

Amendments to Electricity Distribution Services Input Methodologies Determination

Reasons paper

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1. Introduction

Purpose of paper

- 1.1 This paper provides our decisions and supporting reasons on amendments to the input methodologies (IMs) for Electricity Distribution Services contained in the *Electricity Distribution Services Input Methodologies Determination 2012* (EDB IM determination).¹
- 1.2 The amendments relate to:
 - 1.2.1 supporting implementation of incremental improvements to the way the default price-quality path (DPP) is set; or
 - 1.2.2 enhancing certainty about the rules and correcting for technical errors ahead of the reset of the default price-quality path for electricity distribution businesses from 1 April 2020 (EDB DPP3).

The process we followed

- 1.3 The IM amendments made in the EDB IM amendments determination, and described in this paper, are made in accordance with s 52X of the Commerce Act 1986 (Act).
- 1.4 In accordance with sections 52V(1) and 52X of the Act, we published notices of intention relevant to the IM amendments set out in this paper on 15 November 2018² and 16 May 2019.³
- 1.5 We then proposed amendments and sought stakeholder views in our IM amendments draft reasons paper “Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited – Reasons paper” – 29 May 2019 (draft decision). The draft decision was accompanied by a draft

¹ Prior to the amendments outlined in this paper, the principal determination was most recently amended in 13 November 2019 by [Electricity Distribution Services Input Methodologies Amendments Determination \[2019\] NZCC 18](#). A consolidation of the principal determination and all subsequent amendments, apart from the amendments made on 13 November 2019 amendments, was published by us on 31 January 2019.

² [Notice of Intention: Proposal to Amend Input Methodologies for Electricity Distribution Services, 15 November 2018](#).

³ [Notice of Intention: Proposal to Consider Amending to Input Methodologies for Electricity Distribution Services and Transpower New Zealand Limited, 16 May 2019](#). This notice was amended by [Amended Notice of Intention: Proposal to Consider Amending Input Methodologies for Electricity Distribution Services and Transpower New Zealand, 27 August 2019](#). Amendment was in respect of input methodologies relating to Transpower New Zealand Limited only.

amendment determination showing how we proposed to give effect to the proposed changes.⁴

- 1.6 In reaching the decisions outlined in this paper, we have taken into account submissions and cross-submissions received from stakeholders in response to our draft decisions referred to in paragraph 1.5. In reaching these decisions, we have also considered submissions received as part of the DPP3 reset consultation process insofar as they related to the EDB IM determination.

Structure of paper

- 1.7 This paper explains:
- 1.7.1 the decision-making framework we have applied to reach our decisions (Chapter 2);
 - 1.7.2 potential amendments we consider fall within the scope of this s 52X amendments process. It explains amendments that we decided to make, as well as those that we decided not to make (Chapter 3); and
 - 1.7.3 IM amendments proposed by submitters that are beyond the scope of this s 52X amendments process (Chapter 4).

Materials released alongside this paper

- 1.8 To give effect to the amendments discussed in this paper, we have also today published an IM amendments determination (EDB IM amendments determination).⁵
- 1.9 The EDB IM amendments determination presents the amendments as a mark-up against the most recent consolidated version of the Electricity Distribution Services Input Methodologies Determination 2012, which also includes the recent amendments made in respect of the treatment of operating leases⁶ (these are not shown in tracking as they were the subject of a separate IM amendment determination on 13 November 2019).

Effective dates for IM amendments

- 1.10 The IM amendments will come into force on the day on which notice of the EDB IM amendments determination is given in the New Zealand Gazette in accordance with s 52W of the Act.
- 1.11 The IM amendments will apply:

⁴ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019.](#)

⁵ [Electricity Distribution Services Input Methodologies Amendments Determination \(No. 2\) \[2019\] NZCC 20.](#)

⁶ [Electricity Distribution Services Input Methodologies Amendments Determination 2019 \[2019\] NZCC 18.](#)

- 1.11.1 under information disclosure requirements for electricity distribution businesses (EDBs, or distributors), immediately upon the amendments coming into force;
 - 1.11.2 for distributors subject to default price-quality paths (DPPs), from 1 April 2020; and
 - 1.11.3 for future EDB customised price-quality path (CPP) proposals, immediately upon the amendments coming into force.
- 1.12 We will apply the amended IMs in our setting of the EDB DPP3 determination.

Publishing a consolidated determination

- 1.13 By February 2020, we intend to publish a consolidated version of the EDB IM determination that incorporates the changes made by the EDB IM amendments determination, as well as the changes to the IMs made on 13 November 2019 in respect of the treatment of operating leases.

2. Framework for our decisions

Purpose of this Chapter

- 2.1 This chapter explains the framework we have applied in reaching our decisions. In doing so, it explains:
- 2.1.1 our approach to deciding what potential IM amendments are within the scope of this amendments process; and
 - 2.1.2 for those potential amendments that are within the scope of this amendments process, our approach for deciding whether to make them.

Scope of this amendments process

Statutory context

- 2.2 The purpose of IMs, set out in s 52R of the Act, is to promote certainty for suppliers and consumers in relation to the rules, requirements and processes applying to regulation under Part 4. To that end, IMs, as far as is reasonably practical, are required to set out relevant matters in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier: s 52T(2)(a). In that way, IMs constrain our evaluative judgements in subsequent regulatory decisions and enhance predictability.⁷
- 2.3 However, some uncertainty remains inevitable.⁸ As the Court of Appeal observed in 2012: "certainty is a relative rather than an absolute value",⁹ and "there is a continuum between complete certainty at one end and complete flexibility at the other".¹⁰
- 2.4 The s 52R purpose is thus primarily promoted by having the rules, processes and requirements set upfront (prior to being applied by suppliers or ourselves). However, as recognised in ss 52X and 52Y, these rules, processes and requirements may change. Where the promotion of s 52A requires amendment to an IM, s 52R does not constrain this. This is because s 52A is the central purpose of the Part 4 regime and other purpose statements within Part 4 are conceptually subordinate.¹¹ We must only give effect to these subordinate purposes to the extent that doing so does not detract from our overriding obligation to give effect to the s 52A purpose.¹² Giving

⁷ *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para 213.

⁸ *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para 214.

⁹ *Commerce Commission v Vector Ltd* [2012] NZCA 220, para 34.

¹⁰ *Commerce Commission v Vector Ltd* [2012] NZCA 220, para 60.

¹¹ *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, para 165.

¹² *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289.

effect to the s 52A purpose may, however, require recognition of the role that predictability plays in providing suppliers with incentives to invest in accordance with s 52A(1).

- 2.5 Section 52Y(1) of the Act requires us to review all IMs no later than seven years after their date of publication. This can be viewed as providing a regular review cycle for the IMs. However, within that period, IMs can be amended pursuant to s 52X, and we can conduct a s 52Y review earlier within the seven-year period (as long as it is completed for each IM no later than seven years after publication).
- 2.6 Where we make an amendment to the IMs under s 52X or s 52Y, price-quality paths cannot be reopened on the grounds of those IM changes.¹³ This has the effect of ‘locking in’ the price-quality path for the regulatory period, which is typically 5 years. This provides certainty to suppliers and consumers about the revenue limit and quality standards applying to the supplier for that 5-year period.

Amending the input methodologies under s 52X

- 2.7 Section 52X allows us to amend an IM at any time, provided that, where the change is material, we follow the consultation process set out in s 52V. However, in deciding whether to exercise our power to consult on amendments to the IMs, we must also have regard to s 52A as the central purpose of Part 4, as well as the purpose of IMs (s 52R).
- 2.8 Accordingly, when undertaking a s 52X amendments process, outside the review cycle mandated by s 52Y, we must carefully assess what amendments are most appropriately (in light of ss 52A and 52R) considered through that process, as opposed to being considered through a review of IMs under s 52Y.
- 2.9 On the one hand, it is important that the IMs are appropriate going into the DPP reset—particularly since IM amendments made after the reset will not impact on the DPP.¹⁴ On the other hand, in determining the scope of a s 52X amendments process, we must be mindful that being overly willing to entertain amendments as part of that s 52X amendments process may have an unduly detrimental effect on:
- 2.9.1 the role that predictability plays in providing suppliers with incentives to invest in accordance with s 52A(1); and
 - 2.9.2 the role that the IMs play in promoting certainty for suppliers and consumers in relation to the rules, requirements, and processes in advance of being applied by us and suppliers (for example, in setting the DPP).

¹³ Section 53ZB(1) of the Act.

¹⁴ Section 53ZB(1) of the Act.

The scope of this amendments process

- 2.10 Leading up to a DPP reset, we may need to consider which topics are appropriate to consult on as potential s 52X amendments.
- 2.11 In the present process, we have focused on considering amendments to the IMs that:
- 2.11.1 **support implementation of incremental improvements to the way the DPP is set** – we noted in our EDB DPP3 process paper on 14 June 2018 that we intended to consult on “any associated changes to Information Disclosure and Input Methodology determinations necessary to implement the DPP”.¹⁵ These changes typically relate to the regulatory processes and rules IMs,¹⁶ and examples include: changes to the specification of price IM, such as the introduction of new recoverable costs, or changes to the circumstances in which the DPP may reconsidered – all of which support refinements to the DPP; or
 - 2.11.2 **enhance certainty about the rules and correct for technical errors ahead of the DPP reset** – we have made changes that increase certainty about rules affecting the price-quality path ahead of the DPP being set for the next 5 years, without materially changing the underlying policy settings. We have also corrected errors in the provisions of the IMs that will impact how the price path (including the IRIS¹⁷ mechanism) operates during the EDB DPP3 period, and do not involve any change in policy settings.
- 2.12 Conversely, in light of the considerations discussed at paragraph 2.9 above, it will not generally be appropriate to consider fundamental changes to the IMs as part of a s 52X amendments process.
- 2.13 By fundamental changes, we primarily mean significant changes to the IMs listed in s 52T(1)(a) – being the cost of capital, valuation of assets, allocation of common costs, and treatment of taxation. These IMs provide the foundational building blocks used to set price-quality paths. While we might consider such amendments in exceptional circumstances, we consider that they will normally be more appropriately considered as part of the next s 52Y review of the IMs. Putting this another way, we should not lightly let the s 52X amendment process override the staggered regulatory cycle based on s 52Y reviews.

¹⁵ [Commerce Commission “Default price-quality paths for electricity distribution businesses from 1 April 2020: Proposed process \(14 June 2018\)”, para 10.4.](#)

¹⁶ See section 52T(1)(c) of the Act.

¹⁷ Incremental rolling incentive scheme.

- 2.14 The s 52Y review process is well-suited to considering amendments to these foundational building blocks. Where fundamental changes are being considered to the building blocks, this is best done when all aspects of a particular IM (or a group of IMs) are subject to review, so that stakeholders are able to consider the impact of any changes to some aspects of the IM on the overall policy stance given by the IM as a whole.
- 2.15 In contrast, the changes we have considered as part of this amendments process have primarily been to the IMs listed in s 52T(1)(c) – being the regulatory processes and rules. In considering changes to these IMs under s 52X, we still must be mindful of the considerations discussed at paragraph 2.9 above; however, considering amendments to these regulatory processes and rules IMs is typically not as disruptive to certainty and predictability as is considering significant changes to the fundamental building blocks IMs listed in s 52T(1)(a). Further, amendments to these regulatory processes and rules IMs are often necessary to give effect to incremental enhancements in the way the price path is set and so, in a practical sense, often lend themselves to being considered in parallel with a DPP reset process.¹⁸
- 2.16 We have also recently concluded a s 52X amendments process to make amendments to the EDB IM determination to respond to changes in the International Financial Reporting Standards 16 (IFRS16), which relates to the accounting treatment of operating leases.¹⁹ The intention of these amendments was to promote certainty through maintaining the workability and effectiveness of the IMs in a way that is consistent with their original policy intent and the section 52A purpose. As such, we consider that consulting on these changes under s 52X was consistent with the approach outlined above.

¹⁸ For example, in parallel with the 2015 DPP reset for electricity distributors, we amended the regulatory processes and rules IMs in a way that allowed for the evolution to revenue-linked quality standards and the introduction of a mechanism to encourage energy efficiency and demand side management in the 2015-2020 DPP. As part of that amendments process, we also made a small number of error corrections, and uncontentious changes to the treatment of taxation IM. See Commerce Commission “Input methodology amendments for electricity distribution services: Default price-quality paths” (27 November 2014). We also acknowledged this point – ie, that it can be necessary to make changes to the IMs in parallel with a price-quality path reset process in order to facilitate incremental changes or innovations from one regulatory period to the next – in a discussion draft framework for making IM amendments that we published as context for the 2015/16 IM review (see Commerce Commission “Developing decision-making frameworks for the current input methodologies review and for considering changes to the input methodologies more generally – Discussion draft” (22 July 2015), Attachment B.

¹⁹ [Commerce Commission “Treatment of operating leases: Final decisions paper” \(13 November 2019\)](#).

Decision-making framework for assessing amendments that are within the scope of this amendments process

- 2.17 In deciding whether to make potential IM amendments that were within the scope of this amendments process, we applied a decision-making framework that we have developed over time to support our decision making under Part 4 of the Act.²⁰ This has been consulted on and used as part of prior processes, and helps provide consistency and transparency in our decision making.
- 2.18 Specifically, we have considered whether candidate IM amendments would promote the following outcomes:
- 2.18.1 promoting the Part 4 purpose in s 52A of the Act more effectively than the current IM;
 - 2.18.2 promoting the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
 - 2.18.3 significantly reducing compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).
- 2.19 Where relevant, we have also considered the purpose of default/customised price-quality regulation,²¹ and s 54Q of the Act.
- 2.20 We refer to the outcomes specified in paragraph 2.18 as the **'IM amendments framework outcomes'** in this paper.

The remainder of this paper

- 2.21 In Chapter 3 of this paper, we discuss potential IM amendments that we consider fall within the appropriate scope of this s 52X amendments process. It explains amendments that we decided to make, as well as those that we decided not to make, applying the framework outlined in paragraphs 2.17-2.20.
- 2.22 In Chapter 4 of this paper, we discuss certain IM amendments proposed by submitters that we decided were beyond the scope of this s 52X IM amendments process having regard to the categories in paragraph 2.11 above, and whether there were any exceptional circumstances justifying the inclusion of these proposals in our review. We have not progressed the consideration of those amendments, as we consider that there are not exceptional circumstances that warranted such changes outside the s 52Y review cycle.

²⁰ [See Commerce Commission "Input methodologies review decisions: Framework for the IM review" \(20 December 2016\)](#), para 59.

²¹ Section 53K of the Act.

3. Amendments within the scope of this amendments process

Purpose of this chapter

- 3.1 This chapter describes the amendments we considered fell within the scope of this s 52X amendments process. It explains amendments that we decided to make, as well as those that we decided not to make.

Summary of IM amendments considered as part of this amendments process

- 3.2 We begin this chapter by outlining the IM amendments we considered making as part of this amendments process. In doing so, we group them according to whether they are:²²
- 3.2.1 changes we considered to support implementation of incremental improvements to the way the DPP is set; or
 - 3.2.2 changes we considered to enhance certainty about the rules or correct errors ahead of the DPP reset.
- 3.3 After outlining these amendments, the remainder of this chapter goes on to explain our reasons for making, or not making, them. Our decisions on these amendments reflect the framework described at paragraph 2.18 above.

Changes we considered to support implementation of incremental improvements to the way the DPP is set

- 3.4 We have amended the specification of price IM to:²³
- 3.4.1 introduce the ability for us to specify in a DPP or CPP for distributors a limit or limits on the annual maximum percentage increase in 'forecast revenue from prices';²⁴
 - 3.4.2 introduce a new recoverable cost for expenditure on innovation projects for distributors subject to a DPP or CPP, including consequential amendments to the value of commissioned assets provisions in respect of that recoverable cost;

²² See paragraph 2.11.

²³ See s 52T(1)(c)(i) of the Act.

²⁴ *Electricity Distribution Services Input Methodologies Amendments Determination (No. 2)* [2019] NZCC 20, clause 3.1.1(3).

- 3.4.3 introduce a new recoverable cost for Fire Emergency New Zealand (FENZ) levies for distributors subject to a DPP or CPP;
 - 3.4.4 clarify and extend the scope of the recoverable cost relating to charges for a 'new investment contract' to allow a distributor to use a third-party financier to finance a new investment contract between the distributor and Transpower or another transmission provider.
- 3.5 We considered, but decided not to, amend the specification of price IM to:
- 3.5.1 change the treatment of consumer price index (CPI) as an element of the price path; and
 - 3.5.2 treat insurance costs as a recoverable cost.
- 3.6 We have amended the IM that specifies the circumstances in which a price-quality path may be reconsidered to introduce new reopeners for distributors subject to a DPP to allow for certain projects which require major capital expenditure (capex) for:²⁵
- 3.6.1 new connections (including alterations to existing connections);
 - 3.6.2 system growth;
 - 3.6.3 a combination of new connections (including alterations to existing connections) and system growth; and
 - 3.6.4 asset relocations.

Changes we considered to enhance certainty about the rules or correct errors ahead of the DPP reset

- 3.7 We have made the following changes to correct errors or enhance certainty about the rules ahead of the DPP reset:
- 3.7.1 updated the pass-through cost available to distributors subject to a DPP or CPP for levies that were payable by all members of the Electricity and Gas Complaints Commissioner Scheme to now refer to levies payable by all members of the Energy Complaints Scheme operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010;

²⁵ See s 52T(1)(c)(ii) of the Act.

- 3.7.2 amended the definition of ‘operating costs’, specifically so that court-imposed or statutory fines or penalties cannot be treated as ‘operating costs’;
 - 3.7.3 corrected implementation errors in the IRIS drafting applying to distributors subject to DPPs and CPPs;
 - 3.7.4 corrected typographical errors in matters relating to proposals by a regulated supplier for a CPP;
 - 3.7.5 amended the EDB IM determination to clarify that the definition of ‘other regulated income’ includes gains/losses on disposals; and
 - 3.7.6 amended the quality standard variation provisions to be more generalised so that they do not need to be updated whenever the DPP quality standards or quality incentives are changed.
- 3.8 We considered, but decided not to, make an amendment proposed in submissions to the tax-adjusted market risk premium (TAMRP) term in the cost of capital IM in light of an error by the Commission’s expert, Dr Lally, in the calculation that led to the Commission’s determination of a TAMRP term of 7% in the cost of capital IM.^{26, 27} As discussed later in this Chapter, we have not made this amendment, as Dr Lally’s further analysis suggests that correction of the error would not have changed the TAMRP figure used in the determination.

Amendment to limit the percentage annual increase in forecast revenue from prices

Previous IM requirement

- 3.9 Prior to this amendment, the EDB IMs provided that we may specify an “annual maximum percentage increase in forecast allowable revenue as a function of demand”.²⁸ This provision is intended to limit price increases caused by a reduction in demand on the network of the supplier.²⁹ As discussed in the draft EDB DPP3 reasons paper, we have found this provision difficult to apply in practice for DPP3, and that there are sources of price volatility that it does not account for.³⁰

²⁶ [Vector “Submission to Commerce Commission on changes to the Input Methodologies for Electricity Distributors and Transpower due 5th July” \(5 July 2019\)](#), p 4.

²⁷ Section 52T(1)(a)(i) of the Act.

²⁸ [Electricity Distribution Services Input Methodologies Determination 2012](#), as amended, clause 3.1.1(2).

²⁹ Under a revenue cap, decreases in demand can lead to higher prices as the supplier seeks to maintain its revenue at the allowable limit.

³⁰ [Commerce Commission “Default price-quality paths for electricity distribution businesses from 1 April 2020 - Draft Reasons paper” \(29 May 2019\)](#), paras H42-H46.

3.10 We have retained that provision, in addition to the new provision discussed below.

Draft decision

3.11 In our draft decision, we proposed introducing the new provision in the specification of price IM to allow us, through a DPP, to set a limit on the percentage annual increase in forecast revenue from prices.³¹

3.12 We considered that such a provision would be particularly important in setting EDB DPP3 and future price-quality paths owing to the potential for a number of new sources of price volatility.³²

3.13 In our draft decision, we explained that the new provision is intended to operate as follows.

3.13.1 In setting the DPP, we may set a limit or limits on the percentage annual increase in forecast revenue from prices.

3.13.2 Under that DPP, where a distributor was to consider setting its prices such that the limit would be exceeded, this would be apparent to the distributor during the price-setting process. The distributor would then set prices at a lower level so as to not breach the limit.

3.13.3 The existing wash-up mechanism for over- and under-recovery of revenue would allow a distributor that has so limited its prices to recover any lost revenue in subsequent years. This recovery would take into account the time-value-of-money arising from the delay in the cash flow. As such, the effect of the limit would be net present value (NPV) neutral for the distributor over the course of the regulatory period – while reducing year-to-year price shocks for consumers.

Submitters' views

3.14 Several submitters, while supportive of the concept of smoothing to avoid price shocks to consumers, submitted that the limit on the percentage annual increase in forecast revenue from prices be applied to only the distributor's costs and not to the component of revenues related to the recovery of pass-through and recoverable

³¹ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 3.1.1(2A).

³² [Commerce Commission "Default price-quality paths for electricity distribution businesses from 1 April 2020 - Draft Reasons paper" \(29 May 2019\)](#), Attachment H. Specific sources of volatility include; changes to transmission charges, IRIS incentive adjustments, quality incentive adjustments, and the revenue wash-up draw down amount.

costs.³³ In effect, this would apply the limit not to forecast revenue from prices, but to forecast allowable revenue.

3.15 Orion NZ supported the mechanism in its submission on the EDB DPP3 reset.³⁴

3.16 Aurora Energy submitted that the limit should be applied in constant-price terms, rather than in nominal terms.³⁵

Our final decision

3.17 We have introduced a new clause 3.1.1(1)(b), which is largely based on the provision proposed in our draft EDB IM amendments determination.³⁶ This change gives us the ability, in setting DPPs, to limit price shocks to consumers caused by increases in the gross revenue distributors can earn. It allows us to do this while keeping distributors whole across the regulatory period – ie, it is NPV neutral for distributors.

3.18 Our response to submissions that any limit be applied to only the distributor's costs is that this would effectively undermine the purpose of the mechanism. Under a revenue cap, revenue net of pass-through and recoverable costs will see very little volatility. Were pass-through and recoverable costs excluded, significant sources of volatility would pass-through to consumers, creating price shocks.

3.19 Of the major sources of potential volatility, most relate to the distribution business itself, rather than to costs imposed by a third party. The IRIS and quality incentive adjustments relate to the previous performance of the distributor, and the revenue wash-up draw down amount is a key element of the revenue cap regime. We consider it appropriate that recovery of these incentive payments is deferred. If the limit binds, then the distributor's cash flows will be delayed, but any revenue reduction will be able to be recovered in future years along with a time-value-of-money adjustment.

³³ See for example: [Wellington Electricity "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\), p 18](#); [ENA "Submission on IM amendments for DPP and IPP" \(5 July 2019\), p 2](#); [Vector "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\), para 257](#).

³⁴ [Orion "Submission on EDB DPP reset draft decisions paper" \(17 July 2019\), para 46](#).

³⁵ [Aurora "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\), para 8.3](#).

³⁶ *Electricity Distribution Services Input Methodologies Amendments Determination (No. 2)* [2019] NZCC 20, clause 3.1.1(1)(b). The change from our draft decision is that this new clause now goes towards calculating the maximum revenues that may be recovered by an EDB for the purposes of section 53M(1)(a) of the Act.

- 3.20 Transpower charges are one source of potential volatility independent of a distributor's business performance. In this regard, we note:
- 3.20.1 in the Electricity Authority's "Transmission pricing methodology: 2019 issues paper", Table 12 lists the 2022 changes in charges that would result from adopting a proposed transmission pricing methodology.³⁷ The largest increase, relative to 2022 maximum allowable revenue, would be 11.9% for Horizon Energy (based on our updated EDB DPP3 draft decision). In such a case, recovery of only around 2% of the increase would need to be deferred;
 - 3.20.2 in the same paper, the Electricity Authority proposes a transitional price cap to minimise the risk of high price rises;³⁸ and
 - 3.20.3 Transpower's individual price-quality path for the regulatory period commencing 1 April 2020 includes price smoothing without annual updates to its maximum allowable revenue (MAR), and we expect this to limit changes in Transpower charges during the EDB DPP3 period.³⁹
- 3.21 We have not adopted the approach (proposed by Aurora Energy) of applying the limit in constant-price terms because any benefits would be unlikely to outweigh the increased complexity because:⁴⁰
- 3.21.1 within a DPP determination, we may specify the percentage limit, and can take account of likely CPI changes when doing so;
 - 3.21.2 the approach would not have a very material impact on the operation of the limit;
 - 3.21.3 the approach would add complexity to both the specification of the limit and to the calculations relating to the limit; and
 - 3.21.4 we expect that the limit will bind relatively infrequently.

How the amendment is likely to promote an IM amendments framework outcome

- 3.22 The purpose of the new provision is to allow us to, in setting a DPP, limit year-to-year price shocks to consumers caused by increases in gross revenue distributors can earn. This promotes the long-term benefit of consumers, for whom year-to-year price shocks can be undesirable.

³⁷ [Electricity Authority "Transmission pricing methodology: 2019 issues paper" \(30 July 2019\)](#), p 16.

³⁸ [Electricity Authority "Transmission pricing methodology: 2019 issues paper" \(30 July 2019\)](#), para 3.9.

³⁹ [Commerce Commission "Transpower Individual Price-Quality Path from 1 April 2020 – Companion paper to final RCP3 IPP determination and information gathering notices" \(14 November 2019\)](#).

⁴⁰ [Aurora Energy "Submission on EDB DPP reset draft decision paper" \(18 July 2019\)](#).

- 3.23 As explained above, the presence of the existing wash-up mechanism for over- and under-recovery of revenue ensures that, where the new clause 3.1.1(1)(b) is applied to limit price increases in a given year, the distributor is able to recover the lost revenue (ie, the additional revenue it would have earned in that year but for the limit on annual price increases) in subsequent years. This future recovery would take into account the time-value-of-money arising from the delay in the cash flow. As such, the effect of the limit would be NPV neutral for the distributor over the course of the regulatory period. As such, the new provision allows us to promote the long-term benefit of consumers by limiting price shocks to consumers without detrimentally affecting electricity distributors incentives to invest (s 52A(1)(a)).

Amendment to introduce new recoverable cost in respect of expenditure on innovation projects

Previous requirement

- 3.24 There was no recoverable cost for distributors in respect of expenditure on innovation projects. Distributors treated any expenditure of this type as capex or operating expenditure (opex).⁴¹

Draft decision

- 3.25 A focus of the EDB DPP3 reset process has been on promoting greater innovation in the electricity distribution sector. Our draft decisions on both the EDB DPP3 and the EDB IM determination amendments identified that delivering on our intent to better promote innovation through the EDB DPP3 reset would likely require supporting IM changes.
- 3.26 In our draft decision on the IM amendments, we proposed to introduce a new capped recoverable cost term for an ‘innovation project allowance’,⁴² which is for expenditure by distributors on innovation projects. We proposed defining this new recoverable cost term in the EDB IMs as all recoverable cost terms are defined within the specification of price IMs, which promotes certainty about the rules (consistent with s 52R).⁴³
- 3.27 We proposed that certain details relating to the new recoverable cost term would be specified in each s 52P price-quality path determination (ie, in a DPP or CPP

⁴¹ We consider innovation to be creating, developing, or applying a new or improved technology, approach, or process in respect of the provision of electricity lines services in New Zealand.

⁴² [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 3.1.3(1)(x).

⁴³ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 1.4.1(2), definition of **innovation project allowance**.

determination) as part of the process of setting price-quality paths. For example, we proposed that we could set the following details in a s 52P determination:

- 3.27.1 the level of the cap;
 - 3.27.2 the level of contribution that must be made by the distributor (ie, expenditure on the innovation project treated as regulated capex or opex); and
 - 3.27.3 the requirements for approval by the Commission.
- 3.28 We proposed setting these details in the s 52P determinations (eg, in DPPs or CPPs) so that details of the allowance for a given price-quality path could be set specifically for that regulatory period depending on the required strength of the incentive at the time, the success of the incentive in prior periods, and the changing circumstances of the electricity sector.

Submitters' views

- 3.29 There was no consensus in submissions on our draft decision on the introduction and scale of the innovation mechanism. Several submitters supported an innovation mechanism (often submitting that the limit should be higher), while others submitted that it should not be introduced at all. For example:
- 3.29.1 MEUG suggested that there was insufficient evidence of lower than optimal levels of innovation to support such a mechanism.⁴⁴
 - 3.29.2 Several submissions submitted that the introduction of the fund would result in inefficient outcomes for consumers and stifle innovation in competitive markets.⁴⁵
- 3.30 A more detailed discussion of the submissions we received regarding the promotion of greater innovation in the electricity distribution sector will be set out in the EDB DPP3 reasons paper.⁴⁶

⁴⁴ [MEUG "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\)](#), pp 5-7.

⁴⁵ [Meridian "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\)](#), pp 2-3; [Contact Energy "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\)](#), p 2; and [ERANZ "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\)](#), p9-10.

⁴⁶ Available on our website following publication on 27 November 2019 at: <https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-default-price-quality-path/2020-2025-default-price-quality-path>

Our final decision

- 3.31 We have retained our draft decision to amend the IMs to introduce an innovation project allowance recoverable cost term. The recoverable cost will be for an amount drawn down by an EDB from its ‘innovation project allowance’, requiring ex-post approval by the Commerce Commission (Commission) for that purpose.⁴⁷ The details of the innovation project allowance for a given price-quality path period is to be defined in the relevant s 52P determination.⁴⁸
- 3.32 As a result of the new recoverable cost for innovation, we have also made other consequential changes to the IMs. Specifically, we have amended the definition of commissioned assets in Parts 2 and 5 of the EDB IMs to explicitly exclude the amount of the innovation project allowance recoverable cost. We have done this because:
- 3.32.1 In the IMs, recoverable costs are already specifically excluded from the definition of operating cost and therefore opex; however, there was no equivalent exclusion for capex. This means, absent the consequential change we have made to the definition of commissioned assets, where a distributor used the innovation project allowance in the commissioning of an asset, it would have to count the expenditure as both a recoverable cost and capex.
- 3.32.2 By making the consequential change to the definition of commissioned assets, where a distributor uses the innovation project allowance in commissioning an asset, it will not account for the expenditure as opex or capex. This option provides certainty for suppliers and ensures that suppliers are not able to ‘double-recover’ the innovation project allowance at the expense of consumers.
- 3.33 A more detailed discussion of how the mechanism will operate in EDB DPP3 will be set out in the EDB DPP3 reasons paper.⁴⁹

⁴⁷ The innovation project allowance means, in respect of a particular EDB, a maximum amount set by the Commission as an allowance, which the EDB may draw down (requiring ex-post approval by the Commission), for costs incurred by that EDB in relation to one or more innovation projects.

⁴⁸ The details of the innovation project allowance for EDB DPP3 will be set out in our EDB DPP3 decisions to be published 27 November 2019.

⁴⁹ Available on our website following publication on 27 November 2019 at: <https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-default-price-quality-path/2020-2025-default-price-quality-path>

How the amendment is likely to promote an IM amendments framework outcome

- 3.34 We consider that the introduction of the innovation project allowance recoverable cost term is likely to promote the long-term interests of consumers by allowing us to set better incentives for innovation in DPPs and CPPs (consistent with s 52A(1)(a)).
- 3.35 The lack of consensus in submissions in response to our draft decision on the introduction and scale of the innovation mechanism reflects that an innovation mechanism carries both benefits and potential risks for consumers.
- 3.36 However, we consider that the potential longer-term innovation benefits to consumers from the introduction of the innovation project allowance outweigh the shorter-term cost to consumers. The introduction of the innovation project allowance recoverable cost term allows us to, through a DPP or a CPP, incentivise electricity distributors to undertake innovation projects that may not otherwise have occurred, and consumers would not otherwise have received the benefit of.
- 3.37 In reaching this decision we have been mindful of the risks to consumers of introducing an innovation project allowance recoverable cost term. For example, there is some risk that the innovation recoverable cost may cover expenditure that would have happened without its introduction, resulting in a higher cost for consumers and without any additional long-term benefit. The design of the mechanism – ie, enabling the allowance through the inclusion of a recoverable cost term in the IMs, and then setting the details of the innovation project allowance for a particular price-quality path in the relevant s 52P determination – mitigates this risk:
- 3.37.1 through setting the level of allowance for a given DPP period, or a CPP period, as the case may be, we are able to limit the exposure of consumers to the cost of the innovation project allowance;
 - 3.37.2 through setting the criteria for the Commission to approve an allowance within a DPP period, or a CPP period, as the case may be, we have introduced checks and balances on the approval of the allowance draw down for a given project; and
 - 3.37.3 by setting the details of the level of the allowance and the criteria for approval in the relevant s 52P determination, we are able to adjust these details periodically as part of the price-quality path setting process to take account of new evidence about the effectiveness of the innovation project allowance in previous regulatory periods and the levels of innovation by electricity distributors more generally.
- 3.38 More information about how the innovation project allowance will be set for EDB DPP3 will be available in our EDB DPP3 reasons paper to be published on

27 November 2019. The discussion in this paper specifically above relates to our decision to include a new ‘innovation project allowance’ recoverable cost term in the EDB IMs, which facilitates the setting of an innovation project allowance through the DPP.

Amendment to introduce a recoverable cost in respect of FENZ levies

Previous requirement

- 3.39 EBDs are required to contribute to the funding of FENZ through levies on certain insurance contracts they hold.
- 3.40 Prior to today’s amendment, FENZ levies paid by distributors were not included in the IMs as a recoverable cost. Instead, they have previously been considered when forecasting opex allowances under a DPP or CPP.

Draft Decision

- 3.41 Treating FENZ levies as a recoverable cost, rather than forecasting them as part of setting the opex allowance for the DPP, was first proposed in a submission on our EDB DPP3 Issues Paper from the Electricity Networks Association (ENA).⁵⁰
- 3.42 Our draft decision as part of this IM amendments process was to adopt the ENA’s suggestion and we included FENZ levies as a recoverable cost in our draft EDB IM amendments determination.⁵¹
- 3.43 As the quantum of these levies is largely outside of the control of distributors, we considered the nature of these costs are more akin to being recoverable costs than operating costs. We considered that the amendment would also address forecasting risk arising from the uncertainty in future levy rates, as well as any changes in amounts charged to the distributors as a result of the Government’s signalled review of the levy-based funding model.

Submitters’ views

- 3.44 Transpower and ENA generally supported the decision but submitted that FENZ levies should be a pass-through cost, rather than a recoverable cost, in order to apply a consistent treatment of industry levies.^{52, 53}

⁵⁰ [ENA “DPP3, April 2020 – Commission Issues paper – ENA Submission Part One: Regulating capex, opex & incentives” \(20 December 2018\)](#), p 16.

⁵¹ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 3.1.3(1)(w).

⁵² [Transpower “Proposed amendments to input methodologies” \(5 July 2019\)](#), p 1.

⁵³ [ENA “Submission on EDB DPP reset draft decisions paper” \(18 July 2019\)](#), p 15.

3.45 The ENA and PowerNet submitted that, in addition to FENZ levies, all of the costs of insurance should also be treated as a recoverable cost for distributors.⁵⁴ The ENA noted that insurance costs are increasing “way beyond any ‘trend level’ from a scale driven opex model”.⁵⁵ We discuss this proposed amendment separately later in this chapter.

Our final decision

3.46 Our decision is to retain our draft decision and amend clause 3.1.3 of the EDB IM determination to include the FENZ levy as a new recoverable cost.

3.47 We consider that FENZ levies are more suited to being treated as a recoverable cost than an amount to be forecast in setting distributors’ base opex allowance because:

3.47.1 The level of FENZ levies payable by a distributor is largely outside of their control. As such, there is little incentive benefit to exposing distributors to any difference between forecast and actual FENZ levies.

3.47.2 The Government is currently reviewing the way FENZ is funded,⁵⁶ which makes forecasting the amount of future FENZ levies payable by distributors challenging in setting the opex allowance under a DPP or CPP. One possible outcome of the review is that FENZ ceases to be levy funded, in which case treating FENZ levies as opex rather than a recoverable cost would result in distributors still being able to recover from consumers the amount we forecast for the levies, despite the distributors not having to pay those levies.

3.47.3 Therefore, continuing to treat FENZ levies as an opex amount to be forecast in setting a DPP or CPP, rather than treating them as a recoverable cost, could have resulted in consumers over-paying, or us setting an insufficient expenditure allowance for distributors.

3.48 In response to Transpower’s submission referred to above, we consider that the nature of the FENZ levy is more akin to a recoverable cost than a pass-through cost. The FENZ levy is a levy on insurance contracts and not a levy directly on distributors, so it does not meet the definition of a pass-through ‘levy’. The main difference between pass-through and recoverable costs is that recoverable costs are not fully

⁵⁴ [ENA “Submission on EDB DPP reset draft decisions paper” \(18 July 2019\)](#), p 15; [PowerNet “Submission on EDB DPP reset draft decisions paper” \(18 July 2019\)](#) p 3.

⁵⁵ [ENA “Submission on EDB DPP reset draft decisions paper” \(18 July 2019\)](#), p 15.

⁵⁶ Office of the Minister of Internal Affairs “Fire and Emergency New Zealand: a funding review” (released 25 March 2019); see also Department of Internal Affairs “[Fire and Emergency New Zealand Funding Review – Consultation document](#)” (October 2019).

controllable by distributors, but are not completely outside the control of distributors, and there may be judgement involved as to how much should be passed through.⁵⁷ We acknowledge that, practically speaking, there is often little difference between our treatment of the categories, because the mechanism for recovering the pass-through and recoverable costs is the same.⁵⁸

How the amendment is likely to promote an IM amendments framework outcome

3.49 This amendment to treat FENZ levies as a recoverable cost promotes s 52A because:

3.49.1 it will avoid consumers over-paying in the event that the FENZ levies faced by distributors in a given regulatory period turn out lower than we would have forecast in setting the price-quality path for that period. This would be most acute in a scenario where the Government decides to discontinue the levy-based funding model altogether after we had already included an allowance for the FENZ levy in setting distributors' revenue allowances. In this sense, the change promotes s 52A(1)(d).

3.49.2 it will avoid us setting an insufficient expenditure allowance for a distributor where the actual level of the levy payable by the distributor turns out to be higher than we forecast when setting the revenue allowance. In this sense, the change promotes s 52A(1)(a).

3.50 Making clear that FENZ levies are not included in opex allowances and are instead separate recoverable costs set out in the IMs also promotes certainty about the rules (consistent with s 52R).

Amendment to ensure pass-through of Energy Complaints Scheme levies

Previous requirement

3.51 Our EDB IM determination previously allowed for levies payable 'by all members of the Electricity and Gas Complaints Commissioner Scheme by virtue of their membership' to be treated as a 'pass-through cost'.⁵⁹

⁵⁷ [Input Methodologies \(Electricity Distribution and Gas Pipeline Services\) Reasons Paper \(December 2010\)](#), para 8.3.25.

⁵⁸ [Input Methodologies \(Electricity Distribution and Gas Pipeline Services\) Reasons Paper \(December 2010\)](#), para 8.3.26

⁵⁹ *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clause 3.1.2(2)(b)(iii). Our reasons for introducing this levy are explained in [Commerce Commission "Input Methodologies \(Electricity Distribution and Gas Pipeline Services\) Reasons Paper" \(December 2010\)](#), para 8.3.31.

Draft Decision

- 3.52 We proposed amending our EDB IM determination to no longer reference levies payable ‘by all members of the Electricity and Gas Complaints Commissioner Scheme by virtue of their membership’, and to instead reference levies payable ‘by all members of the Energy Complaints Scheme operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010’.⁶⁰
- 3.53 This amendment was proposed because the reference to ‘Electricity and Gas Complaints Commissioner Scheme’ is now redundant due to ‘The Office of the Electricity and Gas Complaints Commissioner’ being rebranded as ‘the Energy Complaints Scheme operated by Utilities Disputes Limited’ in 2016.⁶¹

Submitters’ views

- 3.54 We received no submissions on this amendment.

Our final decision

- 3.55 Our decision is to amend clause 3.1.2 of the EDB IM determination to no longer reference levies payable ‘by all members of the Electricity and Gas Complaints Commissioner Scheme by virtue of their membership’, and to instead reference levies payable ‘by all members of the Energy Complaints Scheme operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010’.

How the amendment is likely to promote an IM amendments framework outcome

- 3.56 Our decision updates clause 3.1.2 of the EDB IM determination to reflect the correct name of the scheme previously referred to as the Electricity and Gas Complaints Commissioner Scheme, thereby clarifying potential uncertainty about how such levies are to be treated (consistent with s 52R).

⁶⁰ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 3.1.2(2)(b)(iii).

⁶¹ For more information about this rebranding, see: https://www.utilitiesdisputes.co.nz/UD/About_us/History_of_Utilities_Disputes/UD/AboutUs/History_of_Utilities_Disputes.aspx.

Amendment to treatment of New Investment Contract charges

Previous requirement

3.57 Our EDB IM determination previously included as an allowable recoverable cost a charge payable by a distributor to Transpower in respect of a ‘new investment contract’ between those parties, or an equivalent type of contract.⁶²

3.58 Our 2010 decision stated:⁶³

“new investment contract (NIC) charges, which are charges payable by a distributor under an NIC with Transpower, or an equivalent contract with another transmission provider (subject to approval by the Commission)”.

Proposed amendment

3.59 We did not propose an amendment for this recoverable cost in our draft decision. In submissions on our draft EDB DPP3 decision, Transpower proposed that the EDB IM determination should be amended to provide the costs of third-party finance contracts with unrelated third parties to fund costs under investment contracts are a recoverable cost.⁶⁴

3.60 Similarly, Network Tasman submitted in its submission on the draft EDB DPP3 decision that it expects to have a new grid exit point (GXP) serving its network during EDB DPP3 and that the GXP would be built by Transpower using a NIC with Transpower.⁶⁵ It noted that the rate of return that Transpower requires on its investment is greater than Network Tasman’s current cost of debt, and it was considering the possibility of using debt to repay the entire cost of the NIC and to recover the cost of debt from customers over a longer term. Tasman noted, however, that the IM recoverable cost provision would have not allowed for this.

3.61 There were no cross-submissions on this point.

Our final decision

3.62 In our view, the previous clause 3.1.3 (1)(c) could more clearly state what costs could be recovered by an distributor. The policy intent in our 2010 IM reasons paper was

⁶² *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clauses 3.1.3(1)(c) and 3.1.3(6). “New investment contract” is defined in the Electricity Industry Participation Code which has the same meaning as ‘code’ is defined in the Electricity Industry Act 2010.

⁶³ [Commerce Commission, Input Methodologies \(Electricity Distribution and Gas Pipeline Services\) Reasons Paper 2010](#), paras 8.3.35 and J2.22.

⁶⁴ [Transpower “Submission on EDB DPP reset draft decisions paper” \(18 July 2019\)](#), p 2.

⁶⁵ [Network Tasman “Submission on EDB DPP reset draft decisions paper” \(18 July 2019\)](#), p 9.

for charges payable by a distributor to Transpower in respect of a NIC, or an equivalent contract with another transmission provider (subject to the approval by the Commission) to be recoverable costs.

- 3.63 While clause 3.1.3(c) of the EDB IM determination allowed a distributor to recover the costs of a NIC or equivalent contract, we agree with Transpower that the clause did not allow for a distributor to recover the costs where a third-party finances the contract.
- 3.64 In our view, the Transpower's proposed amendment is consistent with the underlying policy intent to allow costs of this nature to be recovered by distributors.
- 3.65 We consider it necessary to amend clause 3.1.3(c) before the EDB DPP3 reset as recoverable costs form part of the price path. That way, a distributor considering a NIC contract (or equivalent contract) can recover costs it incurs over EDB DPP3, where it has decided to use a third-party financing option.
- 3.66 Therefore, our decision is to amend clause 3.1.3(1)(c) of the EDB IM determination to extend the scope of the recoverable cost relating to charges for a 'new investment contract' (as defined in the Electricity Industry Participation Code). The amendment will allow a distributor to use a third-party option to finance a NIC between the distributor and Transpower (or an equivalent contract with another transmission provider).
- 3.67 We have also amended the clause to explicitly provide for an appropriate level of scrutiny of any new third-party contract. This amendment is consistent with:
- 3.67.1 our view in our 2010 IM reasons paper, which noted that the distributor has a degree of control over these types of costs, and therefore it is appropriate for us to assess applications for approval of recoverable costs on a case-by-case basis;⁶⁶ and
- 3.67.2 Transpower's NIC contract requirements, as defined in the Transpower IMs, which includes, among other things, a requirement for Transpower to demonstrate that the terms and conditions of the contract were determined following a process that provided opportunities for Transpower's affected customers to make or approve reasonable price-

⁶⁶ [Commerce Commission, Input Methodologies \(Electricity Distribution and Gas Pipeline Services\) Reasons Paper 2010](#), para J2.11.

quality trade-offs; and the competitive provision of new electricity transmission services by parties other than Transpower.⁶⁷

- 3.68 Finally, we have also clarified clause 3.1.3(1)(c) of the EDB IM determination to explicitly set out that an “equivalent contract” relates to an alternative transmission provider. This is because the previous clause gave rise to some ambiguity and did not necessarily reflect the policy intent of our 2010 EDB IM reasons paper, which stated that an distributor could recover the costs of a NIC contract or an equivalent contract “with another transmission provider (subject to approval by the Commission)”.⁶⁸

How the amendment is likely to promote an IM amendments framework outcome

- 3.69 We consider that the amendment promotes the Part 4 purpose in s 52A of the Act, specifically s 52A(1)(a). Our decision extends the scope of the recoverable cost to remove a barrier to distributors making necessary network enhancements and possibly to reduce the financing costs of enhancements (for example, where the rate of return that Transpower requires on its investment is greater than a distributor’s alternative financing options). Where third-party financing reduces the costs of financing network enhancements, these efficiencies should be shared with consumers in future regulatory periods, thus also promoting s 52A(1)(c) of the Act.
- 3.70 By including a requirement for the Commission to provide prior approval to any agreement between the distributor and third-party or alternative transmission provider, our amendment also applies an additional layer of scrutiny to the level of costs that an distributor can recover. While this might increase the compliance costs of an application, we consider that requiring Commission scrutiny is consistent with the existing constraints on Transpower and incentivises the distributor to ensure that any new recoverable cost is efficiently incurred. We consider that this is consistent with the policy intent as set out in the 2010 EDB IM reasons paper.⁶⁹
- 3.71 Clarifying the meaning of “equivalent contract” to specifically refer to alternative transmission providers, as intended in our 2010 EDB IM reasons paper, removes any ambiguity in clause 3.1.3(1)(c) of the EDB IM determination and promotes the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose). While our 2010 EDB IMs reasons paper was clear that the clause intended to allow distributors to recover costs of a contract equivalent to a NIC charge payable to Transpower, our clarification will provide

⁶⁷ [Transpower Input Methodologies Determinations 2010](#), as amended, clause 1.1.4(2), definition of ‘new investment contract’.

⁶⁸ [Commerce Commission, Input Methodologies \(Electricity Distribution and Gas Pipeline Services\) Reasons Paper 2010](#), para 8.3.35 and J2.22.

⁶⁹ [Commerce Commission, Input Methodologies \(Electricity Distribution and Gas Pipeline Services\) Reasons Paper 2010](#), para 8.3.35 and J2.22.

greater certainty to distributors that they can enter agreements with alternative transmission providers and recover costs from consumers.

Decision not to amend the treatment of CPI as an element of the price path

- 3.72 In response to submissions on our draft EDB IM amendments and draft EDB DPP3 decision, we have considered – but have decided not to – amend the specification of price IM to change the treatment of CPI as an element of the price path.
- 3.73 The arguments raised by submitters objecting to the CPI methodology apply (in most cases) to both CPI in the specification of price IM and in the asset valuation IM.⁷⁰ For the reasons set out in Chapter 4, we consider substantive amendments to the asset valuation IM beyond the scope of this IM amendment process.

Current IM requirements

- 3.74 The revenue path is determined on a nominal basis (consistent with the CPI-X DPP/ CPP regime outlined in Part 4, Subpart 6 of the Act). When using a BBAR/MAR model to determine ‘starting prices’, our current approach requires a forecast of CPI to project annual revenues for each year of a DPP or CPP period. During the regulatory period, the revenue cap wash-up mechanism then washes up for the difference between forecast CPI and actual CPI.
- 3.75 The approach to forecasting CPI we must use when setting a DPP or CPP is determined by the EDB IMs.⁷¹ This requires us to use forecasts based on the Reserve Bank of New Zealand’s (RBNZ) forecasts of inflation issued as part of the Monetary Policy Statement immediately prior to the determination of the weighted average cost of capital (WACC) for the DPP.⁷² For the out-years, beyond where RBNZ forecasts are available, we are to assume a linear reversion to the RBNZ inflation target of 2%.

⁷⁰ See for example; [Centralines “Submission on companion paper to updated models” \(9 October 2019\)](#), page 3; [Unison Networks “Submission on companion paper to updated models \(9 October 2019\)](#), page 1; [Vector “Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower” \(5 July 2019\)](#).

⁷¹ [Commerce Commission Electricity Distribution Services Input Methodologies Determination 2012 \[2012\] NZCC 26 \(Consolidated as at 31 January 2019\)](#) clauses 3.1.1(7)-(8).

⁷² For the 2019 EDB DPP3 reset, the WACC was determined on 25 September 2019, [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 \(25 September 2019\)](#); the relevant monetary policy statement is [Reserve Bank of New Zealand “Monetary Policy Statement August 2019” \(7 August 2019\)](#). For a CPP, the relevant WACC is the one that applies to the DPP that is in force at the time the CPP is determined, with a reopener to reset revenues available for when the DPP WACC changes.

- 3.76 In addition to forecasts of CPI, the EDB IMs also require actual CPI to be used when determining actual net allowable revenue for each year of a DPP or CPP regulatory period.⁷³ This requires distributors to use CPI stipulated for each quarter in Statistics New Zealand’s ‘All Groups Index SE9A’ for the relevant year when calculating the revenue wash-up draw down amount.

Proposed changes suggested by submitters

- 3.77 In general, stakeholders were concerned that our forecasts may over-estimate inflation. In its report on behalf of Vector, Competition Economists Group (CEG) proposed greater reliance on inflation-linked government bonds (or “breakeven inflation”) when forecasting inflation.⁷⁴ While not proposing a specific alternative, Unison and the Centralines recommended that we take a conservative approach to forecast CPI.⁷⁵
- 3.78 CEG’s principal critique of the current IM was that it has persistently over-forecast inflation since 2009, to an extent that is extremely unlikely to result from random forecast error.⁷⁶ This analysis covers the post-2008 financial crisis period, and the 2014-2016 period of exceptionally low global inflation. As CEG notes, prior to 2008, the method performed better, with approximately equal instances of over- and under-forecasting.⁷⁷
- 3.79 Considering whether the risk of continued over-forecasting warrants an alternative methodology involves making a judgement as to whether these trends will persist in future. On balance, we are not convinced that the trend from 2008-2018 should be solely relied on, and the evidence of performance prior to that ignored. We note, as shown in Figure 3.1 below, that since 2016 CPI (as reported by Stats NZ) has begun to return to levels approaching 2%.

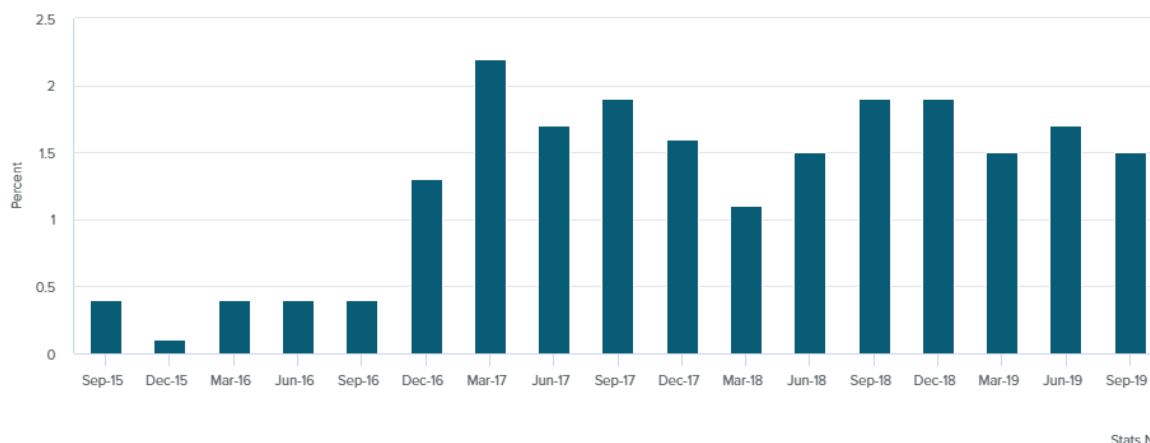
⁷³ [Commerce Commission Electricity Distribution Services Input Methodologies Determination 2012 \[2012\] NZCC 26 \(Consolidated as at 31 January 2019\)](#) clauses 1.1.4(2) and 3.1.3(13)(i)(ii).

⁷⁴ [CEG on behalf of Vector “Submission on IM amendments for DPP and IPP” \(5 July 2019\)](#), p 38.

⁷⁵ [Centralines “Submission on companion paper to updated models” \(9 October 2019\)](#), p 3; [Unison Networks “Submission on companion paper to updated models \(9 October 2019\)](#), p 1.

⁷⁶ [CEG on behalf of Vector “Submission on IM amendments for DPP and IPP” \(5 July 2019\)](#), pp 21-22.

⁷⁷ [CEG on behalf of Vector “Submission on IM amendments for DPP and IPP” \(5 July 2019\)](#), para 63.

Figure 3.1: CPI, annual change, September 2015-2019⁷⁸

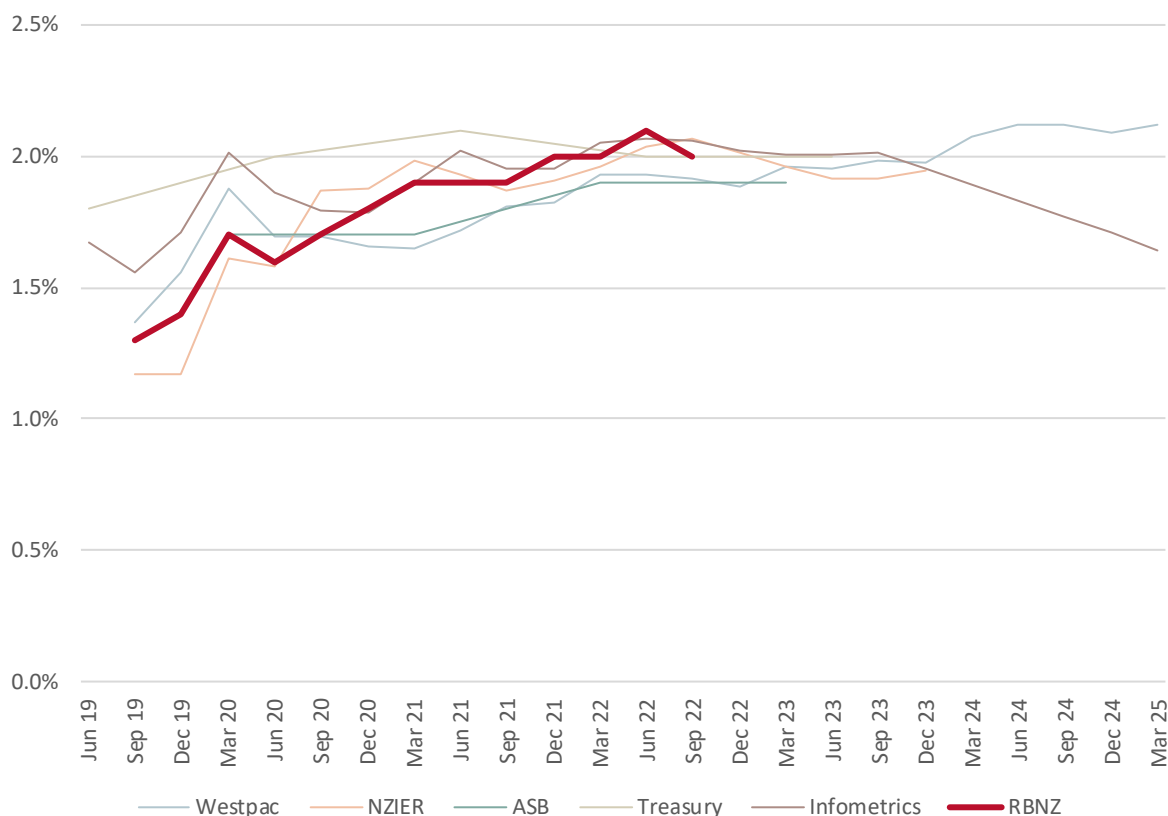
3.80 However, given the concerns about the RBNZ forecasts identified in submissions, we have assessed possible alternatives. These are: different expert forecasts of inflation, and, as suggested by CEG, use of breakeven inflation. We have also considered the links between CPI inflation and other aspects of our regime; specifically, the approach we have taken in DPPs when forecasting input price inflation.

Other forecasts of inflation

3.81 To understand whether RBNZ forecasts are in some way out of step with market expectations of inflation, we have compared them against other available CPI forecasts from trading banks and expert forecasters. As shown in Figure 3.2, the RBNZ forecasts are within the middle of the range, and if anything, under-state short-term inflation relative to other available sources.

3.82 Given the limited difference between the forecasts we make use of and others available, we see no compelling basis for change.

⁷⁸ [Stats NZ "Consumers price index: September 2019 quarter" \(16 October 2019\).](#)

Figure 3.2: Comparison of CPI forecasts

Breakeven inflation

3.83 The CEG report proposes, as a possible alternative: “giving more weight to market based estimates of expected inflation – such as the breakeven inflation rate”.⁷⁹ Breakeven inflation is calculated by taking the difference between nominal bonds and comparable inflation-indexed bonds. This difference can provide information about market expectations of inflation.

3.84 Recent New Zealand Treasury analysis of the use of breakeven inflation noted that:

3.84.1 breakeven inflation in recent years has run below forecasters’ views of inflation;⁸⁰

3.84.2 as inflation-indexed bonds are less liquid than nominal bonds, the higher yield demanded by investors will lead to breakeven inflation being

⁷⁹ [CEG on behalf of Vector “Submission on IM amendments for DPP and IPP” \(5 July 2019\)](#), para 123.

⁸⁰ [Treasury “Risk-Free Discount Rates and CPI Inflation - Assumptions for Accounting Valuations” \(21 May 2019\)](#), p. 22.

lower than expected inflation (with international estimates suggesting this premium is at least 0.3%);⁸¹ and

- 3.84.3 that breakeven inflation may differ from expected inflation due to investors paying an inflation risk premium, while noting that internationally the premium is currently negative.⁸²
- 3.85 Further use of this technique, within the context of a full review of the balance of risks and benefits the IMs provide, may be warranted in future. However, such a consideration would also require a reassessment of the use of CPI in asset valuation, and the relationship to the cost of capital IMs, which for the reasons discussed in Chapter 2, goes beyond what is appropriate in a section 52X IM amendment process.

Relationship of price path CPI inflation to other elements of the regime

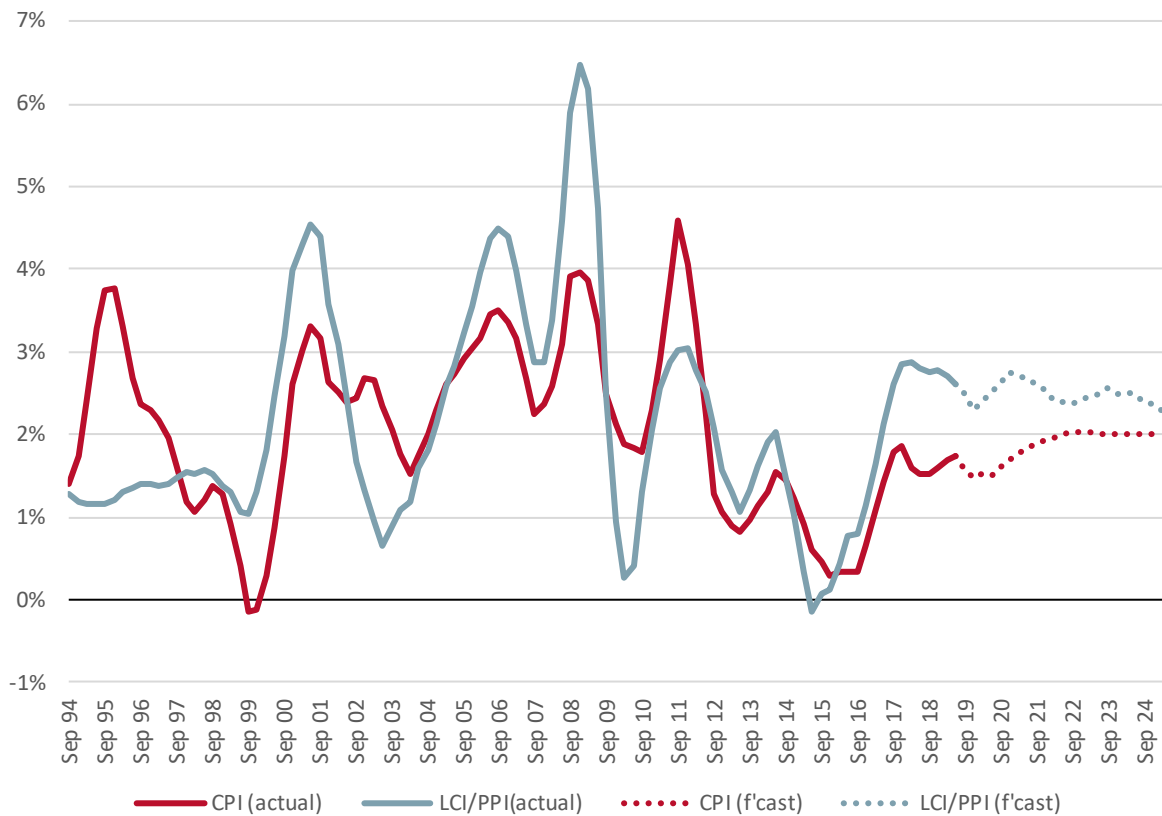
- 3.86 Finally, we note that the risk to consumers and distributors from CPI forecast error can be partially offset by the way we approach setting price-paths; specifically through the use of input price inflators in determining opex and capex forecasts.
- 3.87 While this approach is not determined by the IMs, the availability of this option further decreases the materiality of the risks involved. To the extent that CPI inflation is over- or under-forecast, the effect of this will likely be offset by similar over- or under-forecasts of input price inflation, which has the opposite impact on distributor revenue.
- 3.88 Historically, the link between CPI inflation and Labour Cost Index (LCI) / Producer Price Index (PPI) (the inflators we have used historically for opex) has been consistent, as shown in Figure 3.3. While this off-setting effect is only partial (as the IRIS mechanism will share opex or capex differences between consumers and distributors), it works to limit the materiality of inflation forecast error on both sides (CPI and LCI/PPI).
- 3.89 Were we to amend our approach to CPI inflation, we would need to consider this interlinkage, and potentially changes to the basis on which the IRIS mechanism works. Again, such a fundamental reconsideration of the sources of risk distributors and consumers are exposed to, and the incentives distributors face goes beyond what is appropriate to consider in this section 52X process.⁸³

⁸¹ Ibid, p. 22 and 25.

⁸² Ibid p. 22 and 25.

⁸³ We note that this issue was already considered as part of the 2016 IM review [Commerce Commission "Input methodologies review decisions Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" \(20 December 2016\)](#), paras 254-302.

. Figure 3.3: Comparison of CPI and LCI/PPI inflation⁸⁴



Our decisions to not make an amendment

3.90 Given the analysis above, we have not made an amendment because:

- 3.90.1 consistent with our decision in the 2016 EDB IM review, we consider the current method for forecasting CPI as an element of the price path is meeting its policy intent;
- 3.90.2 we do not consider any of the alternatives proposed in submissions would better promote the purpose of Part 4 or of the IMs; and
- 3.90.3 any changes to the method we use to forecast CPI need to be considered alongside the cost of capital IMs (discussed in Chapter 4) and the IRIS efficiency incentives.

⁸⁴ Four-quarter average of annual change in inflation. LCI/PPI series weighted 60% LCI, 40% PPI as for DPP forecast purposes.

Decision not to introduce a new recoverable cost in respect of insurance costs

3.91 We considered, but decided not to, amend the specification of price input methodology to treat insurance costs as a recoverable cost.

Current IM requirements

3.92 The current EDB IM determination does not treat insurance costs as recoverable costs. As such, any insurance costs that distributors face are treated as opex.

Proposed changes suggested by submitters

3.93 In responding to our proposal in the draft decision to treat FENZ levies as a recoverable cost, the ENA and PowerNet proposed that insurance also be treated as a recoverable cost.⁸⁵

3.94 In support of this proposal, both noted that recent changes in insurance premiums have been significant, outside what could be considered a 'trend'.⁸⁶

Our reasons for not making an amendment

3.95 We disagree with ENA and PowerNet's submissions that the costs of insurance should also be treated as a recoverable cost. Unlike FENZ levies, which distributors are exposed to simply by virtue of holding insurance, distributors have much more control over the specifics of the insurance they take on.

3.96 Treating all insurance as a recoverable cost would undermine any efficiency incentives distributors face when managing their insurance cover. As such, rather than better promoting the purpose of Part 4, this would risk an outcome counter to section 52A(1)(b).

3.97 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.⁸⁷ 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.

Amendment to introduce new reopeners for major unforeseen capex projects for distributors subject to a DPP

Previous requirement

⁸⁵ [ENA "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\), para 64; Power Net "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\), para 4.4.2](#)

⁸⁶ Ibid.

⁸⁷ See [Commerce Commission "Input methodologies review decisions: Framework for the IM review \(20 December 2016\), page 42](#)

3.98 For the most part, while significant, externally driven, and unforeseeable events are covered by existing reopeners under clause 4.5.6 of the EDB IM determination within our DPP framework, major capex projects required to meet unforeseen changes in large consumer demand, system growth requirements or asset relocations are not included as a reopener category.

Draft Decision

3.99 We proposed introducing two new DPP reopeners in the EDB IMs that would apply to new major connection projects, to address uncertainty in the existence, timing, or scope of such projects.⁸⁸

3.100 We structured the reopeners as two separate reopeners. The first covered some projects that were not foreseeable. The second covered some projects that were foreseeable, but are unforeseeably brought forward in time, or unforeseeably increased in size.

3.101 The reopeners were intended to cover some projects within three scenarios:

3.101.1 where a major connection project was not foreseen;

3.101.2 where a major connection project was foreseen, but was not expected until a future regulatory period; and

3.101.3 where the major connection project was foreseen, but during the regulatory period the expectation changed so that the connection project was expected to be much larger.

3.102 The new reopeners would only apply to major new consumer connection projects that:

3.102.1 could not have reasonably been foreseen at the time of setting expenditure forecasts which we could have considered when determining the DPP, or were foreseen but reasonably expected to not be required until a future regulatory period or were foreseen but expected to be much larger than forecasted;

3.102.2 were not included in the distributor's expenditure forecasts considered when setting our capex forecasts for the DPP;

3.102.3 were not covered through the distributor's capital contributions policy and there is reasonable justification for it not being covered;

⁸⁸ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 4.5.5A and 4.5.5B.

- 3.102.4 require additional expenditure (net of the capital contributions) by the distributor in that disclosure year of more than 5% of the forecast net allowable revenue for that year for the connection and related network reinforcement;
- 3.102.5 had sufficient commitment from the connecting party; and
- 3.102.6 would appropriately apportion any proposed additional revenue sought.
- 3.103 We considered that the expenditure or additional expenditure must have not been included in our DPP forecasts of the distributor's capex. In particular, this would prevent the distributor being compensated for the same expenditure twice.
- 3.104 We proposed linking the reopeners to the distributor's last forecast before the DPP. We considered that this would generally prevent double compensation.
- 3.105 The reopeners would not apply to situations where the distributor had already forecast the expenditure and we then decided to exclude the expenditure from our DPP allowances. We did not intend for the reopeners to respond to situations which were forecast and the expenditure was foreseeable.

Submitters' views

- 3.106 Submissions on the draft decision that addressed the reopeners were supportive in principle, although some suggested changes to the reopeners to allow greater flexibility,⁸⁹ such as a lower threshold and addition of other categories of expenditure like asset relocations.
- 3.107 Alpine Energy proposed in its submission on our DPP draft decision that system growth be included in the reopener mechanism.⁹⁰ Powerco also raised system growth expenditure in the context of exclusion from the IRIS mechanism.⁹¹
- 3.108 Powerco and Vector recommended including asset relocations within the scope of the reopener, as in their view relocation expenditure is similar in nature to a large new connection.⁹² This was supported in cross-submissions by Orion.⁹³

⁸⁹ [Wellington Electricity "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\)](#), p7-8; [Alpine Energy "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\)](#), p7; and [MEUG "Submission on IM amendments for DPP and IPP" \(5 July 2019\)](#).

⁹⁰ [Alpine Energy "Submission on EDB DPP reset draft decisions paper" \(18 July 2019\)](#), p7.

⁹¹ [Powerco "Submission on EDB DPP reset draft decision paper" \(18 July 2019\)](#), p18.

⁹² [Powerco "Submission on EDB DPP reset draft decision paper" \(18 July 2019\)](#), p18; and [Vector "Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower" \(5 July 2019\)](#), p. 5.

⁹³ [Orion "Cross-submission on EDB DPP reset draft decision" \(12 August 2019\)](#), p7 para 23.

3.109 MEUG proposed a further requirement on distributors when they seek these new reopeners. MEUG suggested that a distributor must also attest, in seeking the reopener that it is fully complying with the pricing principles published by the Electricity Authority, or has a development plan to move to compliance at a rate expected of a reasonable and prudent distributor.⁹⁴ Orion in its cross-submission on our draft decision disagreed and did not believe that it is appropriate to have a stand-alone requirement in this regard and it being codified in the IMs.⁹⁵

Our final decision

3.110 Following the consultation, our final decision is to introduce two new reopeners for:

3.110.1 unforeseeable major capex projects or programmes;⁹⁶ and

3.110.2 foreseeable major capex projects or programmes.

3.111 These new reopeners apply to individual projects or programmes relating to large connections (including alterations to existing connections),⁹⁷ large system growth, and to large asset relocation expenditure.

3.112 The reopeners apply to projects and programmes that are unforeseen, under-forecasted, or under-funded. The reopeners cover the following types of situations:

3.112.1 projects and programmes that were unforeseen at the time of publishing the expenditure forecasts that the Commission based its DPP allowances on;

3.112.2 projects and programmes that were foreseen but were not accounted for in the DPP allowances set by the Commission, because the project is a one-off large project meaning it is out of step with historic expenditure or household growth rates;

3.112.3 projects and programmes that were foreseen, but changes in circumstances mean that the cost is expected to be significantly greater than that forecast in the disclosures used by us for setting DPP allowances; or

3.112.4 projects and programmes that were foreseen for later regulatory periods, but changes in circumstances mean that the project or programme is brought forward into the current regulatory period.

⁹⁴ [MEUG "Submission on IM amendments for DPP and IPP" \(5 July 2019\).](#)

⁹⁵ [Orion "Cross submission on proposed amendments to input methodologies for electricity distributors and Transpower NZ Ltd" \(18 July 2019\).](#)

⁹⁶ A programme is a group of related projects with a common purpose.

⁹⁷ For example, the conversion of an existing dairy plant from coal boilers to electric boilers may be a substantial increase in capacity of the existing connection rather than a new connection.

- 3.113 Our final decision is largely based on our draft decision, but with the following changes:
- 3.113.1 we have renamed the reopeners as being for ‘unforeseeable major capex projects’ and ‘foreseeable major capex projects’;
 - 3.113.2 we have retained that projects or programmes to meet system growth capex demand as being eligible for these reopeners but removed the requirement that system growth expenditure be caused by a new connection. This is largely aimed at projects and programmes that are prudent but were unable to be accepted in our capex forecasts because they are large one-off projects or programmes that are out of step with historic expenditure and any predictable drivers of growth;⁹⁸
 - 3.113.3 we have added to the reopeners, projects or programmes that are to meet asset relocations demand. We consider that this is appropriate because asset relocations can be difficult to accurately forecast because they are dependent on circumstances outside the control of the distributor. For example, the decisions on the extent and location of various transport infrastructure projects by Auckland Transport could cause some very large new asset relocation projects or programmes by Vector;
 - 3.113.4 we will take into account projects and programmes that were forecast by the distributor but were not included in our capex forecasting for the DPP. We consider that this is appropriate because our capex forecasting approach for connections and system growth is focused on expected broad growth (eg, through the relationship with forecast household growth) and not scrutiny of individual large projects such as a new dairy plant;
 - 3.113.5 we have set a minimum threshold for a project or programme to be eligible for these reopeners at 1% of forecast net allowable revenue over the regulatory period or two million dollars per project or programme — whichever is less for the distributor; and
 - 3.113.6 we have also included a maximum cap of \$30m for the aggregate expenditure for all projects and programmes that can be applied for under these reopeners in any one disclosure year.
- 3.114 The threshold and cap relate to the amount of additional expenditure (net of capital contributions) that the distributor includes in its reopener application (rather than the calculated effect on revenue).

⁹⁸ An example of a predictable driver of growth could be household growth.

- 3.115 We have set the threshold to ensure that the benefits of reopeners outweigh the administrative and compliance costs associated with distributors making the application and us assessing that application.
- 3.116 We have set the threshold as a percentage and an absolute value—whichever is the lesser for a distributor—because, as several submitters raised in submissions, the percentage threshold may be unrealistic for the largest EDBs to be able to meet on individual projects or programmes.
- 3.117 We have introduced a cap to the reopeners because we consider that, particularly with the addition of system growth and asset relocations, the reopeners could otherwise apply to situations for which a CPP is more appropriate. The limited level of scrutiny applied under these reopeners, in line with the low-cost nature of DPPs, is not appropriate for larger projects and programmes that are out of step with original forecasts or historic expenditure. It is our view that 30 million dollars is an appropriate level to achieve this
- 3.118 We would not allow a reopener where the application relates to a project (or part thereof) that is better viewed as part of a larger project or programme, where that wider project or programme would not be under the cap. In those circumstances we consider that a CPP would be the more appropriate mechanism.
- 3.119 Other specific requirements of the reopeners include:
- 3.119.1 the reopeners only apply to the portion of the additional expenditure that is not covered through the distributor’s capital contributions policy (which must be reasonable) and there must be reasonable justification of the distributor’s intended approach to allocating costs to consumers; and
 - 3.119.2 the distributor must demonstrate a high level of confidence in the requirement for the expenditure, for example through a firm request and commitment from a new connecting party that this investment is required.
- 3.120 We expect distributors to take a reasonable approach to allocating the costs of the project or programme to customers through a reasonable capital contributions policy and future pricing, ideally in line with the pricing principles published by the Electricity Authority. As such, we may consider a distributor’s planned pricing in relation to the project or programme when considering whether a reopener should be granted. We consider that this addresses the points raised on this issue by MEUG and Orion.
- 3.121 Similar to all reopeners, there is a two-step process before the DPP may be amended for a foreseeable major capex project or a foreseeable major capex project. Once the Commission is satisfied (either where the Commission considers, or where an EDB applies to the Commission and satisfies the Commission) that the criteria for these

reopeners are met,⁹⁹ we will then amend the DPP price path in respect of an unforeseeable major capex project or a foreseeable major capex project by an amount that does not exceed the efficient costs that a prudent EDB would incur in undertaking that project.¹⁰⁰ In reaching any decision we will be guided by the purpose of Part 4 of the Act.

- 3.122 In applying our discretion for reopener applications for system growth projects in particular, we expect that the types of projects that would be viewed as most appropriate for a reopener are those that were forecast by the distributor prior to the DPP being set but were not provided for by the low-cost approach to DPP setting. This could, for example, include a project to increase the capacity of a zone substation by a small distributor, which was included in the distributor's forecast, but was not provided for under the DPP allowable revenue because it was a very large increase in expenditure.
- 3.123 In contrast, we expect that a reopener application for a system growth project that had not been forecast by the distributor before the DPP but arises due to general growth in demand that the distributor had not expected or taken into account would be unlikely to be successful. In particular, we would generally consider this in light of the asymmetric nature of the reopener provisions, noting that actual demand can be greater or less than expected but a distributor would be unlikely to request a reopener due to lower than expected demand making a planned system growth project no longer necessary.
- 3.124 We also note that some system growth projects are closely related to the actions of Transpower, which can create external uncertainty for a distributor. For example, if it was established that a system growth project such as a new grid exit point that was planned to be completed by Transpower would actually be better to be undertaken by the distributor, then we would likely consider allowing for this expenditure under a reopener for the distributor if it is in the long-term interests of consumers.

How the amendments are likely to promote an IM amendments framework outcome

- 3.125 We consider that these amendments are likely to better promote the Part 4 purpose because:

3.125.1 under the previous EDB IMs, if a distributor was to face an unforeseen major capex project, it would face disincentives to invest. This is because any additional commissioned assets would lead to a penalty under the

⁹⁹ *Electricity Distribution Services Input Methodologies Amendments Determination (No. 2)* [2019] NZCC 20, clause 4.5.6.

¹⁰⁰ *Electricity Distribution Services Input Methodologies Amendments Determination (No. 2)* [2019] NZCC 20, clause 4.5.7(3).

capex IRIS mechanism, with no off-setting incentive to improve efficiency, as the demand for new connections is substantially beyond the distributor's control; and

3.125.2 if we were to include a forecast allowance for potential major capex projects when setting a DPP, a distributor may earn excessive profits where the demand does not eventuate.

3.126 Because of this, we consider additional reopeners the appropriate mechanism.

3.127 A key aim of the reopeners is to ensure, where possible, that distributors can connect and manage significant new demand; particularly where it arises from demand for low carbon technologies if New Zealand increases its focus on decarbonisation, and while maintaining network reliability and meeting the long-term interests of consumers. Our understanding is that access to new connections and increased capacity of connections is an important feature of quality to consumers and is investment that should be incentivised. This promotes the Part 4 purpose in s 52A of the Act more effectively, specifically by providing an incentive for distributors to invest.¹⁰¹

3.128 When a distributor applies for a reopener under these new provisions, we recognise that this will involve administrative and compliance costs for the distributor and the Commission. However, we consider this disadvantage in terms of the IM amendments framework outcomes is more than offset by the Part 4 benefits discussed above – particularly given we introduced a threshold to ensure that projects are of a sufficient size to warrant this additional compliance cost.

We note that the new reopeners may also reduce any current incentive of distributors to encourage new connections to be arranged directly with Transpower, despite connection to the distributors possibly being a more efficient option.

Amendment relating to treatment of Court or other statutory imposed penalties

Previous IM requirement

3.129 Clause 1.1.4(2) of the EDB IMs defined 'operating costs' as:

a cost incurred by the EDB in question relating to the supply of-

(a) regulated services alone; or

(b) regulated services and one or more unregulated service,

¹⁰¹ [Commerce Act 1986](#), s 52A(1)(a).

3.130 The definition also contained exclusions for matters such as the cost of assets recognised as such under generally accepted accounting principles (GAAP), pass-through costs and recoverable costs. However, these exclusions were not relevant for the purposes of this proposed IM amendment.

Draft decision

3.131 Our draft decision was that the previous definition of operating costs (which is used in the EDB IMs for determining opex IRIS incentives, and under our current approach to setting DPPs or CPPs on the basis of current and projected profitability) did not provide sufficient certainty about the treatment of pecuniary penalties.

3.132 For clarity, we proposed an additional exclusion in the definition of “operating costs” for “**pecuniary penalties**”,¹⁰² and a new defined term ‘pecuniary penalties’,¹⁰³ defined as:

means fines or penalties imposed-

- (a) by a court; or
- (b) by any other body with a statutory power to impose such fines or penalties

Submitters’ views

3.133 Transpower supported this proposed amendment, however, the ENA, Unison and Vector did not.¹⁰⁴

3.134 The ENA considered that the proposed amendment is a policy change and is not a correction, and therefore any change must be applied consistent with the requirements of s 53ZB of the Act and must not be applied retrospectively. The ENA also believes that the proposed definition is too broad and will capture a range of penalties, some of which should be able to be calculated as operating costs.¹⁰⁵

3.135 Unison was also of the view that the proposed amendment is a policy change and needs to be further considered in context of the opex IRIS scheme. Unison agreed with the ENA that most businesses would operate very low risk tolerances for breach

¹⁰² [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 1.1.4(2), definition of **operating cost**.

¹⁰³ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 1.1.4(2), definition of **pecuniary penalties**.

¹⁰⁴ [Electricity Networks Association “EDB and Transpower IM amendments” \(5 July 2019\)](#), at 1 & 2; [Unison “Submission on DPP Input Methodology Amendments” \(7 July 2019\)](#), p. 1 & 2; [Vector “Submission to Commerce Commission on changes to the Input Methodologies for Electricity Distributors and Transpower due 5th July” \(5 July 2019\)](#), at 34.

¹⁰⁵ [Electricity Networks Association “EDB and Transpower IM amendments” \(5 July 2019\)](#), at 1 & 2.

of laws and regulations, although there is always more that can be done to strengthen controls. Unison considered that the change should apply from the commencement of the next disclosure year (ie, from 1 April 2020) and strongly disagreed that the change is a “clarification” and therefore should not be applied retrospectively.¹⁰⁶

3.136 Vector submitted that the definition of costs is clear, and that fines and penalties are operating expenses incurred from time to time in the course of carrying out the business of conveying electricity by line. Therefore, Vector argues that this proposal should be considered as a change in the IMs rather than a clarification.¹⁰⁷

3.137 Submitters noted various risks and consequences of excluding pecuniary penalties from opex. In particular:

3.137.1 the ENA noted that distributors will bear 100% of cost over-runs whereas previously under IRIS distributors bore only 26% of opex cost over-runs;

3.137.2 Vector noted that distributors may be undercompensated because the definition of pecuniary penalties is too broad;

3.137.3 Unison submitted that the decision to in-source and out-source will be distorted because a contractor is unlikely to pass-through the costs of penalties to a principal but will include a margin in their prices to cover this risk, whereas an distributor’s internal division will bear 100% of the same pecuniary penalties; and

3.137.4 Unison noted that the change needs to be reflected in weighing up any future changes to the cost of capital, as the risk of breach of laws and regulation has an asymmetric effect on returns, unless we are happy to finance excessive risk aversion to eliminate all risks of breach.

Our final decision

3.138 Our final decision is to introduce an additional exclusion in the definition of ‘operating costs’ for “payment of any **pecuniary penalties**”,¹⁰⁸ and a new defined term ‘**pecuniary penalties**’.¹⁰⁹

¹⁰⁶ [Unison “Submission on DPP Input Methodology Amendments” \(7 July 2019\)](#), at 2.

¹⁰⁷ [Vector “Submission to Commerce Commission on changes to the Input Methodologies for Electricity Distributors and Transpower due 5th July” \(5 July 2019\)](#), at 34.

¹⁰⁸ [Transpower Input Methodologies Amendments Determination 2019 \[2019\] NZCC 10 \(28 August 2019\)](#), clause 1.1.4(2), definition of ‘operating cost’.

¹⁰⁹ [Transpower Input Methodologies Amendments Determination 2019 \[2019\] NZCC 10 \(28 August 2019\)](#), clause 1.1.4(2), definition of ‘pecuniary penalties’.

- 3.139 We maintain that pecuniary penalties and fines are intended to penalise distributors for conduct contravening standards that apply to them. We do not consider that there is a sound policy argument for these costs to be shared with consumers.
- 3.140 It was never our intention that pecuniary penalties and fines would be included as operating costs and therefore built into the revenue allowances which suppliers can recover from consumers. Such treatment would be inconsistent with the long-term interests of consumers.
- 3.141 However, we accept that this intention was not clear. A plain reading of the previous definition of operating costs could have allowed distributors to treat pecuniary penalties as operating costs. As such, our decision is to:
- 3.141.1 clarify the treatment of pecuniary penalties and fines going forward by making it explicitly clear in the EDB IMs that pecuniary penalties and fines are not operating costs; and
 - 3.141.2 not apply this treatment with any retrospective effect, in recognition that our previous intent may not have been clear.
- 3.142 In response to submitters views on the risks and consequences of excluding pecuniary penalties from opex, we note that:
- 3.142.1 if pecuniary penalty costs were able to be included in distributor's forecast opex allowance, approximately 76% of the cost would be passed through to consumers via the opex IRIS mechanism. This would be a perverse outcome; pecuniary penalties and fines are intended to penalise lines companies for conduct contravening standards that apply to them. We do not consider that there is a sound policy argument for these costs to be shared with consumers;
 - 3.142.2 evidence of penalties incurred in 2018/19 via the information we sought under s 53ZD notices show that they are not material enough to materially impact distributors' ability to finance themselves (or affect their insourcing versus outsourcing decisions). Therefore, we expect distributors to continue have an expectation of earn normal returns;¹¹⁰
 - 3.142.3 we consider that penalties, whether imposed under the Act or otherwise, are not efficient costs. Penalties and fines are under management control and so we think it is appropriate that distributors bear 100% of these costs.

¹¹⁰ [Commerce Commission "Notice to supply information to the Commerce Commission under section 53ZD\(1\)\(e\) and 53ZD\(1\)\(f\) of the Commerce Act 1986" \(28 June 2019\)](#)

We want to incentivise distributors to minimise these costs consistent with s 52A of the Act; and

- 3.142.4 there is a greater risk of moral hazard and a lower incentive for distributors to minimise pecuniary penalties when the costs are shared with customers. This means customers are more likely to face higher charges due to inefficient costs incurred by distributors from penalties.
- 3.143 Under our final decision, pecuniary penalties will not qualify as opex from 1 April 2020. IRIS rewards and penalties paid after 1 April 2020 which are based on profits made during DPP2 will not be retrospectively adjusted downwards for pecuniary penalties incurred before 1st April 2020. For example, if a distributor incurred a pecuniary penalty during DPP2 before the 1st April 2020, its IRIS payment in five years' time, after the 1st April 2020 would not be adjusted to exclude those pecuniary penalties.
- 3.144 For the purpose of determining distributor's forecast operating costs in EDB DPP3, we will remove any actual pecuniary penalties from the base year opex, which will ensure that we get our best estimate of the forecast opex for EDB DPP3 on a pecuniary penalty exclusive basis. This amendment will also apply to all opex IRIS incentive amounts that will be calculated with respect to 'forecast opex' for EDB DPP3 onwards.
- 3.145 We consider that the long-term benefits of regulatory certainty outweigh any short-term benefit to consumers of making retrospective adjustments. Making a retrospective adjustment may reduce distributors' confidence in future regulatory decisions and could potentially hold up investment. A retrospective adjustment also adds complexity to the IRIS mechanism which could reduce its effectiveness.
- 3.146 As distributors' regulatory opex disclosed under information disclosure (ID) informs both the opex forecasts we set, and the opex IRIS recoverable costs, we want to provide certainty as to how these penalties should be treated.
- 3.147 Our final decision means that distributors can pass on the costs of penalties incurred before April 2020 via the IRIS mechanism. It is within each distributor's discretion whether it chooses to pass on the costs of these pecuniary penalties to its customers.

How the amendment is likely to promote an IM amendments framework outcome

- 3.148 This IM amendment provides more certainty for suppliers on the treatment of pecuniary penalties. Therefore, the IM amendment better promotes the IM purpose in s 52R of the Act.

- 3.149 As distributors' regulatory opex disclosed under ID informs both the opex forecasts we set,¹¹¹ and the opex IRIS recoverable costs, we consider that it is important for consumers and suppliers to have certainty as to how these penalties should be treated.
- 3.150 Pecuniary penalties and fine are intended to penalise distributors for conduct contravening standards that apply to them. Allowing penalties to be included as operating costs and therefore built into the revenue allowances which suppliers can recover from consumers would be inconsistent with the long-term interests of consumers.

Amendment to correct implementation errors in IRIS drafting

Previous requirement

- 3.151 Our previous EDB IM determination included 'opex incentive amounts' for the purposes of the 'IRIS incentive adjustment'.¹¹²
- 3.152 As a result of the 2016 IM review, we amended the 'opex incentive amount' calculation to "fit the purpose of the 'adjustment to the opex incentive' by using a modified version of the 'capex incentive adjustment' calculation".¹¹³ We did this to remedy the risk of fluctuations in allowable revenue (and therefore prices to consumers) resulting from adjustments to the opex incentive in the second year of a regulatory period.¹¹⁴
- 3.153 As part of drafting the amendments resulting from the 2016 IM review, we made implementation errors in the 'opex incentive amount' calculation:
- 3.153.1 in the time-value-of-money adjustment; and in the time-value-of-money adjustment;¹¹⁵ and
- 3.153.2 by referencing the 'DPP regulatory period', rather than the 'regulatory period'.

¹¹¹ [Electricity Distribution Information Disclosure Determination 2012](#), as amended, Schedule 6a.

¹¹² [Electricity Distribution Services Input Methodologies Determination 2012](#), as amended, clause 3.3.2.

¹¹³ [Commerce Commission "Input Methodologies review decisions: Report on the IM review" \(20 December 2016\)](#), page 112-115.

¹¹⁴ [Commerce Commission "Input Methodologies review decisions: Report on the IM review" \(20 December 2016\)](#), paragraph 369-372.

¹¹⁵ In the formula for calculating the 'adjustment to the opex incentive amount', the time-value-of-money component of the formula incorrectly used $(1 + r)^{Y+0.5}$ which was correct for the capex incentive amount but not for the opex incentive amount.

Draft decision

- 3.154 In our draft decision we proposed amending the calculation for the ‘opex incentive amount’ for distributors to correct these implementation errors made as part of the 2016 IM review and therefore, accurately give effect to our 2016 IM review decision.¹¹⁶
- 3.155 In the formula for calculating the ‘opex incentive amount’, we proposed correcting the time-value-of-money adjustment to be calculated using “ $(1 + r)^{Y-1}$ ”.

Submitters’ views

- 3.156 On the proposed time-value-of-money adjustment, Vector suggested that there appears to be an error in the formula by using $(Y-1)$ for the opex incentive amount, as this would only allow recovery for three years rather than the intended four.¹¹⁷ Vector states that this is contrary to the intention of the change to the IMs to allow smoothed recovery of the ‘base year adjustment term’ over four years. For this to occur Vector recommend the adjustment to the opex incentive should not be recovered over $(Y-1)$ but should be recovered over Y (the remaining years in the regulatory period).
- 3.157 We received no submissions on our proposed reference to the ‘regulatory period’ rather than ‘DPP regulatory period’.

Our final decision

- 3.158 Our decision is to correct the implementation error in the opex IRIS mechanism.¹¹⁸ We have retained our proposed drafting from our IM amendments draft decision.
- 3.159 In its submission on our draft IM amendments decision and determination, Vector suggested that the proposed change to the formula in clause 3.3.2(2)(b)(i) would only allow for recovery of three years rather than the intended four (using $Y-1$ in the formula instead of over Y).
- 3.160 We consider that the formula proposed in our draft decision does give effect to distributors recovering the adjustment to opex for four years of the regulatory period (years two to five). This is because in the second year of the regulatory period (i.e. when $Y=1$), where the first adjustment takes place, the time-value-of-money adjustment will be equal to a rate of 1. This is because $(1+r)^{Y-1}$ equals $(1+r)^0$, and

¹¹⁶ [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause 3.3.2.

¹¹⁷ [Vector “Submission to Commerce Commission on changes to the Input Methodologies for Electricity Distributors and Transpower due 5th July” \(5 July 2019\)](#), p. 32.

¹¹⁸ [Electricity Distribution Information Disclosure Determination 2012](#), as amended, clause 3.3.2.

$(1+r)^0 = 1$. The adjustment will subsequently be recovered in regulatory period years 3 to 5 (i.e. where $Y=2$ to 4), growing at the cost of debt (' r '). Therefore the 'adjustment to the opex incentive' will be recovered for a total of four years over the regulatory period.

3.161 Table 3.1 demonstrates how the adjustments to the opex incentive take place over a regulatory period.

Table 3.1 – Opex incentive amount time-value-of-money adjustment

RCP Year	Y ¹¹⁹	Y-1	Adjustment to the opex incentive
1	0	-1	No adjustment for a starting price year, refer to clause 3.3.4(1)
2	1	0	$(1+r)^{Y-1} = (1+r)^0 = 1$
3	2	1	$(1+r)^{Y-1} = (1+r)^1$
4	3	2	$(1+r)^{Y-1} = (1+r)^2$
5	4	3	$(1+r)^{Y-1} = (1+r)^3$

How the amendment is likely to promote an IM amendments framework outcome

3.162 We are introducing these implementation changes to give effect to the policy intent of the opex IRIS mechanism. We consider that correcting these implementation errors will promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it will reduce potential confusion for interested persons on how to accurately calculate the 'opex incentive amount' component of the 'IRIS incentive adjustment'.

¹¹⁹ Y being, 'the number of disclosure years preceding the disclosure year in question in the regulatory period'

Amendment to correct typographical errors in matters relating to proposals by a regulated supplier for a CPP

Previous requirement

3.163 Under the EDB IMs, a distributor's CPP proposal must be verified by a verifier, where this verifier must be engaged in accordance with Schedule F of the EDB IMs.¹²⁰ Within Schedule F, there are typographical errors.¹²¹

Draft decision

3.164 In our draft decision we proposed amending these typographical errors as set out in the draft EDB IM amendments determination to correct incorrect cross-references within Schedule F of the EDB IMs.¹²²

Submitters' views

3.165 We received no submissions on this proposed amendment.

Our final decision

3.166 Our decision is to correct these typographical errors within Schedule F of the EDB IMs.¹²³

How the amendment is likely to promote an IM amendments framework outcome

3.167 We consider that correcting these typographical errors promotes the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it reduces potential confusion for interested persons on how distributor's must engage verifiers for the purpose of a CPP proposal.

Amendment to the definition of regulated income

Previous requirement

3.168 The EDB IM previously defined 'other regulated income' as follows:¹²⁴

for the purpose of–

¹²⁰ [Electricity Distribution Services Input Methodologies Determination 2012](#), as amended, clause 5.5.2(1)-(2).

¹²¹ [Electricity Distribution Services Input Methodologies Determination 2012](#), as amended, clause F6(2)(d)(ii) and clause F6(3)(i).

¹²² [\[DRAFT\] Electricity Distribution Services Input Methodologies Amendments Determination 2019](#), clause F6(2)(d)(ii) and clause F6(3)(i).

¹²³ [Electricity Distribution Services Input Methodologies Determination 2012](#), as amended, Schedule F, clauses F6(2)(d)(ii) and F6(3)(i)

¹²⁴ [Commerce Commission Electricity Distribution Services Input Methodologies Determination 2012 \[2012\] NZCC 26 \(Consolidated as at 31 January 2019\)](#) clause 1.1.4(2).

- (a) Part 3, means income associated with the supply of **electricity distribution services** other than -
- (i) income through **prices**;
 - (ii) investment-related income;
 - (iii) **capital contributions**; or
 - (iv) **vested assets**; and
- (b) Part 4, means forecast income associated with the supply of **electricity distribution services**, other than -
- (i) income through **prices**;
 - (ii) investment-related income;
 - (iii) **capital contributions**; or
 - (iv) **vested assets**,
- as determined by the **Commission**;

Draft Decision

3.169 We did not seek views on this amendment in our draft decision, however we received submissions from Orion and Powerco seeking clarification on whether ‘other regulated income’ takes into account gains and losses on disposal.¹²⁵

Submitters’ views

3.170 As noted above we received submissions from Orion and Powerco seeking this clarification.

Our final decision

3.171 We have amended the EDB IM definition of ‘other regulated income’ to clarify that it includes gains and losses on disposals.

3.172 It has been both our intention and our practice to include gain and losses on disposal in ‘other regulated’ income since 2014.

3.173 We do not consider this amendment to be a material; but rather it is necessary for the purposes of clarification and ensuring certainty.

¹²⁵ [Orion “Submission on EDB DPP3 Reset- Draft Decision \(the Paper\)” \(18 July 2019\)](#); and [Powerco “Submission on Electricity DPP reset draft decision” \(18 July 2019\), p6](#).

How the amendment is likely to promote an IM amendments framework outcome

3.174 Our decision to amend the definition of ‘other regulated income’ aligns the definition with actual practice and supports long-term certainty of the regulatory regime. The IM amendment promotes the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it reduces potential confusion for interested persons on how distributor’s must interpret and treat ‘other regulated income’.

Amendment relating to information requirements for quality standard variations

Previous requirement

3.175 Previously the information requirements for the quality standard variation provisions were drafted in a way that was specific to the DPP2 quality standards and incentive scheme. If these information requirements were to change in the future, either an IM amendment would be required each time this happens or the IM would become unworkable.

Draft Decision

3.176 We did not seek views on this amendment in our draft decision. As the change is solely driven by ensuring the workability of the IMs, we do not consider the amendment is material.

Submitters’ views

3.177 No submissions were received on this.

Our final decision

3.178 We have decided to amend the quality standard variation provisions (clauses 4.5.5(2) and 5.4.5) to be more generalised so that they do not need to be updated whenever the DPP quality standards and quality incentives are changed.

How the amendment is likely to promote an IM amendments framework outcome

3.179 We consider that amending the quality standard variation provisions is necessary to promote the original policy intent of the quality standard variation.¹²⁶

3.180 The IM amendment promotes the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it ensures the long-term workability of this IM.

¹²⁶ See [Commerce Commission “Input methodologies review decisions – Topic paper 2: CPP requirements” \(20 December 2016\)](#), Chapter 3.

Decision not to amend the TAMRP term in the cost of capital IM

- 3.181 We considered, but decided not to, make an an amendment proposed in submissions to the TAMRP term in the cost of capital IM in light of an error by the Commission’s expert, Dr Lally, in the calculation that led to the Commission’s determination of a TAMRP term of 7% in the cost of capital IM.¹²⁷
- 3.182 Despite this potential change relating to the cost of capital IM (one of the foundational building blocks IMs listed in s 52T(1)(a)), we considered it to be within the scope of this s 52X amendments process because the nature of the change sought was a technical error correction (consistent with paragraph 2.11.2).
- 3.183 We have not made this amendment, as Dr Lally’s further analysis suggests that correction of the error would not have changed the TAMRP figure used in the determination.

Current IM requirements

- 3.184 The cost of capital IM specifies that the TAMRP to be used by the Commission in determining cost of capital estimates for EDB DPPs, is 7.0% for a 5 year period commencing on the first day of the DPP period.¹²⁸

Proposed changes suggested by submitters

- 3.185 CEG’s report submitted by Vector mentions that there was a mathematical error in Dr Lally’s calculations which, if corrected, would have raised three of his estimates of the NZ TAMRP at the time of his report.¹²⁹ It suggests this would have resulted in a median TAMRP of 7.3% - which would have been rounded to 7.5% under the Commission’s approach.

Our reasons for not making an amendment

- 3.186 We asked Dr Lally to update the TAMRP for the purposes of setting IMs for Part 6 of the Telecommunications Act 2001. As part of this exercise, Dr Lally also independently identified the mathematical error discussed in CEG’s report. He re-performed the TAMRP calculation that was performed in setting the TAMRP figure in the cost of capital IM, correcting the error. However, Dr Lally has informed us that

¹²⁷ [Vector “Submission to Commerce Commission on changes to the Input Methodologies for Electricity Distributors and Transpower due 5th July” \(5 July 2019\)](#), p4

¹²⁸ [Commerce Commission Electricity Distribution Services Input Methodologies Determination 2012 \[2012\] NZCC 26 \(Consolidated as at 31 January 2019\)](#) clause 4.4.2(7).

¹²⁹ [CEG on behalf of Vector “Submission on IM amendments for DPP and IPP” \(5 July 2019\)](#),

after re-performing the calculation (having corrected the error), it still results in the same figure as was the case in his previous analysis — being 7%.¹³⁰

3.187 Furthermore, our estimates of TAMRP are not purely mechanical. We use different methods to produce different estimates, and we also look at other evidence such as investment bank estimates, submissions and cross-submissions. We then make a judgement which involves weighing the available evidence to come up with a final estimate.

¹³⁰ See footnote 2 here: https://comcom.govt.nz/_data/assets/pdf_file/0043/189889/Dr-Martin-Lally-Estimation-of-the-TAMRP-26-September-2019.pdf.

4. IM amendments proposed by submitters that are beyond the scope of this amendments process

Purpose of this chapter

- 4.1 In this chapter, we discuss IM amendments proposed by submitters that are beyond the scope of this amendments process. In doing so we explain:
- 4.1.1 why we consider the proposed amendment to be outside of the normal scope of a s 52X amendments process; and
 - 4.1.2 why we do not consider that exceptional circumstances exist that would warrant such changes outside the s 52Y review cycle.

Summary of IM amendments proposed by submitters that are beyond the scope of this amendments process

- 4.2 Submitters proposed the following amendments which we consider to be beyond the scope of this amendments process:
- 4.2.1 amendments to the cost of capital IM used to calculate the cost of capital estimate for EDB DPP3;¹³¹
 - 4.2.2 amendments to the asset valuation IM – in particular, to change the forecast of inflation used for the revaluation of assets or to un-index the regulatory asset base (RAB) from inflation.¹³²
- 4.3 We have not undertaken a full consultation process in relation to these amendments because they do not fit within the usual scope of an IM amendments process under s 52X and because we do not consider that exceptional circumstances exist that would justify their reconsideration at this time.
- 4.4 As discussed at paragraph 2.11 above, the focus of this IM amendments process, conducted under s 52X and outside the s 52Y review cycle, has been on changes to:
- 4.4.1 support the implementation of DPP policy decisions; and
 - 4.4.2 enhance certainty about the rules and correct for technical errors ahead of the DPP reset.

¹³¹ See s 52T(1)(a)(i) of the Act.

¹³² See s 52T(1)(a)(ii) of the Act.

- 4.5 This is in contrast to the potential amendments discussed in this chapter, which are more fundamental in nature and would represent significant changes to the building blocks used to determine the DPP. We consider that changes of the nature discussed in this chapter are better considered as part of the next s 52Y IM review process, unless there are exceptional circumstances that warrant urgent reconsideration of building blocks, despite the potential harm such reconsideration could do to the certainty and predictability intended to be provided by the IMs.
- 4.6 We have undertaken an assessment of these proposed amendments to determine whether they relate to exceptional circumstances that warrant us considering the amendments, even though they are generally beyond the scope of a s 52X amendments process. For the reasons explained below, we have determined that the circumstances cited by submitters as justification for these amendments could not be regarded as exceptional.

Proposed amendments to the cost of capital input methodology

The cost of capital IM

- 4.7 The cost of capital IM prescribes the approach we must take when determining cost of capital estimates.¹³³ The cost of capital IM requires that we determine a cost of capital estimate to be used for resetting the DPP for distributors as of the first business day of the month 7 months prior to the start of the DPP regulatory period. We must then publish that estimate no later than a month after determining it.
- 4.8 Accordingly, on 25 September 2019, we determined the WACC estimate for EDB DPP3 using the methodology prescribed by the cost of capital IM.¹³⁴

Changes proposed

- 4.9 In a letter to the Commission sent on 5 September 2019 following the submission period on our draft decision, the ENA, on behalf of 14 of its members, highlighted concerns that the WACC estimate was unrealistically low.¹³⁵
- 4.10 The ENA's assessment was that the WACC was impractically low, driven by a low estimate of the risk-free rate. The ENA's letter referred us to CEG's report on

¹³³ [Commerce Commission Electricity Distribution Services Input Methodologies Determination 2012 \[2012\] NZCC 26 \(Consolidated as at 31 January 2019\)](#), Part 4, Subpart 4.

¹³⁴ [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](#).

¹³⁵ [Letter from the ENA \(on behalf of 14 of its members\) to the Commerce Commission "RE: Unsustainable WACC estimate for DPP3; bias and risk in CPI forecasts" \(5 September 2019\)](#). See, also: [ENA "Re: 2020 DPP draft Decision submissions - cross submissions" \(12 August 2019\)](#); [Vector "Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower" \(5 July 2019\)](#).

‘Dealing with negative real risk-free rates’ for how this issue could be addressed through changes to the cost of capital IM.¹³⁶ In particular, the CEG report recommends that the TAMRP term in the cost of capital IM should be updated to account for today’s “radically lower risk-free rates”.¹³⁷

Why we consider consideration of these amendments to be beyond the scope of this amendments process

- 4.11 The cost of capital IM is a foundational building block. It has a direct and significant impact on the setting of revenues under price-quality regulation and the assessment of profitability under ID regulation. As such, we consider that the cost of capital input methodology should only be changed in a material way outside of the s 52Y review cycle in exceptional circumstances. Absent exceptional circumstances, it is not appropriate to materially amend the cost of capital IM under s 52X in parallel with setting the DPP.
- 4.12 The cost of capital IM provides certainty to consumers and suppliers about how the cost of capital will be calculated when we come to set price-quality paths and enables suppliers to employ the necessary strategies to mitigate the effects of prevailing external market conditions; for example, when putting in place financing arrangements.
- 4.13 We note that issues relating to the principles and methodology for calculating the cost of capital were extensively consulted on as part of the s 52Y IM review process in 2016, which resulted in some amendments.¹³⁸ Interested parties also had the ability to seek a merits appeal of our final decision at that time.
- 4.14 In response to CEG’s submission that we should update the TAMRP at this time to reflect the current interest rate environment, we consider it would not be appropriate to do so outside of the s 52Y review cycle. The TAMRP term is deliberately ‘hard-coded’ into the cost of capital IM, as, for example, is the asset

¹³⁶ [CEG “Dealing with negative real risk-free rates” \(July 2019\)](#), which is Attachment C to Vector “Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower” (5 July 2019).

¹³⁷ In addition to suggesting that we should update the TAMRP term in the cost of capital IM to better reflect today’s low interest rate environment, CEG also comments on an error in Dr Lally’s 2015 calculations that informed the current TAMRP term. Dr Lally’s error is discussed in Chapter 3; while the suggestion that we should review the TAMRP term to update it for today’s interest rate environment is discussed in this Chapter 4.

¹³⁸ [Commerce Commission “Input methodologies review decisions – Topic paper 4: Cost of capital issues” \(20 December 2016\)](#).

beta.¹³⁹ This is intended to provide certainty to stakeholders on the value of these important parameters. One consequence of this approach is that over time, the value of the parameters may become out of line with market conditions until they are next reviewed as part of the s 52Y review cycle. Revisiting the value of these parameters whenever they may negatively affect suppliers is unlikely to promote ss 52A or 52R.

- 4.15 Relatedly, we do not consider that the TAMRP term could appropriately be reviewed in isolation of the remainder of the cost of capital IM. To do otherwise would risk that the Commission or stakeholders were seen to be ‘cherry-picking’ certain aspects of the cost of capital IM for review, or failing to properly consider the interactions between the various components of the cost of capital input methodology.

We do not consider that exceptional circumstances apply that mean we should make these amendments despite them being out of scope

- 4.16 We do not consider that exceptional circumstances exist that warrant material amendments to the cost of capital IM outside of the s 52Y review cycle.
- 4.17 In relation to the low risk-free rate, we note that at the time of the IM review in 2016, there was evidence to suggest that the current market conditions could exist. The present environment may have been difficult to forecast with precision, but, in our view, it was certainly a clear possibility at the end of 2016:
- 4.17.1 the five-year risk-free rate in the Commission's September 2016 WACC Determination for distributors was 1.85%, having been on an almost continuous decline since September 2013, when it was 3.95%;
- 4.17.2 noting that the risk-free rate in the cost of capital IM is based on the yield for five-year New Zealand government bonds, the September 2016 market expectation for the 10-year NZ government bond yield (used because there is no equivalent data for five-year bonds) in one year's time was at its lowest since records began, and had been consistently falling since December 2013;¹⁴⁰
- 4.17.3 there were no fewer than 14 foreign governments with negative yielding debt by early June 2016.¹⁴¹

¹³⁹ An alternative to ‘hard coding’ these parameters in the IM would have been to include a variable term that would be calculated by the Commission according to a formula or other rules which could be specified in the IM. This would not provide the same level of certainty about these key terms.

¹⁴⁰ <https://www.rbnz.govt.nz/statistics/m14>.

¹⁴¹ Fitch Ratings, Fitch: Negative-Yielding Sovereign Debt Grew to \$10.4 Trn in May (2 June 2016), <https://www.fitchratings.com/site/pr/1005505>.

- 4.18 For distributors, a lower WACC will result in lower revenues than would otherwise be the case. However, this also reflects an economic environment where distributors' costs are lower, including due to the availability of cheaper financing arrangements. In these circumstances, we would expect distributor shareholders to have revised their assumptions on the returns that could be anticipated, given that the reduction in the risk-free rate incorporated into the WACC is intended to reflect an overall reduction in returns to capital across the economy. As such, shareholders of distributors should be no more adversely affected in relative terms by this reduction than investors in other types of businesses.
- 4.19 On the evidence available, we consider that on balance our current approach does not under-compensate distributors such that they would have concerns with their ability to invest. We acknowledge that the current conditions are challenging for businesses. However, our estimate of the cost of capital that applies to distributors is set at the 67th percentile. This is there to protect against mis-estimation risk, given the potential costs to consumers from underinvestment in electricity lines supply. One practical impact of this is that there exists a financial 'buffer' for investors in distributors.¹⁴²
- 4.20 We further note that, even if we had considered it appropriate to consult on significant changes to the cost of capital IM following the concerns raised by submissions on our draft decisions, this would have been practically very challenging to do in a fair and robust way in the time available.¹⁴³

¹⁴² As part of our work developing the IMs under Part 6 of the Telecommunications Act 2001 for the regulation of fibre networks, we have reached a draft decision to set the TAMRP at 7.5% ([Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" \(19 November 2019\)](#)). This is an indication that, should the economic environment remain the same or similar at the time of the next s 52Y review, it may be appropriate to adopt a TAMRP of 7.5% for Part 4, subject to consultation with all interested parties and further analysis. However, as noted above, the TAMRP term is deliberately hard-coded into the cost of capital IM to provide certainty to stakeholders – an implication of this approach is that the TAMRP term does not necessarily reflect prevailing market conditions at any specific point in time. The appropriate time to consider updating the TAMRP is at the next s 52Y review, when it can be considered alongside the other parameters that make up the cost of capital IM. We note that even if the TAMRP was increased to 7.5% as part of the next s 52Y review, that would not necessarily lead to an overall increase in the WACC as it is possible that updates to other parameters may result in an overall reduction.

¹⁴³ As noted above at paragraph 4.15, we do not generally consider that individual parameters in the cost of capital IM can be effectively reviewed in isolation: the cost of capital IM is best reviewed as a whole. Completing a fair and robust review of the cost of capital IM in the period between when issues about the cost of capital for EDB DPP3 were first being raised by submitters in July 2019, and September 2019, when we were required to determine the cost of capital estimate for EDB DPP3, would have been very challenging. In that time, we would have needed to consider the evidence across all aspects of the cost of capital IM, reach a draft decision on any changes to the cost of capital IM, consult on any changes to provide an opportunity for all stakeholders to provide their views, and then carefully consider these views before reaching a final decision.

Proposed amendments to the asset valuation input methodology

The asset valuation IM

- 4.21 The asset valuation IM, amongst other things, provides for how distributors' RABs are to be revalued.¹⁴⁴ The IM provides that the revaluation rate for the RAB for price-setting purposes (ie, at price-quality resets) is to be calculated using forecasts of CPI (the resulting revaluations are treated as income); and for annually rolling forward the RAB in ID regulation, outturn CPI. This approach is referred to as 'RAB indexation to inflation' or just 'RAB indexation'.
- 4.22 Effectively, this approach results in a price path provides an expectation of a real return on capital with the revaluation of the RAB providing the compensation for outturn inflation over the period.¹⁴⁵

Changes proposed

- 4.23 Challenges raised to the approach in the asset valuation IM to indexing the RAB to inflation for the purpose of revaluations can be broadly grouped as follows:
- 4.23.1 challenges to the approach to forecasting inflation for the purposes of revaluing the RAB,¹⁴⁶ or
 - 4.23.2 a suggestion that we should allow for the RAB to not be indexed to inflation at all.¹⁴⁷

Approach to forecasting inflation for the purpose of revaluing the RAB

- 4.24 The ENA considers that there is a bias in the CPI forecast revaluation component of returns.¹⁴⁸ They mention a clear track record by the RBNZ of systematically over-forecasting CPI throughout the period of DPP regulation.

¹⁴⁴ [Commerce Commission Electricity Distribution Services Input Methodologies Determination 2012 \[2012\] NZCC 26 \(Consolidated as at 31 January 2019\)](#), Part 4, Subpart 2.

¹⁴⁵ For a more detailed account of how RAB indexation works under the IMs, see [Commerce Commission "Input methodologies review decisions – Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" \(20 December 2016\)](#).

¹⁴⁶ [ENA "Letter to the Commission from the ENA on the WACC estimate and CPI forecasts for DPP3" \(5 September 2019\)](#); [Vector "Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower" \(5 July 2019\)](#).

¹⁴⁷ [Vector "Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower" \(5 July 2019\)](#).

¹⁴⁸ [ENA "Letter to the Commission from the ENA on the WACC estimate and CPI forecasts for DPP3" \(5 September 2019\)](#).

- 4.25 The ENA also considers there is a downside risk (ie, it is unlikely) that inflation will trend back to 2%. They propose that we introduce mechanisms within the DPP to ‘true-up’ CPI forecast errors.¹⁴⁹
- 4.26 We note that many of the arguments submitters have raised against our approach to forecasting inflation apply equally to our approach to forecasting inflation in the context of the specification of price IM (discussed in Chapter 3) and our approach to forecasting CPI in the context of the asset valuation IM. To limit duplication, we have not repeated here the points discussed in Chapter 3.

Un-indexing the RAB from inflation

- 4.27 As well as challenging our approach to forecasting inflation, Vector submitted that we should amend the IMs to allow a distributor to elect not to apply indexation to roll-forward the RAB in circumstances where doing so would better promote the long-term interests of consumers.¹⁵⁰ Vector suggested we should amend the IMs to allow for un-indexing of the RAB because:
- 4.27.1 under the current approach where the RAB is indexed against inflation, the risk of CPI forecast error could lead to distributors having insufficient cashflow in the short term to deliver their investment programmes;
 - 4.27.2 un-indexing the RAB would have the effect of bringing forward cash-flows, supporting distributors’ ability to invest in the short term; and
 - 4.27.3 customers would be indifferent as the return on capital under either approach is NPV neutral.

Why consideration of these amendments is beyond the scope of this amendments process

- 4.28 Like the cost of capital IM, the asset valuation IM is a foundational building block. It provides certainty to consumers and suppliers about how supplier’s assets are to be valued for regulatory purposes (including how they will be depreciated and revalued), including for the purposes of setting of revenues under price-quality regulation and the assessment of profitability under ID regulation.
- 4.29 As such, we consider that the IM for asset valuation should only be changed in a material way outside of the s 52Y review cycle in exceptional circumstances. Absent exceptional circumstances, it is not appropriate to materially amend the asset valuation IM under s 52X in parallel with setting the DPP.

¹⁴⁹ [ENA “Letter to the Commission from the ENA on the WACC estimate and CPI forecasts for DPP3” \(5 September 2019\).](#)

¹⁵⁰ [Vector “Submission to Commerce Commission on changes to the input methodologies for electricity distributors and Transpower” \(5 July 2019\).](#)

- 4.30 We reviewed the asset valuation IM as part of our review of all EDB IMs as part of the s 52Y IM review process in 2016. This included considering issues relating to the exposure of distributors to inflation risk in relation to the approach set out in the IMs for indexing distributor's RABs.¹⁵¹ Through that process, we did not identify any significant problems in relation to our approach to RAB indexation for distributors. Interested parties had the ability to seek a merits appeal of our final decision at that time.
- 4.31 In response to the ENA's proposal that we should introduce a mechanism to 'true-up' CPI forecast errors when applied to RAB indexation approach, we note that this would amount to a change to our policy intent of delivering real returns to delivering nominal returns.¹⁵²

We do not consider that exceptional circumstances apply that mean we should make these amendments despite them being out of scope

- 4.32 We do not consider that exceptional circumstances exist that warrant material amendments to the asset valuation IM outside of the s 52Y review cycle to change to the approach to inflation forecasting for revaluations or to allow for the RAB to be un-indexed from inflation.
- 4.33 Below we first discuss the points raised about the inflation forecasts used in the revaluation approach; and second, the point about whether we should allow the RAB to be un-indexed from inflation.

Whether to change the inflation forecasts used for the revaluation of the RAB

- 4.34 In relation to CPI forecasts, and their potential accuracy or bias, we accept that outturn inflation has tended to be lower over the period of DPP2 than the 2% midpoint of RBNZ's target range (except for a brief spike to 2.2% in March 2017). However, we do not consider that the evidence clearly points to there being exceptional circumstances as we look into DPP3.
- 4.34.1 CPI outturns over the current DPP period have averaged 1.2%. The average over the first half of the period was 0.8%. This number has been trending towards the 2% mark during the second half of the period, with an average of 1.6%.¹⁵³

¹⁵¹ [Commerce Commission "Input methodologies review decisions – Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" \(20 December 2016\).](#)

¹⁵² [Commerce Commission "Input methodologies review decisions Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" \(20 December 2016\).](#)

¹⁵³ <https://www.rbnz.govt.nz/statistics/m1>.

- 4.34.2 Inflation expectations (annual CPI growth) have also moved closer to the 2% mark since late 2016. While the 1, 2 and 5-years out measures eased in the last two quarterly updates, their values do not suggest exceptional circumstances (1.7%, 1.8% and 2% respectively). While perhaps less relevant, inflation expectations 10 years out have always been (and remain) anchored above 2% since records began in 2017.¹⁵⁴
- 4.34.3 Our CPI forecast for 2020 used for revaluations in DPP3 is 1.48%, which is lower than both latest inflation outturns and latest inflation expectations for 2020.
- 4.34.4 The ENA considers there are greater downside risks than upside to the RBNZ/Commission CPI forecast that inflation will trend back to 2%.¹⁵⁵ We note that the November RBNZ Monetary Policy Statement continues to mention a downside risk to the inflation objective.¹⁵⁶ However, we do not consider this is an exceptional circumstance. This is because, in addition to the above-mentioned ‘largely-on-target’ inflation outturns and expectations, the RBNZ is yet to use ‘unconventional’ monetary policy tools, unlike some of its overseas peers, although it has been considering its options.¹⁵⁷ So, while the RBNZ’s room to cut interest rates is low by historical standards, it still has the option to stimulate the economy (and therefore support inflation) using unconventional tools.
- 4.35 It is of course possible that outturn inflation is below or above forecast. While our approach ensures the firm receives a real return, this exposes equity holders to a small risk that they will not achieve a real return when inflation outcomes are different to forecast, and the supplier has issued debt in fixed nominal terms. On the other hand, this exposes debt holders to the opposite risk (ie when equity holders make less-than-real returns, debt holders make higher-than-real returns). This was extensively considered and discussed during the IM review.¹⁵⁸
- 4.36 In addition, in assessing whether the firm gets (an expectation of) a real return, it is not the comparison of the forecast CPI to actual CPI that matters, but the

¹⁵⁴ <https://www.rbnz.govt.nz/statistics/m14>. An alternative measure from RBNZ is the “Household inflation expectations”. Their latest mean values for 1 and 5-years ahead are 2.9% and 3.6% respectively.

¹⁵⁵ [ENA “Letter to the Commission from the ENA on the WACC estimate and CPI forecasts for DPP3” \(5 September 2019\)](#).

¹⁵⁶ <https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Monetary%20policy%20statements/2019/mpsnov19.pdf?revision=d0d191e5-704f-4820-9e75-2e8a6e367a2f>

¹⁵⁷ <https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Bulletins/2018/2018may81-04.pdf>.

¹⁵⁸ [Commerce Commission “Input methodologies review decisions - Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” \(20 December 2016\), Chapter 5.](#)

comparison to the implicit inflation forecast inherent in the WACC. If the latter was systematically lower than the CPI forecast we use to calculate revaluations, then the firm's expectation of earning real return could be compromised. However, given the above evidence on inflation expectations compared to our CPI forecast, we do not consider that this issue amounts to an exceptional circumstance that warrants material amendments to the asset valuation IM outside of the s 52Y review cycle.

Whether to allow the RAB to be un-indexed from inflation

- 4.37 We have not seen convincing evidence that distributors are unable to finance themselves and that consumers would benefit in the long term from an un-indexed RAB approach.
- 4.38 We are not aware of any specific and reliable evidence, either as part of this amendments process or our EDB DPP3 consultation process, that the current approach under-compensates distributors to such an extent that they would face significant financial hardship. Further, we note that an un-indexed RAB approach would expose consumers to inflation risk and could lead to fluctuations in real bills. If a distributor were to transition from an indexed to an un-indexed RAB, this could also create short-term pricing shocks.¹⁵⁹
- 4.39 The merits of RAB indexation were explored in depth at the time of the 2016 IM review and we concluded that continuing with the existing approach gave best effect to the purpose of Part 4. Our policy decision remains to provide an ex-post real return which provides protection for suppliers against inflation turning out differently than forecast and keeps prices constant in real terms for consumers.
- 4.40 We do not consider that exceptional circumstances exist that warrant material amendments to the asset valuation IM outside of the s 52Y review cycle to allow for the RAB to be un-indexed from inflation.

¹⁵⁹ In our 2016 IM review, our first order approximation was that indexing Transpower's RAB would lead to revenue decrease of between \$45m to \$135m annually. [Commerce Commission "Input methodologies review decisions - Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower" \(20 December 2016\), Chapter 6.](#)