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Alex Sim  
Chief Adviser  
Regulation Branch  
Commerce Commission  
PO Box 2351  
WELLINGTON

Dear Alex

**Re: Updates to Input Methodologies (Transpower) and Individual Price-Quality Path (Transpower)**

This is Transpower New Zealand Limited's submission on the following:

- *Input Methodologies (Transpower) Consultation Update Paper*, November 2010
- *Individual Price-Quality Path (Transpower) Consultation Update Paper*, November 2010
- Revised draft *Commerce Act (Transpower Input Methodologies) Determination 2010*
- Revised draft *Commerce Act (Transpower Individual Price-Quality Path) Determination 2010*.

Transpower appreciates the consideration that the Commission has given to the submissions made on the June 2010 draft reasons papers and the resulting amendments that have been made to a number of its draft decisions.

While we understand that the prime purpose of this consultation is technical drafting, i.e. whether or not the updated draft decisions are accurately expressed in the wording of the draft determinations, we note that Transpower continues to be concerned about the detail of the following draft decisions:

- the allowed rate of return based on the Commission's estimate of Transpower's weighted average cost of capital (WACC);
- the continued restriction on the recovery from transmission customers of gains and/or losses resulting from land held for resale (pending the establishment of an easement);

- the retention of the 14 day restriction on the recovery of instantaneous reserves availability costs (albeit amended to allow 50% of these costs post the 14 day restriction to be recoverable up to a maximum exposure cap, per event, of c.\$6million); and,
- the project value above which a project is treated as “Major”, which the Commission maintains should be set at \$5 million.

We refer the Commission to our previous submissions which comment on each of the above, in detail, and set out Transpower’s recommended position.

### **Cost of capital decisions**

With respect to the policy content of the cost of capital decisions, Transpower will be reviewing possible options available to it under the Act. While we acknowledge that the Commission has made some minor adjustments to the cost of capital determination for Transpower, the Commission’s 75<sup>th</sup> percentile point estimate of Transpower’s weighted average cost of capital appears to be c. 7.2% to 7.3%<sup>1</sup>, which is significantly below the cost of capital range which independent experts have suggested is appropriate for Transpower. The net outcome of this determination, if it is sustained, will be economically inefficient and produce negative investment incentives.

The points made in the submissions and expert reports which Transpower provided to the Commission in August 2010 remain applicable and Transpower requests that the Commission consider those materials further.

The Commission has sought, through its cost of capital determination, to treat Transpower in much the same way as an electricity distribution business. In doing, so it has arguably failed to comply with its obligations to set an input methodology for Transpower’s cost of capital which is consistent with the requirements of section 52A of the Act, the Government Policy Statement on Electricity Governance, and the requirements of an individual price quality path determination.

Professor Graeme Guthrie has advised that Transpower’s circumstances are not a good fit for the assumptions underlying the Commission’s theoretical framework. The main cause of this is the combination of the size of Transpower, and the Commission’s use of a domestic CAPM. Specifically, Transpower’s investment programme is so large, requiring debt to be secured from offshore investors, that a number of the assumptions underpinning the Commission’s model are not credible. In his view, if the Commission wishes to retain its use of the domestic CAPM, then it needs to recognise that the model error associated with this is substantial. A supplementary note, by Professor Guthrie, entitled “*A Supplementary Note on Measurement Error and Regulated Firms’ Allowed Rates of Return*”, is attached as Appendix 1.

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<sup>1</sup> Precisely estimating the outturn WACC that would result from the Commission’s updated decisions is not possible. In order to calculate the term credit spread differential, reference needs to be made to BBB+ bonds issued beyond 10 years in NZ. To our knowledge there are no BBB+ bonds issued beyond 10 years in NZ.

Professor Bob Officer and Dr S. Bishop have also provided further advice on issues related to efficient capital raising in the context of offshore borrowings and foreign exchange risk, plus additional advice related to gearing and the Commission's changed approach to the risk free rate. From the totality of the advice we have received, it is clear that the Commission's draft cost of capital determination does not satisfy the requirements of section 52A of Part 4 of the Act.

In Appendix 2 we have summarised Transpower's approach to managing interest rate, liquidity, credit and foreign exchange risk and set out the anticipated financial consequences for Transpower of a final determination for the cost of capital based on the Commission's November update decisions.

Regarding the detailed implementation of the cost of capital decisions, as proposed, there are a number of problems relating to practicality, in particular:

- there are no BBB+ bonds issued beyond 10 years in New Zealand. Consequently, it is not possible to calculate BBB+ spreads beyond this time using market information. If the sample is limited to "non-government" owned entities, there is a very limited number of BBB+ bonds of any duration;
- finding spreads on these bonds is difficult as, in reality, they rarely trade and are therefore not liquid instruments;
- the backstop of using US or Australian "fair value" curves is inaccurate as many of the factors driving movements in these markets are different from those that are important to the New Zealand market;
- the face value of qualifying debt should be used, not the book value, especially as Transpower does not hedge account for debt, i.e. debt instruments are accounted for on a mark to market basis, which can differ materially from book value;
- the cost of executing interest rate swaps is permitted as an allowable cost for qualifying debt only – it should be permitted for all debt;
- the draft decisions do not appear to allow for the fact that Transpower manages interest rate risk independently from funding risk – very few of Transpower's swaps would qualify as they are not executed within one week of debt issuance;
- cross currency interest rate swaps do not appear to be contemplated;
- the credit charges on swaps imposed by banks would be considerable for long dated swaps with a BBB+ rated entity – permitting half the bid/offer spread to be accounted for ignores this charge;
- the cost of executing an interest rate swap should be based on the notional principal amount of the swap not the lesser of this amount and the book value of debt;

- it is not clear that the definition of Transpower includes Transpower Finance, which is the company that currently undertakes all of Transpower's debt and related transactions;
- the Commission's calculation of the debt issuance cost re-adjustment is not based on objectively measurable information.

### **Land and Easement decisions**

The Commission's Input Methodologies update decision proposes a fundamental change to the mechanism by which easements (including injurious affection and other related costs) are brought into the RAB. The Commission is proposing that easements will enter the RAB at "valuation" and not at the actual negotiated purchase price.

Under the current Administrative Settlement provisions, where Transpower does not own the land, easements (including injurious affection and other related costs) are brought into the RAB at cost in accordance with GAAP. We are unclear why the Commission is seeking to depart from GAAP and is in effect introducing additional regulation into the commercial negotiation processes between Transpower and landowners – noting that projects will be subject to a maximum expenditure allowance approved by the Commission.

In circumstances where landowners are minded not to accept a "valuation", the Commission's proposal is likely to result in perverse outcomes. Either Transpower will be subject to an economic loss (a risk not reflected in its WACC) or additional compliance costs will be incurred to pursue compulsory acquisitions under the Public Works Act (the costs of which should be fully recoverable by Transpower, but it is unclear how this could be achieved based on the Commission's update decision).

The Commission's updated draft decision is that Transpower must bear the gains or losses incurred from land held for resale (e.g. land which Transpower purchases with the intention of securing an easement and then sells the non-easement related land)

We remain strongly of the view that such gains or losses should be accounted for via the customer EV accounts as the risks associated with uncertain future property market values should not be borne by Transpower. Consequently, if the Commission maintains its draft decision on this matter, Transpower will be exposed to a substantial additional risk not accounted for in its WACC determination.

### **Interpretation and Implementation Issues**

We have identified a number of problems with the practical interpretation of the updated draft decisions in the wording of the draft Input Methodologies and Individual Price-Quality Path determinations. Many of these concerns relate to the use of what appear to be unnecessarily complex expressions which could be ambiguously interpreted or the use of new terms or expressions when more commonly used and understood alternatives exist. We have attached marked up re-drafts of the draft determinations to identify our suggested remedies for these problems.

Some of the significant issues are:

*RAB roll forward – “unallocated” terminology*

“Unallocated” and “allocated” RAB and depreciation are new terms that appear unnecessary and confusing, given that the RAB already excludes those items which relate to non transmission services (including System Operation services). The new terms are also very similar in concept and usage to cost, accumulated depreciation and net book value, which increases the scope for misinterpretation by the regulated entity, regulators and auditors. We recommend that the conventional terms be used.

*Terminology in general*

We believe that more use should be made of the well understood and applied terms used in the Administrative Settlement. We also note that, in many cases, the terms applied to numerical calculations appear to have been created without first modelling and agreeing what is expected to occur, which creates a significant interpretation and implementation risk.

*Timing of commissioning of assets*

Clause 2.2.7 of the Input Methodologies determination requires the value of a commissioned asset to mean the cost of the asset to Transpower determined by applying GAAP to the asset on its commissioning date. This is contrary to current practice, whereby commissioned assets enter the RAB at the average of their opening and closing RAB values (meaning that half the total value of the asset is recognised in the year of commissioning). Given the very large stock of assets held by Transpower and its large investment programme, this approach has the advantage of simplicity, and consequently lower compliance costs (including lower audit costs), and produces, in aggregate, essentially the same outcome as the approach proposed by the draft determination. We recommend that the determination permit the existing practice to be maintained.

*Application of 14 day rule to commissioning of Pole 3*

We have proposed the following rewording of clause 3.1.3 of the Input Methodologies determination to more accurately express the Commission’s updated decision on this matter:

- “(c) any such charge treated by Transpower as capital expenditure in accordance with GAAP in relation to the control systems integration of Pole 2 and the commissioning of Pole 3 of the HVDC link;”

We understand that, in relation to any instantaneous reserve charges incurred post the decommissioning of Pole 1 but prior to the commissioning of Pole 3 (and related Pole 2 work), for the purposes of clause 3.1.3, these will be considered to form part of the commissioning of Pole 3.

With respect to the wording in clause 3.1.3(2)(b), we submit that “commences” should be substituted for “occurs”. Without this change, there is a risk that an event

that extends across two disclosure years (e.g. an event commencing in June and ending in July) could double Transpower's exposure to reserves availability charges.

*Commodity price hedges*

Under the proposed Input Methodologies determination provisions relating to hedge gains or losses, unless hedge accounting is initially obtained, any gains or losses from hedge contracts will be borne by Transpower's shareholder. Unfortunately, under IFRS rules, it is very difficult for Transpower to obtain hedge accounting for commodities such as copper and aluminium, even when the amounts of the commodity required and the required delivery dates are known. Because of this, the proposed determination provisions will incentivise Transpower not to hedge the prices of these commodities, even if its commercial judgement indicates that it should do so, but instead to seek a review of project approvals if commodity prices rise and expenditure on a project exceeds the project approval value as a result, on the grounds that the effect of these price changes was unforeseen. Hence, the proposed determination will create a perverse incentive that is likely to produce inefficient outcomes. To remedy this undesirable outcome of the proposed regulatory arrangements, we recommend that any gains or losses incurred from hedge contracts should be accounted for via the EV accounts.

*Proposed changes to the definitions of Asset Expenditure*

Part 2 (Defined Terms) of the IPP Determination sets out the meaning of the various capex expenditure categories, based on the information previously supplied to the Commission by Transpower. The asset categorisation determines which projects (above a \$5m project value threshold) are required to be approved individually via the GUP process.

On further review we have a concern that the asset category definitions, notably the "asset enhancement" definition, as currently stated has the unintended consequence of capturing a range of projects and programmes, mainly related to asset integrity, which do not change the primary capacity of the grid (which is the driver for projects requiring GUP approval).

As currently worded the following project types, above a \$5m value threshold (which are internally coded by Transpower as enhancement but are not capacity driven) would be required to be approved individually through the GUP process – e.g. seismic strengthening, retrofitting firewalls between transformers, installation of duplicate bus-zone protection at critical stations, etc. Recent discussions with Commission staff suggest that this is not what was intended from a policy perspective.

We suggest that the definitions are simplified to better align with Transpower's current project coding. Under our proposal, Transpower's current categories (as set out in the IPP Determination) would be retained but by default all grid related capex would be classified as Minor Capex, with the exception of enhancement and development projects or programmes which change the capacity of the primary circuits of the grid and where the value of the project or programme is above a threshold of \$5million. For example, a seismic strengthening project (to meet modern

industry practice) if classified as enhancement internally by Transpower and over \$5m in value would be included under the Minor capex category – as the investment does not impact on the capacity of the grid.

*Annual Compliance Statement, inclusion of MAR calculations or disclosures*

Part 5 of the IPP Determination, sets out the information required as part of the Annual Compliance Statement (required by 30 September following each assessment date). This includes forecast MAR calculations and disclosures which *inter alia*, include a forecast of minor and major capex forecast to be capitalised for the remaining disclosure years.

It is not practical to complete the forecast MAR calculations and capex forecasts by 30 September, given that these are dependent on the finalisation of the EV accounts for the preceding assessment period. Part 3 (Price Path) of the IPP Determination, we note that Transpower is required to submit its forecast MAR (including updated capex forecasts) to the Commission by 21 October following each assessment date. We therefore recommend that the forecast MAR requirement in the compliance statement be removed.

*MAR and EV Wash-up application process not clear*

We understand the intention of the Commission's policy for setting the MAR and determining the annual EV wash-up, as set out in the decision papers. However, the subsequent translation of the principles (with which we are in broad agreement) into the wording of the draft Input Methodologies and Individual Price-Quality Path determination is less clear. We have a concern that the calculation processes, as described in the determinations, are unnecessarily complex in places and are "untested" from the point of view of practical implementation. (In some areas, how aspects of the calculations are required to be applied has not been specified.)

In order to be applied effectively, we need to be confident that all of the calculation components fit together to provide certainty that any future application (and judgement applied by Transpower where parts of the process have not been specified) will comply with the Commission's expectations in terms of Part 4 compliance.

We strongly recommend that, before finalising the drafting, Transpower and Commission staff work together to stress test the logic of the calculation processes for determining the forecast MAR and EV wash-up (as well as other significant changes to Transpower's current methodologies, e.g. the move to vanilla WACC, tax changes, etc) by developing a basic model with stylised data inputs. At the level of testing envisaged, we estimate that this could be achieved within a week and we are willing to commit resource to the exercise to ensure that this timeframe is met. It would also be appropriate for the model "test" calculations to be independently reviewed.

As we work through this process, we should also seek to capitalise on any opportunities to simplify the drafting where this can be achieved to the Commission's satisfaction.

This recommendation is made having had some experience over recent years of applying the current thresholds (which are considerably less complex than the IPP and IM determinations) – a lack of clarity or any ambiguity in the wording, which describes what are quite complex processes, will undoubtedly result in unnecessary frustrations further down the line.

#### *Definitions of HVAC revenue and HVDC revenue*

The definitions of "HVAC revenue" and HVDC revenue" in the individual price-quality path determination are defined to mean the summation of HVAC and HVDC transmission charges respectively. However, in the transmission pricing methodology, the HVAC and HVDC transmission charges are allocations of the AC revenue and HVDC revenue respectively which are amounts approved by Transpower's Board subject to Part 4 of the Commerce Act. This could give rise to confusion because of the use of the same terminology, so that HVDC revenue, for example, could be read to mean the amount approved by the Transpower Board and allocated via HVDC charges. It would be better simply to refer to the "sum of HVAC charges" and the "sum of HVDC charges", if that is what is intended.

#### *Quality standards – definitions*

We have marked up several changes to the IPP draft determination to clarify the definitions relating to the proposed quality standards under the IPP. Appendix 3 provides a more detailed rationale to support each of our proposed amendments.

#### **Proposed meeting to resolve outstanding issues**

Given the number of drafting points identified, the detail involved and the time available, we suggest that we meet with Commission staff at the earliest opportunity to discuss the wording and interpretation problems we have identified and explore the most practical solutions to address these, where the Commission accepts that problems exist.

Yours sincerely



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Transpower New Zealand Ltd