the need to appropriately restrict the circumstances or events under which a path may be reconsidered.

9. Clause 4.5.1(d)(iv) of the IMs stipulates the materiality threshold for defining a catastrophic event.[4]

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[2] Electricity Distribution Services Input Methodologies Determination 2012 – consolidated as of 20 May 2020, clause 4.5.1.

[3] ibid, clause 4.5.1(d)(i).

[4] ibid, clause 4.5.1(d)(iv).

(iv) in respect of an **EDB** subject to a **DPP**, the cost of remediation net of any insurance or compensatory entitlements has had or will have an impact on the price path over the **disclosure years** of the **DPP** remaining on and after the first date at which a remediation cost is proposed to be or has been incurred, by an amount equivalent to at least 1% of the aggregated **forecast net allowable revenue** for the **disclosure years** of the **DPP** in which the cost was or will be incurred.

10. The threshold requires the *impact of costs on the price path* to be equivalent or greater than 1% of the aggregated forecast net allowable revenue (FNAR). The assessment is not whether the cost of remediation is greater than 1% of the aggregated FNAR.

11. Accordingly, the assessment requires two calculations:

    a. Impact of costs on the price path (Impact on the price path); and

    b. 1% of FNAR (Threshold).

12. While it is clear that 'impact on price path' rather than 'incurred cost' is assessed against the threshold, there is scope for interpretation of what costs can be included in the cost of remediation and how the impact on the price path is determined. These matters are discussed further below.

Period the materiality assessment relates to

13. The materiality assessment references two time periods, being:

    - the remaining years of the DPP, when determining the Impact on the price path; and
    - the disclosure years of the DPP in which the cost was or will be incurred, when determining the Threshold.

14. Accordingly, our preliminary interpretation is the threshold is determined based on the years costs are incurred and the impact on the price path is over the remaining years of the DPP. For example:

    If the costs of remediation were incurred across disclosure years 1 and 2, and FNAR was $400 and $600 in disclosure year 1 and 2 respectively;

    - *Then 1% of FNAR in the years in which costs are incurred is $10 (1% of 600 + 400)*
    - *The threshold will be met if the Impact on price path over the remaining years of the DPP > $10.*

Determining the impact on the price path

15. The materiality assessment requires the 'impact on the price path' to be calculated i.e. how much does the price path change if new inputs to the model were included.

16. The challenges with assessing 'impact on price path' have been noted in the IM review, and the draft decision has proposed changing to a simpler 'incurred costs' approach to establishing materiality.[5] However, for the purpose of Cyclone Gabrielle and the Auckland Floods of 2023 applications, the current definition still applies. Accordingly, we have sought to provide further context.

17. The remaining subparts of this section and other areas of clarification section set out our preliminary views on matters relating to the determination of the impact on the price path, including:

    - treatment of IRIS costs in determining impact on price path;
    - quality incentive penalties are not included in the materiality assessment;
    - costs covered by the reopener;
    - deferred works do not effect the reopener;
    - combining events; and
    - uncertainty of insurance proceeds.

18. We note that the requirements do not set out a calculation of how the 'impact on the price path' must be determined. Therefore, there is room for interpretation, even after consideration of the matters included in this note. We welcome further engagement from EDBs on how they intend to interpret the requirements or for applicants to set out their interpretation in the application.

Treatment of IRIS costs in determining impact on price path

19. EDBs have asked whether IRIS costs can be included as a 'cost of remediation' when assessing materiality.

20. Our preliminary view is that IRIS incentives can be considered a cost of remediation in assessing materiality, but the IRIS incentives from Cyclone Gabrielle and the Auckland Floods of 2023would not be recognised in the assessment. While IRIS incentives can be included in the impact on the price path calculation by assessing the impact on forecast allowable revenue (FAR) rather than FNAR, the assessment only relates to the remaining

[5] CPP and in-period adjustment mechanisms topic paper - Part 4 Input Methodologies Review 2023-Draft decision see sections 7.22 to 7.29.

years of the DPP and the IRIS incentives would not be realised until the next regulatory period.

Quality incentives are not included in the materiality assessment

21. EDBs may have incurred negative impacts from the quality incentive scheme due to the impact of the cyclone or floods. However, we do not consider the quality incentive scheme to be a "cost of remediation", so it should not be included as a cost in the materiality assessment.

How costs are recovered through the reopener

22. The IMs allow for EDBs to be compensated for remedial costs associated with the catastrophic event. This section discusses how this occurs through the catastrophic event allowance, reopening of the price path and adjusted IRIS inputs. We then go on to discuss how these components may be reflected in pricing.

Catastrophic event allowance

23. Between the date of the event and the effective date of an amendment to the DPP following reconsideration of the price-quality path under clause 4.5.6(1)(a)(i)), costs relating to the event that have been approved may be recovered through a catastrophic event allowance as defined within clause 1.1.4(2), this includes any impact of the event on a quality incentive adjustment.

Reopening of the price path

24. Between the effective date of an amendment to the DPP and the end of DPP3, costs relating to the event that have been approved can be recovered through a forward looking adjustment of the price path.

Adjusted IRIS inputs

25. The impact of the catastrophic event on IRIS is considered within clause 3.3.13(1) which allows for amendments to the forecast opex and forecast aggregate value of commissioned assets. The amendment neutralises the impact of expenditure that is later approved as part of the reopener.

Catastrophic Event allowance available without a reopening of the price path

26. We consider a catastrophic event allowance is available via a reopener even if the supplier does not seek a forward-looking adjustment to recover additional costs in the remainder of the regulatory period.

When a reopener may be reflected into prices

27. EDBs have asked whether it is possible to set prices using a draft DPP determination, so the costs of the cyclone or floods can be included in consumer bills sooner.

28. To comply with the price path during an assessment period, an EDB's forecast revenue from prices must not exceed the forecast allowable revenue (FAR) for that assessment period.[6]

29. The components of FAR affected by a catastrophic event reopener are:

- The forecast net allowable revenue (FNAR), which may be amended for the remaining years of the reopener.
- The catastrophic event allowance, which is included as a recoverable cost[7] which may be forecast by EDBs.

Using a draft forecast net allowable revenue (FNAR) exposes an EDB to non compliance

30. To be compliant with the price path the forecast revenue from prices for that period must not exceed the forecast allowable revenue for that assessment period.[8] Forecast allowable revenue is comprised of FNAR and other items.[9]

31. FNAR is specified for each non-exempt EDB for each year of DPP3.[10] Using a FNAR value from the draft DPP reopener determination could cause non-compliance with the price path, as it may not be the FNAR value specified in a final DPP determination. Given this, we are interested in any potential concerns which this may raise for EDBs.

Using a draft catastrophic allowance may be appropriate for forecasting recoverable costs

32. All forecasts of pass-through costs and recoverable costs used to calculate the 'forecast allowable revenue' must be demonstrably reasonable[11]. The application of a draft catastrophic event allowance when forecasting recoverable costs would be demonstrably reasonable.

33. If the catastrophic event allowance changes between the draft and final decision, this can be settled in the existing wash up process that handles variation between forecast and actual recoverable costs.

34. The method to calculate the catastrophic event allowance is not specified in the current DPP. We expect an amended DPP would specify a sum for the catastrophic event allowance for the EDB affected based on the definition provided in the IMs[12] and our assessment of the application.

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[6] Or an amount determined in accordance with the formula in clause 8.4(b) of the Electricity Distribution Services Default Price-Quality Path Determination 2020, if lesser than the forecast allowable revenue.
[7] ibid, at 1, clause 3.1.3(1)(m).
[8] Electricity Distribution Services Default Price-Quality Path Determination 2020, clause 8.4.
[9] ibid, schedule 1.5 clause 5.
[10] ibid, schedule 1.5.
[11] ibid, schedule 1.5 clause 3.
[12] ibid, at 1, clause 1.1.4(2) definition 'catastrophic event allowance'.

Other areas of clarification

35. The final section of this letter discusses other areas for clarification, including aspects which relate to both the materiality assessment and how costs are recovered through the reopener, being:

- reopener covers remedial costs only;
- deferred work does not affect the reopener;
- combining events;
- uncertainty of insurance proceeds; and
- accounting for insurance proceeds.

Reopener covers remedial costs only

36. We cannot amend the price path more than is reasonably necessary to mitigate the effect of the catastrophic event[13] when applying a catastrophic event reopener. Our view is that this means that funding for network improvements cannot be included when amending the price path in response to a catastrophic event.

37. We note that the interpretation of this provision will require judgement on specific application as we would:

- expect an EDB to replace assets with a modern equivalent which may of itself provide more resilience;
- not expect the EDB to rebuild an asset in an unsuitable location (i.e. an area which had been shown to be prone to flooding).

38. EDBs have expressed a desire to use this opportunity to 'build back better'. The catastrophic event reopener cannot compensate for network improvements. EDBs could consider alternative funding or reprioritising work to fund network improvements while rebuilding (especially where deferred work may have led to a reduction in planned spending).

Deferred work does not affect the reopener

39. We are aware some EDBs had to defer planned work in order to deliver more urgent remediation work. This may appear as 'underspending' against the DPP3 forecast

[13]ibid, clause 4.5.7 (2)(a)(i).

(although EDBs have indicated they forecast they will catch up by the end of the reset period).

40. Costs associated with the cyclone or floods do not have to be offset by underspend due to deferred work when calculating the Impact on price path.

41. Underspend due to deferring planned work will also not be taken into account when calculating the catastrophic event allowance. Funding to mitigate the effect of the cyclone or floods will be considered separately to general fungibility within the DPP.

42. We also expect some projects with longer lead times (such as zone substations) may fall within DPP4, in which case there may be opportunity to include these plans in the reset.

Combining events

43. An EDB asked for clarification on whether Cyclone Gabrielle and the Auckland floods of 2023 can be combined as one 'event' for the purposes of a catastrophic event reopener, noting that they considered that it was not practical or reasonable to differentiate between costs incurred in responding to the flooding and costs incurred in responding to the cyclone.

44. Our preliminary view is that the impacts of Cyclone Gabrielle and Auckland floods of 2023 cannot be combined into one catastrophic event for the purposes of a reopener, as the two are separate meteorological events with different causes. We would be happy to consider information/analysis which may support a different view.

45. If an EDB submits separate applications for separate events, we may be able to consider the applications in tandem so they can be included in the same DPP determination.

46. We are also open to further discussion regarding how costs are allocated between events where the events had a compounding effect on assets.

Uncertainty in insurance proceeds

47. An EDB has requested further understanding on how we intend to deal with uncertainty relating to insurance payments.

48. The uncertainty of insurance payments impacts the threshold calculation.

49. We intend to take a pragmatic approach to managing the uncertainty, whereby we apply judgement based on the value and uncertainty involved. We recommended applicants clearly identify where there is uncertainty and basis of assumptions made. When further information is available on the value and uncertainty, we will determine appropriate treatment.

50. We note that while the criteria to consider an application (materiality assessment) may be based on reasonable forecast assumptions available at that time of an application, we may consider more updated information in the adjustment to the price path.

Accounting for insurance proceeds

51. An EDB has suggested that accounting for insurance proceeds received for operating expenditure appears to fit within 'other regulated income', resulting in a wash-up amount that reduces future allowable revenue. In addition, the excess opex incurred in responding to Cyclone Gabrielle incurs an IRIS penalty.

52. We note that further work is required to clarify this point.

Next steps

53. Some EDBs have expressed an interest in having a combined workshop on the catastrophic event reopener and Cyclone Gabrielle. At this stage we are not planning a workshop, however we will keep this format of engagement in mind should the need and opportunity arise.

54. EDBs have expressed uncertainty around the level and types of supporting evidence required in an application. As there are no prior applications to reference, we welcome the opportunity to review draft applications and further discussions with EDBs regarding evidence that can be provided and other matters relating to an application.

Yours sincerely

Ben Woodham