

Wellington Electricity's proposal to customise its prices to better prepare its network for an earthquake

Change from the draft decision

16 February 2018

Purpose of this paper

1. We have identified an issue with our approach to determining the price path in our draft decision on a customised price-quality path (CPP) for Wellington Electricity (WELL).
2. This paper explains the issue and sets out a proposed change from the draft decision to address it. We seek your views on the change as part of submissions on our draft decision due 22 February 2018.
3. This paper should be read alongside our draft decision on WELL's CPP which provides context for the streamlined approach that we have taken to setting WELL's CPP.¹

Overview of issue

- i. The streamlined approach we have used to set WELL's price path for the CPP uses **forecast CPI** in setting the default price-quality path (DPP) component, not **actual CPI** which WELL would have been subject to under the DPP.
- ii. An adjustment is required to the proposed approach because:
 - the intention when providing for the streamlined CPP was to allow WELL to recover the approved additional resilience expenditure, as well as revenues currently allowed for under its DPP (base revenue)—taking into account the input methodology (IM) change to apply a revenue cap.²
 - under a DPP, actual CPI (not forecast CPI) is applied to revenues to determine what EDBs may actually recover.
- iii. To address this issue, we intend to revise the proposed IM variation required to implement the streamlined CPP, which we set out in our draft decision.
- iv. The change to the proposed IM variation would amend our decision on the CPP price path as outlined in our draft decision paper. The change would not impact any of our other draft decisions.

IM variations proposed to implement streamlined CPP and set WELL's price path

4. To set a streamlined CPP we have proposed to use IM variations to enable us to use a simplified approach to set WELL's price path.

¹ Commerce Commission "Draft decision on Wellington Electricity's customised price-quality path" (1 February 2018).

² Commerce Commission "Discussion paper – our proposed approach to assessing Wellington Electricity's additional resilience expenditure" (17 November 2017), para 22

5. The intent of the price path IM variations was to allow WELL to recover the revenue it was allowed to recover under the DPP for the first two years (base revenue),³ as well as an additional allowance for resilience expenditure.⁴
6. Under the currently drafted IM variation, our draft decision proposed implementing this by using the DPP maximum allowable revenue (DPP MAR) values as the base revenue for the first two years of the CPP.
7. The DPP MAR values come from the DPP model and were derived in 2014 when setting WELL's DPP.
8. The derived MAR's from the DPP model do not reflect the actual revenues WELL would be entitled to recover under its DPP. Instead, the DPP determination specifies that allowable revenue is the MAR for the first year of the DPP period, as set out in the DPP determination, and for each year preceding, the previous year's allowable revenue plus an adjustment for actual CPI.

Applying forecast CPI would mean WELL will recover approximately \$6m more base revenue than it would under a DPP

9. Actual CPI has been lower than the forecast CPI used in 2014 to determine the MAR. Accordingly, WELL's allowable revenue calculated in accordance with the DPP determination is less than the MAR outlined in 2014.
10. By using the MAR values (determined using forecast CPI) as our base for the first two years of the CPP, as set out in our draft decision, would result in additional revenue for WELL of around \$6m over a three year CPP.⁵

How we propose to address this

11. We propose to adjust the IM variation outlined in our draft decision and used for setting the draft decision price path. The updated IM variation would use base revenue values for the first two years of the CPP, that take into account inflation information that would have been used to determine WELL's actual allowable revenue under its DPP.
12. We consider the proposed adjustment better reflects what we intended to provide for in allowing for a streamlined CPP. This position is supported by WELL.

³ Under the current DPP, preceding year's allowable revenues are set as a weighted average price cap. For the purpose of explaining the CPI issue, for rest of this paper, the effect of the form of control on DPP allowable revenues is ignored.

⁴ The third year WELL is to recover maximum allowable revenue determined consistent with the DPP revenue setting process (using forecast opex and capex), as well as an additional allowance for resilience expenditure.

⁵ The impact of the CPI issue on WELL's price path is outlined in the attachment of this paper.

The CPI change would amend our draft decision CPP MAR

13. Table 1 sets out the impact of our change to the CPP MAR draft decision.

Table 1: Nominal maximum allowable revenue before tax

Maximum allowable revenue (\$m)	2018/19	2019/20	2020/21
DPP forecast MAR	105.6	108.4	n/a
CPP MAR draft decision	107.4	109.6	111.8
DPP MAR - with CPI change	102.7	104.7	n/a
CPP MAR draft decision - with CPI change	105.2	107.4	109.5

WELL's transition from a weighted average price cap to a revenue cap

14. As part of the streamlined CPP, WELL is to transition from a weighted average price cap (WAPC) to a revenue cap.⁶
15. In our draft decision paper, we outlined how this transition was expected to increase 2018/19 allowable revenues by 5.5%. We now estimate this increase to be 2.6% when taking into account the effect of using actual CPI in determining base revenues.

We are interested in your view in this change

16. We are seeking your views on this proposed change to determining WELL's CPP.
17. Submissions are due alongside consultation on our draft decision on 22 February 2018. As the issue has arisen during the consultation period, we are willing to consider extensions to the timeframe if sought in advance of the due date.
18. Cross-submissions are due 1 March 2018.
19. Please email your submissions to regulation.branch@comcom.govt.nz with 'Wellington Electricity CPP draft decision' in the subject line.

⁶ As discussed further in the document: Commerce Commission "Wellington Electricity's proposal to customise its prices to better prepare its network for an earthquake – Draft Decision" (1 February 2018), paras 31-33

Attachment: Impact on the draft decision calculation

Purpose of attachment

20. This attachment outlines how we have calculated the effect the CPI change would have on the CPP MAR draft decision.
21. We outline how we have calculated the CPI using updated CPI information, how the updated CPI affects the DPP allowable revenues and then the effect this has on the CPP MAR.

Actual CPI using updated CPI information

22. We have calculated WELL's DPP allowable revenues for 2018/19 and 2019/20 using available actual CPI information and updated forecast CPI information where actual information is not available.⁷
23. CPI values have been calculated consistent with how CPI is required to be calculated under the DPP determination which includes a lag.⁸
24. Table A1 sets out the historic CPI information used to determine the CPI element for the DPP price path. Table A2 overleaf sets out the RBNZ forecast change in CPI for the periods

Table A1: Historic CPI series

Date	CPI	Date	CPI
Dec-12	954	Sep-15	982
Mar-13	958	Dec-15	977
Jun-13	959	Mar-16	979
Sep-13	968	Jun-16	983
Dec-13	969	Sep-16	986
Mar-14	972	Dec-16	990
Jun-14	975	Mar-17	1000
Sep-14	978	Jun-17	1000
Dec-14	976	Sep-17	1005
Mar-15	975	Dec-17	1006
Jun-15	979		

⁷ The updated CPI information is from the Statistics NZ release of CPI for the December 2017 quarter and the Reserve Bank Monetary policy statement in February 2018. Forecast CPI has been calculated per the EDB input methodology.

⁸ Calculation of changes in CPI (ΔCPI_t) has been per Schedule 3B of the EDB DPP determination 2015.

Table A2: RBNZ forecast change in CPI%

Date	Forecast change
Mar-18	1.10%
Jun-18	1.60%
Sep-18	1.60%

DPP allowable revenues

25. The updated CPI values were then used to determine the DPP MAR – with CPI change, using assumptions consistent with the DPP model for all other values, including the 2015/16 MAR and constant price revenue growth values.
26. Table A.3 sets out the changes made to WELL’s financial model as they relate to DPP allowable revenues.

Table A.3: Changes to the DPP allowable revenue calculations in WELL’s financial model

	2015/16	2016/17	2017/18	2018/19	2019/20
CPI element of the DPP price path – as per the 2014 DPP model	1.53%	1.51%	1.77%	2.11%	2.15%
DPP MAR - as per the 2014 DPP model (\$m)	98.8	100.7	103.0	105.6	108.4
CPI element of the DPP price path - with CPI change	1.43%	0.46%	0.33%	1.78%	1.48%
DPP MAR - with CPI change (\$m)	98.8	99.7	100.5	102.7	104.7

Impact on CPP MAR draft decision

27. The DPP MAR – with CPI change was then used in the financial model provided by WELL as part of its CPP application (WELL’s financial model).
28. Table A4 sets out the resulting CPP MAR draft decision – with CPI change.

Table A.4: Impact of the CPI change to the CPP MAR draft decision

CPP MAR draft decision (\$m)	2018/19	2019/20	2020/21
CPP MAR draft decision - original	107.4	109.6	111.8
CPP MAR draft decision - with CPI change	105.2	107.4	109.5