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

Draft reasons paper

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Associated documents

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20 May 2020	ISBN 978-1-869458-15-7	Electricity Distribution Services Input Methodologies Determination 2012 – Consolidated as of 20 May 2020
27 November 2019	ISBN 978-1-869457-68-6	Default price-quality paths for electricity distributors from 1 April 2020 – Final decision reasons paper
20 May 2020	ISBN 978-1-869458-16-4	Electricity Distribution Services Default Price-Quality Path Determination 2020 — Consolidated as of 20 May 2020
7 October 2016	ISBN 978-1-869455-33-0	Orion New Zealand's transition to the 2015-2020 default price-quality path – Final Report
7 October 2016	[2016] NZCC 19	Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016
28 March 2018	ISBN 978-1-869456-33-7	Wellington Electricity's customised price-quality path — Final decision
20 May 2020	ISBN 978-1-869458-17-1	Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018 — Consolidated as of 20 May 2020

Commerce Commission
Wellington, New Zealand

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Executive Summary

Purpose of this reasons paper

X1 This reasons paper explains our decision to amend the 2020-2025 default price-quality path (DPP) to provide for the transition by Wellington Electricity Lines Limited (Wellington Electricity) from its 2018-2021 customised price-quality path (CPP) to the 2020-2025 DPP (DPP3).

X2 Wellington Electricity will move from its CPP to DPP3 on 1 April 2021. This means that Wellington Electricity will be subject to DPP3 for only the last four years of the five-year regulatory period. The 2020-2025 DPP currently applies to 15 other electricity distribution businesses (EDBs).

X3 We welcome your views on the matters raised in this paper, and on the drafting of the DPP3 amendment determination within the timeframes set out below:[1]

X3.1 submissions by 5pm Friday 16 October 2020; and

X3.2 cross-submissions by 5pm Friday 23 October 2020.

X4 Further information on how you can provide your views is set out at paragraphs 1.8-1.14.

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

X5 The focus of our decision is on setting starting prices when Wellington Electricity moves onto DPP3. When we set the 2020-2025 DPP in November 2019, we specified the rate of change and the quality standards that will apply to Wellington Electricity when it moves to the DPP3.[2]

Draft decision on starting prices

X6 Our draft decision is to use a "building blocks" approach to set starting prices for Wellington Electricity.

X7 Under section 53X(2) of the Commerce Act, we have a choice of rolling over the prices that applied at the end of Wellington Electricity's CPP, or setting different starting prices.

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[1] [DRAFT] Electricity Distribution Services Default Price-Quality Path Amendments Determination 2020 [2020] NZCC [XX] available here.

[2] For more detail on the treatment of Wellington Electricity in the 2020-2025 DPP refer to: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2020: Reasons paper" (27 November 2019), Attachment I.

X8 The building blocks approach provides a way to take account of the current and projected profitability of each distributor to set starting prices. The approach is identical to that used for each of the other EDBs subject to DPP3, but would use information from Wellington Electricity’s latest information disclosures.

X9 Accordingly, we have set the 2022 forecast net allowable revenue at $89.737 million. This is 2.1% lower than the 2021 forecast net allowable revenue that was set as part of Wellington Electricity’s CPP, and reflects a reduction in operating costs Wellington Electricity has recently achieved.

X10 In making our decision we are exercising our discretion under section 53X, while being guided by sections 52A and 53K. In particular, we consider that our draft decision:

X10.1 maintains Wellington Electricity's incentives to innovate and invest (section 52A(1)(a));

X10.2 limits Wellington Electricity’s ability to extract excessive profits (section 52A(1)(d)); and

X10.3 reflects a relatively low-cost approach to the transition (section 53K).

X11 We also consider that our decision is consistent with section 53P because it is based on Wellington Electricity’s current and projected profitability, does not seek to recover excess profits from the prior period, and is not derived from comparative benchmarking.

Chapter 1 Introduction

Purpose of this reasons paper

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

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

1.2 Wellington Electricity applied for a CPP following the November 2016 Kaikoura earthquakes and a Government Policy Statement (GPS) that noted the increased likelihood of a large earthquake occurring and highlighted the importance of key "lifeline" utilities in Wellington, including Wellington Electricity, taking action to ensure they were well prepared for such an event. [3]

1.3 On 28 March 2018, we determined a CPP to apply to Wellington Electricity between 1 April 2018 and 31 March 2021.[4]

1.4 Wellington Electricity has entered the third year of its three-year CPP. One requirement of its CPP determination is for it to prepare and disclose an annual compliance statement including agreed measures that demonstrate the progress of its procurement and installation programme and the effectiveness of the seismic strengthening building works that were approved under the CPP. Statements to date show that in 2019 and 2020 Wellington Electricity outperformed its CPP resilience quality standard, and that it appears to be on track to comply in 2021.

1.5 On 27 November 2019, we set the DPP applying to 15 EDBs for the five year period from 1 April 2020 to 31 March 2025 (ie, DPP3).[5] The DPP3 determination specified the rate of change in revenues and the quality standards that would apply to Wellington Electricity when it transitioned to the DPP on 1 April 2021, but did not determine its starting prices.[6] In the associated reasons paper we noted our intention to determine Wellington Electricity's starting prices once more up-to-date information became available.[7]

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

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

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

[6] For more detail on the treatment of Wellington Electricity in the 2020-2025 DPP refer to: Commerce Commission "Default price-quality paths for electricity distributors from 1 April 2020: Reasons paper" (27 November 2019), Attachment I.

[7] ibid, at para I15.

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

Structure of this paper

1.7 In this paper, we explain:

1.7.1 the legal framework relevant to Wellington Electricity's transition to the DPP3 (Chapter 2);

1.7.2 our draft decision on Wellington Electricity's starting prices when it transitions to the DPP3 (Chapter 3); and

1.7.3 how we propose to implement Wellington Electricity's transition to the DPP3.

How you can provide your views

Timeframe for submissions

1.8 We welcome your views on the matters raised in this paper, on the drafting of the DPP3 amendment determination, on the accompanying models, and on any other matters relevant to Wellington Electricity's transition to the DPP3, within the timeframes below:

1.8.1 submissions by 5pm on Friday 16 October 2020; and

1.8.2 cross-submissions by 5pm on Friday 23 October 2020.

Address for submissions

1.9 Responses should be addressed to:

Dane Gunnell (Manager, Price-Quality regulation)
c/o regulation.branch@comcom.govt.nz

1.10 Please include "CPP to DPP" in the subject line of your email

Confidential submissions

1.11 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 where parties that make submissions wish to provide information in confidence.

1.12 We offer the following guidance:

1.12.1 If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.

1.12.2 Where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information.

1.12.3 Both confidential and public versions of the submission should be provided.

1.12.4 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.[8]

1.13 We prefer to receive submissions in both a format suitable for word processing (such as a Microsoft Word document), and in a 'locked' format (such as a PDF) clearly labelled 'public version' for publication on our website.

Next steps

1.14 The next steps in the process for developing the final decision are as follows:

Submissions due	Friday 16 October 2020
Cross submission due	Friday 23 October 2020
Final decision released	Monday 23 November 2020

[8] 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.

Chapter 2 Legal framework

Purpose of this chapter

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

Section 53X

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

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

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

2.3 Section 53X(1) requires that, when Wellington Electricity's CPP ends, it be made subject to the DPP that is "generally applicable" to the other EDBs. In this case, this is the DPP3 that is set out in the DPP3 determination.

2.4 Clause 3.4 of the DPP3 determination provides that the DPP3 determination does not apply to Wellington Electricity until the expiration of Wellington Electricity's CPP determination. Wellington Electricity's CPP determination expires on 31 March 2021 and, as such, the DPP3 determination applies to Wellington Electricity from 1 April 2021 onwards.

2.5 However, some amendments to the DPP3 determination are required to make Wellington Electricity subject to the DPP that is "generally applicable" to the other EDBs. Without these amendments, Wellington Electricity would be on a materially different DPP to the other EDBs. We explain what these necessary amendments are in Chapter 4 on "Implementation".

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

2.6 We have previously considered how we should set a transitioning supplier's starting prices under s 53X(2) when Orion New Zealand Limited transitioned from its CPP to the EDB DPP for the last year of the 2015-2020 regulatory period. Our Final Report set out the key considerations for this task, which we summarise below.[9]

2.7 We have a discretion in setting starting prices under section 53X(2). This discretion involves:

2.7.1 choosing between rolling over the prices that applied at the end of the CPP or setting different starting prices; and

2.7.2 if we choose to set different starting prices, deciding on the prices that apply.

2.8 In exercising our discretion under s 53X(2), we must do so in the manner we judge best meets the purpose of Part 4 of the Commerce Act (as set out in s 52A[10]) and the purpose of DPP/CPP regulation (as set out in s 53K[11]). However, the section 52A purpose provides the primary objectives and considerations that we must give weight to when exercising our judgement.

2.9 Of particular relevance to our s 53X(2) discretion are:

2.9.1 the s 52A(1)(a) outcome relating to incentives to innovate and invest and the s 52A(1)(b) outcome that suppliers are limited in their ability to extract excessive profits; and

2.9.2 under the s 53 K purpose, the desirability of keeping the cost and complexity of the transition low, including our approach to setting starting prices.

2.10 In deciding whether to roll over the prices that applied at the end of the CPP, or to set different starting prices, the primary consideration will be which option will better promote the objectives in the s 52A purpose. If, for example, rolling over the

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

10 Section 52A provides that "The purpose of this Part 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 (d) are limited in their ability to extract excessive profits".

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

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

2.11 Exercising our discretion consistent with the s 52A and 53K purposes means that the length of the DPP regulatory period still to run when a supplier transitions from a CPP is relevant to our decision on setting starting prices. A shorter period to run may weigh in favour of a lower-cost exercise, such as rolling over the prices that applied at the end of the CPP or a relatively simple approach to setting different starting prices. This is because the costs involved in a more complex exercise may outweigh any associated incremental gains in accuracy.

2.12 On the other hand, a longer period to run may weigh in favour of a relatively higher-cost approach to setting prices, such as more detailed modelling of the costs the supplier is likely to incur.

2.13 If we decide to set different starting prices, section 53P is a relevant consideration. Relevantly, s 53P requires that starting prices:

2.13.1 be based on the current and projected profitability of the supplier (if prices are being reset);

2.13.2 must not seek to recover any excessive profits made during any earlier period; and

2.13.3 must not be derived from comparative benchmarking.

2.14 We have some flexibility in how we set prices based on the current and projected profitability of the supplier. In particular, we are not required to undertake a full 'building blocks' analysis. Nor are we required to accommodate all of a supplier's specific circumstances, given the low-cost nature of DPP regulation.

Section 52Q

2.15 Any amendments to the DPP determination must be made under s 52Q of the Commerce Act. Section 52Q(1) requires the Commission to consult with interested parties on any material amendments to the DPP determination.

2.16 Since the amendments we propose in this paper are material, we are consulting with interested parties.

Chapter 3 Our decision

Purpose of this chapter

3.1 This chapter explains our draft decision on Wellington Electricity's DPP starting prices as it moves to the DPP3. Specifically, it addresses:

3.1.1 our draft decision to set Wellington Electricity's starting prices based on a building blocks approach;

3.1.2 our draft decision on Wellington Electricity's request for an adjustment to its base year operating expenditure (opex); and

3.1.3 how the existing building blocks models have been used to calculate Wellington Electricity's starting prices.

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

3.2 As noted in paragraph 2.7, we can choose between rolling over the prices that applied at the end of the CPP or set different starting prices.

3.3 Our draft decision is to set different starting prices rather than rolling over the CPP prices, and to base those different starting prices on a building blocks approach. The building blocks approach was used to set the starting prices of the other EDBs subject to the DPP3. In applying the building blocks approach, we have used more recent data than was available when we set DPP3.

3.4 We consider that our draft decision best meets the Part 4 purpose as set out in s 52A. We also consider the draft decision meets the purpose of default/customised price-quality regulation as set out in the s 53K purpose.

Reasons for our draft decision

3.5 We consider that our draft decision:

3.5.1 maintains Wellington Electricity's incentives to innovate and invest (section 52A(1)(a));

3.5.2 limits Wellington Electricity's ability to extract excessive profits (section 52A(1)(d));

3.5.3 reflects a relatively low-cost approach to the transition (section 53K); and

3.5.4 is consistent with s53P.

Maintaining Wellington Electricity's incentives to innovate and invest

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

Limiting Wellington Electricity's ability to extract excessive profits

3.7 In our reasons paper for the final decision on the DPP3, we noted that Wellington Electricity's CPP would "not be a suitable base for future revenue allowances". This was because of Wellington Electricity's unique CPP circumstances whereby the 2015-2020 DPP was extended and an increment applied to allow for resilience investments.

3.8 By taking into account Wellington Electricity's current and future profitability, the draft decision to use a building blocks approach takes account of Wellington Electricity's current costs and projections of expected costs to help lock in place the recent operating cost savings that Wellington Electricity has made. This approach best promotes the s 52A outcome of limiting a supplier's ability to extract excessive profits.

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

3.9 Our draft decision is a relatively low-cost way of managing Wellington Electricity's transition to the final four years of the DPP3.

3.10 When we set the DPP3, we modelled an indicative price path for Wellington Electricity. The existence of that indicative modelling provides us a relatively low-cost opportunity to apply a building blocks approach.

3.11 An s 53X(2) roll-over has not been carried out before. It is not clear how a roll-over could be implemented for a price path that contains an Incremental Rolling Incentive Scheme (IRIS) mechanism. The IRIS mechanism needs a consistent 'forecast opex' and 'forecast aggregate value of commissioned assets' to be determined, potentially requiring significant resources and extensive consultation.[12]

[12] Orion's starting price, when it moved from a CPP to a DPP, was determined as a different starting price under s 53X(2). Orion moved from its CPP in the final year of a DPP regulatory period and IRIS rules did not apply to Orion for that regulatory period.

3.12 Given that Wellington Electricity will be subject to the DPP3 for four years, we consider the benefits of adopting a building blocks approach to be justified.

Consistent with section 53P

3.13 Section 53P is a consideration when setting starting prices using a building blocks approach. It requires that starting prices be based on the current and projected profitability of the supplier, must not seek to recover any excessive profits made during any earlier period, and must not be derived from comparative benchmarking.

3.14 We consider that we have been consistent with s 53P because we have followed the DPP3 processes, and we considered those processes produced outcomes consistent with s53P.

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

3.15 In a letter to us on 26 August 2020,[13] Wellington Electricity requested that the base year opex figure we use in our modelling be increased from the amount disclosed in Wellington Electricity's 2020 information disclosure. The reason cited by Wellington Electricity is that its ongoing earthquake readiness and insurance costs are not well reflected in actual expenditure in the 2020 base year.

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

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

3.17 In the DPP3 reasons paper, we set out a test for considering whether to accept opex step changes.[14] The test was that each of the following needed to be met for a step change in opex to be approved:

3.17.1 significant;

3.17.2 robustly verifiable;

[13] Letter from Wellington Electricity, WELL DPP3 draft determination (26 August 2020).

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

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

3.17.4 largely outside of the control of distributors; and

3.17.5 be applicable to most, if not all distributors.

3.18 In submissions made on the DPP3 draft decision, Wellington Electricity raised concerns in regard to its ongoing earthquake readiness costs and its increasing insurance costs.[15]

3.19 In our DPP3 reasons paper, we noted that:

3.19.1 in relation to the ongoing earthquake readiness costs, we would review Wellington Electricity's situation when it transitioned to the DPP3.[16]

3.19.2 in relation to the increasing insurance costs, existing insurance costs may be included in the opex baseline, but that the insurance costs in Wellington Electricity's submission were "not sufficiently significant" to be added to the base year.[17]

Our draft decision

Ongoing earthquake readiness costs

3.20 Our draft decision is to approve an adjustment to Wellington Electricity's base year opex figure that would allow the building blocks projection of Wellington Electricity's operating costs to reflect the 2021 earthquake readiness expenditure approved in the CPP determination, instead of the actual expenditure incurred on those projects in 2020.

3.21 We accept that the 2021 earthquake readiness opex expenditure reflects a continued annual cost of maintaining Wellington Electricity's new earthquake readiness capability for the remainder of the DPP3 regulatory period. To determine the starting prices in this draft decision, we have added an increment of $0.287m to Wellington Electricity's base year opex in relation to ongoing earthquake readiness costs. We will seek further assurances from Wellington Electricity that this increment reflects the approved adjustment.

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[15] Wellington Electricity "Submission on EDB DPP reset draft decisions paper" (18 July 2019), Sections 3 and 5.

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

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

3.22 We recognise that Wellington Electricity's request for an increment relating to ongoing earthquake readiness costs does not satisfy the step change criteria set out in paragraph 3.17. In particular, these costs are not applicable to most EDBs.

3.23 However, we recognise that the earthquake readiness component of Wellington Electricity's 2018 CPP was approved to allow Wellington Electricity to properly respond to a GPS on the Resilience of Electricity Services in the Wellington Region.[18] That statement highlighted the importance of key "lifeline" utilities in Wellington (including Wellington Electricity) taking action to ensure they are well prepared for a large earthquake event. The GPS states:

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

3.24 Under s 26 of the Commerce Act, the Commission is required to have regard to the GPS in exercising its powers.

3.25 The increment to base year opex that Wellington Electricity has requested in its 26 August 2020 letter is for ongoing opex that is directly related to the earthquake readiness component of Wellington Electricity's CPP.[19]

3.26 As such, in this limited circumstance, we propose to include this opex in the base year, despite not satisfying our criteria for accepting opex step changes.

Insurance costs

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

3.28 Wellington Electricity has provided evidence of the growth in its insurance premiums between 2017 and 2021. Notably, its insurance costs, which increased by 26 percent in the year to 2020, are projected to increase by a further 37 percent in the year to 2021 despite a decrease in the coverage of the policy.

3.29 However, we note that the expected increases in insurance costs:

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

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

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

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

3.30 Recently, we considered the treatment of insurance in the 26 November 2019 input methodology amendments. Our concern was whether insurance should be treated as a recoverable cost. In deciding that insurance should not be treated as a recoverable cost, we commented:[20]

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

3.31 We do not consider it is appropriate to make insurance an exception to the criteria set out in paragraph 3.17. In implementing a building blocks approach to setting supplier starting prices, insurance does not appear to be fundamentally more deserving of being singled out for special treatment than other controllable costs affecting individual EDBs.

3.32 As such, we do not consider it appropriate to increase Wellington Electricity's base year opex to reflect the expected increase in its insurance costs in the last year of its CPP.

Modelling methodology and results

3.33 To set Wellington Electricity's starting prices we have revised four of the models that were used in 2019 to set the DPP3: the financial model, the capex projections model, the opex projections model and the input cost inflators model.

3.34 The purpose of the revisions is to:

3.34.1 modify the building blocks and maximum allowable revenue modelling to set a four-year price path for Wellington Electricity, rather than the five-year price path for the other EDBs;

3.34.2 modify the capex projections and opex projections models to project costs for a four-year price path rather than a five-year price path;

[20] Commerce Commission "Amendments to Electricity Distribution Services Input Methodologies Determination, Reasons paper" (26 November 2019), paragraph 3.97.

3.34.3 incorporate Wellington Electricity's most recent annual information disclosures of historical opex and capex;[21]

3.34.4 incorporate Wellington Electricity's 2020 AMP forecast of capital expenditure, rather than its 2019 AMP forecast;[22]

3.34.5 calculate opex and capex cost allowances using updated cost inflators from NZIER; and

3.34.6 include adjustments to the base year opex, as discussed at paragraph 3.15.

3.35 Information about the modifications made to each model is available in the 'Description' sheet of the model. The models can be downloaded from the Commission's website.

3.36 There are a number of feeder models that provide inputs to these four models. These feeder models have not been updated for the reasons set out in the table below.

[21] Wellington Electricity, 2020 information disclosure report, at https://www.welectricity.co.nz/disclosures/network-information/document/225

[22] Wellington Electricity, 2020 asset management plan data, at https://www.welectricity.co.nz/disclosures/asset-management-plan/document/213

Model	Reason for not updating
Econometric	The elasticities determined with the econometric model are expected to be relatively stable, so we do not consider the resource requirements for updating this model justify an update in the relatively low-cost DPP context.
Disposals	The disposals projection extrapolates an historical average level. For Wellington this has been less than $3,000 pa over the last six years which we consider is immaterial.
CPI	The input methodologies specify which Reserve Bank forecast we must use in establishing 'forecast CPI'. This results in 'forecast CPI' not being updated since the DPP3 CPI model was prepared and published. CPI is an input to the capex model, and this use is not constrained by the input methodologies. Updating this CPI forecast would have no impact on the capex projection.[23]
Operating lease	An operating lease model was prepared for the DPP3 decision, based on s 53ZD information. We have not repeated the s 53ZD information request as we did not consider the significant effort by and cost on Wellington Electricity and us to be justified, as the projections made in the DPP3 process were likely to be adequate for the transition to the DPP3.
Household growth	An update to the household growth model would require an updated population growth projection from Statistics New Zealand. No updated projection is available since the DPP3 decision.
Circuit length	We tested the sensitivity of the opex projections to an update of the model and found an update, on average, would increase the opex allowance by less than 0.05%.

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

Modelling results

3.37 The starting price is calculated in the models as the 2022 'Maximum Allowable Revenue' (MAR). it appears in the determination as the 2022 forecast net allowable revenue. The model calculates Wellington Electricity's forecast net allowable revenue in 2022 to be $89,737,000. The forecast allowable revenue remains at the same level, in constant real terms, throughout the DPP3 regulatory period.

3.38 We can compare this value to:

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

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

3.39 The values are compared in this table:

All values $'000	**2021**	**2022**
DPP3 indicative MAR	91,407	93,190
CPP final year MAR	91,697	
CPP to DPP draft decision: 2022 MAR		89,737

3.40 The draft decision value reflects a 2.1% reduction in net allowable revenue relative to the current year's CPP value.

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

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

3.43 In Wellington Electricity's 2021 price setting compliance statement,[24] for example, the total forecast allowable revenue (which includes forecast pass-through and recoverable costs) was $146.2m while the forecast net allowable revenue was $91.7m, so the forecast net allowable revenue was 63% of total forecast allowable revenue.

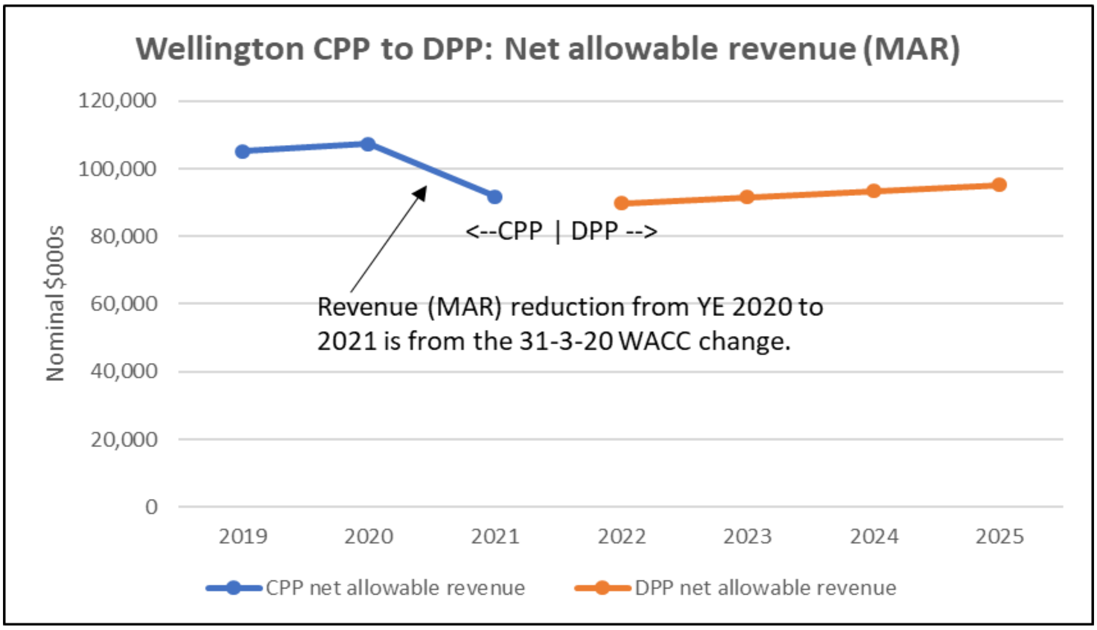

Figure 3.1 Net allowable revenue

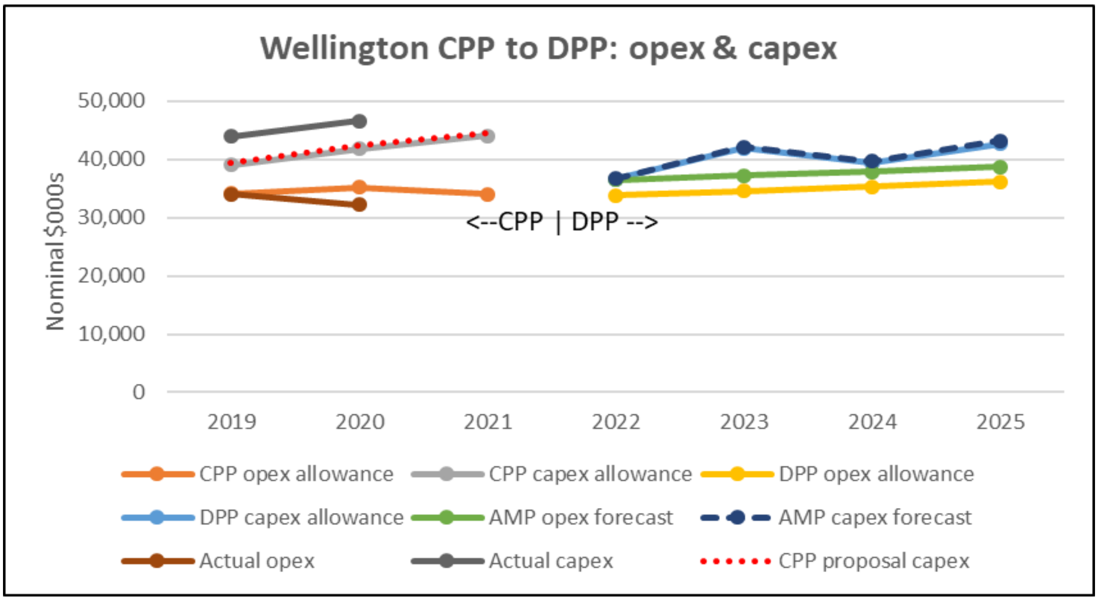

Figure 3.2 Opex and capex

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

Chapter 4 Implementation

4.1 The draft DPP3 amendment determination, published alongside this reasons paper, sets out the way we propose the starting prices be implemented.[25]

Pass-through balance allowance

4.2 The existing paragraph 5 of Schedule 1.5 of the DPP3 determination provides a formula for EDBs to calculate their ‘forecast allowable revenue’. It includes the term ‘PTBA’ (pass-through balance allowance) which is defined in Clause 4.2 of the DPP3 determination.

4.3 That definition relies on the values of the ‘pass-through balance’ and 'ePTB' (an estimate of the pass-through balance). These are also defined in Clause 4.2.

4.4 For the year ended 31 March 2020, Wellington Electricity was not subject to the DPP3 determination[26] that is referred to in the clause 4.2 definition of pass-through balance. Unlike the other EDBs, Wellington Electricity will therefore not have values for ‘pass-through balance’ and 'ePTB'.

4.5 The residual pass-through balance from when Wellington Electricity was subject to the 2015-2020 DPP has been dealt with in the Wellington Electricity CPP. There is now no need for any further transitional requirements for a pass-through balance.

4.6 A workable outcome requires the pass-through balance allowance for Wellington Electricity to be defined as nil for all assessment periods of the DPP3. Alternatively, the term ‘pass-through balance allowance’ could be removed from the formula for ‘forecast allowable revenue’ and ‘actual allowable revenue’. Our draft decision is to adopt the former of these two options.

4.7 The pass-through balance is also used in the DPP3 Schedule 1.6(2)(a) formula for ‘actual allowable revenue’. In the draft decision determination, the schedule provides a formula for only Wellington Electricity which makes no reference to a pass-through balance.

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

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

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

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

4.9 The calculation of 'actual allowable revenue' in the DPP3 determination does not provide for taking a 2020 wash-up amount into account, so we have in the draft decision determination added a new paragraph (4) to Schedule 1.6 to set out the methodology for Wellington Electricity.

4.10 Schedule 1.7(1)(a) defines the 'opening wash-up account balance' for 2022 (i.e. the second assessment period in DPP3) as nil. That is problematic as Wellington Electricity will have calculated a 'wash-up amount' for 2020 which should, from a policy intent perspective, be taken into account for pricing two years later, i.e. pricing for 2022. The DPP3 drafting would result in the wash-up from 2020 not ever being taken into account.

4.11 The draft decision determination Schedule 1.7 has been amended from the DPP3 text to achieve the policy intent.

Actual net allowable revenue for 2022

4.12 From a policy perspective, we would expect that the DPP3 determination would specify the 2022 actual net allowable revenue as a numerical value. That value will have been produced from the financial model for the CPP to DPP3 transition.

4.13 IM Clause 3.1.3(13)(i) effectively requires the 2022 value to be the previous year's value increased by CPI–X. That is different from simply specifying a numerical value as the 2022 actual net allowable revenue.

4.14 To comply with the IM requirement, and to also apply a known numerical value to the 2022 actual net allowable revenue, we have drafted the determination to effectively back-calculate a 2021 actual net allowable revenue. The back-calculation is such that, when it is rolled forward at CPI–X to a 2022 value, the calculated result is equal to the known numerical value.

4.15 We used a very similar approach earlier in 2020 for Wellington Electricity and Powerco, which were both on CPPs and were subject to a 'WACC change'.[27]

4.16 A complication arises with the CPI values for the CPI–X adjustment not being available until after the end of the 2022 year. This complication has been resolved in the draft determination by using a formula, instead of numerical values, to specify the 2021 forecast net allowable revenue.

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

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[27] Further information on the WACC change decision is available on our Wellington Electricity CPP webpage.

IRIS amounts and Innovation allowance

4.18 Schedule 2.2 of the draft DPP3 amendment determination amendment contains tables of specified amounts for the IRIS. The amounts are sourced directly from the opex projections model and the capex projections model.

4.19 Schedule 5.3 of the draft DPP3 amendment determination contains a table showing the innovation project allowance for the DPP regulatory period. As for the 15 other EDBs in the determination, Wellington Electricity's allowance is based on the total annual forecast net allowable revenue.