

# **Powerco Limited's transition to the 2020-2025 default price-quality path**

## **Draft Reasons Paper**

Date of publication: 18 August 2022



## Associated Documents

Publication Date	Reference	Title
20 May 2020	ISBN 978-1-869458-15-7	Electricity Distribution Services Input Methodologies Determination 2012 – Consolidated as of 20 May 2020
27 November 2019	ISBN 978-1-869457-68-6	Default price-quality paths for electricity distributors from 1 April 2020 – Final decision reasons paper
20 May 2020	ISBN 978-1-869458-16-4	Electricity Distribution Services Default Price-Quality Path Determination 2020 – Consolidated as of 20 May 2020
7 October 2016	ISBN 978-1-869455-33-0	Orion New Zealand’s transition to the 2015-2020 default price-quality path – Final Report
7 October 2016	[2016] NZCC 19	Electricity Distribution Services Default Price-Quality Path Amendment Determination 2016
28 March 2018	ISBN 978-1-869456-33-7	Wellington Electricity’s customised price-quality path – Final decision
20 May 2020	ISBN 978-1-869458-17-1	Wellington Electricity Lines Limited Electricity Distribution Customised Price-Quality Path Determination 2018 – Consolidated as of 20 May 2020
28 March 2018	ISBN 978-1-869456-32-0	Powerco’s customised price-quality path – Final decision
26 May 2022	ISBN 978-1-99-101208-1	Powerco’s transition to the 2020-2025 default price-quality path – Process and Issues paper
18 August 2022	ISBN 978-1-99-101228-9	[DRAFT] Electricity Distribution Services Default Price-Quality Path (Powerco transition) Amendments Determination 2022

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## Executive Summary

### Purpose of this Reasons Paper

- X.1 This reasons paper explains our draft decision to amend the 2020-2025 default price-quality path (**DPP**) to provide for Powerco Limited's (**Powerco's**) transition from its 2018-2023 customised price-quality path (Powerco **CPP**) to the 2020-2025 DPP (**DPP3**).
- X.2 Powerco will move from its CPP to DPP3 on 1 April 2023. This means Powerco will be subject to DPP3 for only the last two years of the five-year regulatory period. DPP3 is the default price path generally applicable to EDBs that do not have a customised price path. DPP3 currently applies to 14 electricity distribution businesses (**EDBs**).<sup>1</sup>
- X.3 The focus of our decision is on the starting prices for Powerco when it moves onto DPP3. Under s 53X(2) of the Commerce Act, we have a choice of rolling over the prices that applied at the end of Powerco's CPP or setting different starting prices.
- X.4 We welcome your views on the matters raised in this paper, and on the drafting of the DPP3 amendment determination within the timeframes set out below:<sup>2</sup>
- X.4.1 submissions by 5pm **Thursday 15 September 2022**; and
- X.4.2 cross-submissions by 5pm **Thursday 29 September 2022**.
- X.5 Further information on how you can provide your views is set out at paragraphs 1.8-1.14.

### Draft decision on starting prices

- X.6 Our draft decision is to:
- X.6.1 not allow prices to roll-over under s 53X of the Act, but instead to notify Powerco that different prices will apply;
- X.6.2 use a Building Blocks Allowable Revenue (**BBAR**) approach to set starting prices for Powerco under DPP3.
- X.6.3 set Powerco's 2024 forecast net allowable revenue (**FNAR**) at \$319.723 million. This is a 5.63% nominal increase from the 2023 FNAR set as part of the Powerco CPP, and reflects both the growth in Powerco's regulatory asset base (**RAB**) following a period of heightened investment during its CPP, and Powerco's current level of operating efficiency.

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<sup>1</sup> Currently only two of the 16 non-exempt EDBs have customised price paths. The two EDBs on a customised price path are Powerco and Aurora Energy.

<sup>2</sup> Available at: [comcom.govt.nz/regulated-industries/electricity-lines/projects/powercos-20232025-dpp](https://comcom.govt.nz/regulated-industries/electricity-lines/projects/powercos-20232025-dpp)

- X.7 In making our decision we are exercising our discretion under section 53X, while being guided by sections 52A and 53K. In particular, we consider that our draft decision:
- X.7.1 maintains Powerco's incentives to innovate and invest (section 52A(1)(a));
  - X.7.2 limits Powerco's ability to extract excessive profits (section 52A(1)(d)); and
  - X.7.3 reflects a relatively low-cost approach to the transition (section 53K).
- X.8 We also consider that our decision is consistent with section 53P because it is based on Powerco's current and projected profitability, does not seek to recover excess profits from the prior period, and is not derived from comparative benchmarking.
- X.9 The BBAR approach provides a way to take account of Powerco's current and projected profitability to set starting prices. The approach is largely similar to that used for each of the other EDBs subject to DPP3 but uses information from Powerco's latest information disclosures.
- X.10 Table X1 below set out the source data we have used for the draft decision.

**Table X1 – Source data for determining allowable revenue**

Data	Source
Real forecast capex	Powerco 2022 AMP update
Base-year opex	Powerco 2022 ID, schedule 6b (unaudited)
Opex trend – household growth	StatsNZ, Family and household projections: 2018(base)–2043, 15 December 2021
Opex trend – line length growth	Powerco ID 2015-2021, schedule 9c Powerco ID 2022, schedule 9c (unaudited)
Opex step changes – non-recurring costs	Powerco CPP application Commission analysis
Opex escalators (LCI, PPI) Capex escalator (CGPI) CPI for revenue path	NZIER forecasts, 27 June 2022
Financial model base year data	Powerco 2022 ID (unaudited) data
All other values	2019 DPP3 financial model

- X.11 This draft decision uses unaudited Information Disclosure (ID) data for the year ended 31 March 2022 supplied to us by Powerco after we requested it. We will have access to Powerco's final audited ID data which we will incorporate before our final decision later this year.

## Chapter 1 Introduction

### Purpose of this Reasons Paper

- 1.1. This reasons paper explains our draft decision for Powerco's transition from its 2018-2023 CPP to DPP3.

### Powerco's CPP and the DPP3 currently applying to 14 electricity distributors

- 1.2. Powerco applied for a CPP for major network investment to address ageing assets, to address an increase in network faults, and to keep up with population and economic growth in the region.<sup>3</sup>
- 1.3. On 28 March 2018, we determined a CPP to apply to Powerco between 1 April 2018 and 31 March 2023.<sup>4</sup>
- 1.4. Powerco has entered the final year of its five-year CPP. One requirement of its CPP determination was for it to prepare and disclose an annual delivery report. This included agreed measures that demonstrate the progress of its network upgrade and how capital and operating expenditure (capex and opex) are tracking with allowable amounts. Powerco's reports to date show that actual capex has been above its allowable capex, while opex has been below its allowable opex.<sup>5</sup>
- 1.5. On 27 November 2019, we set the DPP for the five-year period from 1 April 2020 to 31 March 2025 (i.e., DPP3).<sup>6</sup> The DPP3 determination specified the quality standards that would apply to Powerco when it transitioned to the DPP on 1 April 2023, but did not determine its starting prices.<sup>7</sup> In the associated reasons paper we noted our intention to determine Powerco's starting prices once more up-to-date information became available.<sup>8</sup>
- 1.6. Powerco will move from its CPP to the DPP3 on 1 April 2023. Once it moves, we expect Powerco will be subject to the DPP3 for the remaining two years of the regulatory period unless it applies for another CPP.

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<sup>3</sup> See [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0023/61592/ CPP-application-Powerco-CPP-12-June-2017.pdf](https://comcom.govt.nz/__data/assets/pdf_file/0023/61592/ CPP-application-Powerco-CPP-12-June-2017.pdf)

<sup>4</sup> Available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0028/78715/Final-decision-on-Powercos-2018-2023-customised-price-quality-path-28-March-2018.PDF](https://comcom.govt.nz/__data/assets/pdf_file/0028/78715/Final-decision-on-Powercos-2018-2023-customised-price-quality-path-28-March-2018.PDF)

<sup>5</sup> Latest report (for year ended March 2021) available at: <https://www.powerco.co.nz/media/annual-delivery-report-2021-now-available#:~:text=Last%20year%2C%20Powerco%20replaced%20or,Report%202021%2C%20published%20online%20today.>

<sup>6</sup> Available at: [comcom.govt.nz/regulated-industries/electricity-lines/projects/2020-2025-default-price-quality-path?target=documents&root=91370](https://comcom.govt.nz/regulated-industries/electricity-lines/projects/2020-2025-default-price-quality-path?target=documents&root=91370)

<sup>7</sup> For more detail on the treatment of Powerco in the DPP3 determination refer to: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF](https://comcom.govt.nz/__data/assets/pdf_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF), Attachment I.

<sup>8</sup> Paragraph I15, *ibid*

## Structure of this paper

- 1.7. In this paper, we explain:
- 1.7.1. the legal framework relevant to Powerco’s transition to the DPP3 (Chapter 2);
  - 1.7.2. our draft decision on Powerco’s starting prices when it transitions to DPP3 (Chapter 3); and
  - 1.7.3. how we propose to implement Powerco’s transition to the DPP3 (Chapter 4).

## How you can provide your views

### *Timeframe for submissions*

- 1.8. We welcome your views on the matters raised in this paper, the drafting of the DPP3 amendment determination, the accompanying models, and on any other matters relevant to Powerco’s transition to the DPP3, within the timeframes below:
- 1.8.1. submissions by 5pm on Thursday 15 September 2022; and
  - 1.8.2. cross-submissions by 5pm on Thursday 29 September 2022.

### *Address for submissions*

- 1.9. Responses should be addressed to:
- 1.9.1. Jo Lipscombe (Acting Electricity Distribution Manager)
  - 1.9.2. c/o [infrastructure.regulation@comcom.govt.nz](mailto:infrastructure.regulation@comcom.govt.nz)
- 1.10. Please include “Powerco CPP-to-DPP Draft” in the subject line of your email

### *Confidential submissions*

- 1.11. We discourage requests for non-disclosure of submissions, so that all information can be tested in an open and transparent manner. However, we recognise there may be cases where parties making a submission wish to provide information in confidence.
- 1.12. We offer the following guidance:
- 1.12.1. If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.



- 1.12.2. Where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information.
- 1.12.3. Both confidential and public versions of the submission should be provided.
- 1.12.4. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.<sup>9</sup>
- 1.13. We prefer to receive submissions in both a format suitable for word processing (such as a Microsoft Word document), and in a 'locked' format (such as a PDF) clearly labelled 'public version' for publication on our website.

### Next steps

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

Date	Item
15 September 2022	Submissions Due
29 September 2022	Cross-submissions Due
Early November 2022	Final Decision Released

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<sup>9</sup> Parties can also request that we make orders under section 100 of the Act in respect of information that should not be made public. Any request for a section 100 order must be made when the relevant information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on section 100 orders if requested by parties. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. Any section 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

## Chapter 2 Legal Framework

### Purpose of this chapter

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

### Section 52A – Purpose of Part 4

- 2.2 Part 4 of the Act provides for the regulation of the price and quality of goods or services in markets where there is little or no competition, and little or no likelihood of a substantial increase in competition.
- 2.3 Section 52A sets out the purpose of Part 4 and states:

#### 52A Purpose of Part

(1) The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
- (d) are limited in their ability to extract excessive profits.

- 2.4 In deciding whether to roll over the prices that applied at the end of the CPP, or to set different starting prices, the primary consideration is which option will better promote the objectives in the s 52A purpose.

### Section 53K – Purpose of default/customised price-quality regulation

- 2.5 Section 53K establishes that “the purpose of default/customised price-quality regulation is to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated goods or services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.”
- 2.6 This purpose emphasises the desirability of keeping the cost and complexity of a transition low, including in our approach to setting starting prices.

### Section 53X – What happens when a customised price-quality path ends

- 2.7 Section 53X(2) of the Act gives the Commission two options for determining prices for the CPP-to-DPP transition. Section 53X states:

#### **53X What happens when customised price-quality path ends**

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

2.8 Section 53X(1) and 53X(2) contain the most relevant considerations and are explored in more detail below.

### **Section 53X(1) – Making the supplier subject to the DPP**

- 2.9 Section 53X(1) establishes that when Powerco’s CPP ends it will become subject to the DPP that is “generally applicable” to the other EDBs. In this case, the generally applicable DPP is the DPP3 determination.<sup>10</sup>
- 2.10 Under clause 3.3 of the DPP3 determination, the determination does not apply to Powerco until the expiration of Powerco’s CPP determination. This means that, when Powerco’s CPP determination expires on 31 March 2023, the EDB DPP3 determination will apply to Powerco from 1 April 2023 onwards.
- 2.11 However, some amendments to the DPP3 determination may be required to ensure the DPP that is “generally applicable” to the other EDBs is workable for Powerco.<sup>11</sup> Without these amendments, the mechanics of the DPP determination may not effectively regulate Powerco’s revenue.

### **Section 53X(2) – Setting the transitioning supplier’s starting prices**

- 2.12 Section 53X(2) establishes a default position whereby Powerco’s CPP prices will be applicable when it transitions to DPP3.<sup>12</sup> However, it also gives the Commission the discretion to apply alternative starting prices provided we give Powerco notice of this at least four months prior to their CPP ending.

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<sup>10</sup> A copy of DPP3 can be found here: [comcom.govt.nz/\\_data/assets/pdf\\_file/0029/191972/2019-NZCC-21-Electricity-distribution-services-default-price-quality-path-determination-2020-27-November-2019.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0029/191972/2019-NZCC-21-Electricity-distribution-services-default-price-quality-path-determination-2020-27-November-2019.pdf)

<sup>11</sup> Any amendments to a DPP determination must be made under s 52Q of the Commerce Act, and we note that s 52Q(1) requires the Commission to consult with interested parties on any material amendments to the DPP determination.

<sup>12</sup> We note that s 53X(2) deals with the starting prices that apply when a CPP ends and the supplier transitions to the DPP, while s 53P(11) deals with the starting prices (and rates of change and quality standards) that apply when a DPP ends and the Commission has not reset the DPP for the next regulatory period. Section 53P(11) has the effect of extending DPP starting prices if the Commission doesn’t reset it when a DPP ends, while section 53X(2) establishes that the CPP starting prices will roll over at the end of

- 2.13 We have previously considered how we should set a transitioning supplier's starting prices under s 53X(2). We did this when Orion New Zealand Limited transitioned from its CPP to the EDB DPP for the last year of the 2015-2020 regulatory period,<sup>13</sup> and when Wellington Electricity Limited transitioned from its CPP to the EDB DPP one year into the 2020-2025 regulatory period.<sup>14</sup>
- 2.14 Our discretion in setting starting prices under s 53X(2) involves:
- 2.14.1 choosing between rolling over the prices that applied at the end of the CPP or setting different starting prices; and
  - 2.14.2 if we choose to set different starting prices, deciding on the prices that apply.
- 2.15 In exercising our discretion under s 53X(2), we must do so in the manner we believe best meets the purpose of Part 4 of the Commerce Act (as set out in s 52A), and the purpose of DPP/ CPP regulation (as set out in s 53K) which emphasises the desirability of keeping the cost and complexity of the transition low, including our approach to setting starting prices.
- 2.16 However, the s 52A purpose provides the primary objectives and considerations that we must give weight to when exercising our judgement.

### **Section 53P – Resetting starting prices and rates of change**

- 2.17 If we decide to set different starting prices, s 53P (which sets out the requirements for resetting the DPP at the end of a regulatory period) is a relevant consideration. Section 53P requires that starting prices at the start of a DPP:
- 2.17.1 be either the prices that applied at the end of the preceding regulatory period (s 53P(3)(a)), or based on the current and projected profitability of the supplier (if prices are being reset, s 53P(3)(b));
  - 2.17.2 must not seek to recover any excessive profits made during any earlier period (53P(4)); and
  - 2.17.3 must not be derived from comparative benchmarking (53P(10)).

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a CPP, unless the Commission advises differently before the end of that CPP. The relevance of s 53P is discussed in further detail below.

<sup>13</sup> Available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0021/63255/Orions-transition-to-the-2015-2020-DPP-Final-report-7-October-2016.PDF](https://comcom.govt.nz/__data/assets/pdf_file/0021/63255/Orions-transition-to-the-2015-2020-DPP-Final-report-7-October-2016.PDF)

<sup>14</sup> Available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0034/228886/Wellington-ElectricityE28099s-transition-to-the-2020-2025-DPP-final-decision-Reasons-paper-26-November-2020.pdf](https://comcom.govt.nz/__data/assets/pdf_file/0034/228886/Wellington-ElectricityE28099s-transition-to-the-2020-2025-DPP-final-decision-Reasons-paper-26-November-2020.pdf)

- 2.18 We have some flexibility in how we set prices based on the current and projected profitability of the supplier. In particular, we are not required to undertake a full ‘building blocks’ analysis. Nor are we required to accommodate all of a supplier’s specific circumstances, given the low-cost nature of DPP regulation. See our commentary on s 53K above which highlights the desirability of keeping the cost and complexity of transitions low.
- 2.19 Our view is that it is appropriate for us to apply the section 53P restrictions on setting starting prices when making decisions under section 53X. This is unless particular circumstances lead us to consider that this would be inconsistent with sections 52A or 53K.
- 2.20 Price shocks are also a relevant consideration we refer to later in this paper, and we note that s 53P(8)(a) states:
- (8) The Commission may set alternative rates of change for a particular supplier—
- (a) as an alternative, in whole or in part, to the starting prices set under subsection (3)(b) if, in the Commission’s opinion, this is necessary or desirable to minimise any undue financial hardship to the supplier or to minimise price shock to consumers.

### **Section 52Q**

- 2.21 Any amendments to the DPP determination must be made under s 52Q of the Act. Section 52Q(1) requires the Commission to consult with interested parties on any material amendments to the DPP determination.
- 2.22 Since the amendments we propose in this paper – to reset the starting price for Powerco – are material, we are consulting with interested parties.

## Chapter 3 Our draft decision

### Purpose of this chapter

- 3.1 This chapter explains our draft decision on Powerco's DPP starting prices as it moves to DPP3. Specifically, it explains:
- 3.1.1 how our draft decision aligns with the Act and the legal framework set out in Chapter 2;
  - 3.1.2 our proposal not to allow prices to roll-over under s 53X(2) of the Act, but instead to set Powerco's starting prices based on a BBAR approach;
  - 3.1.3 how we propose to forecast Powerco's opex using a base-step-trend model;
  - 3.1.4 how we propose to assess Software-as-a-Service (SaaS) expenditure being accounted for, once audited actual information for the year ended 31 March 2022 from Information Disclosure (ID) is available before the final decision;
  - 3.1.5 how we propose to forecast Powerco's capex allowance largely based on its 2022 AMP update, subject to a top-down assessment with certain modifications;
  - 3.1.6 our draft decision to use the most recently available inflation forecasts with respect to opex and capex cost escalators;
  - 3.1.7 how the IRIS mechanism will apply;
  - 3.1.8 our proposal not to smooth Powerco's price path; and
  - 3.1.9 details of our methodology for how the existing building blocks models have been used to calculate Powerco's starting prices.
- 3.2 We have set Powerco's 2024 forecast net allowable revenue (FNAR) at \$319.723 million. This is a 5.63% nominal increase from the 2023 FNAR set as part of the Powerco CPP, and reflects both the growth in Powerco's regulatory asset base (RAB) following a period of heightened investment during its CPP, and Powerco's current level of operating efficiency.

### Reasons for our draft decision in alignment with the Act

- 3.3 We consider that our draft decision:
- 3.3.1 maintains Powerco's incentives to innovate and invest (s 52A(1)(a));
  - 3.3.2 limits Powerco's ability to extract excessive profits (s 52A(1)(d));
  - 3.3.3 reflects a relatively low-cost approach to the transition (s 53K); and
  - 3.3.4 is consistent with the requirements of s 53P.

*Maintaining Powerco's incentives to innovate and invest*

- 3.4 Our draft decision uses the BBAR approach and updates the DPP3 models with more recent information (for example from Powerco's 2022 AMP update and unaudited 2022 ID schedules) around recurring and CPP-specific (i.e. non-recurring) expenditure from Powerco. This allows us to better match DPP expenditure allowances with projected expenditure requirements. We consider that appropriate scrutiny of costs helps maintain Powerco's incentives to innovate and invest.

*Limiting Powerco's ability to extract excessive profits*

- 3.5 Our draft decision to use a BBAR approach takes account of Powerco's current costs and projections of expected costs. This takes into account Powerco's more recent actual spending on opex (based on unaudited 2022 ID) and most recent forecasts of capex (for the 2022 AMP update) compared with its allowable opex and capex during the CPP period. In particular, its actual opex has been consistently lower than its allowable opex during its CPP. This approach best promotes the s 52A outcome of limiting a supplier's ability to extract excessive profits.

*A relatively low-cost approach to Powerco's transition*

- 3.6 Our draft decision is a relatively low-cost way of managing Powerco's transition to the final two years of DPP3. As noted above, we have made use of existing models, and available information, and the level of scrutiny we have applied is proportionate to both the levels of expenditure involved, and the period of time remaining on the DPP. This has allowed us to keep the cost and complexity of the transition low in line with the purpose of s 53K.
- 3.7 We consider a roll-over approach would have been higher-cost to develop than applying established BBAR models. A s 53X(2) roll-over has not been carried out before. This would require developing a method of making the roll-over consistent with the Incremental Rolling Incentive Scheme (IRIS) mechanism. The IRIS mechanism needs a consistent 'forecast opex' and 'forecast aggregate value of commissioned assets' to be determined, potentially requiring significant resources and extensive consultation.<sup>15</sup>
- 3.8 Given that Powerco will be subject to the DPP3 for two years, we consider the benefits of adopting a BBAR approach to be justified.

*Our decision is consistent with section 53P*

- 3.9 We have sought to remain consistent with s 53P when determining starting prices using a BBAR approach. It requires that starting prices be based on the current and projected profitability of the supplier, must not seek to recover any excessive profits made during any earlier period, and must not be derived from comparative benchmarking.

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<sup>15</sup> Orion's starting price, when it moved from a CPP to a DPP, was determined as a different starting price under s 53X(2). Orion moved from its CPP in the final year of a DPP regulatory period and IRIS rules did not apply to Orion for that regulatory period.

- 3.10 We consider that we have been consistent with s 53P because we have followed the DPP3 processes in all aspects in which they relate to s 53P.

### **Setting Powerco's starting prices based on a BBAR approach**

- 3.11 As noted in paragraph 2.7, we can choose between rolling over the prices that applied at the end of the CPP or setting different starting prices.
- 3.12 Our draft decision is to set different starting prices rather than rolling over the CPP prices, and to base those different starting prices on a BBAR approach. The BBAR approach was used to set the starting prices of the other EDBs subject to the DPP3. In applying the BBAR approach for Powerco, we have used more recent data, where appropriate, than was available when we set DPP3.
- 3.13 We consider that our draft decision best meets the Part 4 purpose as set out in s 52A, because it maintains Powerco's incentives to innovate and invest and limits the ability to extract excessive profits. We also consider the draft decision meets the purpose of price-quality regulation as set out in the s 53K purpose, because it is a relatively low-cost approach to the DPP transition.
- 3.14 In its submission, Powerco commented that a BBAR approach was preferable because:<sup>16</sup>

It transparently links costs and revenues, is relatively low cost, and sets the right incentives.

...

A BBAR approach is appropriate for setting revenues as it aligns revenues with costs, provides Powerco an expectation of a normal return after accounting for efficient operating costs, incentivises cost savings being shared between us and customers, and can transparently account for the specific circumstances of an EDB. A roll-over approach does not deliver these as noted in the [Process and Issues] Paper (para 55, 58, 63) and there are peculiarities associated with Powerco's CPP that make the rollover approach more nuanced than it may appear.

### **Our draft decision on setting Powerco's opex**

- 3.15 This section sets out our proposed approach to forecasting Powerco's opex. It covers:
- 3.15.1 our high-level approach and the resulting draft opex allowance;
  - 3.15.2 our draft decision on the base-year;
  - 3.15.3 our draft decisions on step-changes; and
  - 3.15.4 our draft decisions on trend factors.

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<sup>16</sup> Pages 1 and 3, see: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0028/286426/Powerco-Submission-on-Powerco-transition-to-DPP3-Process-and-Issues-Paper-16-June-2022.pdf](https://comcom.govt.nz/__data/assets/pdf_file/0028/286426/Powerco-Submission-on-Powerco-transition-to-DPP3-Process-and-Issues-Paper-16-June-2022.pdf)



*Our modelling approach to operating expenditure*

- 3.16 We have proposed setting Powerco's opex allowance using a base-step-trend model, consistent with the approach taken for other EDBs subject to DPP3, but modified for the most up-to-date information, and to account for non-recurring expenditure during the CPP period.
- 3.17 As a result of this approach, we have proposed a draft opex allowance of \$112.678m in 2024 and \$118.930m in 2025. The details of this decision are set out in Table 1 below.

**Table 1: Network and non-network opex, 2024-2025 (\$000s, nominal)**

Opex Allowances	DY24 (\$m)	DY25 (\$m)
Network opex	51,160	54,672
Non-network opex	61,518	64,258
<b>TOTAL</b>	<b>112,678</b>	<b>118,930</b>

- 3.18 The key parameters within the base-step-trend model are set out in Table 2 below.

**Table 2: base opex, scale growth factors, opex PPF, escalators, step changes**

Base, step and trend parameters, \$000s, nominal	
Base opex, i.e. actual 2022 opex expenditure	103,455
Network annual scale growth, 2018 to 2023	0.93%
Network annual scale growth, 2023 to 2028	0.66%
Non-network annual scale growth, 2018 to 2023	1.04%
Non-network annual scale growth, 2023 to 2025	0.64%
Network opex partial productivity factor	0.00%
Non-network opex partial productivity factor	0.00%
Network opex step factors (nominal) 2024	-2,607
Network opex step factors (nominal) 2025	-948

- 3.19 Inflaters are also key parameters and are set out in Table 6 below.

- 3.20 This is consistent with the opex modelling approach taken in EDB DPP3, and allows us to:
- 3.20.1 model step changes to account for recurring and non-recurring expenditure;
  - 3.20.2 forecast growth due to network changes in scale;
  - 3.20.3 inflate opex using a weighted average of the All-Industries Labour Cost Index (LCI) and Producers Price Index (PPI); and
  - 3.20.4 model partial productivity if this is appropriate.
- 3.21 In the EDB DPP3 decision we explained we had taken the base-step-trend modelling approach because we considered that, when combined with the IRIS incentive scheme, it created the right incentives for distributors to improve efficiency while at the same time providing an ex-ante expectation of a normal return.<sup>17</sup>
- 3.22 The base-step-trend modelling approach is appropriate for projecting Powerco's opex for its transition to the DPP3 because most opex relates to activities that recur. As such, the expenditure is likely to be repeated regularly, and can be expected to be influenced by certain known and predictable factors.

*Choice of base year*

- 3.23 Powerco was allowed a certain amount of operating expenditure (opex) during its CPP. So far, Powerco's annual delivery reports shows it has underspent on its allowed opex.<sup>18</sup>
- 3.24 The CPP opex final decision for Powerco recognised that an uplift was necessary to ensure Powerco had sufficient funds to:
- 3.24.1 invest in a range of improvement initiatives, such as the Enterprise Resource Planning tool to coordinate asset and project planning;
  - 3.24.2 correct a backlog of maintenance defects in its network;
  - 3.24.3 improve vegetation management;
  - 3.24.4 deliver a range of renewals and network capacity upgrades; and
  - 3.24.5 increase staff levels to deliver necessary work programmes.

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<sup>17</sup> EDB DPP3 Final Decision para X44 page 21 available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF](https://comcom.govt.nz/__data/assets/pdf_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF)

<sup>18</sup> Latest report (for year ended March 2021) available at: <https://www.powerco.co.nz/media/annual-delivery-report-2021-now-available#:~:text=Last%20year%2C%20Powerco%20replaced%20or,Report%202021%2C%20published%20online%20today.>

3.25 In its submission on our process and issues paper, Powerco noted:

The length of the historical reference period can have a material impact on Powerco's forward looking allowances and, therefore, on our ability to deliver our efficient and planned investments. We support the Commission using its discretion to right-size historical reference periods and other settings in the BBAR model to assess our allowances.<sup>19</sup>

3.26 The question arises as to how suitable a proxy Powerco's recent opex is for forecasting future opex. In its CPP application, Powerco noted expected opex efficiencies in future years from its CPP expenditure.

3.27 Powerco noted in its process and issues paper submission that pre-CPP opex of approximately \$75m per year would not adequately cover future opex. It has projected opex of approximately \$100m per year as a result of previously constrained opex prior to its CPP and ongoing higher expenditure due to an increase in required asset management from increased work during the CPP.

3.28 We agree that pre-CPP opex might not be an appropriate baseline for continuing opex. We are of the view, however, that there should be some observed efficiencies in projected opex, as stated in the excerpt from Powerco's CPP application above. This was the outcome expected by Powerco, the Verifier, and the Commission from the elevated CPP expenditure covering a wide range of initiatives. Therefore, we do not agree that the CPP – without adjustment – provides an appropriate new baseline for opex.

3.29 For this draft decision, and in applying the base-step-trend modelling, we have used Powerco's unaudited DY22 opex as base opex prior to this being disclosed in its 2022 Information Disclosure by 31 August 2022 (in time to use for our final decision later this year). We have used DY22 opex as this is the most recent actual opex, and is consistent with the current opex IRIS.

3.30 The base year determines the initial level of opex that is trended forward. Any efficiencies or inefficiencies contained within the base year will therefore be captured in the baseline opex for the remainder of DPP3.

#### *Proposed step-changes*

3.31 Step-changes allow us to adjust base opex for one-off or non-recurring costs present in the base year, or to make allowance for future steps up or down in opex not captured by trend factors.

3.32 We have identified one proposed set of step changes: adjustments to remove non-recurring costs driven by CPP-specific activities.

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<sup>19</sup> Page 5, see: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0028/286426/Powerco-Submission-on-Powerco-transition-to-DPP3-Process-and-Issues-Paper-16-June-2022.pdf](https://comcom.govt.nz/__data/assets/pdf_file/0028/286426/Powerco-Submission-on-Powerco-transition-to-DPP3-Process-and-Issues-Paper-16-June-2022.pdf)

- 3.33 In addition, we have considered but proposed not to implement two other kinds of step-changes:
- 3.33.1 the impact of the International Financial Reporting Standards (IFRS) accounting change in 2021 which required that Software-as-a-Service (SaaS) costs are no longer treated as non-network capex but should be accounted for as opex; and
  - 3.33.2 reductions for anticipated efficiency gains expected to result from the CPP.
- 3.34 We do not consider it necessary to apply other step-changes that applied at the start of DPP, as these factors are already accounted for in the base year.<sup>20</sup>

*Non-recurring CPP costs*

- 3.35 As noted above in the discussion of the base-year, we agree with Powerco's submission that its pre-CPP opex baseline is not the best reflection of the current and likely future state of its operations. However, there are specific initiatives that were undertaken as part of the CPP that led to opex being incurred that we do not expect will recur in future.
- 3.36 In particular, after reviewing the Powerco CPP opex models we note the following CPP-specific and non-recurring costs were predicted to end by DY23:
- 3.36.1 System Operations and Network Support (SONS) opex. There should be a decrease in SONS opex FTE costs due to asset management, design, service delivery improvement initiatives ending in DY23. This should total about \$0.5 million over DY24 and DY25.
  - 3.36.2 Vegetation management opex. A reduction of \$1.8m from DY23 onwards after a vegetation catch-up spend is completed, and management moves to a sustainable cyclical strategy.
  - 3.36.3 Corrective maintenance opex. An approximate \$0.48 million step down in DY25 for non-recurring corrective maintenance work.
- 3.37 We consider that, as these activities will not be on-going beyond the CPP, they should be removed from forecast opex via a step-change. These specific costs differ from general improvements in overall operating efficiency, which for the reasons discussed below, we have not proposed an adjustment for.
- 3.38 These adjustments are set out in Table 3 below.

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<sup>20</sup> These were: the removal of FENZ levies now treated as a recoverable cost, and adjustment for the treatment of operating leases, and an adjustment to remove any pecuniary penalties.[Ref]

**Table 3: Downward step changes due to non-recurring CPP opex and opex efficiency adjustments from Powerco CPP (\$000, nominal)**

CPP proposal expenditure category	DY24 (\$000, nominal)	DY25 (\$000, nominal)
<b>System operation &amp; network support</b>	-318	-327
<b>Vegetation management</b>	-2,289	0
<b>Corrective maintenance</b>	0	-621
<b>Total</b>	-2,607	-948

3.39 In response to our questions, Powerco stated it had identified ‘three material non-recurring maintenance step change programmes’ and ‘arguably \$1.475m of non-recurring maintenance opex in our FY22 actuals compared to a long-term level of expenditure’, but that:

3.39.1 \$475,000 for LV pillar box data capture is due to end in DY24 (so will only apply as a reduction in DY25); and

3.39.2 \$1m of defect spend is a forecast reduction from DY26 onwards.

3.40 However, Powerco did not discuss the forecast non-recurring expenditures in the CPP SONS opex and vegetation management opex categories. In the expenditure modelling for the remainder of DPP3 we have retained these forecast non-recurring opex reductions.

#### *Adjustment for CPP efficiencies*

3.41 We have considered whether a one-off adjustment to account for efficiencies over the CPP period is justified. We considered this step-change because, in its CPP Proposal, Powerco stated its CPP would result in both capex and opex efficiencies over the CPP period and beyond:

Through these asset management improvements, we intend to achieve significant cost efficiencies. We estimate that by the end of the CPP Period we will achieve Capex efficiencies of around \$6m per year and Opex efficiencies of around \$2m because of asset management improvements. These savings have been reflected in the various Opex and Capex portfolios.

Given the structural improvements we are planning, these efficiencies will not only persist, but will grow in future years as the longer-term benefits sets in. Improved asset management is seen as a key area that will contribute to the long-term interest of our customers.<sup>21</sup>

<sup>21</sup> CPP Main Proposal Section 15.9.2 page 192. Available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0028/61597/Main-proposal-Powerco-CPP-12-June-2017.pdf](http://comcom.govt.nz/__data/assets/pdf_file/0028/61597/Main-proposal-Powerco-CPP-12-June-2017.pdf)

- 3.42 Powerco's Process and Issues paper submission discussed efficiencies as a result of the CPP. It noted that opex efficiencies exist in the service, interruptions and emergencies opex category due to improved network and asset condition, but that these efficiencies had been offset by increased labour rates and staffing requirements. Additionally, Powerco briefly noted that efficiency was a continued focus in its business support opex category.<sup>22, 23</sup>
- 3.43 We tested Powerco about the extent of its opex efficiencies as a result of the CPP. We also tested Powerco about the CPP-specific non-recurring opex costs, and how these had been reflected in its 2022 AMP update opex forecast.
- 3.44 We also reviewed the Powerco discussion on efficiency initiatives and why these have not resulted in the opex cost reductions that were expected to occur as a result of the CPP. At the time Powerco stated that by the end of the CPP these efficiencies may be worth \$2m per annum and would continue after the CPP.
- 3.45 Consistent with s 52A(1)(c) of the Act, improvements in efficiencies should be shared with consumers. However, we consider:
- 3.45.1 to the extent that these efficiency gains have been successfully achieved already, they will be reflected in the base year; and
  - 3.45.2 any future improvements in efficiency will eventually be passed on to consumers in future periods via the opex IRIS mechanism.
- 3.46 As a general principle, our approach to opex efficiency works on a revealed-cost basis, with gains being passed on as they are made. This is consistent with our overall incentive framework. In certain cases – for example when the justification for particular capex projects is premised on future reductions in opex – we may decide to factor in forecast efficiency gains into expenditure forecasts.
- 3.47 In this case, we consider the existing efficiency incentive and sharing mechanisms (the base-step-trend model and the opex IRIS) are sufficient to both:
- 3.47.1 maintain incentives to improve efficiency, consistent with s 52A(b); and
  - 3.47.2 ensure any efficiency gains are share with consumers, consistent with s 52A(c).
- 3.48 While Powerco has cited rising input prices as a potential offset to these efficiency gains, we consider this is best dealt with via the input price trend factor discussed below.

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<sup>22</sup> CPP Main Proposal Section 15.9.2, page 192, available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0028/61597/Main-proposal-Powerco-CPP-12-June-2017.pdf](https://comcom.govt.nz/__data/assets/pdf_file/0028/61597/Main-proposal-Powerco-CPP-12-June-2017.pdf)

<sup>23</sup> Powerco CPP to DPP Process and Issues paper submission, page 18, available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0028/286426/Powerco-Submission-on-Powerco-transition-to-DPP3-Process-and-Issues-Paper-16-June-2022.pdf](https://comcom.govt.nz/__data/assets/pdf_file/0028/286426/Powerco-Submission-on-Powerco-transition-to-DPP3-Process-and-Issues-Paper-16-June-2022.pdf)

### *Software-as-a-Service operating costs*

- 3.49 Software-as-a-Service (SaaS) refers to ongoing subscription-based software services, as opposed to the ownership of software as an asset. It is required to be categorised as opex, rather than non-network capex.<sup>24</sup>
- 3.50 This change in accounting treatment occurred between the determination of Powerco's CPP and the transition to the DPP.<sup>25</sup> As a result we need to ensure these costs are not double- or under-counted.
- 3.51 We tested Powerco on its SaaS costs, asking for information about SaaS costs incurred as opex in DY22 and what levels of SaaS opex costs were forecast from DY23. We also asked Powerco to supply us with a non-network capex forecast with SaaS costs removed.
- 3.52 Powerco responded with further information around its SaaS costs, confirming that 2022 actual opex included SaaS costs, and estimating the deductions that would need to be made from forecast capex. As such, no step-change to opex forecasts is necessary.
- 3.53 Once audited actual opex information from Information Disclosure (ID) is available for the final DPP transition decision, we are confident these costs will be treated appropriately on the opex side. However, we are still confirming the treatment of forecast non-network capex, to ensure the appropriate adjustment is made. This involves seeking further assurance from Powerco about the estimated capex impact. See discussion on non-network capex below.

### *Trend factors*

- 3.54 The final element of our opex model is a set of trend factors that account for predictable ways in which opex may change over time. We have adopted the same trend factors that we applied when determining DPP3 for other EDBs.<sup>26</sup> These are:
- 3.54.1 a scale-growth trend factor, based on an econometric analysis of line-length and ICP growth (as a proxy for growth in the number of households). The 2018 to 2023 scale-growth trend factor is used for the base year (2022) to 2023, while the 2023 to 2025 factor is used for growth from 2023 to 2025;
  - 3.54.2 an opex partial productivity factor; and
  - 3.54.3 a weighted average of the all-industries LCI (60%) and PPI (40%) as a cost escalator.

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<sup>24</sup> Due to revised International Financial Reporting Standards (IFRS).

<sup>25</sup> See <https://www.xrb.govt.nz/assets/pdfs/XRB-Staff-QA-Guidance-on-IASB-Agenda-Decision-Configuration-and-Customisation-Costs-in-Cloud-Based-Computing-Arrangements-.pdf>

<sup>26</sup> Details of this approach can be found in [DPP3 final paper, Attachment A].

- 3.55 We have updated:
- 3.55.1 the historical line-length values from ID used to extrapolate forecast growth;
  - 3.55.2 StatsNZ forecasts of household growth used to proxy forecast ICP growth; and
  - 3.55.3 the most recently available NZIER forecasts of LCI and PPI inflation.
- 3.56 However, because these factors are more stable over time, we have not updated:
- 3.56.1 the network and non-network opex elasticities to line length growth and ICP growth; and
  - 3.56.2 the 0% forecast change in opex partial productivity.
- 3.57 We discuss our approach to cost escalation, and its relationship to the inflation forecasts used to smooth the revenue path further below.

### **Our draft decision on setting Powerco's capital expenditure**

#### *Capital expenditure*

- 3.58 We have taken a largely top-down approach in setting capex allowances for DY24 and DY25. This approach is largely consistent with the capex modelling approach taken in EDB DPP3, with the exception that we have:
- 3.58.1 considered non-network capex separately given a significant portion of this is non-recurring expenditure and using historical capex may not be a good predictor of future needs; and
  - 3.58.2 approved asset replacement and renewals capex as forecast because Powerco asset health modelling has matured since the 2017 CPP.
- 3.59 Based on applying the same top-down approach taken in EDB DPP3 to set DY24 and DY25 capex allowances, we have used the Powerco 2022 AMP update forecast and have forecast capex by:
- 3.59.1 relying on distributor constant-price AMP update capex forecasts, subject to a cap based on historical expenditure;
  - 3.59.2 forecasting network and non-network capex separately;
  - 3.59.3 using a five-year historical reference period;
  - 3.59.4 applying a uniform 120% cap relative to historic average network capex (assessed net of capital contributions);



- 3.59.5 applying a linear ‘sliding-scale’ cap relative to historic average expenditure for non-network capex, with a maximum cap of 200% where non-network capex was less than 5% of total capex, and a minimum of 120% where non-network capex was more than 25% of total capex;
- 3.59.6 inflating constant-price capex forecasts to a nominal forecast series using NZIER’s forecast of the All-Industries Capital Goods Price Index (CGPI);
- 3.59.7 including an explicit allowance for forecast cost of financing, and forecast value of vested assets; and
- 3.59.8 assuming forecast aggregate value of commissioned assets is the same as forecast capex, as required in the IMs.<sup>27</sup>

### General approach

- 3.60 In our EDB DPP3 Final Reasons paper we describe the top-down capex setting process fully in Attachment B and the process is generally represented in Figure 1:<sup>28</sup>

**Figure 1: Top-down capex setting approach**



- 3.61 As shown in Figure 1, our approach consists of four main steps:

- 3.61.1 Step 1 is to scrutinise forecast expenditure. Our approach scrutinises categories of capex within the current AMP update forecasts, utilising the expenditure categories within ID. We have applied scrutiny to expenditure used for meeting growth — comprising ‘consumer connection’ and ‘system growth’ capex — and expenditure used to improve existing capabilities — comprising ‘reliability, safety and environment’ (RS&E) capex. We have identified cost drivers for these bundled categories, and have assessed whether the expenditure for each category appears consistent with those cost drivers, within a tolerance commensurate with the high-level nature of the analysis.

<sup>27</sup> Commerce Commission Electricity Distribution Services Input Methodologies Determination 2012 [2012] NZCC 26 (Consolidated as at 31 January 2019), clause 4.2.5.

<sup>28</sup> Available at: [comcom.govt.nz/\\_\\_data/assets/pdf\\_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF](https://comcom.govt.nz/__data/assets/pdf_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF)

- 3.61.2 Step 2 is to calculate fall-back expenditure where necessary. Where we concluded that forecasts for the capex categories we have scrutinised do not reflect their cost drivers, we calculated an expenditure allowance for that category that is more consistent with those cost drivers.
- 3.61.3 Step 3 is to cap 'other' expenditure. We have capped the remaining, minor categories of expenditure, being asset relocations and non-network expenditure. We have used the higher of a dollar-cap and a percent-based cap on growth over historic average expenditure. The percent-based cap uses the same 'sliding scale' that was used for expenditure on non-network assets in DPP2.
- 3.61.4 Step 4 is to apply an aggregate cap. As a final step, we have capped our aggregate capex forecasts for Powerco at 120% of its historical average expenditure. This is similar to DPP2 where we capped expenditure for network assets at 120% of historical average levels. This overall cap is intended to reflect the point at which we consider the cost impact on consumers justifies further scrutiny of expenditure.
- 3.62 We have used historical capex to calculate average capex projections to limit forecast capex. Similar to EDB DPP3 we have used the most recent five years of historical capex data (2018 – 2022 for Powerco) to create the average capex projections.

#### *Non-network capex*

- 3.63 Due to the non-recurring nature of some non-network capex, using historical expenditure may not be a good predictor of future expenditure. We scrutinised Powerco's forecast non-network capex using its 2021 AMP and 2022 AMP Update.
- 3.64 In our review of Powerco's non-network capex forecasts we observed a significant uplift in routine and atypical expenditure, due to ICT capex in DY24 and DY25 and facilities capex in DY23, DY24 and DY25. See last two rows of Table 4.

**Table 4: Comparison of Powerco 2021 AMP and 2022 AMP update non-network capex forecasts – uplift between 2021 and 2022 AMPs**

Non-network capex All values 2022 \$000s	DY23		DY24		DY25	
	2021 AMP	2022 AMP	2021 AMP	2022 AMP	2021 AMP	2022 AMP
<b>Routine expenditure</b>						
ICT capex	5,197	4,742	6,436	9,608	4,983	4,615
Facilities capex	905	963	281	254	426	254
Leases	1,812	1,268	1,812	1,268	1,812	1,268
<b>Subtotal</b>	<b>7,915</b>	<b>6,973</b>	<b>8,528</b>	<b>11,130</b>	<b>7,221</b>	<b>6,137</b>
<b>Atypical expenditure</b>						
ICT capex	7,880	4,676	4,085	2,778	1,196	2,318
Facilities	113	1,438	253	4,354	507	4,608
<b>Subtotal</b>	<b>7,994</b>	<b>6,114</b>	<b>4,338</b>	<b>7,132</b>	<b>1,703</b>	<b>6,926</b>
<b>Non-network capex total</b>	<b>15,908</b>	<b>13,087</b>	<b>12,867</b>	<b>18,262</b>	<b>8,924</b>	<b>13,063</b>
<b>ICT uplift</b>			<b>3,172</b>		<b>1,122</b>	
<b>Facilities uplift</b>	<b>1,382</b>		<b>4,101</b>		<b>4,101</b>	

3.65 In testing Powerco's 2022 AMP update we could find no explanation of these expenditure increases, so decided to not include them in the capex modelling. Instead, in our capex allowance modelling we have used Powerco's 2021 AMP forecast amounts for:

3.65.1 DY24 and DY25 ICT capex; and

3.65.2 DY23, DY24 and DY25 Facilities capex.

#### *Asset replacement and renewals capex*

3.66 One key driver of the CPP for Powerco was to improve its data processes and asset health modelling. Mature asset health models make it much more likely than not that asset replacement and renewals capex forecasts can be relied upon, rather than using historical expenditure to predict future expenditure needs.

3.67 We reviewed Powerco's latest AMP material to test the maturity of its asset health modelling to assess whether we could approve this category of expenditure outside of the top-down approach we propose to take for other categories of expenditure.

- 3.68 In its most recent full AMP in 2021, Powerco stated it has been refining Condition Based Risk Management (CBRM) asset models since 2016. This is a method that:

“...uses a combination of asset condition and risk to predict failure cost, helping to prioritise renewal expenditure.”<sup>29</sup>

- 3.69 Powerco further states:

With the development of our new Copperleaf C55 system, these models, along with a majority of our asset types are now integrated in to it for a total of 9 Asset models, covering 50 different asset types – now including linear assets (cables and conductor) as well as our high volume fleets such as poles and crossarms. This greatly refines our modelling approach for these asset categories.

This methodology differs from other forecasting methods that we use in that it develops a bottom up estimate of current and future asset health, probability of failure and risk for each individual asset in the fleet. Information used to produce these estimates includes the asset’s characteristics (what the asset is), the asset’s condition (how the asset is) and the asset’s operational context (how failure could affect safety, network performance, operational and environmental objectives).<sup>30</sup>

- 3.70 Our view is that taking a bottom-up condition-based failure risk approach to forecasting means we can have confidence in those forecasts. Our draft decision is that the forecasts are reasonable and we can approve these.

*Revised non-network capex forecast due to SaaS costs treated as opex*

- 3.71 Due to the IFRS accounting change in 2021, which requires that Software-as-a-Service (SaaS) costs be treated as opex, we asked Powerco to supply us with a revised non-network capex forecast with SaaS costs removed from its 2022 AMP update forecast.

- 3.72 Powerco provided this revised forecast and we have used this to set capex allowances for DY24 and DY25. Once audited actual capex information from Information Disclosure (ID) is available for the final DPP transition decision, we will confirm the appropriate adjustment is made. This involves, as mentioned above, seeking further assurance from Powerco about the estimated capex impact.

*CPP capital expenditure and projections*

- 3.73 Powerco commented in its process and issues paper submission that its CPP capex spending was not a short-term catchup:

For the most part, our CPP wasn’t a short-term ‘one-off’ catchup in investment. It was a reset to a new baseline. This is reflected by the trace of historical and forecast capital expenditure – the level of forecast costs in FY24/25 is better represented by more recent historical data compared to earlier historical data.

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<sup>29</sup> Page 108, Powerco 2021 Asset Management Plan, Section 10.4.2.2

<sup>30</sup> Ibid

3.74 Regarding capex so far, Powerco's annual delivery reports shows it has been exceeding its allowances.<sup>31</sup>

3.75 Powerco commented in its process and issues paper submission that:

Our pre-CPP expenditure was constrained because allowance levels did not reflect our long-term investment requirements. The CPP approval process provided evidence of this.

3.76 We agree that pre-CPP capex does not represent a suitable baseline for projected capex and is lower than long-term requirements. However, we do not necessarily agree that the CPP approval process in itself demonstrates CPP capex to be a suitable baseline.

3.77 Powerco further commented:

Our pre-CPP expenditure levels for customer connections and asset relocations are not a fair reflection of our ongoing investment requirements in these areas. Noting that we have little to no control over the level of these investment requirements.

The asset replacement and renewal models used in the CPP approval process demonstrated that expenditure in this area needed to be at CPP approved levels for longer than the CPP period. A reduction in expenditure in this area post-CPP would negatively impact asset health.

and

Our pre-CPP investment in system growth was constrained and did not represent our long-term investment requirements. The CPP approval process provided evidence of this, and our AMP22 update suggests there is no let-up in demand growth which reflects more recent trends.

3.78 We agree that capex on customer connections and asset relocations are less controllable factors for Powerco's capex. There is also a risk that a reduction in capex allowance in this area risks reallocation of capex away from maintenance of assets.

Our pre-CPP investment in system growth was constrained and did not represent our long-term investment requirements. The CPP approval process provided evidence of this, and our AMP22 update suggests there is no let-up in demand growth which reflects more recent trends.

3.79 We agree that pre-CPP system growth capex does not reflect projected capex. We explain further below how we propose to address this issue.

*Our draft decision for capex*

3.80 Our draft decision for capex is to:

3.80.1 approve the Asset Replacement & Renewal capex forecast for DY2024 and DY2025 provided in Powerco's 2022 AMP update;

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<sup>31</sup> Latest report (for year ended March 2021) available at: <https://www.powerco.co.nz/media/annual-delivery-report-2021-now-available#:~:text=Last%20year%2C%20Powerco%20replaced%20or,Report%202021%2C%20published%20online%20today>.

- 3.80.2 scrutinise the non-network capex based on the AMP material and perhaps seek supporting evidence from Powerco if this is not sufficient; and
  - 3.80.3 apply a top-down business-as-usual threshold type analysis with no margin added to the remaining capex categories noting there are re-opener possibilities for selected capex categories (System Growth, Consumer Connections and Asset Replacement & Renewal); and
  - 3.80.4 apply an aggregate 120% cap to capex as a whole, consistent with the treatment applied for other EDBs on DPP3.
- 3.81 We have proposed a capex allowance of \$229.965m in 2024 and \$228.671m in 2025. See Table 5.

**Table 5: capex, DY2024-2025, (\$000, nominal)**

Capex Allowances, \$000s, nominal	DY24	DY25
Consumer connections	25,125	24,720
System growth	78,443	78,745
Asset replacement and renewal	94,447	94,554
Asset relocation	1,424	1,459
Total reliability, safety and environment	18,958	20,911
Non-network	11,568	8,282
<b>Total</b>	<b>229,965</b>	<b>228,671</b>

#### **Our draft decision on cost escalators for opex and capex**

- 3.82 We have proposed applying the same choice of opex and capex cost escalators series for Powerco as we applied for other EDBs on DPP3, and to use the most recently available NZIER forecasts of these series. The indices (forecasts of which are shown in Table 6 we have applied are:
- 3.82.1 for opex, a weighted average of the all-industries LCI (60% weighting) and producer price index (40% weighting); and
  - 3.82.2 for capex, the all-industries capital goods price index (CGPI).

**Table 6: Forecast cost escalators (base year 2022 = 1.0000)**

Series	2023	2024	2025
LCI	1.0260	1.0480	1.0648
PPI	1.0480	1.1366	1.1795
Total opex escalator	1.0533	1.0953	1.1256
CGPI	1.0613	1.0998	1.1281

- 3.83 Powerco commented in its submission that cost inflators should be updated where appropriate:

The Commission has discretion in how expenditure allowances are set and we think they should be based on the most up-to-date information available to allow for appropriate cost recovery... including cost inflators. While CPI and WACC are locked in by the input methodologies, the input cost inflators are not.

- 3.84 It further notes that updating DPP3 indices is important for preserving its incentives to innovate and invest, because updating:

provides an ex-ante expectation that revenues reflect estimated costs; and

ensures IRIS expenditure allowances are appropriate - as expenditure allowances are set in nominal terms, insufficient input cost inflation will increase the risk of Powerco incurring IRIS penalties even if we spend exactly to our allowances in real terms.

- 3.85 Powerco also made the following points about cost inflators:

- 3.85.1 DPP should be a low-cost regime. Updating PPI, LCI, CGPI would still fit with this.
- 3.85.2 There should be an expectation of normal returns. A revenue allowance set too low for expected expenditure is likely to result in Incremental Rolling Incentive Scheme (IRIS) penalties.
- 3.85.3 Capex re-openers and the innovation allowance do not address inflation. As such, remedies for inadequate expenditure allowances are limited.
- 3.85.4 Powerco faces different circumstances to Wellington Electricity (which did not have updated cost inflators for PPI, LCI and CGPI in its 2021 DPP3 transition). Cost inflators are further out-of-date, as they were set in 2018.
- 3.85.5 CPI provides an inadequate hedge for Powerco. The wash-up balance only applies for one year, but cost inflators apply for three years; and
- 3.85.6 Updating cost inflators for Powerco will maintain consistency with other EDBs on DPP3, because there are different macroeconomic conditions, and the wash-up has a limited hedge effect due to a shorter DPP3 period for Powerco.

- 3.86 We agree that the DPP transition decision should provide the prior expectation of a normal return, and that the choice of escalators has an effect on this.
- 3.87 During the DPP period, allowable revenue from one year to the next (in this case 2024 to 2025) will increase at outturn CPI, and the prices Powerco will pay for its inputs will also be subject to inflation. Because of this, using a set of consistent, up-to-date forecasts of the inflation components of the revenue path and of nominal expenditure increases helps create the expectation of a normal return.
- 3.88 As Powerco notes in its submission, macroeconomic conditions have changed significantly since 2019 when the DPP was determined. Under current settings in the IMs and our approach to DPPs, regulated suppliers are exposed to real price effects (increases in input costs relative to inflation). Using up-to-date and independent forecasts (such as those produced by NZIER) means this risk is symmetric.<sup>32</sup>
- 3.89 In accordance with s 53X, when Powerco's CPP ends we are required to ensure it is subject to the same DPP3 that is 'generally applicable' to other EDBs on the DPP3. As we explain in paragraph 2.11, some amendments may be necessary to ensure that the 'generally applicable' DPP3 is workable for Powerco and, as such, we have some discretion in how cost inflators are taken into account.

#### **Our draft decision on the treatment of IRIS**

- 3.90 For the DPP3 IRIS retention factor for financial years 2024 and 2025, we do not consider a special adjustment is required, which is consistent with Powerco's own view.
- 3.91 Therefore, a retention factor of 23.5% will apply to Powerco for capex and opex. This is the same retention factor as for other EDBs on the DPP3.

#### **Our draft decision to not smooth the price path**

- 3.92 As explained above in paragraph 2.21, the Act allows us to smooth an EDB's price path to minimise price shocks to consumers. However, as the proposed revenue change is nominally a 5.63% increase and therefore less than a 10% real increase, our draft decision is not to smooth the price path.

#### **Modelling methodology and results**

- 3.93 To set Powerco's starting prices we have used models that were used in 2019 to set the DPP3 price paths.

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<sup>32</sup> Reconsideration of the overall treatment of inflation under the CPP-DPP system goes beyond the scope of this project.



- 3.94 We have revised seven of the models that were used in 2019 to set the DPP3: the financial model; the capex projections model; the opex projections model; the disposals model; the household growth model; the circuit length model; and the input cost inflators model.
- 3.95 The purpose of the revisions is to:
- 3.95.1 modify the financial model to change the BBAR and maximum allowable revenue (MAR) modelling to set a two-year price path for Powerco, rather than the five-year price path for the other EDBs;
  - 3.95.2 modify the capex projections and opex projections models to project costs for a two-year price path rather than a five-year price path and to implement expenditure projection policy changes from DPP3;
  - 3.95.3 incorporate Powerco's most recent annual information disclosures of historical opex and capex;<sup>33</sup>
  - 3.95.4 incorporate Powerco's 2022 AMP update forecast of capital expenditure, rather than its 2019 AMP forecast in our determination of capex allowances;<sup>34</sup>
  - 3.95.5 calculate opex and capex cost allowances using updated cost inflators from NZIER;
  - 3.95.6 incorporate the most recent annual information disclosures of circuit length and level of disposed assets;
  - 3.95.7 incorporate the most recent NZIER indices used in the cost inflators model; and
  - 3.95.8 incorporate the most recent Statistics NZ forecasts on household growth.
- 3.96 Information about the modifications made to each model is available in the 'Description' sheet of the model. The models can be downloaded from the Commission's website.<sup>35</sup>
- 3.97 There are a number of feeder models that provide inputs to these seven models. These feeder models have not been updated for the reasons set out in the table below:

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<sup>33</sup> Available at: [powerco.co.nz/-/media/project/powerco/powerco-documents/who-we-are---pricing-and-disclosures/disclosures/electricity-disclosures/5-electricity-information-disclosure-financial-and-technical/fy21-electricity-disclosure-1-april-2020-31-march-2021.pdf](https://powerco.co.nz/-/media/project/powerco/powerco-documents/who-we-are---pricing-and-disclosures/disclosures/electricity-disclosures/5-electricity-information-disclosure-financial-and-technical/fy21-electricity-disclosure-1-april-2020-31-march-2021.pdf)

<sup>34</sup> Available at: [powerco.co.nz/-/media/project/powerco/powerco-documents/who-we-are---pricing-and-disclosures/disclosures/electricity-disclosures/2-electricity-asset-management-plans/2022-electricity-asset-management-plan.pdf](https://powerco.co.nz/-/media/project/powerco/powerco-documents/who-we-are---pricing-and-disclosures/disclosures/electricity-disclosures/2-electricity-asset-management-plans/2022-electricity-asset-management-plan.pdf)

<sup>35</sup> Available at: [comcom.govt.nz/regulated-industries/electricity-lines/projects/powercos-20232025-dpp](https://comcom.govt.nz/regulated-industries/electricity-lines/projects/powercos-20232025-dpp)

Model	Reason for not updating
Econometric	The elasticities determined with the econometric model are expected to be relatively stable, so we do not consider the resource requirements for updating this model justify an update in the relatively low-cost DPP context.
CPI	<p>The input methodologies specify which Reserve Bank forecast we must use in establishing 'forecast CPI'. This results in 'forecast CPI' not being updated since the DPP3 CPI model was prepared and published.</p> <p>CPI is an input to the capex model, and this use is not constrained by the input methodologies. Updating this CPI forecast would have no impact on the capex projection.<sup>36</sup></p>
Operating lease	An operating lease model was prepared for the DPP3 decision, based on s 53ZD information. We have not repeated the s 53ZD information request as we did not consider the significant effort by and cost on Powerco and us to be justified, as the projections made in the DPP3 process were likely to be adequate for the transition to the DPP3.

### Modelling results

3.98 The starting price is calculated in the models as the 2024 MAR. It appears in the determination as the 2024 FNAR. The model calculates Powerco's FNAR in 2024 to be \$319.723m.<sup>37</sup>

3.99 We can compare this value to:

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

3.100 The values are compared in this table:

All values \$'000	2023	2024	2025
CPP final year to MAR	302,685		
CPP to DPP draft decision: year to MAR		319,723	326,118

3.101 The draft decision value reflects a nominal 5.63% increase in net allowable revenue relative to the current year's CPP value.

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

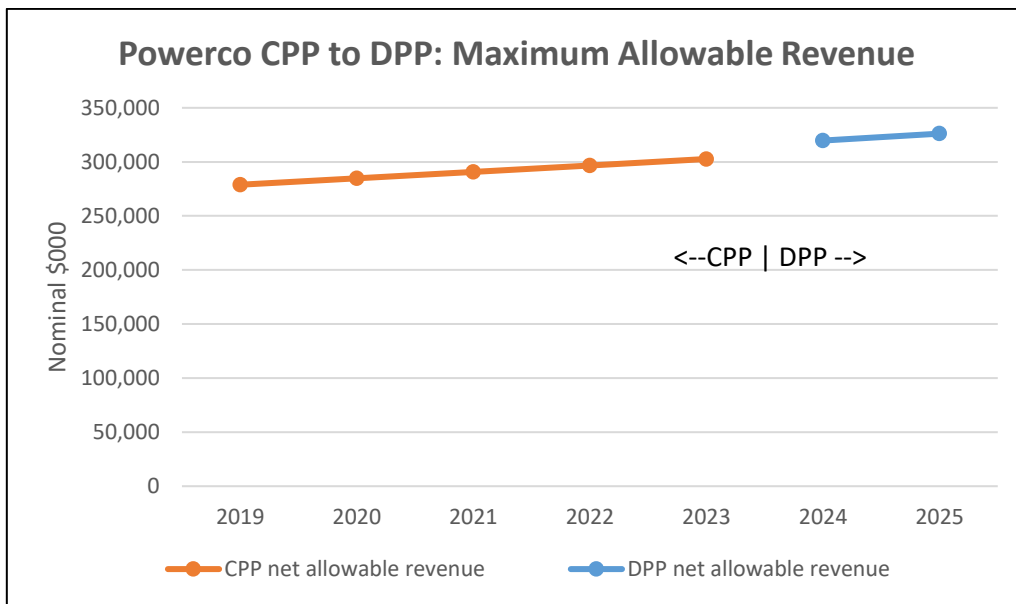
<sup>36</sup> The CPI is used to determine whether an EDB passes one of the capex scrutiny tests: "Gate 3 – Asset replacement and renewals". Powerco passes this gate by a wide margin, and any CPI update would not change its pass result for this gate.

<sup>37</sup> MAR is the forecast value from the financial model. FNAR is the amount specified in the determination, and is updated each year for changes in inflation. In the first year of the regulatory period – or after a transition – these values are the same.

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

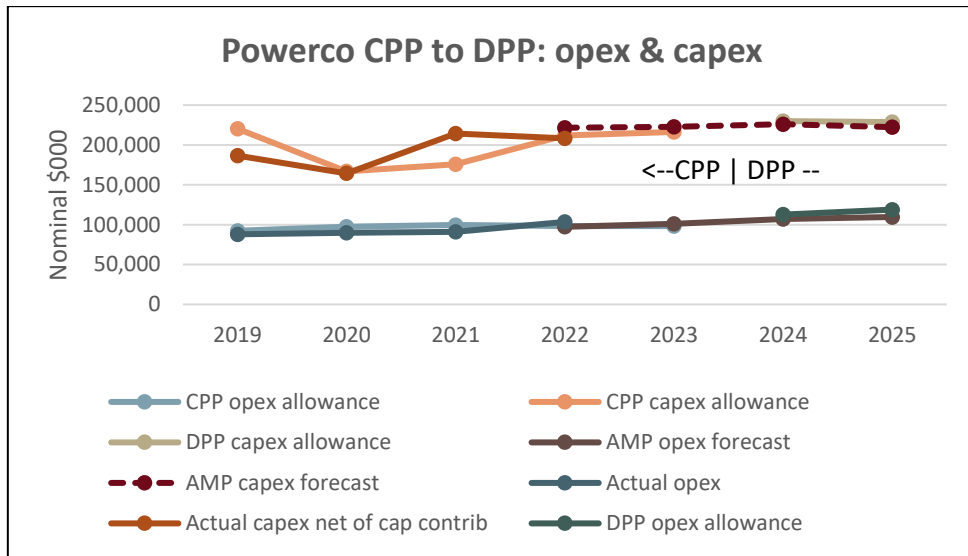
3.104 In Powerco’s price-setting compliance for disclosure year 2023 (the last year of its CPP) statement, for example, the total forecast allowable revenue (which includes forecast pass-through and recoverable costs) was \$405.2m while the FNAR was \$250.9m, so the FNAR was 62% of total forecast allowable revenue.<sup>38</sup>

**Figure 2: Powerco CPP to DPP, Maximum Allowable Revenue**



<sup>38</sup> Available at: [powerco.co.nz/-/media/project/powerco/powerco-documents/who-we-are---pricing-and-disclosures/disclosures/electricity-disclosures/3-electricity-customised-price-quality-path/2023/fy23-annual-pricesetting-compliance-statement-1-april-2022-31-march-2023.pdf](https://powerco.co.nz/-/media/project/powerco/powerco-documents/who-we-are---pricing-and-disclosures/disclosures/electricity-disclosures/3-electricity-customised-price-quality-path/2023/fy23-annual-pricesetting-compliance-statement-1-april-2022-31-march-2023.pdf)

Figure 3: Powerco CPP to DPP, opex & capex



## Chapter 4 Implementation

### Purpose of this chapter

- 4.1 The draft DPP3 amendment determination, published alongside this draft reasons paper, sets out the way we propose the starting prices be implemented.<sup>39</sup>

### Pass-through balance allowance

- 4.2 The existing paragraph 5 of Schedule 1.5 of the DPP3 determination provides a formula for EDBs to calculate their forecast allowable revenue. It includes the term 'pass-through balance allowance' (PTBA) which is defined in Clause 4.2 of the DPP3 determination.
- 4.3 That definition relies on the values of the pass-through balance and estimate of the pass-through balance (ePTB). These are also defined in Clause 4.2.
- 4.4 For the year ended 31 March 2020, Powerco was not subject to the DPP3 determination that is referred to in the clause 4.2 definition of 'pass-through balance' (PTB).<sup>40</sup> Unlike the other EDBs, Powerco will therefore not have values for pass-through balance and ePTB.
- 4.5 The residual PTB from when Powerco was subject to the 2015-2020 DPP has been dealt with in the Powerco CPP. There is now no need for any further transitional requirements for a PTB.
- 4.6 A workable outcome requires either the PTBA for Powerco:
- 4.6.1 to be defined as nil for all assessment periods of the DPP3; or alternatively,
  - 4.6.2 the term 'pass-through balance allowance' could be removed from the formula for 'forecast allowable revenue' and 'actual allowable revenue'.
- 4.7 Our draft decision is to adopt the second of these two options.
- 4.8 The PTB is also used in the DPP3 Schedule 1.6(2)(a) formula for 'actual allowable revenue'. In the draft decision determination, the schedule provides a formula for only Powerco which makes no reference to a PTB.

### *Ensuring the 2018/19 and 2019/20 wash-up amounts are taken into account*

- 4.9 For EDBs other than Wellington Electricity and Powerco, 2019 and 2020 was before the revenue cap applied and no wash-up amount applied in those year. However, for Wellington Electricity and Powerco, 2019 and 2020 wash-up amounts do apply as the revenue cap applied in during those assessment periods, and they need to be taken into account.

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<sup>39</sup> Available at: [comcom.govt.nz/regulated-industries/electricity-lines/projects/powercos-20232025-dpp](http://comcom.govt.nz/regulated-industries/electricity-lines/projects/powercos-20232025-dpp)

<sup>40</sup> Electricity Distribution Services Default Price-Quality Path Determination 2015 [2014] NZCC 33.

- 4.10 The calculation of ‘actual allowable revenue’ in the DPP3 determination does not provide for taking 2019 or 2020 wash-up amounts into account, so in the draft decision determination we have added a new paragraph (9) to Schedule 1.6 to set out the methodology for Powerco.
- 4.11 The draft decision determination Schedule 1.7 has been amended from the DPP3 text to achieve the policy intent.

*Actual net allowable revenue for 2024*

- 4.12 From a policy perspective, we could expect the DPP3 determination would specify both the forecast and actual net allowable revenue (ANAR) values for 2024 as a numerical value. That value will have been produced from the financial model for the CPP to DPP3 transition.
- 4.13 IM Clause 3.1.3(13)(i) effectively requires the ANAR<sub>2024</sub> value to be the previous year’s value increased by CPI–X. That is different from simply specifying a numerical value as the 2024 ANAR.
- 4.14 To comply with the IM requirement, and to also apply a known numerical value to the 2024 ANAR, we have drafted the determination to effectively back-calculate a 2021 ANAR. The back-calculation is such that, when it is rolled forward at CPI–X to a 2024 value, the calculated result is equal to the known numerical value.
- 4.15 We used a similar approach earlier in 2020 for Wellington Electricity and Powerco, which were both on CPPs and were subject to a ‘WACC change’.<sup>41</sup>
- 4.16 A complication arises with the CPI values for the CPI–X adjustment not being available until after the end of the 2024 year. This complication has been resolved in the draft determination by using a formula, instead of numerical values, to specify the 2023 FNAR.
- 4.17 To comply with IM 3.1.1(13)(h), the 2021 ANAR is specified through a reference to the 2021 FNAR. The reason for this is that IM 3.1.1(13)(h) defines the actual value in terms of the forecast value.

*IRIS amounts and Innovation allowance*

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

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<sup>41</sup> Further information on the WACC change decision is available on our Wellington Electricity CPP webpage: [comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-customised-price-quality-path/wellington-electricitys-20182021-cpp](https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-lines-price-quality-paths/electricity-lines-customised-price-quality-path/wellington-electricitys-20182021-cpp).

- 4.19 For consistency with the amendments made in 2019 to the opex IRIS to account for the change in accounting treatment of operating leases under IFRS16, we have specified a separate opex forecast for IRIS purposes, that excludes operating lease amounts.<sup>42</sup>
- 4.20 Schedule 5.3 of the draft DPP3 amendment determination contains a table showing the innovation project allowance for the DPP regulatory period. As for the other EDBs in the determination, Powerco's allowance is based on the total annual FNAR.

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<sup>42</sup> See: [Commerce Commission 'Treatment of operating leases – Final decision paper' \(13 November 2019\)](#), Chapter 4.