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Consultation on Electricity and Gas Input Methodologies: Cash flow timing for customised price-quality paths

Draft amendments to Decisions 710, 711, and 712 under s 52X of the Commerce Act 1986

Date: 10 August 2012

CONTENTS

Section One: Introduction

Purpose

1. This paper explains our proposals to amend input methodologies (IMs) for electricity distribution businesses (EDBs) and gas pipeline businesses (GPBs).

2. The proposals relate to the assumptions adopted for the timing of cash flows used to determine customised price-quality paths (CPPs).

3. You are invited to provide your views on this paper—submissions are due Friday **7 September 2012**.

Intra year cash flow timing assumptions for CPPs

4. Suppliers of electricity lines services and gas pipeline services who are subject to a default price-quality path may apply for a customised price-quality path to better meet their particular circumstances.[1]

5. The current input methodologies for CPPs include implicit assumptions as to when various building block items for regulated suppliers occur as forecast cash flows. At present, most of the forecast cash flow inputs are assumed to occur at year-end.

6. We propose to amend the assumptions to recognise various forecast cash flow items on an intra-year basis in order to better promote the purpose of Part 4 regulation.

7. A summary of the proposed intra-year cash flow timing assumptions is set out below.

Table 1: Overview of proposed intra-year cash flow timing assumptions

Building block item	Forecast timing assumption	Proposed implementation in IM
Revenue	20th day of the following month	Aggregate revenue received 20th day after mid-year
Operating expenditure	Evenly during the year	Aggregate operating expenditure paid at mid-year
Commissioned assets	Commissioning date	No change required
Disposed assets	Disposal date	No change required
Tax	Instalments during the year	Aggregate tax is paid at mid-year
Other regulatory income	Evenly during the year	Other regulatory income is received at mid-year
Term credit spread differential allowance	Evenly during the year	Allowance occurs at mid-year

1 As provided for by section 53K of the Commerce Act 1986.

Structure of the remainder of this paper

8. The remainder of this paper is structured in two main sections supported by an attachment:

- **Proposed IM amendments for intra-year timing** (**Section Two):** this section provides our reasons for the proposed intra-year timing assumptions, and an overview of the proposed intra-year timing assumptions themselves.

- **Next steps (Section Three)**: this section indicates how we propose to implement intra-year timing assumptions, and explains how you can respond to this paper.

- **Overview of previous consultation on cash flow timing (Attachment A)**: this attachment provides background to prior consultation on cash flow timing from our July 2011 draft decision to reset electricity distribution default price-quality paths, and our December 2011 update paper on DPP additional input methodologies.

9. We intend to provide marked-up versions of each of the relevant sections of the current IMs for consultation by Friday 17 August 2012. These marked-up sections will demonstrate how we intend to give effect to the proposed intra-year timing assumptions. Further detail is set out in paragraphs 25-27.

Section Two: Proposed IM amendments for intra-year timing

Purpose

10. This chapter provides an overview of, and reasons for, our proposed amendments on cash flow timings for CPPs. It also discusses other matters we have had regard to for the proposed amendments.

More accurate modelling of cash flows to better meet the Part 4 purpose

11. We propose to amend the timing assumptions used in CPPs to forecast cash flows on an intra-year basis. Intra-year timing assumptions more accurately reflect expected cash flows compared with many of the current year-end assumptions in CPP IMs.

12. More accurate modelling of cash flow timing better promotes the long-term benefit of consumers under s 52A of the Commerce Act. In particular, it reduces the likelihood of suppliers under- or over-recovering returns for the CPP period after taking account of the time value of money.[2]

13. One of the points raised by submitters as part of the default price-quality path consultation process was that more accurate timings could mean undue added complexity.[3] We consider that our proposals achieve an appropriate balance between the benefits of increased accuracy for CPPs and administrative costs of compliance, particularly in light of the expected materiality of the change for price paths.

14. Other submissions received in prior consultation on intra-year timings for default price-quality paths are potentially relevant. These are discussed in Attachment A.

Intra-year cash flow timings for CPPs[4]

15. The specific proposals for intra-year timing assumptions are as follows:

    15.1 **Revenue—recognised as being received evenly on the 20th day of the following month:** We understand that suppliers generally expect to receive revenue from electricity distribution services or gas pipeline services on the 20th day of the month following supply. Assuming that revenues are received evenly throughout the year on this basis is equivalent to assuming that forecast aggregate revenues are received slightly later than mid-year on average.[5] For EDBs we have calculated the relevant date as 3 November. For GPBs the relevant date depends

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2 Providing for incentives for suppliers to innovate and invest in replacement, upgraded, and new assets is referred to in s 52A(a) as part of the purpose of Part 4, as well as limiting the ability of suppliers to extract excessive profits in s 52A(1)(d). We consider our proposals promote both of these outcomes.

3 For example, Vector, *Submission to Commerce Commission on Draft Decision on Starting Price Adjustments for Electricity Distribution Businesses*, 24 August 2011, page 16.

4 The cash flow timing of depreciation and revaluations has not been considered since these are non-cash items in the context of the relevant CPP building blocks formula.

5 While there is some seasonality of accrued revenue, this is offset by the timing effect of when revenues are actually received.

on the particular disclosure year that applies. We expect that any forecast seasonality of revenues would not materially detract from these assumptions.

15.2 **Operating expenditure—recognised as occurring evenly during the year:** We understand that most operating expenditure is incurred on standard commercial terms, ie, the 20th day of the following month; and other expenses can be paid somewhat earlier, such as salaries and wages. Assuming that forecast operating expenditure is paid on this basis evenly throughout the year, an assumption that aggregate opex is paid mid-year in aggregate appears reasonable.

15.3 **Commissioned assets—recognised at commissioning date:** The CPP IMs currently provide for commissioned assets to be recognised with respect to their forecast commissioning date. In conjunction with the works under construction allowance already provided for in the IMs, this appears to provide a reasonable reflection of the actual timing of forecast capital project payments.[6] Accordingly there is no change proposed for this aspect of cash flow timing in the CPP IMs.

15.4 **Disposed assets—recognised at disposal date:** Similar to commissioned assets, the existing CPP IM treatment of forecast disposed assets adopts the relevant forecast disposal dates. No change is therefore proposed to this treatment.

15.5 **Tax—recognised as occurring evenly during the year:** Corporate tax is paid on the provisional and terminal tax dates, which average out to later than mid-year.[7] We have proposed a mid-year timing assumption for the forecast tax amount as this is likely to be closer to actual cash flow timing than the current end of year assumption currently implicit in the CPP building blocks formula.

15.6 **Other regulatory income—recognised as being received evenly during the year:** An assumption that suppliers receive forecast other regulatory income evenly during the year is consistent with a cash flow timing assumption that other regulatory income is received in aggregate at mid-year. As other regulatory income could generally expect to represent a relatively small proportion of overall income, we expect there to be no material difference between different timing assumptions—however, we have proposed a mid-year assumption consistent with general revenue and operating expenditure.

15.7 **Term credit spread differential allowance—recognised as occurring evenly during the year:**[8] The costs of issuing debt generally occur in relation to the

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6 To the extent this does not take into account cash payments that occur after the commissioning date, it would be to the benefit of regulated suppliers.

7 Terminal tax dates may vary, depending on which provisional payment option is used by individual suppliers.

8 The term credit spread differential in the ROI calculation in the Commission's *Draft Commerce Act (Electricity Distribution Services Information Disclosure) Determination 2012* and *Draft Commerce Act (Gas Distribution Services Information Disclosure) Determination 2012* was proposed as a year-end value

issue dates of the particular debt instruments, however an assumption that those costs occur, on average, evenly throughout the year is consistent with an expectation that an efficient firm would expect to arrange its debt financing obligations to match its overall net cash flows. A mid-year assumption would generally be consistent with this and would also reflect the calculation of the notional interest deduction for tax purposes on a mid-year basis.

Other matters we have given regard to

16. We have considered a number of other matters to inform our proposed amendments including:

 16.1 whether the exact cash flow timing circumstances of suppliers should be adopted

 16.2 consistency with the corresponding input methodologies for other forms of regulation.

Potential for specific cash flow timings

17. CPPs are intended to be business specific and allow for a greater level of detail than default price-quality paths. We have therefore considered whether cash flow timing assumptions could be made even more accurate, for instance, by having regard to forecast monthly or daily forecast transactions of individual suppliers.

18. We have concluded that—except for the existing CPP IM timings for forecast commissioned and disposed assets—reflecting specific transactions at this level of detail is not appropriate. This is because:

 18.1 the level of detail required is likely to exceed that typically employed by suppliers in their own cash flow planning

 18.2 CPPs depend heavily upon forecasts where the actual timing of cash flows is likely to diverge from that assumed at this level of detail (particularly as forecasts reach out over a regulatory period of a number of years).

19. These points support that requiring a greater level of detail is likely to impose administrative costs on suppliers which outweigh the benefits of more accurate timing.[9]

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for the sake of simplicity. However, we consider the difference between end-year and mid-year recognition of this item to not be material for information disclosure purposes.

[9] It is possible that a supplier may want to adopt more specific timings than those proposed (or less specific, if there are information constraints). In this case, the supplier is able to apply for the input methodology to be varied by agreement with the Commission under s 53V(2).

Consistency with other forms of regulation

20. The proposed amendments are consistent with the overall approach for cash flow timings for draft information disclosure regulation—although small differences may exist in light of the regulatory purpose of each of the instruments.

21. We also note that the proposed cash flow timings are not inconsistent with the approach we have taken so far in consultation on default price-quality paths.[10]

[10] Timing assumptions for default price-quality paths will be included as part of any process required to reset the 2010-15 default price-quality paths, or to set initial gas default price-quality paths.

Section Three: Next steps

Purpose

22. This section explains how we propose to amend the relevant input methodologies to give effect to cash flow timings. It also sets out how you can respond to this paper.

The proposed amendments relate to three input methodologies determinations

23. To give effect to the proposed intra-year cash flow timing assumptions we will need to amend the CPP IMs contained in the following determinations:

- Decision 710, *Commerce Act (Electricity Distribution Services Input Methodologies) Determination 2010*, 22 December 2010
- Decision 711, *Commerce Act (Gas Distribution Services Input Methodologies) Determination 2010*, 22 December 2010
- Decision 712, *Commerce Act (Gas Transmission Services Input Methodologies) Determination 2010*, 22 December 2010.

24. No changes are proposed for the IMs that relate to information disclosure regulation, or to default price-quality path regulation. Also, no changes for the IMs for Transpower or suppliers of specified airport services are being proposed as part of this consultation.

How we propose to implement intra-year timings within input methodologies

25. As indicated in paragraph 9, we intend to provide the relevant marked-up sections of the draft IMs referred to above separately for consultation by Friday 17 August 2012.

26. We have opted for a later release of the mark-ups to allow more time to complete the drafting changes required. However, as an interim guide for interested persons, we expect the marked up determinations will include:

    26.1 added timing factor adjustment terms for the formula for CPP building blocks allowable revenue

    26.2 consequential changes to CPP information requirements

    26.3 relevant additional definitions.

27. At the time the draft IMs are made available we may also publish further technical explanations or material that we consider will assist readers in reviewing the marked-up IMs.

We intend to make a final decision by 28 September 2012

28. As per the process set out in our Notice of Intention we intend to make a final decision on the proposed cash flow timing assumptions by 28 September 2012.

29. Any amendments would take effect from this date, and affect proposals submitted in the February 2013 CPP proposal window.

How you can respond to this paper

30. To help inform our final decision on the proposed amendments, you are invited to provide your views on this paper. Submissions on both this paper and the marked-up IM determinations are **due Friday 7 September 2012**.

31. You should address your responses to:

    Dane Gunnell
    Senior Analyst
    Regulation Branch
    c/o regulation.branch@comcom.govt.nz

Format of responses

32. We intend to publish all submissions and cross submissions on our website. We therefore request that you provide 'unlocked' electronic copies of your submissions, as well as a clearly labelled 'public version' if your submission contains confidential information or if you wish for the published electronic copies to be 'locked'.

Requests for confidentiality

33. We discourage requests for non-disclosure of submissions, as it is desirable to test all information in a fully public way. However, we recognise that there may be cases where parties in making submissions may wish to provide confidential information to us. [11] We offer the following guidance:

    33.1 if it is necessary to include confidential material in a submission, the information should be clearly marked as such

    33.2 both confidential and public versions of the submission should be provided

    33.3 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.

[11] Parties can also request that we make orders under s 100 of the Act in respect of information that should not be made public. Any request for a s 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 s 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 s 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.

At this stage we do not expect to require a round of technical consultation

34. At this stage we do not consider that technical consultation on revised draft IMs will be required. We will review this position in light of submissions on this paper and update parties on the process at that time.

Attachment A: Overview of prior consultation on cash flow timing

July 2011 draft decision to reset the electricity distribution default price-quality path

A1. We first proposed intra-year timing as part of our July 2011 draft decision for the reset of the electricity default price-quality path. At that time, and in that context, submissions[12] were generally opposed to intra-year cash flow timing assumptions, citing:

A1.1 an additional level of complexity

A1.2 inconsistency with the input methodologies for CPPs (on the basis they assumed year-end cash flow timing assumptions).

December 2011 update paper for additional input methodologies

A2. Intra-year cash flow timing was retained in our December 2011 update paper for additional input methodologies for default price-quality paths—with clarifications to address some concerns. Subsequent submissions were more favourable in response:

A2.1 PwC (on behalf of Powerco) supported our proposal stating "[intra year-timing would] provide a close approximation for the timing of revenue for the EDBs under the standard arrangement in the industry whereby EDBs invoice monthly in arrears and are paid on the 20th of the following month."[13]

A2.2 Powerco's own view was that it preferred the simplicity of the Australian/CPP approach, but acknowledged PwC's statement and accepted the Commission's proposed approach.[14]

A2.3 ENA submitted that intra-year timing should include explicit recognition of a lag between when revenue cash flows are received relative to expenditure cash flows (working capital allowance).[15]

A3. The Commission has had regard to these submissions in formulating our proposals on intra-year cash flow timing for CPPs.

12 For example, Vector, *Submission to Commerce Commission on Draft Decision on Starting Price Adjustments for Electricity Distribution Businesses*, 24 August 2011, page 16.

13 PwC*, Additional Input Methodologies for Default Price-Quality Paths: Process and Issues Paper (prepared as Appendix 2 to Powerco's report)*, 27 January 2012, page 7.

14 Powerco*, Submission on Additional Input Methodologies for Default Price-Quality Paths – Process and Issues Paper,* 27 January 2012*,* paragraphs 79-80.

15 ENA, *Submission on Additional Input Methodologies for Default Price-Quality Paths*, 27 January 2012, paragraph 25.