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Amendments to input methodologies for electricity distribution businesses, gas pipeline businesses and Transpower relating to insurance entitlements, compensatory entitlements, third-party liability entitlements and other regulated income

Final decision and reasons paper

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Associated documents

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20 May 2024		Notice of Intention - Potential amendments to Input Methodologies for Electricity Distribution Services, Gas Distribution Services, Gas Transmission Services and Transpower
28 September 2012	NZCC 26	Electricity Distribution Services Input Methodologies Determination 2012
28 September 2012	NZCC 28	Gas Transmission Services Input Methodologies Determination 2012 [2012]
28 September 2012	NZCC 27	Gas Distribution Services Input Methodologies Determination 2012 [2012]
29 June 2012	NZCC 17	Transpower Input Methodologies Determination [2012]

Commerce Commission
Wellington, NEW ZEALAND

Contents

Glossary

Acronym	
Capex IM	Transpower Capital Expenditure Input Methodologies
CPP	Customised price-quality path
DPP	Default price-quality path
DPP3	Default price-quality path for the third regulatory period (1 April 2020 – 31 March 2025)
DPP4	Default price-quality path for the fourth regulatory period (1 April 2025 – 31 March 2030)
the Act	Commerce Act 1986
EDB	Electricity Distribution Businesses
GAAP	Generally accepted accounting practice
GDB	Gas Distribution Business
GPB	Gas Pipeline Business
GTB	Gas Transmission Business
ID	Information Disclosure
IMs	Input Methodologies
IRIS	Incremental Rolling Incentive Scheme
ORI	Other regulated income
Part 4	Part 4 of the Commerce Act 1986

Executive summary

X1 This paper sets out our final decision on amendments we proposed to the current input methodologies (IMs) for default price-quality paths (DPPs), customised price-quality paths (CPPs), Transpower's individual price-quality path (IPP), and information disclosure (ID), in relation to the treatment of insurance entitlements, compensatory entitlements, third-party liability entitlements and other regulated income (ORI).

X2 The amendments apply to the IMs:

X2.1 for electricity distribution services, gas transmission services, gas distribution services, and Transpower; and

X2.2 that currently apply, and as amended by the IM amendments from the recent Part 4 IM Review.[1]

X3 As part of giving effect to our final decision, this paper also explains a related amendment to the definition of 'other regulated income' in:

X3.1 the Transpower Individual Price-Quality Path Determination 2020 [2019] NZCC 19 (IPP for RCP3); and

X3.2 the Transpower Individual Price-Quality Path Determination 2025 [2024] NZCC 26 (IPP for RCP4).

IM amendments

X4 The current IMs treat insurance entitlements and some other compensatory entitlements as ORI which must be returned to consumers via wash-up rules for electricity distribution businesses (EDBs), First Gas Transmission (GTB) and Transpower or deducted from building blocks allowable revenue for gas distribution businesses (GDBs). This means that regulated suppliers are not able to retain and use the cash proceeds from insurance and similar entitlements if they are recognised as ORI.

1 Our final decisions and IM amendment determinations for the Part 4 IM Review 2023 are available at: 2023 Input Methodologies Review.

X5 The amendments are intended to allow regulated businesses to treat these entitlements in respect of capex the same way as capital contributions under the EDB and GPB IMs, reducing the cost of relevant asset repairs or replacement, or as ORI less retained entitlements, where the retained entitlements are the value of IRIS penalties associated with the additional expenditure.[2]

X6 The amendments also allow the option to net off insurance entitlements for opex that arise from damaged assets (including destroyed assets) and third-party liability entitlements against operating expenditure or treat them as ORI less retained entitlements.

X7 In summary, the amendments are as follows:

X7.1 define and apply new terms in the IMs: 'insurance entitlements', 'compensatory entitlements', and 'third-party liability entitlements';

X7.2 provide that capex insurance entitlements and compensatory entitlements for EDBs and GPBs, and insurance entitlements for Transpower, may be netted off against remediation costs, or treated as ORI less retained entitlements;[3]

X7.3 specify that opex entitlements relating to asset damage and third-party liability claims may be netted off against operating expenditure or treated as ORI less retained entitlements;

X7.4 exclude retained entitlements in relation to insurance entitlements, compensatory entitlements and third-party liability entitlements from the definition of 'other regulated income';[4]

X7.5 amend the Transpower Capex IM to apply the correct incentive adjustment for base capex and major capex when the netting off approach for capex insurance entitlements is applied; and

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2 Unlike the EDB and GPB IMs, the Transpower IMs do not prescribe how capital contributions are recognised. Treating the entitlements as capital contributions means that rather than being immediately returned to consumers through the wash-up or forecast revenue requirement, the cash entitlements are deducted from replacement asset costs and are returned to consumers over the life of the assets.

3 In this decisions paper we use the term 'asset remediation' to describe asset reinstatement, whether by repair or replacement. For GPBs, who are not subject to IRIS capex or opex incentives, retained entitlements are not deducted from ORI.

4 To give effect to our final decision, we have made related amendments to the definition of 'other regulated income' in Transpower's IPP for RCP3 and IPP for RCP4, as well as excluding retained entitlements in relation to insurance entitlements and third-party liability entitlements, as defined in the amendments to the Transpower IMs from that definition.

X7.6 make consequential amendments to:

X7.6.1 replace undefined references to 'insurance entitlements', 'compensatory entitlements' and 'third-party liability entitlements' in certain of the IMs for reconsidering a price-quality path with the equivalent defined terms from the amendments summarised above; and

X7.6.2 remove the phrase 'net of any insurance or compensatory entitlements' from provisions governing the scope of an amendment to the price path after reconsideration, to prevent any 'double' netting off from the terms 'change' or 'change in costs,' where the scope of these terms is already modified by our main amendments to include netting off of entitlements where applicable.

X8 We sought the views of interested parties on the proposed amendments. Our final decision adopts a change recommended by interested parties in their submissions on our proposed amendments, to allow an additional option for EDBs, GPBs and Transpower to treat entitlements as ORI (less retained entitlements for EDBs and Transpower). For the reasons we outline in the body of this paper, we consider this change better promotes the Part 4 purpose.

Chapter 1 Introduction

Purpose of paper

1.1 This paper outlines our decision to amend the IMs for EDBs, GPBs and Transpower contained in the following determinations:

1.1.1 Electricity Distribution Services Input Methodologies Determination 2012 [2012] NZCC 26;

1.1.2 Gas Transmission Services Input Methodologies Determination 2012 [2012] NZCC 28;

1.1.3 Gas Distribution Services Input Methodologies Determination 2012 [2012] NZCC 27;

1.1.4 Transpower Input Methodologies Determination [2012] NZCC 17; and

1.1.5 Transpower Capital Expenditure Input Methodology Determination [2012] NZCC 2.

1.2 We will also make related amendments to the definition of 'other regulated income' in Transpower's IPPs for RCP3 and RCP4.

1.3 The amendments have been assessed in accordance with the decision-making framework outlined in Chapter 2.

1.4 In accordance with s 52V of the Commerce Act 1986 (**Act**), we published a notice of intention relating to the proposed IM amendments set out in this paper on 20 May 2024.[5]

1.5 This chapter sets out:

1.5.1 the structure of this paper;

1.5.2 when the amendments to the IMs and the IPPs for RCP3 and RCP4 will apply; and

1.5.3 what materials have been released with this paper.

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5 Commerce Commission, "Notice of Intention – Potential amendments to Input Methodologies for Electricity Distribution Services, Gas Distribution Services, Gas Transmission Services and Transpower" (20 May 2024).

Structure of paper

1.6 Chapter 2 outlines our framework for considering the scope of IM amendments and the decision-making framework we have applied in the IM amendments and amendments to the IPP for RCP3 and the IPP for RCP4.

1.7 Chapter 3 describes our changes to the IMs, the IPPs for RCP3 and RCP4. It sets out:

1.7.1 the current requirements;

1.7.2 the amendments and why we proposed these changes;

1.7.3 our summary and analysis of feedback provided by submitters on our draft decision; and

1.7.4 our final decision and how the amendments meet the decision-making framework.

Application dates for amendments

1.8 Section 52W of the Act requires us to publish, by way of notice in the *Gazette,* a brief description of any IM amendment and the goods and services to which it applies, the reasons for determining that IM amendment and how we are making it publicly available.[6]

1.9 Our amendments to the IMs and the IPPs for RCP3 and RCP4 come into force after publication of the requisite Gazette notices, and apply as summarised below:

1.9.1 the IM amendments will apply:

1.9.1.1 to the current IMs, immediately;[7] and

1.9.1.2 to the IMs as amended following the 2023 IM Review, immediately after those amendments apply;

1.9.2 the amendment to the IPP for RCP3 will apply immediately; and

1.9.3 the amendment to the IPP for RCP4 will apply for that IPP that commences on or after 1 April 2025.

[6] Section 52W(1)(b) states that IM amendments are secondary legislation which means that the publication requirements for secondary legislation in the Legislation Act 2019 apply.

[7] We outline in Chapter 3 our view that, consistent with s 53ZB(1) of the Act, making and applying the IM amendments as summarised above would not reopen any price-quality (PQ) path within the current regulatory period.

1.10 We provide some further information on the application dates for the IM amendments in the IM amendment determinations, as follows:

1.10.1 the IM amendments apply on the date each amendment determination comes into force under clause 4.1 of the relevant IM amendment determination (ie, the day after notice is published in the Gazette), except for the amendments listed in clause 4.2 of each draft IM amendment determination.

1.10.2 The amendments listed in clause 4.2 of each IM amendment determination comprise most of the amendments we are proposing. Clause 4.2 specifies various application dates for these amendments to reflect our draft decision to (a) amend the IMs that apply now (eg, for RCP3 for Transpower) and (b) amend the IMs being amended by the 2023 IM Review, some of which are still to apply (eg, in most cases, the IM Review amendments to the IMs for information disclosure regulation in Part 2 of the principal IM determinations apply from the commencement of disclosure year 2026).

1.10.3 In the case of the Transpower and EDB IM amendment determinations, we have added provisions that would revoke certain of the amendments that are not needed once all IM amendments from the Part 4 IM Review apply (eg, clauses 4.6 and 4.7 of the Transpower IM amendment determination).

Materials released alongside this paper

1.11 Alongside this paper, we have published the:

1.11.1 Electricity Distribution Input Methodologies Amendments Determination;

1.11.2 Gas Distribution Services Input Methodologies Amendments Determination;

1.11.3 Gas Transmission Services Input Methodologies Amendments Determination;

1.11.4 Transpower Input Methodologies Amendments Determination;

1.11.5 Amendment Determination to the IPP for RCP3; and

1.11.6 Amendment Determination to the IPP for RCP4.

Chapter 2 Decision-making framework

Purpose of this chapter

2.1 This chapter describes:

2.1.1 our framework for considering the scope of potential IM amendments, which is relevant when considering which IMs it may be appropriate to amend outside of the statutory IM review cycle in s 52Y of the Act; and

2.1.2 the decision-making framework we have applied in determining the IM amendments and amendments to the IPPs for RCP3 and RCP4.

Framework for considering the scope of potential IM amendments

2.2 Our framework considers:

2.2.1 the statutory context;

2.2.2 our specific powers to amend IMs; and

2.2.3 what we must take account of when amending IMs outside of the statutory IM review cycle under s 52Y.

Statutory context

2.3 When considering amendments to IMs, we must consider the purpose of IMs and the purpose of Part 4. This section discusses the tensions between making changes to improve the regime and the certainty intended by the IMs.

2.4 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 the regulation, or proposed regulation, of goods or services under Part 4. To that end, s 52T(2)(a) requires all IMs, as far as is reasonably practicable, 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. In that way, the IMs constrain our evaluative judgements in subsequent regulatory decisions and increase predictability.[8]

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

2.5 However, some uncertainty remains inevitable.[9] As the Court of Appeal observed (in relation to a judicial review against decisions made in the IMs under Part 4) "certainty is a relative rather than an absolute value",[10] and "there is a continuum between complete certainty at one end and complete flexibility at the other".[11]

2.6 The s 52R purpose is primarily promoted by having the rules, processes and requirements set upfront prior to being applied by regulated suppliers or ourselves.

2.7 However, as recognised in ss 52X and 52Y, these rules, processes and requirements may change over time.

2.8 The power to amend an IM must be used to promote the policy and objectives of Part 4 of the Act as ascertained by reading it as a whole. It is clear that Parliament saw the promotion of certainty as being important to the achievement of the purposes of PQ regulation. While this is to an extent implicitly inherent in s 52A (for example, providing suppliers with incentives to invest in accordance with s 52A(1)(a)), it is also expressed in s 52R in relation to the purpose of IMs, but also in other aspects of the regime, such as the restrictions on reopening DPPs during their regulatory periods.[12]

2.9 When considering IM amendments, we must therefore be mindful that this may have a detrimental effect on:

2.9.1 the role that predictability plays in providing suppliers with incentives to invest in accordance with s 52A(1)(a); 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 in setting the DPP.

2.10 At times there will be a tension between making changes to improve the regime and better promote the s 52A purpose on the one hand, and certainty on the other.

2.11 While we have regard to the s 52R purpose (and the other indications of the importance of promoting certainty), ultimately, we must make decisions that we consider promote the s 52A purpose.

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

10 *Commerce Commission v Vector Ltd* [2012] NZCA 220, [2012] 2 NZLR 525, para [34].

11 *Commerce Commission v Vector Ltd* [2012] NZCA 220, [2012] 2 NZLR 525, para [60].

12 For further discussion see *Wellington International Airport Ltd & others v Commerce Commission* [2013] NZHC 3289, para [213]-[221].

2.12 Section 52A governs all our decision-making processes under Part 4, including our IM decisions. The other purpose statements within Part 4 are relevant matters but they should be applied consistently with s 52A.[13]

2.13 When making our decisions we must only give effect to these other purposes to the extent that doing so does not detract from our overriding obligation to promote the purpose set out in s 52A.

2.14 Therefore, where the promotion of s 52A requires amendment to an IM, s 52R does not prevent us from making a change that is consistent with s 52A.

Amendments inside and outside the IMs statutory review cycle

2.15 This section considers the circumstances in which IMs may be amended and what must be taken into account when making amendments to IMs outside of the statutory review cycle.

2.16 All IMs must be reviewed at least once every seven years, as mandated by s 52Y.[14] This process is key to deliver on the s 52R certainty purpose of IMs, while at the same time allowing the regime to mature and evolve in response to changing circumstances.

2.17 Given the certainty purpose of the IMs and the scheme set out in the Act to promote this purpose, we must carefully assess what amendments are appropriate to consider outside the statutory IM review cycle. Additionally, the predictability the IMs provide is key to promoting the s 52A purpose and, in particular, incentives to invest as required under s 52A(1)(a).

2.18 On the other hand, it is important that the IMs are fit-for-purpose.

Amendments outside of the statutory IM review cycle

2.19 We generally focus on two types of amendments outside the statutory IM review cycle:

2.19.1 those that support incremental improvements to PQ paths; and

2.19.2 those that enhance certainty about – or correct technical errors in – the existing IMs.

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[13] We note that the High Court, in *Wellington International Airport Ltd & Ors v Commerce Commission* considered that the purpose of IMs, set out in s 52R, is “conceptually subordinate” to the purpose of Part 4 as set out in s 52A when applying the "materially better" test. See *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289, para [165].

[14] The next statutory Part 4 IM review is due in 2030.

2.20 We do not generally consider it to be appropriate to consider 'fundamental' changes outside the statutory IM review cycle. Fundamental IMs are generally those that define the fundamental building blocks used to set PQ paths (listed in s 52T(1)(a)), and that are central to defining the balance of risk and benefits between suppliers and consumers.

2.21 However, we can and will reconsider fundamental building blocks where there is a compelling and urgent rationale for doing so.[15]

The decision-making framework we have applied

IM amendments

2.22 In deciding whether to propose IM amendments, we used a decision-making framework that we developed over time to support our decision-making under Part 4 of the Act.[16] This has been consulted on and used as part of prior processes, and helps provide consistency and transparency in our decision-making.

2.23 Specifically, in respect of each potential IM amendment we have considered whether it would:

2.23.1 promote the Part 4 purpose in s 52A of the Act more effectively;

2.23.2 promote the IMs purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose); and

2.23.3 significantly reduce compliance costs, other regulatory costs, or complexity (without detrimentally affecting the promotion of the s 52A purpose).

2.24 We may take into account the following (where relevant and where taking into account does not compromise our achievement of the s 52A purpose of Part 4):

2.24.1 whether there are alternative ways to address the identified issues with the relevant IM that do not involve changing the IMs;

2.24.2 the permissive considerations under s 5ZN of the Climate Change Response Act 2002; [17] and

[15] An example of this was the re-consideration of the Part 4 WACC percentile decision in 2014. The compelling reason for this was criticism by the High Court of this decision in the IM merits appeal process, and the urgency was due to the upcoming default price-quality path and individual price-quality resets for EDBs and Transpower.

[16] See, for example, Commerce Commission "Part 4 Input Methodologies Review 2023 Framework paper" (13 October 2022), para X20-X21.

[17] Commerce Commission, "Default price-quality paths for gas pipeline businesses from 1 October 2022 – Final reasons paper" (31 May 2022) Gas DPP3 final decision, at para 2.24-2.25; Note of clarification – our Part 4 Input Methodologies Review 2023 Framework paper (21 December 2022).

2.24.3 other Part 4 provisions, namely:

(A) the purpose of ID (s 53A);

(B) the purpose of default/customised price-quality regulation (DPP/CPP regulation) (s 53K);

(C) requirements relating to energy efficiency (s 54Q);

(D) decisions made under the Electricity Industry Act 2010 (s 54V); and

(E) decisions under the Gas Act 1992 (s 55I).

2.25 We refer to the outcomes specified in paragraph 2.23 as the 'IM amendments framework outcomes' in this paper.

Amendments to the IPP for RCP3 and IPP for RCP4

2.26 Our discretion as to whether we amend the IPP for RCP3 and IPP for RCP4 is driven by whether such an amendment would promote the s 52A purpose of Part 4.

2.27 We may also take into account the s 52R IM purpose as well as the other matters listed at paragraph 2.24, where they are relevant and where taking them into account does not compromise our achievement of the s 52A purpose of Part 4.

Chapter 3 Final decision on amendments to the IMs

Purpose of this chapter

3.1 This chapter describes our final decision on the changes we proposed to the IMs. Most of the changes are the same or similar for EDBs, GPBs and Transpower.

3.2 We also describe related changes to the definition of 'other regulated income', which for Transpower sits in the IPP determination rather than in the Transpower IMs.

3.3 Our final decision adopts a change recommended by interested parties in their submissions on our proposed amendments, to allow an additional option for EDBs, GPBs and Transpower to treat entitlements as ORI (less retained entitlements for EDBs and Transpower). For the reasons we outline in this chapter, we consider this change better promotes the Part 4 purpose.

3.4 We outline in detail below:

3.4.1 our current requirements;

3.4.2 our summary and analysis of submissions and cross-submissions on our draft decision;

3.4.3 our decision on the amendments; and

3.4.4 how the amendments are likely to promote an IM amendments framework outcome, as defined in Chapter 2, para 2.23.

Current requirements – insurance entitlements and compensatory entitlements

3.5 The current IMs, and those IMs that will apply as a result of the IM review completed in 2023, treat insurance entitlements as ORI. Capex insurance entitlements do not generally fall within the definition of 'capital contributions', as applies to EDBs and GPBs, because their purpose is to compensate businesses for damage to assets. They are not payments for the purposes of asset construction, acquisition or enhancement.

3.6 ORI is included in forecast revenue in setting price paths and in actual revenue for the revenue wash-up calculation (applicable to EDBs, GTBs and Transpower). This means that any surplus over the forecast amount must be returned to consumers as a (negative) recoverable cost. Regulated suppliers are not able to retain and use the cash proceeds from insurance and similar entitlements if they are recognised as ORI.

3.7 There may be grants or other compensatory payments intended to facilitate reinstatement or construction of assets, which under the existing definitions must also be treated as ORI and passed on to consumers if they do not meet the definition of 'capital contributions'. This treatment may deter third parties from making payments to assist with asset remediation, and otherwise act as a disincentive to remediation investment. For Transpower, there is no requirement to treat compensatory payments as ORI, as the Transpower IMs allow Transpower the discretion to recognise such payments as an offset against the cost of assets or as income in accordance with GAAP.

3.8 The treatment of insurance entitlements as ORI under the IMs also means that they are not netted off additional remediation costs for IRIS calculation purposes in a catastrophic event situation. They are, however, required to be netted off in calculating the price path impact of catastrophic event remediation costs and in calculating a catastrophic event allowance.

3.9 This means that we are only able to compensate suppliers via the catastrophic event reopener for the IRIS impacts of additional costs that are not covered by insurance. From a policy perspective, this disadvantages suppliers who have taken out insurance cover.

3.10 Suppliers may also face opex IRIS penalties for consequential opex arising from damaged assets or from payments in respect of third-party liability claims where that opex is covered by insurance.

3.11 In respect of routine remediation expenditure arising from damage to assets or third-party liability events, insured suppliers will not enjoy the immediate benefit of the cashflow provided by asset or third-party liability insurance cover, as this must be passed on to consumers via the revenue wash-up.

3.12 Supplier asset damage could subsequently give rise to third-party liability costs. We consider there is no policy reason to distinguish damage to a third party's assets that arises from damage to a supplier's assets, and similar entitlements arising from direct causes of liability such as damage to a third party's assets or other third-party costs that might occur, for example, as a result of a regulated supplier carrying out lines services work. We therefore proposed changes to the treatment of third-party liability entitlements generally. This will mean that suppliers subject to IRIS opex incentives are not exposed to opex IRIS penalties arising from the settlement of unforecast third-party liability claims, whether arising from damage to third-party assets or any other cause.

Summary and analysis of submissions and cross-submissions on our proposed amendments

Allowing a choice of approaches - EDBs

3.13 The ENA initially proposed an alternative simplified approach for PQ regulation whereby insurance and compensatory entitlements are treated as ORI less an IRIS retention factor adjustment.[18]

3.14 Following a submission by Unison and cross-submission by Vector, the ENA's cross-submission proposed a change to their alternative: an optional approach whereby an EDB can choose to apply ENA's simplified approach or to apply the approach proposed by the Commission in the draft decision.[19]

3.15 Unison supported the intent of both the Commission's and ENA's approaches and explained that:

> As regards cashflow, the Commission's approach is more beneficial in principle in that it allows EDBs to use insurance to manage the financing risks associated with the response to significant insured events. A key benefit of insurance is that it compensates EDBs immediately for the – on occasion substantial – unforecast costs of responding to a majored insured event. ENA's approach allows EDBs to retain insurance proceeds only up to the present value of IRIS penalties. That approach therefore assumes that EDBs have sufficient debt headroom to finance the response to catastrophic events. We prefer a solution that at least enables EDBs the option to use insurance to manage these financing risks.[20]

3.16 Vector similarly argued for the benefit of allowing cashflow retention:

> The downside of that [ENA] approach – and we think this is a significant problem – is that EDBs do not get the cashflow benefits of holding insurance. When planning for the risk of a catastrophic event, it is important that EDBs can use insurance cover to manage the financing challenge of the response to a natural disaster/catastrophic event. ENA's solution assumes that EDBs will always have debt headroom to finance the response.

3.17 In supporting an optional approach, Vector acknowledged that the Commission's proposed approach diverges from GAAP unlike the simplified approach proposed by the ENA, but argued "the IMs should place more weight on the Part IV purpose than GAAP compliance".[21]

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[18] ENA "Submission on draft IM amendments (Insurance entitlements)" (3 October 2024).

[19] Unison "Submission on draft IM amendments (Insurance entitlements)" (4 October 2024); Vector "Cross-submission on draft IM Amendments (insurance entitlements)" (21 October 2024); and ENA "Cross-submission on draft IM Amendments (insurance entitlements)" (21 October 2024).

[20] Unison "Submission on draft IM amendments (Insurance entitlements)" (4 October 2024), para 28b.

[21] Vector "Cross-submission on draft IM Amendments (insurance entitlements)" (21 October 2024), para 10.

Transpower approach

3.18 Transpower submitted that:

> Transpower's current treatment for all insurance entitlements is to treat these amounts as ORI, after adjusting for the 'retention factor'[1] relating to the adverse incentive outcome because of the incremental expenditure responding to the insurance event. This is consistent with our previous communications with the Commission on this in August 2023.
>
> We consider the proposal by the Commission has a high, and complex, administrative burden and would potentially lead to perverse outcomes in the TPM as it stands.

3.19 We note that Transpower's treatment as described is the same as the simplified approach proposed by the ENA.[22]

3.20 Transpower notes that it is incentivised for capex on an as incurred basis, and the Commission has not proposed amendments to Transpower's Capex IM to account for this.[23]

3.21 Transpower further submits that the proposed changes are not compatible with the transmission pricing methodology (TPM), as write-offs of existing assets (ie, shortening the physical asset lives of damaged assets based on an engineer's assessment) are recovered through the residual charge allocated to load customers; whereas the corresponding entitlement offset would be enjoyed by customers subject to benefit-based charges (BBC customers, comprising load and generation customers). Where the entitlements fully offset the costs of a replacement asset, the BBC customers would not incur any charge in relation to that asset.

3.22 This means that in the transition to the new TPM, the application of the netting off approach would lead to cross-subsidisation between customers who are charged for the write-off of a damaged asset and the customers who enjoy the benefits of insurance on that asset.[24]

3.23 The 'ORI less retention benefits' approach, on the other hand, recovers write-offs and refunds ORI to the same set of customers through the residual charge.

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[22] This approach is not available under the Transpower IMs for RCP3, as the recognition of entitlements as ORI does not allow for a 'retention factor' adjustment.

[23] Including the base capex expenditure adjustment in Schedule B1 of the Transpower Capex IM and the major capex expenditure and output adjustment in Schedule B3 of the Transpower Capex IM.

[24] The revenue recovered through residual charges will decrease over time, as assets recovered via the residual charge become fully depreciated and new assets are all subject to the BBCs. Some pre-July 2019 investments are designated 'Appendix A BBC investments'.

3.24 Our policy objective of enabling suppliers to retain and use the cash proceeds from insurance is slightly less important for Transpower than other suppliers because Transpower's ORI is taken to the EV account and washed up into pricing at the end of each regulatory period rather than on an annual basis, as for EDBs and GTBs. This means that the cash may be retained by Transpower for up to five years and the impact of the wash-up may be dealt with through the smoothing applied in the reset.

3.25 However, there may be significant events for which the netting off approach would provide a level of cashflow relief that is unable to be achieved by smoothing, if its implementation is compatible with the TPM at the time.

3.26 Therefore, we have decided that Transpower should have the option of applying the ENA's simplified approach or the Commission's proposed netting off approach. We have amended the Capex IM to apply the correct adjustment to the calculation of the base capex expenditure adjustment and major capex expenditure and output adjustment when the netting off approach is used.[25]

Suggested modifications to the Commission's proposed approach

3.27 In respect of the Commission's proposed approach, Vector argued:

> the netting off approach should not be limited just to insurance proceeds as there should be equivalence for those EDBs and GPBs that choose to insure and those that do not for valid reasons (such as the rising costs of insurance premiums for some assets). Ultimately the cost of insurance is borne by consumers so EDBs and GPBs need to be prudent when placing insurance.

3.28 In an example provided by Vector, where an EDB pursues a party that has damaged a pole and recovers the costs, Vector submits the treatment of the recovery method must be the same as a recovery via insurance. We consider this will be the case under our changes, as the recovery of costs from the party damaging the pole will likely meet the criteria for recognition as a 'compensatory entitlement.' Therefore, no further change is necessary.

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[25] Transpower differs from the EDBs and GPBs in that its IRIS incentive calculations are applied to capex rather than commissioned assets. We have used Transpower's base capex standard incentive rate, based on the explanation of Transpower's existing treatment in its submission.

3.29 Vector also argued that the proposed matching approach should apply to all insured opex:

> The Commission's approach only applies to opex "arising from damaged or destroyed assets". That assumes that only opex arising from damaged or destroyed assets is insured and therefore eligible for this treatment. A wider definition that captures all insured opex is more appropriate given the policy objectives of the amendments.[26]

3.30 Our proposals already extend the netting off of insurance entitlements to opex arising from the settlement of third-party liabilities. Along with opex relating to network reinstatement, we consider this is likely to constitute the majority of insured opex, excluding business interruption insurance.[27] We have not been provided with examples of other types of opex insurance in submissions that warrant further extension of our netting off approach.

Application of approaches to PQ and ID regulation

3.31 Vector submitted that "The optional approach could be applied to PQ regulation only but if implemented for ID will allow exempt EDBs to maintain their previous treatment."

3.32 We consider that applying an optional approach will enable exempt EDBs to maintain their previous treatment and will avoid the complexity associated with specifying a separate set of IM rules.

Changes to the catastrophic event reopener threshold

3.33 Vector, ENA and Unison made submissions on the impracticability of netting off insurance and other compensatory entitlements in assessing whether the catastrophic event threshold is met.

3.34 We have decided to consider this threshold issue under our *Proposed amendments to input methodologies for electricity distribution businesses and Transpower (Reopener and Other Matters)* consultation workstream, which is looking at possible IM changes to make reopeners more workable.

3.35 How entitlements are treated in assessing expenditure under a reopener if the threshold is met is determined by the IM decisions described in this paper. This means that in a reopener application a supplier will apply their choice of treatment for entitlements, as an offset to expenditure or forecast expenditure or as ORI less retained entitlements.

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26 Vector "Cross-submission on draft IM Amendments (insurance entitlements)" (21 October 2024), para 8a.

27 We excluded business interruption insurance from our proposed changes as it is generally used to recover the loss of profits.

NPV equivalence of approaches

3.36 In allowing suppliers the choice of whether to treat entitlements as ORI less retained entitlements or to net them off against the relevant expenditure, we have considered the Net Present Value (NPV) equivalence of the approaches.

3.37 In its cross-submission, the ENA provided an appendix demonstrating the relative NPV equivalence of the approaches in respect of the recognition of entitlements.[28] We agree with this analysis.

Application of netting off approach to value of commissioned assets and calculation of IRIS

3.38 Vector and Unison both submitted that:

> We do not understand how disclosing separate 'adjustment' assets will deal with the capex IRIS. Given the IRIS is calculated annually based on annual forecasts of commissioned assets it would appear that adjusting assets in subsequent years would not deal with retention factors in relation to insured assets commissioned in earlier years.[29]

3.39 The capex IRIS, defined in the EDB IMs as the 'retention adjustment', is calculated at the end of the regulatory period and spread as a recoverable cost (positive or negative) over years 2 to 5 of the next regulatory period. Because the negative asset is included in commissioned assets, an asset overspend against forecast in an earlier year of the regulatory period may be offset by a negative asset spend against forecast in a later year, reducing the value of any negative retention adjustment for the period.

3.40 If the recognition of any insurance or compensatory entitlement as a negative asset is delayed until the next regulatory period, it will offset to some degree any overspend occurring in that period or, if there is no overspend, give rise to a positive recoverable cost.

3.41 Vector submitted that the amendments to the IMs providing for value of commissioned assets only apply to "an asset that replaces an asset" in respect of which insurance was received and that a broader definition is more consistent with the Commission's policy objectives. Vector proposed this should instead refer simply to "an asset in respect of which insurance was received".

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28 ENA "Cross-submission on draft IM Amendments (insurance entitlements)" (21 October 2024), Appendix C.

29 Vector "Cross-submission on draft IM Amendments (insurance entitlements)" (21 October 2024), para 8c; and Unison "Cross-submission on draft IM Amendments (insurance entitlements)" (21 October 2024), para 34c.

3.42 Our proposed wording reflected our understanding that insurance is generally received as compensation for damaged assets and the offset should be applied to the corresponding replacement assets (or repairs that constitute assets). However, we interpret that Vector's proposed wording change broadens the application of the offset to assets that may not be a 'like for like' replacement. Therefore, we have adopted Vector's proposed change.

3.43 Unison submitted that the treatment of insurance entitlements should account for any delay between when the insured expenditure is incurred and when insurance proceeds are able to be recognised.[30] To account for the delay, we have specified that in applying the netting off approach, the recognition of separate assets or negative assets subsequent to a replacement asset's commissioning date will be adjusted to reflect their net present value at that commissioning date.

3.44 Orion was supportive of the intent of our proposed changes, but sought clarification about how the damaged and newly built assets would be treated as part of the regulatory asset base (RAB).[31]

3.45 Under our changes, insurance entitlements and compensatory entitlements for damaged or destroyed assets under the netting off approach will be treated as if they are capital contributions. Any replacement assets built using these entitlements are only recognised in the RAB to the extent that the costs exceed the entitlements.

3.46 The current IMs provide that existing assets having a standard physical asset life may have their lives adjusted where an engineer documents that, as a result of damage, the service life potential is shorter than the standard physical asset life.

3.47 Assets may be removed from the RAB when they become disposed assets, as defined in the IMs.

[30] Unison "Submission on draft IM amendments (insurance entitlements)" (4 October 2024), para 13.
[31] Orion "Submission on draft IM amendments (insurance entitlements)" (25 September 2024), p 1.

IM amendments – final decision

3.48 Our IM amendments are as follows:

3.48.1 New definitions of 'insurance entitlements', 'compensatory entitlements', and 'third-party liability entitlements' for EDBs, GPBs, and Transpower;

3.48.2 New definition of 'retained entitlements' for EDBs and Transpower;

3.48.3 For EDBs, we are allowing an option to treat capex insurance entitlements and capex compensatory entitlements in respect of damaged or destroyed assets:

3.48.3.1 like capital contributions, and net them off the cost of assets where they are applied to the remediation of assets; or

3.48.3.2 as ORI less retained entitlements, where the retained entitlements are the value of IRIS penalties associated with the additional expenditure.

3.48.4 For GPBs, we are allowing an option to treat capex insurance entitlements and capex compensatory entitlements in respect of damaged or destroyed assets:

3.48.4.1 like capital contributions, and net them off the cost of assets where they are applied to the remediation of assets; or

3.48.4.2 as ORI.

3.48.5 For Transpower, we are allowing a similar option to treat capex insurance entitlements in respect of damaged or destroyed assets:

3.48.5.1 like capital contributions, and net them off the cost of assets where they are applied to the remediation of assets; or

3.48.5.2 as ORI less retained entitlements, where the retained entitlements are the value of IRIS penalties associated with the additional expenditure.[32]

[32] In our recent Part 4 IM Review, we decided not to amend the Transpower IMs in respect of specifying the treatment of contributions from third parties that are not insurance entitlements. See Commerce Commission "Transpower investment topic paper, Part 4 Input Methodologies Review 2023 - Final decision" (13 December 2023), pp. 137-139.

3.48.6 The above change required a consequential amendment to the Transpower Capex IM to apply the correct incentive adjustment for base capex and major capex when the netting off approach for insurance entitlements is applied.

3.48.7 For Transpower, we decided to exclude any amounts of retained entitlements from the definition of 'other regulated income' in Transpower's IPP Determination. This is because that definition is included there rather than in the Transpower IMs. We set out the change to:

3.48.7.1 the IPP for RCP3, in an amendment determination to that IPP; and

3.48.7.2 the IPP for RCP4, in an amendment determination to that IPP.

3.48.8 We did not provide for an exclusion for compensatory entitlements for Transpower, as Transpower has a discretion to treat these as a reduction in asset costs or as income under the Transpower IMs.

3.48.9 Where insurance entitlements are netted off asset costs, we have changed the asset valuation IMs to require EDBs, GPBs and Transpower to treat any subsequent adjustments after the asset's commissioning date (for example, due to a change in the estimated value of entitlements) as separate assets or negative assets present valued as at the same commissioning date.[33] This approach, to treat subsequent expenditure as a separate asset, is consistent with the current treatment of subsequent expenditure on an asset in accordance with clause 2.2.11(4)(b) of the EDB/GPB IMs and clause 2.2.7(4)(b) of the Transpower IMs.

3.48.10 For EDBs, we are allowing an option for opex to:

3.48.10.1 net off opex insurance entitlements, opex compensatory entitlements and third-party liability entitlements against the corresponding operating expenditure in the year or years of remediation or third-party compensation spend; or

3.48.10.2 treat opex insurance, opex compensatory entitlements and third-party liability entitlements as ORI less retained entitlements, where the value of retained entitlements reflects the IRIS penalties associated with the additional opex.

[33] This ensures that the netting off is NPV equivalent.

3.48.11 For GPBs we are allowing an option for opex to:

3.48.11.1 net off opex insurance entitlements, opex compensatory entitlements and third-party liability entitlements against the corresponding operating expenditure in the year or years of remediation or third-party compensation spend; or

3.48.11.2 treat opex insurance, opex compensatory entitlements and third-party liability entitlements as ORI.

3.48.12 For Transpower, we are allowing a similar option to:

3.48.12.1 net off opex insurance entitlements and third-party liability entitlements against the corresponding operating expenditure in the year or years of remediation or third-party compensation spend; or

3.48.12.2 to treat opex insurance entitlements and third-party liability entitlements as ORI less retained entitlements, where the value of retained entitlements reflects the IRIS costs of the additional opex covered by the insurance, compensatory or third-party liability entitlement.

3.48.13 Netting off may give rise to the need for a restatement of operating expenditure where estimates of insurance entitlements and third-party liability entitlements are adjusted after they are first recognised.

3.48.14 We have provided for the exclusion of retained entitlements (EDBs and Transpower) and any amounts of insurance entitlements, compensatory entitlements and third-party liability entitlements which have been netted off in calculating an operating cost or have been applied to reduce the value of a commissioned asset (EDBs, GPBs and Transpower) from the definition of ‘other regulated income’.

3.48.15 For all PQ-regulated suppliers, we have made consequential amendments:

3.48.15.1 to replace undefined references to ‘insurance entitlements’, ‘compensatory entitlements’ and ‘third-party liability entitlements’ in certain of the IMs for reconsidering a PQ path with the equivalent defined terms from the amendments summarised above: and

3.48.15.2 to remove the phrase ‘net of any insurance or compensatory entitlements’ from provisions governing the scope of an amendment to the price path after reconsideration, to prevent any ‘double’ netting off from the terms ‘change’ or ‘change in costs,’ where the scope of these terms is already modified by our main amendments to include netting off of entitlements where applicable.

3.49 Consistent with s 53ZB(1) of the Act, we consider that making and applying the IM amendments in the IM amendment determinations would not reopen any existing PQ path within the current regulatory period (ie, DPP3 for gas transmission and distribution services, RCP3 for Transpower, and DPP3 for EDBs). This reflects that in each case, the IM amendments would not reopen within the regulatory period, the allowable revenue for the remaining years of the regulatory period.

3.50 For the same reason, we consider that the amendment to the IPP for RCP3 and RCP4 would not reopen within relevant regulatory period the PQ path for Transpower.

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

3.51 We acknowledge that the IM amendments affect elements of a foundational building block of the regime. Under normal circumstances, we would be hesitant to make changes to fundamental IMs outside of the statutory IM review cycle. However, as explained below, the changes are necessary for us to continue to apply our regulatory framework consistently and will enable us to promote the Part 4 purpose more effectively.

3.52 The current IMs’ treatment of insurance entitlements as ORI means that suppliers may not be compensated for the IRIS costs of additional remediation expenditure in a catastrophic event situation, although insurance entitlements are taken into account for assessing costs that can be recovered through a catastrophic event reopener. This disadvantages suppliers that have taken out insurance cover compared to those suppliers that have not.

3.53 For routine remediation expenditure and third-party liability costs, under the current IMs, insured suppliers do not get the benefit of the cashflow provided by asset insurance cover, as this must be passed on to consumers via the revenue wash-up.

3.54 Unforeseen damage to supplier assets could also subsequently give rise to third-party liability costs. We do not consider there is a policy reason to distinguish damage to a third party's assets that arises from damage to a supplier's assets, and similar entitlements arising from direct causes of liability such as damage to a third party's assets or other third-party costs that might occur, for example, as a result of a regulated supplier carrying out lines services work. The current treatment of these as ORI exposes suppliers to IRIS costs in relation to the settlement of third-party liabilities and may disincentivise suppliers from taking out third-party liability insurance cover.

3.55 Where compensatory entitlements other than insurance must be passed on to consumers as ORI, this may deter third parties from making payments to assist with asset remediation, and otherwise act as a disincentive to remediation investment.

3.56 For the reasons outlined above, the IM changes will promote the s 52A(1)(a) limb of the Part 4 purpose more effectively by improving incentives to innovate and to invest, including in replacement, upgraded, and new assets. In particular, our decisions to allow entitlements to be offset against asset costs and opex, as proposed in our draft decisions, means insured suppliers get the cashflow benefits of insurance to spend on remediation of assets and/or opex without incurring IRIS costs, where applicable, in relation to the additional expenditure.

3.57 Likewise, our decision to provide for the option for suppliers to choose to treat entitlements as ORI, as widely supported in submissions, means suppliers will not get the full cashflow benefits of entitlements but can retain a portion of those entitlements (the retained entitlements) to offset any IRIS costs arising from the additional expenditure. The availability of this option means that suppliers can choose the method that suits their particular circumstances and minimises their regulatory costs. This is particularly so for exempt EDBs, who may continue to treat entitlements as ORI, consistent with how they already disclose transactions under ID. The ability for suppliers to choose between methods also means that the payment of compensatory entitlements by other parties is not disincentivised because of accounting outcomes.

3.58 The changes will also promote s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose) by giving clarity about what is meant by insurance entitlements, other compensatory entitlements and third-party liability entitlements and how they should be accounted for.

3.59 We consider the reasons outlined above are compelling enough to justify making these changes outside of the normal statutory IM review cycle, because they would promote the Part 4 purpose and support incremental improvements to PQ paths.

3.60 The changes may place some additional compliance obligations on EDBs, GPBs and Transpower in calculating asset values, operational expenditure and ORI for revenue forecasting and for ID reporting.[34] However, we consider that the likely long-term benefits to consumers would sufficiently outweigh any increase in compliance costs, other regulatory costs or complexity.

How the amendment to the IPP for RCP3 and RCP4 aligns with our decision-making framework

3.61 The amendment to the IPP for RCP3 and RCP4 would give effect to the policy change for Transpower as outlined above.

3.62 We therefore consider the amendment to the IPP for RCP3 and RCP4 would have the same effect in terms of promoting the s 52A(1)(a) limb of the Part 4 purpose more effectively, for the reasons outlined above.

[34] This will depend on which options suppliers choose to apply. For exempt EDBs, there should be no additional compliance obligations if entitlements are treated as ORI.