TRANSPOWER NEW ZEALAND LIMITED

Formal Settlement Proposal

11 April 2008 (Amended as at 12 May 2008)

TRANSPOWER

1. Introduction

1. Transpower is a state-owned enterprise which owns and operates New Zealand's high voltage electricity transmission network known as the 'National Grid'. The National Grid transmits electricity from generators to distribution businesses and large industrial users.

2. Subpart 1 of Part 4A of the Commerce Act 1986 establishes a targeted control regime for large electricity lines businesses (i.e. distribution businesses and Transpower) (**LELBs**).

3. Under Subpart 1 of Part 4A (**Part 4A**) the Commerce Commission is required to set thresholds for the declaration of control of goods or services supplied by LELBs. The Commerce Commission must assess LELBs against the thresholds, identify any LELBs that breach the thresholds and determine whether or not to declare control in relation to the services supplied by identified LELBs, taking into account the section 57E purpose statement.

4. By notice published in the *New Zealand Gazette* on 6 June 2003, the Commerce Commission set two initial thresholds applicable to Transpower from 6 June 2003 to 30 June 2004: a price path threshold, and a quality threshold. These thresholds were subsequently reset by notices published in the *New Zealand Gazette* on 30 June 2004, 29 June 2005, 23 June 2006 and 29 June 2007, in each case for 12 months from 1 July in the relevant year.

5. Transpower is required to submit to the Commerce Commission a written self assessment against the thresholds, known as a threshold compliance statement, for each specified assessment date.

6. Transpower's threshold compliance statements for the first, second, third, fourth and fifth assessment dates (6 September 2003, 30 June 2004, 30 June 2005, 30 June 2006 and 30 June 2007 respectively) identified Transpower as having breached the price path thresholds during each of the relevant periods (together **Breaches**).

7. On 23 December 2005, the Commerce Commission published in the *New Zealand Gazette* notice of its intention to make a declaration of control under Part 4A of the Commerce Act in respect of the transmission services supplied by Transpower (**Gazette Notice**). On 27 January 2006 the Commerce Commission published a paper titled *Regulation of Electricity Lines Businesses – Targeted Control Regime – Intention to Declare Control – Transpower New Zealand Ltd* setting out the Commerce Commission's reasons for forming an intention to declare control.

8. On 31 March 2006, the Commerce Commission and Transpower reached agreement whereby:

   (a) The Commerce Commission agreed to delay its decision on whether to impose control and to provide Transpower with an opportunity to put forward an administrative settlement proposal; and

   (b) Transpower agreed to invoice customers in accordance with the notified 2006/07 prices, but provide a credit note that effectively restored customer charges to the level applicable in March 2006 pending the outcome of any settlement discussions, which would include agreement on Transpower's revenue increase for the 2006/07 pricing year and process for recovery of that increase.

9. In early December 2006, following discussions with the Commerce Commission, in order that Transpower might comply with notice and pricing provisions binding on it, Transpower notified customers of prices for the 2007/08 pricing year. These prices incorporated an effective 12.2% increase for the 2006/07 pricing year, to be recovered through adjustments to future prices via the Economic Value Accounts and a 2.7% increase for the 2007/08 pricing year.

10. While the Commission indicated a preliminary view that Transpower's proposed revenue (and therefore prices) for 2006/07 and 2007/08 and the mechanism to recover the effective revenue increase for 2006/07 were appropriate, it was agreed that any final decisions on those prices (and mechanism for adjustment) would be subject to consultation on an administrative settlement or any other regulatory outcome.

11. The Commission issued a draft decision not to declare control of Transpower on 5 October 2007, along with Transpower's formal settlement proposal dated August 2007, for formal consultation. In December 2007, a further average price increase of 6.3% for the 2008/09 pricing year was notified to customers.

12. Following the consultation process, the Commission requested a number of amendments to the settlement proposal, which Transpower has agreed to and reflected in the current settlement proposal.

13. This settlement proposal:

    (a) Sets out Transpower's proposal for an administrative settlement by way of resolution of the Breaches and the Gazette Notice (section 2);

    (b) Outlines the constraints on Transpower, proposed as part of the administrative settlement (detailed in Schedules 1, 2 and 3), which will apply from 1 July 2006 to 30 June 2011. From 1 July 2006 to 30 June 2008, the constraints will apply as commitments made by Transpower to the Commerce Commission. From 1 July 2008 to 30 June 2011 the constraints will apply as thresholds which will replace the current price path threshold; and

    (c) Proposes a 'compliance' reporting framework.

14. This settlement proposal is made without prejudice to Transpower's position should the parties fail to reach agreement on settlement. If the parties reach an agreement on settlement, Transpower's commitments will be recorded in a Deed.

15. This settlement proposal replaces Transpower's previous formal administrative settlement proposals dated August 2006, October 2006, May 2007, August 2007 and March 2008.

16. Transpower has put forward this settlement proposal willingly and in good faith. Transpower acknowledges that Part 4A is the prevailing regulatory framework within which the company must operate and considers the settlement thresholds to be appropriate thresholds for the purposes of Part 4A. The settlement proposal is made without prejudice to any submissions Transpower has made, or may in future seek to make, as to the appropriateness of Part 4A as the basis for economic regulation of Transpower's specified services.

2. Proposal

17. Transpower proposes the Commerce Commission's inquiry into the Breaches and the Gazette Notice be settled on the following terms:

(a) The price path threshold applicable to Transpower is replaced by three new thresholds together with the existing quality threshold (**settlement thresholds**) to take effect from 1 July 2008. The three new thresholds are as follows:

(i) A new transmission (revenue requirement) threshold as outlined in Schedule 1 of this settlement proposal (**transmission (revenue requirement) threshold**).

Under this threshold, Transpower will be required to demonstrate that it has applied the principles set out in Schedule 1 in determining and recovering its annual revenue requirement for those services that fall within the definition of 'specified services' contained in the Commerce Act (Transpower Thresholds) Notice 2007, but excluding any services provided under the System Operator Service Provider Agreement (**specified services**).[1] The Schedule 1 principles will apply to Transpower's annual revenue requirement:

- for the provision of specified services in relation to conveyance of electricity through the national grid other than the HVDC inter-island link, during the relevant pricing year (**AC revenue requirement**); and
- for the provision of specified services in relation to the conveyance of electricity through the HVDC inter-island link during the relevant pricing year (**HVDC revenue requirement**).

The Schedule 1 principles are not intended to exhaustively prescribe how Transpower determines and recovers the AC revenue requirement and HVDC revenue requirement. Rather they are intended to provide auditable and transparent principles in respect of key aspects of Transpower's revenue setting.

[1] It is proposed that System Operator Services provided by Transpower are subject to a separate threshold.

The transmission services (revenue requirement) threshold will apply for the period commencing 1 July 2008 and ending 30 June 2011.

(ii) A new transmission (non-Part F capex) threshold as outlined in Schedule 2 (**transmission (non-Part F capex) threshold**).

Under this threshold, Transpower will be required to demonstrate that capital expenditure not currently subject to an approval requirement by the Electricity Commission under Part F of the Electricity Governance Rules has not exceeded the threshold specified in Schedule 2 for the assessment period to 30 June 2009 and thereafter, any subsequent threshold amount determined by the Commission on an annual basis in accordance with the reset principles described in Schedule 2.

(iii) A new System Operator Services threshold in the form outlined in Schedule 3 of this settlement proposal (**System Operator Services threshold**).

Under this threshold, Transpower will be required to demonstrate that it charged for System Operator Services in accordance with the System Operator Service Provider Agreement (**SOSPA**).

The System Operator Services threshold will apply for the period commencing 1 July 2008 and ending 30 June 2011 or the date on which the SOSPA is materially changed (whichever is earlier).

Transpower understands that if the current SOSPA is materially changed and the Commerce Commission determines at the time that any materially changed System Operator Services contract is entered into by Transpower, that the System Operator role is not contestable, the Commerce Commission reserves the right to set a new System Operator Services threshold.

(b) The current quality threshold as set out in the Commerce Act (Transpower Thresholds) Notice 2007 will continue to apply to Transpower, at least until alternative service reporting obligations acceptable to the Commerce Commission are established.

(c) Gazettal of the settlement thresholds will include a framework for Transpower demonstrating compliance, similar to the requirements in the Commerce Act (Transpower Thresholds) Notice 2007 but relevant to the settlement thresholds as follows:

(i) Compliance reporting for the settlement thresholds will be undertaken:

- Separately in respect of the AC revenue requirement and HVDC revenue requirement for each of the transmission thresholds. Transpower will separately publish the customer and shareholder EV accounts for each of the HVDC and AC networks in a transparent manner;

- Annually in relation to the transmission (revenue requirement) threshold and the System Operator Services threshold; and
- Annually in relation to the transmission (non-Part F capex) threshold, while that threshold continues to apply,

by 30 September each year for the assessment period ending June 30 immediately prior.

(ii) In assessing threshold compliance, revenue recovered during a Transpower pricing year will be deemed to be recovered in the financial year starting on 1 July following the start of that pricing year. This approach is adopted to address the mismatch between Transpower's pricing and financial years. By way of example, revenue recovered during Transpower's pricing year April 2008 to March 2009 will be deemed to be received in the financial year 1 July 2008 to 30 June 2009 and compliance will be reported within the specified reporting period following 30 June 2009.

(iii) Compliance with each of the thresholds will be demonstrated by:

- a written statement by Transpower confirming Transpower's compliance or otherwise with each of the thresholds, and containing the information needed to support the statement;
- a report on the statement by an auditor and a certificate signed by two directors of Transpower.

(iv) Transpower will provide a compliance statement in accordance with the above requirements for the 2007/08 financial year as if the settlement thresholds had applied to the 2007/08 year.

(d) Transpower will use best endeavours to remain within the settlement thresholds.

(e) The Commerce Commission determines, in relation to each of the Breaches described in paragraph 6, not to declare control of services provided by Transpower.

(f) The AC revenue requirement and HVDC revenue requirements for Transpower's 2006/07, 2007/08 and 2008/09 pricing years were determined prior to the settlement thresholds being set. Although the thresholds will apply from 1 July 2008, Transpower will limit its year end revenue requirement for the 2006/07 and 2007/08 pricing years to the level that would have been allowed had the settlement thresholds applied to Transpower in these years. Transpower will achieve compliance with this requirement through the operation of Transpower's Economic Value Account framework, notwithstanding that Transpower's pricing and revenue for the period to 30 June 2007 (i.e. its 2006/07 pricing year) has been reported against the price path threshold in the

Commerce Act (Transpower Thresholds) Notice 2006. Transpower will make an ex post adjustment using the Economic Value Account framework so that relevant settlement adjustment amounts as (described below) are applied to the relevant Customer Accounts in accordance with paragraph (f) below.

(f) The **settlement adjustment amount**:

(i) is the difference between the AC and HVDC year end revenue requirement calculated by Transpower in relation to the specified services during each of the 2006/07, and 2007/08 financial years and the AC and HVDC year end revenue requirement it would have calculated in relation to the specified services had its year end revenue requirements for those financial years complied with the settlement thresholds;

(ii) is in addition to other ex post adjustments that adjust actual against forecast inputs used in the revenue setting process;

(iii) is calculated separately for the AC revenue requirement and the HVDC revenue requirement;

(iv) for the 2006/07 financial year will be applied to the relevant Customer Accounts (i.e. the AC Customer Account or the HVDC Customer Account) as an economic loss or gain (as the case may be) to form part of the balance as at 30 June 2007;

(v) for the 2007/08 financial year will be applied to the relevant Customer Accounts as at 30 June 2008;

(g) Transpower non-Part F capital expenditure, for the 2007/08 financial year, will not exceed a total of $120.7 million.

(i). If Transpower exceeds the non-Part F capital expenditure cap in any one year, but commits not to bring the amount of over-expenditure into the regulatory asset base during the settlement period, then Transpower will be deemed to have not breached the non-Part F threshold in that year.

(ii). If Transpower exceeds the expenditure cap in any one year, and does not commit to exclude the amount of over-spend from the regulatory asset base, and the circumstances in clause D in Schedule 2 do not apply, then Transpower will breach the non-Part F threshold. Once Transpower becomes aware that it has over-spent the non-Part F capex threshold it will advise the Commerce Commission. If the Commerce Commission determines that some or all of the over-expenditure cannot be justified, Transpower will exclude the amount of expenditure not approved by the Commerce Commission from its regulatory asset base for the remainder of the settlement period.

Schedule 1: Proposed Transmission (Revenue Requirement) Threshold

This Schedule describes the principles that form the basis of the proposed transmission (revenue requirement) threshold.

In this Schedule all references to paragraphs are references to paragraphs in this Schedule.

Economic Value Framework

A. The ex post economic gains or losses in relation to the provision of specified services by Transpower will be calculated at the end of each financial year (on the basis that revenue received in the pricing year starting immediately prior to the start of the financial year is deemed to have been received in the financial year) and allocated between AC customers and HVDC customers on the one hand and Transpower's shareholder on the other hand in a manner consistent with paragraphs E to AA of this Schedule.

B. Economic gains or losses allocated to AC customers and HVDC customers will be recorded in separate accounts (each a 'Customer Account'). Economic gains or losses in any year allocated to customers will be accumulated in the relevant Customer Account and will attract interest at Transpower's WACC as defined in paragraph R. The balance of the existing customer accounts for AC customers and HVDC customers as at 30 June 2008 will be carried forward and form the opening balance as at 1 July 2008 for each of the Customer Accounts for the purposes of the threshold.

C. Economic gains and losses attributable to customers will be returned to or recovered from customers over time via separate adjustments to the forecast AC revenue requirement and forecast HVDC revenue requirement. These adjustments will be equal to:

One third of

[The relevant Customer Account at June 30, nine months prior to the commencement of the pricing year

plus

The expected economic gain or loss (to be allocated to the relevant Customer Account) for the financial year ending on June 30, three months after the commencement of the pricing year

plus

The expected economic gain or loss (to be allocated to the relevant Customer Account) for the financial year ending 30 June, fifteen months after the commencement of the pricing year]

Subject to the following constraints (calculated separately for AC and HVDC):

- The maximum recovery from customers in any year will not exceed 10% of the relevant forecast revenue requirement for the pricing year.
- If the balance of the Customer Account is less than $20 million,

Transpower may decide not to adjust the forecast revenue requirement. The balance will be carried forward and attract interest at Transpower's weighted average cost of capital (WACC).

D. All insurance income received by Transpower for an insurance event will be credited to the relevant AC or HVDC Customer Account.

Capital Expenditure

E. All investments in respect of specified services[2] apart from those related to the System Operator Service, cannot be included in the asset base used to determine the AC revenue requirement or HVDC revenue requirement (as applicable) unless:

(a) The investment has been approved by the Electricity Commission under the procedures in Part F of the Electricity Governance Rules (Part F) (**Part F investment**); or

(b) The investment is within a class of investments in specified services the Electricity Commission has for the time being explicitly identified as not requiring approval in accordance with Part F; or

(c) The investment is one to which the transmission (non-Part F capex) threshold applies. The definition of such expenditure is provided in Schedule 2; or

(d) The investment relates to business support assets;

(e) The investment relates to Part F expenditure which has not been approved under the Part F approval process, but for which the Electricity Commission has formally communicated to the Commission that it considers such expenditure to be prudent; or

F. Subject to paragraph G below, capital expenditure associated with Part F investment and non-Part F capex (as defined in Schedule 2):

(a) Will be held in a works under construction account until the relevant assets are commissioned. Interest at Transpower's cost of debt will accrue and be capitalised using Generally Accepted Accounting Principles (**GAAP**); and

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[2] The definition of specified services in the current gazette notice is proposed to be adopted. System Operator Services which will be subject to a separate threshold will be excluded from these capital expenditure principles. Under the definition of specified services, the following goods and services provided by Transpower are (inter alia) excluded:

- If provided under new investment contracts entered into prior to 5 June 2003; or
- If provided under new investment contracts entered into after 5 June 2003 if the other party agrees in writing that the terms and conditions are reasonable or reflect contestable provision of the goods and services.

Accordingly revenue recovered pursuant to such investment contracts (and other exclusions to the definition of specified services) is recovered independently of the revenue requirement calculations for the purposes of the threshold.

(b) Can be included in the asset base used to determine the AC revenue requirement and HVDC revenue requirement (as applicable) upon commissioning.

G. (a) Capital expenditure associated with:

- transmission corridor investments; or
- land and easement investments,

and any associated resource consents or designations, that form part of, or are otherwise required for, investments that are subject to approval processes under Part F (whether such investments have been included in a grid upgrade plan proposal to the Electricity Commission or are acquired in anticipation of a grid upgrade plan proposal) or which are acquired for strategic option value purposes for future grid investment, can be included in the asset base used to determine the AC revenue requirement and HVDC revenue requirement (as applicable) once:

(i) Their purchase has been approved by the Electricity Commission and in the case of land acquired for strategic option value purposes, meets the requirements of Rule 4.2 of the Grid Investment Test in Schedule F4 of Section III of Part F; and

(ii) The capital expenditure has taken place.

(b) Where Transpower purchases land to gain an easement with the intention of on-selling some or all of that land:

(i) Land held for resale will be accounted for as unregulated;

(ii) The value of land held for re-sale (including the costs associated with purchasing the land) will be excluded from the regulatory asset base and thus from the calculation of the relevant revenue requirement;

(iii) Costs and income from land held for re-sale will be treated as an unregulated activity;

(iv) As required, easements will be established over land held for re-sale. The capital value of the easement, together with any injurious affection payments and all other costs of establishing the easement will be transferred to the regulated business and become part of the regulatory asset base, subject to the approval of purchase costs by the Electricity Commission;

(v) The capital value of the easement and any injurious affection payments will be valued based on an independent valuation;

(vi) The inclusion within the regulatory asset base of the full costs of establishing the easement will occur at the date of the next regulatory asset base valuation following either purchase of the land or the approval of the purchase by the Electricity Commission, whichever is the later; and

(vii) All other costs associated with land held for re-sale will be treated as an unregulated activity with the benefits or costs borne by the shareholder, including purchase costs, holding costs, operating income, maintenance costs, property development costs, and sale costs.

H. For the purposes of paragraphs E, F, G and J:

(i) A reference to approval by the Electricity Commission means approval given under a Part F approval process or, if there is no applicable Part F process, a formal communication to the Commerce Commission from the Electricity Commission that it considers the capital expenditure or, in the case of transmission alternative services, the costs, to be prudent, and in either case irrespective of whether approval is sought or given before, or subsequent to, the capital expenditure being incurred.

(ii) A reference to transmission corridor investments means investments in any of easements, access rights, access ducts, cable ways or tunnels, (in each case whether above or below ground), land, buildings or other improvements to provide corridors for transmission assets and sites for substations.

(iii) GAAP will be used to determine the date on which assets are commissioned and their capital cost. Upon asset commissioning Transpower will be entitled to a return on these assets.

(iv) Transpower will recover the lesser of actual costs or the upper limit of costs as proposed by Transpower and approved by the Electricity Commission under the Part F approval processes.

I. Easements will be depreciated only when they have a limited life or are required for a known, limited period of time. Land will not be depreciated.

J. Transpower may from time to time develop alternative services which substitute for investment in connection assets or interconnection assets or both (**transmission alternative services**). The cost of developing and funding such alternatives:

(a) Will, where these costs are operating expenditure, be in addition to any Base Opex expenditure, for the purposes of the operating cost constraint in paragraph W to Y; and

(b) Will be recovered from customers only if the Electricity Commission approves such expenditure under a Part F approval process.

Accounting for the Regulatory Asset Base

K. Transpower has used the 30 June 2006 ODV as the basis for, and to value, transmission system fixed assets included in the asset base used to determine the AC revenue requirement and HVDC revenue requirement for the pricing year commencing 1 April 2007.

L. For all subsequent pricing years, Transpower will use depreciated historical cost (**DHC**) accounting principles to value transmission system fixed assets included in the asset base used to determine the AC revenue requirement and HVDC revenue requirement.

M. For the purposes of paragraphs K and L:

(i) All of Transpower's fixed assets as at 30 June 2006 are included in the asset base, except where they are part of the System Operator or unregulated asset base.

(ii) The ODV of Transpower's system fixed assets at 30 June 2006 will be used to establish the historical cost base for the purpose of calculating depreciation and the net book value of transmission system fixed assets in subsequent years.

(iii) All transmission system fixed asset additions subsequent to 30 June 2006 will be recorded at cost and brought into the asset base in accordance with this schedule.

(iv) The term 'cost' will be interpreted in a manner that is consistent with GAAP and the other principles of the proposed transmission (revenue requirement) threshold.

N. Transpower proposes to use the asset values in the financial accounting book for regulatory purposes. In order to align the financial accounting book asset values to the historical ODV asset values, Transpower proposes creating five 'pseudo' assets, which will be depreciated over a period of four to ten years. The five pseudo assets will be the HVDC mercury arc valve pseudo asset, other HVDC pseudo asset, HVDC lines pseudo asset, AC lines pseudo asset, and AC substations pseudo asset. The value of the pseudo assets will be the difference between the financial accounting book transmission asset values, and the ODV transmission asset values. This approach will be net present value (**NPV**) neutral for Transpower and its customers.

O. From 1 July 2006, the value of the pseudo assets will be as follows: HVDC mercury arc pseudo asset $21 million, the other HVDC pseudo asset $17 million, HVDC line pseudo asset negative $4 million, the AC lines pseudo asset $64 million and the AC substations pseudo assets $14 million. From 21 September 2007 (the date the mercury arc valve assets were taken out of service) the HVDC mercury arc valve pseudo asset will be valued at $0.

P. Transpower proposes that it be exempt from all information disclosure obligations which relate specifically to the disclosure of transmission system fixed assets at ODV value, as set out in the Commerce Commission's "Electricity Information Disclosure Requirements" issued 31 March 2004 (as amended from time to time). Transpower will instead report on the transmission system fixed assets at regulatory asset value (historic cost plus pseudo asset value) in accordance with clauses J and K of this proposal.

Depreciation, Impairment and Asset Stranding

Q. Transpower will receive a return of capital through a depreciation charge. Depreciation will be based upon the life of the underlying assets. The depreciation charge and any asset write-off will be calculated consistent with GAAP and the DHC valuation methodology, and will also include 'depreciation' relating to operating leases. Transpower will adjust cash flows (using accelerated depreciation) to achieve a return of capital as asset stranding or impairment becomes apparent. Transpower will not earn a return on capital for stranded or impaired assets. Such an approach to recovery is consistent with the Commerce Commission, *Draft Guidelines: The Commerce Commission's Approach to Estimating the Cost of Capital*, November 2005, pp 27-29. Asset stranding may be handled through the EV Account with recovery achieved through an adjustment to the Customer Account if stranding is not anticipated at the time the revenue requirement is set.

Cost of Capital

R. Transpower will use a post-tax nominal WACC of 7.2% and a post-tax nominal WACC of 7.7% to calculate the AC revenue requirement and HVDC revenue requirement and any settlement adjustment for 2006/07 and 2007/08 respectively. Transpower will use a post-tax nominal WACC of 7.8% for 2008/09, 2009/10 and 2010.

S. The difference between Transpower's actual financing costs and the capital charge arising from application of the approved WACC in any year will be to the benefit of, or cost to, Transpower's shareholder.

Cross Border Leases

T. Transpower's shareholder will retain the benefits of any future cross-border leases or structured finance arrangements that Transpower undertakes and assume the costs of developing such agreements whether or not final agreements are concluded.

Tax Treatment

U. Transpower will use a tax payable approach to calculate the AC revenue requirement and HVDC revenue requirement.

Operating Costs

V. Operating costs will be determined in accordance with paragraph W before being allocated between the AC revenue requirement and HVDC revenue requirement.

W. Operating costs to be allocated between the AC revenue requirement and HVDC revenue requirement in any pricing year will be the sum of the following, in each case as forecast for the forthcoming financial year:

(i) Base Opex, determined in accordance with paragraph X;

(ii) Operating lease costs, determined in accordance with paragraph AA;

(iii) Pass through costs (currently EC levies and Local Authority rates) as defined by the Commerce Commission from time to time;

(iv) Any operating costs associated with transmission alternative services (if approved by the Electricity Commission); and

(v) Any operating expenditure incurred as a result of an insurance event which has been recovered by insurance income, or is reasonably anticipated by Transpower to be so recovered.

X. Base Opex is determined as follows:

(i) For the financial year 2006/07, an amount equal to $199.61 million; and

(ii) For the 2007/08 financial year, an amount equal to $199.61 million adjusted by the annual average change in the CPI over the 12 month period ending 30 June 2008.

(iii) Thereafter for each subsequent financial year, an amount equal to the Base Opex for the previous financial year adjusted by the annual average change in CPI to 30 June at the end of that financial year, less 75% of any saving in administration costs Transpower identifies as resulting from alignment of the regulatory and financial asset books in accordance with paragraph N.

Y. The difference (whether positive or negative) between:

(a) Transpower's actual operating costs in providing specified services for a financial year less the costs specified in paragraph W(ii to iv); and

(b) The Base Opex for that financial year recalculated at the end of the relevant financial year (substituting actual CPI data for forecast data),

will be to the account of the shareholder and will not be recovered from or returned to customers through the EV Account framework.

Z. For the purposes of assessing whether actual operating costs exceed or are less than the amount determined in accordance with paragraph W, expenditure relating to investigation and feasibility work that is accounted for as an expense for financial reporting purposes is to be included as an actual operating cost.

AA. Operating lease costs for assets are in addition to Base Opex. Future committed operating lease costs will be capitalised and a WACC return on the NPV of leased assets will be included in the AC revenue requirement or HVDC revenue requirement (as applicable). A depreciation charge will also be included in the AC revenue requirement and HVDC revenue requirement (as applicable). The depreciation and NPV will exclude the estimated financing component inherent in the operating leases. Any capitalised operating leases entered into after 1 July 2006 will be treated as capital expenditure.

Schedule 2: Transmission (Non-Part F Capex) Threshold

In this Schedule all references to paragraphs are references to paragraphs in this Schedule.

Schedule 2 describes the proposed transmission (non-Part F capex) threshold.

A **Non-Part F capex** is capital expenditure on any of[3]:

(i) Replacement and refurbishment of existing transmission assets;

(ii) Minor development and enhancements of transmission assets;

(iii) Operational network information and technology services (**IT**);

directly related to the provision, operation and maintenance of electricity works used to provide specified services but excluding any such expenditure:

(iv) On business support assets;

(v) Relating to investments which are subject to a bilateral agreement with customer(s);

(vi) Submitted to the Electricity Commission for approval under Part F;

(vii) Associated with the provision of non specified services; and

(viii) Expenditure related to the System Operator service.

B. The transmission (non-Part F capex) threshold for the 2008/09 financial year provides that non-Part F capex will not exceed a total of [$203.7 million] plus any non-Part F capex expenditure in 2008/09 which is the result of an insurance event, and for which insurance income is, or is reasonably anticipated by Transpower to be received (up to the amount of that insurance income) (initial threshold).

C. For the subsequent financial years 2009/10 and 2010/11, the transmission (non-Part F capex) threshold will be established as follows:

(i) Transpower will record any material changes to its asset management, business planning and capital works policies and/or processes or policies, relating to non-Part F capex, which have occurred during the previous calendar year. These records are to be provided to the Commission in January immediately preceding the start of the financial year.

(ii) In January immediately preceding the start of the financial year, Transpower will make available to the Commission a schedule that shows, for non-Part F capex projects completed in the first half of the financial year, a comparison of actual expenditure (in the first half of the financial year) versus budgeted expenditure (for the first half of

[3] Transpower has documented the definitions and criteria that it uses to categorise expenditure types and to determine which investments require Electricity Commission approval under the processes currently defined in Part F. The classification, which has been agreed with the Electricity Commission, is provided in the Annex to Schedule 2.

the financial year). Reasons for variations will be provided for all projects that have exceeded 10% of budgeted cost.

(iii) Transpower will make available upon request a schedule which sets out significant movements of non-Part F capex projects into and out of the capital works plan which have occurred during the first six months of the financial year as well as a forecast of similar movements to the financial year end.

(iv) Transpower will prepare its non-Part F capital works plan and business plan forecasts for the forthcoming financial year in accordance with capital works and business planning processes and policies in the January/February of each preceding financial year[4].

(v) Transpower will ensure contingency sums are adjusted as per the initial threshold to no more than 7.5% for IT and 0% for replacement, refurbishment, minor development and enhancement expenditure.

(vi) Transpower will make available upon request project approval documentation, including a final schedule of all projects making up the proposed non-Part F capital expenditure, for the forthcoming financial year, together with the project approval status, in final, non-draft form (non-Part F capex plan).

(vii) The Commission (at its discretion) will review (or engage an independent third party to review) the non-Part F capital works plan beginning in February of each year, to provide assurance that:

- The levels of contingency included in the project budgets have been established in accordance with (v) above.
- The expenditure forecasts have been prepared in accordance with Transpower's capital works and IT planning processes and policies.
- Transpower's processes have considered and targeted appropriate least-cost, efficient, interventions.
- Transpower has proactively pursued and implemented process improvements and delivered on commitments made to review the scope for improvement to its non-Part F capital works processes around (a) procurement audit, (b) review of open book tendering for R&R, and (c) PAD templates[5].
- If Transpower is found to have complied with and provided for the above then the resulting capital expenditure should be deemed appropriate for the transmission (non-Part F threshold).
- Prior to the Commerce Commission making a determination on

[4] The capital expenditure forecasts (and Business Plan) prepared in January / February of each financial year, which will set out the forecast non-Part F capex threshold expenditure for the subsequent financial year, will be approved by the Transpower Board during the month of April.

[5] Note that for the threshold set for 2008/09, within the time available, it will not be possible to fully implement all process improvements.

the level of the annual transmission (non-Part F capex) threshold Transpower will be provided with a draft copy of the Commission's (or their agent's) findings and any recommendations from the annual review process, for identification of any factual errors.

(viii) The threshold will include non-Part F capex expenditure which is the result of an insurance event occurring in that or any previous financial year, and for which insurance income is, or is reasonably anticipated by Transpower to be received, up to the amount of that insurance income.

C. If the Electricity Commission introduces procedures that allow it to approve all or any category of non-Part F capex, then:

(a) all expenditure associated with such categories (or part categories) will be excluded from the transmission (non-Part F capex) threshold when the threshold is next set, subject to subclause (b);

(b) where expenditure relates to a non-Part F capex project that has been included in a non-Part F capex plan which has been consulted on and forms the basis of the transmission (non-Part F capex) threshold for an assessment period in accordance with paragraphs B or C, prior to the Electricity Commission introducing its procedures, Transpower need not submit that expenditure to the Electricity Commission. The on-going project expenditure will continue to be treated as part of the transmission (non-Part F capex) threshold.

D. For the purposes of the transmission (non-Part F capex) threshold:

(a) A Force Majeure Event occurs if:

- an event that is beyond the reasonable control of Transpower (**event**) has occurred and the occurrence of that event at that time, could not reasonably have been foreseen by Transpower at the time the threshold was set; and
- no forecast capital expenditure for the event was included in the applicable threshold; and
- Transpower proposes to undertake non-Part F capex within the threshold period to rectify the adverse consequences of the event; and
- the total of the non-Part F capex to rectify the adverse consequences of the event exceeds $5 million; and
- the expenditure is such that, if undertaken, it is reasonably likely (in the absence of any other reduction in non-Part F capex) to result in the total actual non-Part F capex for the relevant or subsequent threshold period exceeding total forecast non-Part F capex for that period; and
- a failure to rectify the adverse consequences of the event would be likely to materially adversely affect the reliability and security of the transmission system; and

- Transpower can demonstrate it is not able to reduce capital expenditure in other areas without materially adversely affecting the reliability and security of the transmission system.

(b) A Security of Supply Event occurs if:

- non-Part F capex for which no contingency is included in the threshold limit (i.e. non-Part F capex on replacement, refurbishment, development and enhancement of transmission assets) appears likely to exceed the threshold; and
- the scope of the expenditure required, or the timing of expenditure was not anticipated at the time the threshold was set; and
- the total of the non-Part F capex to rectify the adverse consequences of the event exceeds $5 million; and
- Transpower can demonstrate that the additional expenditure is required to ensure the reliability and security of the transmission system; and
- Transpower can demonstrate it is not able to reduce capital expenditure in other areas without materially adversely affecting the reliability and security of the transmission system.

E. If:

(a) Transpower becomes aware of, or anticipates, a Force Majeure Event or a Security of Supply Event (**Excepted Event**); and

(b) the total non-part F capex for an individual Force Majeure or Security of Supply Event in the relevant assessment period to date exceeds or is likely to exceed $5 million, or the total of all Force Majeure Events and Security of Supply Events (**Combined Event**) in the relevant assessment period exceeds or is likely to exceed $10 million; and

(c) Transpower advises details of such event to the Commerce Commission in advance of the compliance reporting requirement for the relevant threshold period,

the Commerce Commission will confirm within a reasonable period whether it agrees that the event is a Force Majeure Event or a Security of Supply Event or a Combined Event, as the case may be, and inform Transpower accordingly. Where the Commission confirms that an event is a Force Majeure Event or a Security of Supply Event, or a Combined Event, compliance reporting by Transpower is to separately identify the Force Majeure Event or Security of Supply Event or Combined Event expenditure and report compliance with the transmission (non-Part F capex) threshold excluding any Force Majeure Event or Security of Supply Event or Combined Event expenditure.

Annex: Classification of Non-Part F Expenditure

Introduction

Transpower's criteria for defining non-Part F expenditure are set out below. This categorisation has been discussed with staff at the Electricity Commission and Commerce Commission. To the extent practicable, individual project categorisation will be recorded directly in Transpower's project planning system (AMBD) to assist in tracking compliance.

At a summary level Transpower has classified all of its Transmission Services capital expenditure (and projects) into one or other of the following categories:

1. Part F approved investment;
2. New investment contracts (customer);
3. **Asset replacement;**
4. **Asset refurbishment;**
5. **Asset enhancement & development (non-Part F);**
6. **Operational network information and technology services (IT); and**
7. Business support.

All expenditure falling within categories 3, 4, 5 and 6 is included within the Non-Part F capital expenditure threshold. A description of the criteria applied by Transpower to assign expenditures into each "threshold" category is set out below.

Replacement

The key criterion which determines inclusion into the replacement category, is that the expenditure is to replace an existing asset where the primary driver is replacement due to the condition of the asset or performance issues (including replacement due to obsolescence). This is essentially replacement with the modern equivalent of the existing asset. Any incidental increase in performance (for example, the minimum conductor size available to mitigate noise issues being larger than that used when the asset was originally installed) is still considered to be replacement.

Refurbishment

The key drivers for the refurbishment of assets are Transpower's technical standards and policies. Refurbishments are classified as capital works if the work extends the life of the asset.

Examples include painting of buildings and towers; bus and structure refurbishment; renewal of switchyard gravel; reseal of access roads; CT and disconnector refurbishment; transmission line refurbishment; and grillage foundation refurbishment.

Asset Development and Enhancement (Non-Part F)

Asset development and enhancement expenditure which is categorised as non-Part F threshold expenditure relates to work required on an existing asset, or investment in a new asset to:

a) bring the performance / security of service of the asset up to a modern standard or industry good practice;

b) ensure compliance with statutory or EGR requirements;

c) correct historical design or construction issues; or

d) provide physical protection of assets.

Transpower submits projects to the Electricity Commission for approval under Part F in cases where the expenditure to develop new assets is primarily driven by the need to enhance: a) capacity; or b) security / quality of service. However, Transpower project investments with a total value below a practical financial limit, in the range $1m to $1.5m, are not generally submitted for Electricity Commission approval (an element of judgment is applied by Transpower in these cases).

New "programmes" of work, where the driver for the programme is to enhance service capacity (capacity or quality of service) and the programme of work affects a large number of assets, will be submitted to the Electricity Commission for approval under Part F (and will not form part of the transmission (non-Part F capex) threshold) subject to the total cost of the programme being greater than $5m.

Examples of the type of work that Transpower would generally not seek Electricity Commission approval for under Part F and which would be included under a transmission (non-Part F capex) threshold includes the following:

- work required under the Rules (Part C);
- duplicating battery banks;
- Installation of vibration dampers on overhead lines;
- Increasing physical security for assets - fences, seismic upgrades, retaining walls, site and equipment earthing;
- Installation of temperature control in building;
- Installing or upgrading oil containment;
- Installation of CB fail protection, bus zone protection, and transformer protection; and
- Improving the lightning protection of transmission lines.

Operational Network Information Services (IT)

Transpower distinguishes between IT expenditure which is operations or network focused, and IT expenditure where the driver for investment is for business support purposes.

Operating leases (telecommunications)

Anticipated operating lease costs associated with Transpower's telecommunication upgrade programme have been capitalised by discounting the future cash commitment at the cost of debt to determine the implicit asset value. The value of the assets is then included in operating capital and capital invested by adjusting fixed assets and debt respectively. The interest component of the operating lease charge is estimated based upon the cost of debt implicit in the cost of capital. Depreciation expense is then calculated for the operating capital employed.

Schedule 3: Proposed System Operator Services Threshold

Schedule 3 describes the proposed System Operator Services threshold.

A. The System Operator Services threshold will be set equal to the price under the SOSPA, and expressed as:

System Operator Threshold = B + V + FC

where:

B = the base fee under the SOSPA (as amended from time to time by agreement between the Electricity Commission and Transpower);

V = the variable fees under the SOSPA, which are compliance investigation and proceedings fees, development fees, identification costs, information system access fees and audit fees, as set out in Schedule 1 of the SOSPA; and

FC = any adjustment to the price under the SOSPA made as a result of a fee change event agreed with the EC under the terms of the SOSPA.

B. Transpower will allocate costs to the System Operator function using the avoidable cost allocation methodology (**ACAM**) based on the Commerce Commission guidelines. Should the Commerce Commission determine alternative cost allocation guidelines during the term of the SOSPA, Transpower will apply the revised allocation methodology transparently and in full, subject to the following:

(i) the allocation results in no net reduction or increase in business cost recovery by Transpower as a result of the methodology change;

(ii) the Electricity Commission agrees to revise its SOSPA fee, as may be necessary to comply with the revised cost allocation methodology; and

(iii) the operating expenditure cap, forming part of the transmission (revenue requirement) threshold, is adjusted to reflect the reallocation of operating costs to or from the transmission business as a result of the application of any revised allocation methodology.

C. Transpower understands that if the current SOSPA is materially changed and the Commerce Commission determines, at the time that any materially changed System Operator Services contract is entered into by Transpower, that the System Operator role is not contestable, the Commission reserves the right to set a new System Operator Services threshold.