

TRANSPower NEW ZEALAND LIMITED

Part 1 – Submission to the  
Commerce Commission on:

Input Methodologies Transpower  
(excluding Chapter 6 – Cost of Capital)

and

Individual Price-Quality Path Transpower

Draft Reasons Papers

*August 2010*



**TRANSPower**

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- 1) **Ian Millard QC:** Legal Opinion – Commerce Commission Draft Determination on Input Methodologies – Transpower
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## **Overview**

### **Context**

Transpower has come through a prolonged period of under-investment. Compared to other transmission grids internationally, our national grid is older and more heavily loaded. This has: led to deteriorating reliability of supply for consumers; affected the development and operation of the energy market; and created uncertainty for regional economic development. Furthermore, we are in an age of technological change with respect to supply, demand and transmission of electricity that, if it is to benefit consumers, will require timely adoption and integration of new technology. Providing strong incentives for investment is, therefore, paramount when setting the regulatory framework for transmission. We submit that the proposed regulatory arrangements fail to achieve this overriding objective and require significant changes as a result.

### **Policy intent**

The clear intention of policy makers is to provide strong incentives to remedy past under-investment so that the transmission system provides a reliable core infrastructure and a secure platform for economic and energy market development. The Part 4 Purpose Statement, in section 52A of the Commerce Act, has been deliberately revised to give pre-eminence to the need for regulated firms to *“have incentives to innovate and to invest, including in replacement, upgraded and new assets”*. Similarly, Government Policy Statements have been amended to emphasise the importance of streamlined regulatory processes which encourage investment to maintain and develop the national grid over the long-term. The reality underlying these policies is the strong asymmetry between the relatively smaller welfare losses from early or over-investment and the much larger losses that result from late or under-investment in transmission. However, the draft decisions reflect a propensity to control each and every risk of early or over-investment, resulting in an outcome that sends very strong signals to under-invest.

### **Concerns with the Commission’s response**

While we do not doubt the Commission embarked with the intent to deliver on the policy objectives in the Commerce Act and the Government Policy Statements, much of the detail in its proposals will achieve the reverse. The draft decisions contain a lot of well meaning detail, but in aggregate this detail combines into a framework that manifestly does not achieve what the Commission set out to do.

We believe the Commission has attempted to move toward the mature form of regulatory regime found, for example, in Australia. However, a simple comparison against the Australian regime is telling: the investment risks faced by Transpower under the proposed regulations are higher than those faced by our Australian counterparts (refer to Harding Katz’s expert opinion), while the proposed rate of return on investment is below the Australian benchmark (as will be discussed further in part 2 of our submission due on 16 August 2010). These risks include uncertainty created by the extent of discretion that the Commission proposes to assume, compared to that of the Australian regulator.

### **Conclusion**

Collectively, the draft decisions discourage investment by not striking an appropriate balance between risk and return. They favour low risk, incremental investment and discourage major, innovative and long term investments. This is exactly what not to do to encourage the efficient development of long-life infrastructure.

### **Remedy**

Transpower’s submission (of which this is Part 1 of 3), provides constructive solutions to these problems, which we recommend to the Commission.

## **Introduction**

1. This is the first part of Transpower's submission on the Part 4 consultation material, comprising the Commission's draft decisions on Input Methodologies and Individual Price-Quality Path for Transpower, and the accompanying draft determination ("the draft decisions").
2. Our submission on the draft decisions will be made in three parts:
  - Part 1: on all non-cost of capital issues (this document);
  - Part 2: on cost of capital issues (to be submitted by 16 August); and
  - Part 3: comments on the wording of the draft determination (to be submitted by 16 August).
3. Part 1 consists of: an Overview; this Key Point Summary; detailed submissions on the draft decisions (in tabular form); a comparison between the regime contemplated by the draft decisions and the regime applied in Australia by the Australian Energy Regulator (AER) (prepared by Harding Katz); and an opinion from Ian Millard QC on various legal issues raised by the draft decisions.
4. We note at the outset of our submissions that Section 52T(2)<sup>1</sup> requires that the matters to be addressed under Section 52T(1) are to be dealt with in the Input Methodology determination in sufficient detail for Transpower to be able to reasonably estimate the material effects on it of the methodologies. When working through the proposed Input Methodologies, we have found that we can only estimate these impacts by also considering many of the proposed decisions in the Individual Price-quality draft reasons paper. This dependency is discussed further in Mr Millard's opinion.
5. Further we note that the Commerce Commission ("the Commission") has failed to give adequate weight to the changes in the Part 4 Purpose Statement (section 52A) and to the Government Policy Statements transmitted to it under Section 26 of the Act. As a consequence, the draft decisions fail to provide adequate incentives for investment and innovation or to deliver outcomes consistent with those found in (workably) competitive markets.
6. We believe that the intention of the Commission was to set out a path toward less intrusive, incentive-based regulation of transmission, and we acknowledge some progress on this path: for example, the increased flexibility for substitution of Minor capital projects and the planned move to five-yearly revenue resets.
7. This creates some similarities with the regime developed in more mature regulatory jurisdictions such as the regime in Australia, developed more recently under the auspices of the AER. However, sharp differences between the two regimes remain: for example the greater exposure to the risks of unrecovered costs under the Commission's regime<sup>2</sup>.

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<sup>1</sup> Legislative references are to Part 4 of the Commerce Act 1986 unless otherwise stated.

<sup>2</sup> Further details are provided in the comparison of the two regimes prepared by Harding Katz.

8. As a result, the regulatory framework envisaged by the draft decisions compares unfavourably with the regime in Australia, exposing Transpower to risks for which there is no compensation. Overall, the Commission's putative regime is NPV and cash flow negative compared to that in Australia. We are disappointed that the Commission has not paid greater attention to the Australian experience to draw lessons from what is now a relatively mature regulatory regime.
9. We are most concerned that the rate of return on investment projected from the draft decisions (based on the Commission's methodology for estimating Transpower's cost of capital) will be insufficient to encourage efficient investment and thus fails to meet the requirements of the section 52A purpose statement.
10. In part, this conclusion reflects the asymmetric and uncompensated risks, referred to above, to which Transpower would be exposed. The proposed treatment of historical customer EV balances, the risk of unrecoverable capital expenditure and the deferred recovery of approved capital expenditure are examples. These proposals would have material adverse cash flow impacts which further compound the cash flow impacts of a low rate of return. These risks should be removed in the final decisions.
11. We will address cost of capital issues specifically in Part 2 of our submission and assess the impact on our future financial flexibility measured in terms of, for example, balance sheet gearing or capacity for dividend payments to the Crown. Below, we summarise the most significant of our concerns with the remainder of the draft decisions, beginning with the draft decisions in respect of capital expenditure approval and recovery.

### **Major capital expenditure approval and cost recovery**

12. The Commission has defined Major capital expenditure as upgrade projects in excess of \$5m (\$1.5m for the Transition Year). As discussed, below this threshold is set too low.
13. Under the draft decision for "Major" capital investment, Transpower recovers the lesser of the approved project budget or actual project spend. There is no ability to offset or substitute expenditure between projects to mitigate the risk of project cost overruns. The Commission is also opposed to ex post review of project approvals. These draft decisions create risks of unrecovered capital expenditure for which there is no alternative compensation. As a result, Transpower is all but guaranteed a return below its estimated cost of capital.
14. This outcome represents a disincentive to investment and risks creating perverse incentives to address investment needs through a number of smaller, potentially less efficient projects rather than a "major" upgrade.
15. This asymmetric treatment of project cost risk without alternative compensation must be addressed. In the first instance, there should be a clearly defined process for "re-approval" of project cost forecasts when it becomes apparent that the original project budget is likely to be exceeded. The re-approval process must be streamlined to ensure that the delivery of ongoing projects is not delayed. This mirrors the approach that has developed under the Electricity Commission and is consistent with the 2009 Government Policy Statement. An application for re-approval should be possible at any stage of a project which will, in most cases, be

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once a project is already well advanced. Additionally, the basis for re-approval should allow for any unforeseen circumstances (for example a change in scope in response to customer load requirements or equipment performance specifications) and not be limited to exogenous factors such as exchange rate movements. A clear process for re-approval reduces the requirement otherwise that approval for Major projects be based on extreme cost estimates (e.g. P(99) cost)<sup>3</sup>.

16. Where a project exceeds its ex ante approved budget (and for which no subsequent increase in costs has been approved), the project should be included at cost in the RAB from the beginning of the next Regulatory Control Period (RCP). In other words, for projects exceeding their final approved cost, Transpower should be at risk of not recovering its full costs only for the remainder of the current RCP.<sup>4</sup>
17. We disagree strongly with the draft decision not to re-open the determination of maximum allowable revenue (MAR) during the Remainder Period of RCP1 to allow timely recovery of costs for Major projects that are approved (and commissioned) after the initial setting of MAR. This draft decision is in contrast to the annual revenue reset process operating under the Administrative Settlement and exposes Transpower to the risk of additional cash flow deferral.
18. We propose that the re-setting of MAR be an annual process for RCP1 for the purpose of accommodating approved Major capital projects. An annual reset is, in our view, consistent with the current (transitional) regime in which project by project assessments and approvals of Major capital projects are likely to occur on an “ongoing” basis throughout the first RCP.
19. We should emphasise that, in principle, we support the concept of a largely fixed MAR for the duration of an RCP, once a regime is adopted in which the MAR is set based on a forecast of all capital expenditure for the entire RCP, in common with the AER regime<sup>5</sup>. We are hopeful that the Commission will adopt such an approach from RCP2.

### **Threshold for “Major” capital expenditure approval**

20. As noted above, the \$5m threshold for Major grid upgrades is too low<sup>6</sup>. To put the threshold into context, \$5m represents the cost of purchasing and installing an upgraded supply transformer. As such, a low threshold creates a strong incentive for Transpower to avoid the time, bureaucracy and risk of project specific approval, to favour “like for like” asset replacement rather than planning and investing for the future in the most efficient and innovative way possible.

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<sup>3</sup> P(99) means a probability of being exceeded of 1%.

<sup>4</sup> This mirrors the capex incentive arrangements under the AER regime in Australia

<sup>5</sup> In common with the AER regime, the only exception would then be for true “contingent” projects triggered by pre-specified events. These projects would be exceptional and the MAR would be re-opened in the event that such a contingent project was “triggered”.

<sup>6</sup> Transpower’s concerns about the level of the proposed Major capital expenditure threshold were presented to the Commission at the Transpower Workshop in March 2010.

21. We propose that the threshold be increased to \$20m. A \$20m threshold is consistent with the 2009 Government Policy Statement (GPS), to which the Commission must have regard<sup>7</sup>. We note that the GPS was written expressly as a signal to the regulator of Part F, followed extensive industry discussion and debate and reflected experience of operating under the current arrangements with the Electricity Commission.
22. As well as being consistent with a directly relevant statement of government policy, this change would have other practical benefits. There would be a reduced workload for the Commission in reviewing fewer individual projects, which would enable greater focus on larger, more complex investments. This would help constrain some of the increase in regulatory costs that the MED has signalled will occur as a result of the transition from Electricity Commission oversight<sup>8</sup>, as well as facilitating more timely investment.
23. Importantly, an increase of the threshold would not reduce the requirements for justification and review of the investments that would now be below the threshold. These projects would be subject to the Commission's alternate processes for approval of Minor capital expenditure. Similarly, the application of Transpower's minor grid investment process could be applied to ensure appropriate consultation with stakeholders on, for example, alternative investment options.

## **Minor capital expenditure**

24. Raising the threshold for Major capital expenditure increases the "pool" of Minor capital expenditure projects. This would increase Transpower's operating flexibility in a way that would benefit consumers. A higher threshold would reduce the incentive to favour "like for like" (Minor) replacement or refurbishment of existing assets in preference to (Major) investment in innovative or forward looking alternatives. Similarly, a higher threshold would increase Transpower's flexibility to reprioritise across its investment portfolio and to evolve investment programmes over time in response to changing circumstances and requirements.
25. We agree with the proposal to set MAR to reflect forecast annual Minor capital commissioning, with a wash-up mechanism to account for annual variances. However, we are concerned about the Commission's proposal that any review of commissioning at the end of the RCP would allow only "emergency" investment in excess of the forecast to be included in the RAB going forward. In our view, the ex post review should be extended to include consideration of projects that have been commissioned earlier than forecast, i.e. that were begun during the RCP and unexpectedly completed during the RCP. To exclude these projects from ex post

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<sup>7</sup> Government Policy Statement on Electricity Governance – May 2009. *...The [Electricity] Commission should not be required to assess and evaluate the merits (whether technical, economic or otherwise) of small investment plans with an expected cost of less than \$20 million.* While the GPS pre-dates the transfer of jurisdiction from the EC to the CC proposed by the Electricity Industry Bill, we believe the principle set out in the GPS is clear and transcends the subsequent changes to institutional arrangements.

<sup>8</sup> Costs for implementing new Electricity Industry Governance Arrangements – Impacts on Electricity Levies, MED 7 July 2010 *...During the transition phase, while the Commerce Commission implements this function, it is estimated there will be an increase in costs (relative to the proposed reduction in electricity governance costs from transfer of this function)*.

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review would create perverse incentives to “slow down” projects toward the end of the RCP rather than deliver them most efficiently (i.e. early).

26. We strongly disagree with the proposal that no contingency be allowed on IST projects in setting the Minor capital forecast (in common with zero contingency for replacement and refurbishment projects). The “logic” for having “zero contingency” is that all projects are forecast at their P(50)<sup>9</sup> cost and that the distribution of estimation errors will be evenly distributed around the P(50) estimates. In practice, to account for unforeseen circumstances and events, a P(50) project cost estimate will include an allowance for “unspecified” costs. Forecasting uncertainty is heightened for IST projects especially in relation to applying new technologies. We propose that the contingency of 7.5% allowed under the Administrative Settlement for IST projects be retained. Moreover, the Commission must recognise that a true P(50) cost estimate for any project will necessarily incorporate some allowance for unforeseen costs.

### **Capital recovery on an as incurred basis**

27. The Commission’s overarching approach to capital recovery is that this should occur on an “as commissioned” basis, rather than an “as incurred” – the latter is the approach adopted by the Australian regulator. The “as commissioned” approach was a non-negotiable condition adopted by the Commission at the outset of negotiations on the Administrative Settlement.
28. The key impact of the “as commissioned” approach is the cash flow deferral that results compared to “as incurred”<sup>10</sup>. In addition, it requires regulation based on forecasts of project commissioning dates rather than forecasts of capital expenditure, which is harder to apply in practice. Accordingly, it contributes to the overall package of measures that act as a disincentive to investment.
29. We submit that the Commission should re-examine this key difference with the AER regime, and adopt capital recovery on an “as incurred” rather than an “as commissioned” basis.

### **Acquiring property rights**

30. Following on from the discussion of Minor capital expenditure, we propose an additional Minor Capex category for “Transmission corridor, land and easements<sup>11</sup>”. The draft decisions require that such capex must be approved ex ante by the Electricity Commission or the Commission. Often such property purchases need to happen quickly and opportunistically. Requiring prior regulator approval hinders efficient purchases and either eliminates the opportunity or drives up the cost.

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<sup>9</sup> P(50) means a probability of being exceeded of 50%.

<sup>10</sup> Correctly applied, the two approaches should be equivalent in NPV terms.

<sup>11</sup> Examples of transmission corridor investments (i.e. not linked to a particular project) are: (i) purchase of land or easement to mitigate the risks of further development under our lines, without which our future ability to do maintenance and upgrade works is impeded; or (ii) acquiring land adjacent to an existing substation that is likely to be required in the future (e.g. for expansion, entry of a new line) but which might otherwise be sold for alternative use preventing the future development of the site.

31. Therefore, we submit that an explicit provision be made in the Minor Capex categories for an asset classification “Transmission corridor, land and easements”. This would enable us to secure revenue in the MAR for a forecast annual cost of obtaining strategic property rights. A property rights strategy would support the capex forecast, consistent with the asset strategies developed for other classes of Minor capital expenditure.
32. We propose a fundamental change to the basis for the recovery of costs associated with the purchase and re-sale of land, compared with the terms of the Administrative Settlement. The reasons for this change are summarised below.
33. Our experience of the purchase of freehold titles to facilitate easement acquisition is that, while a necessary approach in some circumstances to ensure efficient project delivery, it raises complex commercial and regulatory issues that were not well understood at the time of the settlement.
34. The settlement assumed that, in those cases where the acquisition of an easement is facilitated by also purchasing the underlying freehold title, a clear distinction could be made between the costs of acquiring the easement and related expenses on the one hand and all other costs on the other. In practice this is not the case. Moreover, the cost of acquiring easements by negotiation with third-parties has differed markedly from the independent valuation of easements placed on Transpower owned land.
35. Going forward we propose as follows:
  - The gains and losses associated with the purchase and resale of freehold property acquired for the purposes of establishing an easement should be included as a project cost.
  - The final decisions should allow flexibility in the nature of the costs that are recoverable in respect of acquiring property rights. In future, costs might include: the full costs of freehold purchase and re-sale; negotiated easement costs; or other forms of commercial agreement acceptable to landowners that secures the property rights necessary to complete the project most efficiently.
  - The appropriate time for regulatory consideration of the costs of acquiring the required property rights is when the “grid investment test” is applied i.e. when the total project costs are weighed against the net benefits to consumers. This assessment would include valuing the risks of securing property rights in a more or less timely and/or costly manner to support efficient project delivery.

## **Elimination of historical customer EV account balances**

36. We support the Commission’s proposal to change the current EV account balance adjustment mechanisms to eliminate the historical imbalances in the HVAC and HVDC customer accounts. The respective imbalances are roughly equal in dollar terms but opposite in terms of “ownership”. However, we strongly disagree with the Commission’s suggestion that the proposed solution is symmetric: this characterisation stemming from the fact that the draft decisions may, to some extent, mimic what would occur under the status quo.
37. In our view, a change that is symmetric is one that delivers a broadly cash flow neutral outcome. In practical terms, this means eliminating the imbalances over similar time periods. Given the scale of the balances, and the fact that the sum owed to Transpower is allocated amongst relatively few HVDC customers

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(compared to the allocation of amounts owed amongst many HVAC customers), we propose that the elimination of both customer accounts occur over the first two regulatory periods.

38. A wash-up mechanism to adjust for economic over/under-recovery is an essential part of the regulatory regime and it should be designed to avoid allowing imbalances to develop of the scale that has occurred under the previous regulatory arrangements. We, therefore, support the Commission's proposal to redress future imbalances that arise in each subsequent regulatory period.

## **Treatment of HVDC Instantaneous Reserves Costs**

39. We welcome the Commission's recognition that Transpower should not be the party which bears the costs of instantaneous reserves for the HVDC link. We disagreed with the Commission's reasoning for denying relief to recover these costs in full during the Administrative Settlement. That decision represents a present cost to Transpower's Shareholder of ca. \$48m over the first four years of the settlement.
40. This cost is sunk. However, its occurrence should not be overlooked. This episode, and the attendant signals it sends about the balance of regulatory risk, is now factored into rating agencies' assessment of Transpower's economic outlook and, in the real world, is built into our cost of capital.
41. It also illustrates, in general, the unforeseen "downside" losses to which Transpower (and most other regulated entities) are exposed. Any countervailing opportunity for "upside" gains is, at best, very limited (e.g. by holding operating expenditure below the regulatory allowance). In fact, the distribution of such unforeseen losses and gains is highly asymmetric and must be factored into an assessment of an appropriate regulated rate of return.
42. The draft decision to allow the future recovery of HVDC instantaneous reserves costs is satisfactory in principle, but unacceptable in practice.
43. First, the proposal to disallow the recovery of costs associated with outages in excess of 14 days should be removed. This exclusion is arbitrary and totally undermines the intent of the underlying decision.
44. Second, the treatment of Event Charges should be revised. The Commission proposes that Transpower continue to be exposed to the risk of Event Charges, which are only partly controllable by Transpower. However, under-frequency events can also arise from the actions of a third party but Transpower still determined to be the "causer" of the event. The recent changes to the Electricity Governance Rules regarding event charge causer determination make this outcome more likely in the future<sup>12</sup>.
45. To address this and to reflect the future outlook for Event Charges based on the current and future operation of the HVDC link, we propose as follows:

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<sup>12</sup> Electricity Governance (Event Causer Determination) Amendment Rules 2010 (*Gazette Notice* 5 August 2010)

- that there be an additional provision included in base operating expenditure for the Transition Year<sup>13</sup> (of \$0.8m) for Event Charges; and
- where Event Charges exceed this allowance, as a result of charges for events outside our control, any over expenditure should be fully recoverable.

## **Operating cost allowance for 2011/12**

46. Transpower notes that the Commission's draft decision allows for an increased operating expenditure allowance for additional maintenance expenditure but submits that the operating expenditure allowance for the Transition Year (2011/12) should be \$234.02 million, compared with the Commission's draft decision of \$231.67 million.
47. The calculation of the transition year operating allowance in the draft decision incorrectly double counts the adjustment for instantaneous reserve availability charges. In addition, as noted above, we propose that a provision of \$0.8m be included to reflect Transpower's ongoing and increased exposure to Event Charges.

## **Departure from using GAAP as the default**

48. A key feature of the current Administrative Settlement is its reliance, where possible, on Generally Accepted Accounting Principles (GAAP) for determining the appropriate regulatory accounting treatment. The reliance on GAAP imports into the settlement framework a set of sound and well tested governing principles, the application of which is subject to the external financial audit conducted under the oversight of the Office of the Auditor General (OAG). The reliance on GAAP simplifies codification of the regulatory arrangements and allows, as far as possible, consistent treatment of costs and asset values for both financial and regulatory accounting purposes.
49. The draft decisions seek, in several places, to overturn this approach in favour of setting prescriptive rules for regulatory accounting. As a consequence, the draft decisions make it inevitable that Transpower would need to prepare a set of (non GAAP) regulatory accounts. In some instances, the proposals are impracticable and beyond the capability of our existing financial systems.
50. The allowance for tax costs is a notable example. The Commission has proposed a simplified methodology for estimating a regulatory tax allowance that approximates to Transpower's actual tax payments but ignores real-world effects. We propose that, in common with the Administrative Settlement, the regulatory tax allowance be Transpower's actual tax paid.
51. As a result of the proposed departures from GAAP, the application of the draft decisions would incur inefficient costs. We agree with the Commission's previous view that "... consumers would benefit from both the greater transparency and lower administrative costs arising from Transpower having one set of accounting

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<sup>13</sup> An allowance will also need to be provided for the Remainder Period. This will be included in our operating expenditure proposals to be submitted in due course.

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*records for regulatory and financial accounting purposes...*<sup>14</sup> Accordingly, we urge the Commission to revert to the underlying principle of the Administrative Settlement and, where possible, defer to GAAP to set the framework for regulatory accounting.

52. Any increased operating costs resulting from these and other additional compliance requirements signalled by the Draft Decisions, would need to be reflected in future regulatory operating cost allowances.

## **Quality performance framework**

53. Transpower is generally in agreement with the proposed quality performance framework. However, we disagree with the inclusion of the unserved energy (or total impact) of interruptions measured in system minutes. As we have argued consistently, this is an unsatisfactory measure of the effectiveness of actions taken by Transpower to improve quality performance. For example:

- the figure will vary markedly from year to year sometimes because of factors beyond Transpower's control; and will not readily reflect the actions undertaken by Transpower to improve reliability;
- a single high impact, low probability event can markedly skew the result;
- actions by transmission customers may contribute to system minute events, and actions which could reduce such events most effectively may be within the control of transmission customers rather than Transpower.

54. We note that the use of the system minutes measure has been discontinued in Australia, following a review which found that the measure was statistically unsound.

55. The Commission comments that it will need to work with the Electricity Commission (and subsequently the Electricity Authority) in respect of the Electricity Commission's unconditional service guarantee (USG) concept. We refer the Commission to our submission on the EC's consultation paper "Transmission Pricing Review: High-Level Options" for a summary of our major, fundamental concerns with the USG concept. We strongly recommend that the USG concept be abandoned and that the performance incentive scheme developed by the Commission be the sole quality performance framework.

## **Re-opening provisions**

56. We submit that the thresholds for reopening the price path are set too high. In particular, the requirement that an adverse event needs to have a net cost impact of at least 5 per cent of annual RCP revenue is at a level of materiality that exceeds what is normally considered acceptable and its application would give rise to outcomes inconsistent with those found in competitive markets. We propose that the materiality threshold be set at 1 per cent of annual RCP revenue. This is a relatively high threshold, which will only be triggered in exceptional circumstances.

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<sup>14</sup> Refer "Input Methodologies (Transpower) Draft Reasons Paper", 4.3.12 (page 35).

57. The substantial increases that occurred in the cost of instantaneous reserves allocated to the HVDC provides an example of an unforeseen event. The extent to which the regime fails to recognise the possibility of, and allow for, future unforeseen event, lets a further source of asymmetric risk persist which again will have an impact on our real cost of capital (an impact which, we note, has not been reflected in the Commission's draft decisions).
58. In part, for similar reasons to those put forward in respect of other re-opening provisions, the cost impacts of regulatory or legislative changes should be adjusted in the MAR in full on an annual basis, without the restriction of any materiality threshold.

### **Approach to information disclosure**

59. The continuation of Information Disclosure requirements that are different from the information required under the individual price-quality path is both confusing and costly for consumers<sup>15</sup>.
60. We acknowledge that Transpower is subject to an information disclosure regime under Section 54F, as well as an individual price-quality path. However, the draft decisions impose two separate accounting regimes for these purposes, for example, in relation to anything that involves the application of WACC. We can see no justification for this separate disclosure requirement. We submit that sufficient information will be available to interested persons to assess whether the purpose of Part 4 of the Commerce Act is being met under the individual price-quality path and that the associated compliance statements satisfy the requirements of Section 54F without the need for separate (and inconsistent) information disclosures.

### **Incentives for efficient foreign exchange hedging**

61. Although not contemplated by the draft decisions directly, we have included submissions on the need to ensure that there are appropriate incentives on Transpower to undertake hedging of foreign exchange and commodity price risks efficiently and in the best interests of consumers. This is an issue that we have highlighted to Commission staff informally already and is relevant to the final decisions. In our view, it is at best uncertain whether the present or proposed capital approval regimes provide the right incentives. There are two aspects to this issue.
62. First, where the Commission approves project capital expenditure in NZ\$, the decision should be clear as to the assumptions made for foreign exchange rates and commodity prices, with the understanding that the final approved amount may be adjusted to reflect any material movements in these costs. This is particularly important for individual project approvals where there is little or no scope to substitute or re-prioritise work or to offset cost variations with other projects.

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<sup>15</sup> We note also that there is considerable scope to streamline other compliance requirements by removing those requirements that add little value to either the Commission or to Transpower's customers – the annual price / quality consultation and reporting process being such an example.

63. Second, the project value established in accordance with IFRS<sup>16</sup> will depend upon whether or not any foreign exchange hedging undertaken meets the effectiveness test necessary to qualify for hedge accounting<sup>17</sup>. Unless, the test for hedge accounting is met, the economic costs of a project will be represented by two separate accounting entries: the project capital value calculated at the spot exchange rate and a Profit and Loss statement adjustment for the cost difference due to the variance between the spot and hedged exchange rates. Irrespective of the accounting outcome, the full costs of the project including the outcomes of any hedging should be borne by customers<sup>18</sup>.

## **Process timings**

64. We are concerned with several of the proposed timings for implementation of the new arrangements.
65. The proposed deadline for calculating the MAR for the Remainder Period and subsequent RCPs is impracticable, as it does not provide adequately for all the processes that must be completed. We recommend that the draft decision be amended such that Transpower will be required to provide its calculated MAR for each year of the RCP by 31 October.
66. The proposed date of 30 November by which the Commission will make its decision on the MAR is too late for Transpower to finalise calculation and notification of transmission prices to its customers. Transpower is legally required to notify its prices before the end of the calendar year, which makes Christmas Eve the latest practicable date. To achieve this deadline, the final MAR must be approved by the Commission by mid November. If the approved MAR varies from that originally calculated by Transpower (and used to calculate transmission prices) this timeframe would give Transpower sufficient time to recalculate the prices, have this change audited and approved by the Transpower Board, and then to communicate prices appropriately to our customers before Christmas. Any later decision on the final MAR would make this impossible.
67. We disagree with the proposed requirement that Transpower publish a written statement that confirms compliance, or otherwise with the individual price-quality path by the second Friday of each August. It is impractical to meet this date and submit that the earliest achievable date is 30 September, consistent with the current administrative settlement. We note that both the Listing Rules for the New

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<sup>16</sup> International Financial Reporting Standards

<sup>17</sup> If a foreign exchange hedge contract can be "hedge accounted", the project value will reflect the hedged foreign exchange rate. If not, the project value will reflect the spot rate on the day that the goods or service is received. In the former case, the economic outcome of the foreign exchange contract is represented by the single accounting entry (i.e. the capitalised value of the project on the balance sheet calculated at the hedged rate). In the latter case, the economic outcome of the foreign exchange contract is represented by two accounting entries (i.e. the capitalised value of the project on the balance sheet calculated at the spot rate and an entry in the profit and loss account for the difference (gain or loss) in project value based on the spot rate and the hedged rate.

<sup>18</sup> In practice, we note that for reasons of both efficiency and accounting, foreign exchange and commodity price risks will typically not be hedged at the time of project approval but only subsequently when contracts are let.

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Zealand Stock Exchange and the State-owned Enterprises Act allow three months for the year end audited accounts.

## **Concluding remarks**

68. As noted above, Parts 2 and 3 of Transpower's submission are still in preparation for submission by 16 August 2010, in accordance with the Commission's revised submission timetable. We have, to the extent practical, sought to separate and conclude our submissions on non cost of capital issues in Part 1 of the submission. We note, however, that this division of issues is artificial and there are inevitably matters raised in each Part of the submission that ultimately will need to be read in conjunction with the other Parts.

We note also that the subsequent submission on draft determination issues may identify contradictions or inconsistencies between the reasons papers and the effect of the draft determinations. We will endeavour to highlight any such contradictions, and their impacts on our position, in Part 3 of our submission.

Submission to the  
Commerce Commission on:  
Input Methodologies Transpower  
Draft Reasons Paper

<b>Draft Decisions for Cost Allocation (Chapter 3)</b>		
<b>Topic</b>	<b>Draft decision</b>	<b>Transpower comment</b>
<b>Overall Approach</b>	<p><u>Unregulated services</u></p> <p>The revenue associated with the unregulated services provided by Transpower (consisting of Energy Market Services Limited, d-cypha Trade and Risk Reinsurance Limited) is approximately 2.2% of Transpower’s total revenue, which is below the 5% threshold in the Commission’s proposed CAMSC process. Any common costs between the unregulated services and regulated services are therefore likely to be of relatively low value.</p> <p>Transpower is therefore not required to adjust the total costs associated with supplying its regulated services. Should it become evident in future that this threshold is likely to be exceeded, the Commission proposes consulting on including additional elements of the cost allocation IM for EDBs in the cost allocation IM for Transpower.</p> <p><u>System operator activities</u></p> <p>The Commission’s draft decision is that the system operator activities undertaken by Transpower form part of the conveyance of electricity by line and are therefore an activity that forms part of the electricity lines services regulated under Part 4 of the Act.</p> <p>The revenue for the system operator activity is determined through a fixed price SOSPA with the EC. The latest SOSPA came into effect in August 2009.</p> <p>The Commission’s draft decision is that, where the EC and Transpower have an agreed SOSPA, the Commission should not interpose itself between the EC and Transpower by requiring the revenue associated with the SOSPA to be subject to an individual price-quality path.</p> <p>The revenue associated with the system operator activities undertaken by Transpower is approximately 3.2% of Transpower’s total revenue and therefore, any common costs between the system operator activities and other regulated activities are likely to be relatively small.</p>	<p>Transpower agrees with the Commission’s proposed approach.</p>

	<p>Given the above, the Commission’s draft decision is that Transpower is not required to adjust the costs of undertaking its regulated activities, other than for the costs of system operator activities. Transpower is required to exclude the costs set out in the SOSPA from any opex or capex forecasts used to determine Transpower’s individual price-quality path.</p> <p><u>New Investment Contracts (NICs)</u></p> <p>As set out in Chapter 4 of this paper the Commission’s draft decision is that services provided by NICs fall under the Part 4 definition of electricity lines services because they involve the conveyance of electricity by line. However, the Commission will not interpose itself between Transpower and its contract counterparties by requiring the revenue associated with NICs to be subject to an individual price-quality path, provided certain conditions are met around workable competition.</p> <p>Given the reasons above, the Commission’s draft decision is that the assets associated with NICs should be excluded from Transpower’s RAB and any capex included in NICs is to be excluded from any capex forecasts used to determine Transpower’s individual price-quality path. This is further discussed in paragraphs 4.4.2 and 4.4.15 in Chapter 4.</p> <p>The operating costs associated with NIC assets are included within Transpower’s total opex for providing regulated services and are recovered through the Transpower pricing methodology. This is because it is more efficient for Transpower to use one allocation tool (Transpower pricing methodology) to allocate all of its operating and maintenance costs than to directly identify and allocate operating and maintenance costs to a number of individual NICs.</p> <p>The Commission’s draft decision is that it is appropriate for Transpower to continue to include all operating costs associated with NICs within its total operating costs associated with providing regulated services.</p>	
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<b>Draft Decisions for Asset Valuation (Chapter 4)</b>		
<b>Topic</b>	<b>Draft decision</b>	<b>Transpower comment</b>
<b>Components of Methodology New Investment Contracts</b>	The assets covered by NICs are excluded from the Transpower RAB and therefore the revenue associated with electricity lines services provided by Transpower through NICs will be excluded from any individual price-quality path.	Transpower agrees.
	The initial value of the RAB should include the remaining value of the HVAC lines pseudo asset, established by the settlement agreement, as at 30 June 2011.	Transpower agrees.
	Any assets not used to provide electricity lines services, as defined in s 54C of the Commerce Act, should be excluded from the RAB.	Transpower agrees.
	Transpower must allocate asset values to electricity transmission services using the process set out in the cost allocation IM.	Transpower agrees. The response to Chapter 3 above refers. However, the Commission should note that while SCADA is a grid asset, the SCADA EMS software system is a System Operator asset, and charged for accordingly, i.e. it is outside the regulatory asset base (contrary to paragraph 5.3.8 on p.49 of the Individual Price-Quality Path consultation paper.)
	The Transpower RAB must be rolled forward for Commission approved capital additions at depreciated historical cost. No indexation is to be applied in rolling forward the RAB. As stated above the initial value of the RAB is deemed to be the historical cost value as at 30 June 2011	Transpower agrees.
	In the case of NICs entered into after 5 June 2003, assets will be excluded from the RAB only if the other party to the new investment contract agrees in writing that the terms and conditions are reasonable or reflect workable or effective competition for the provision of the goods and services.	Transpower agrees.
<b>Components of Methodology System Operator Services</b>	Where the EC and Transpower have an agreed SOSPA, the assets associated with delivering the SOSPA will be excluded from Transpower's RAB.	Transpower agrees, but notes that the costs of grid investment-specific System Operator tool upgrades should be able to be recovered through the regulatory asset base.

<p><b>Components of Methodology</b> <b>Pseudo assets</b></p>	<p>The remaining pseudo assets created under the administrative settlement (the HVAC lines pseudo asset) will continue to be depreciated over the period to 30 June 2016.</p>	<p>Transpower agrees.</p>
<p><b>Components of Methodology</b> <b>Works under Construction</b></p>	<p>The Commission’s draft decisions on works under construction are that Transpower should be required to:</p> <ul style="list-style-type: none"> <li>• exclude any asset that is part of a work under construction from its RAB;</li> <li>• capitalise the financing costs attributable to the construction of an asset, and cease capitalising financing costs at the point at which the asset is commissioned;</li> </ul>	<p>The current proposal needs to be modified to clarify the intent.</p> <p>In particular, the revised wording should recognise that, in practice, it is common for Transpower to partially commission assets. This means that, although the new asset concerned is used and useful, additional costs which form part of the investment in the asset are either currently being incurred or are expected to be incurred later, e.g. a software project that is live and being used but which is also being further developed, or a substation which is in use but landscaping of the substation and as-built drawings of it are still being completed.</p> <p>To give effect to this common and efficient practice, the wording should be clarified. To ensure the Commission’s underlying principle is preserved, the revised wording might include a statement such as the following:</p> <p style="text-align: center;"><i>“Transpower should not have costs relating to a particular asset simultaneously earning capitalised interest and included in the regulatory asset base.</i></p>

	<ul style="list-style-type: none"> <li>calculate the financing costs by applying its post-tax WACC (or alternately, its post-tax cost of debt, provided this is lower than WACC) to the amounts expended on the construction of the asset; and</li> </ul>	<p>Transpower disagrees with the Commission’s argument for potentially setting financing costs differently from GAAP (NZ IAS 23). In paragraph 4.4.44, the Commission states that it believes the GAAP approach may encourage Transpower to find the ‘easiest’ source of funds. However, under GAAP, Transpower must use its actual cost of debt. If the cost of debt incurred to fund construction is greater than Transpower’s WACC, there is no incentive to delay commissioning of an asset, because the incremental actual debt cost and the interest during construction (IDC) both cease when the asset is commissioned. By contrast, the Commission’s proposed approach of requiring Transpower to use the regulated WACC, when the actual cost of borrowing to fund construction is greater, creates a perverse incentive to reduce economic investment by, in some circumstances, exposing Transpower to negative cashflow in order to enable investment expenditure to continue.</p> <p>For financial accounting purposes Transpower must apply its weighted average borrowing rate to determine capitalised IDC. Requiring Transpower to apply different rates for financial accounting and regulatory purposes will also add to compliance costs for no economic benefit. Consequently, Transpower submits that the GAAP provisions should apply in order to avoid creating perverse incentives to under-invest and also to minimise compliance costs.</p>
	<ul style="list-style-type: none"> <li>suspend capitalising financing costs during periods in which it suspends construction of the asset.</li> </ul>	<p>Transpower agrees with the underlying principle. Consistent with other submissions, the principle should be implemented in a manner that complies with GAAP.</p> <p>Transpower notes that for cashflow reasons it is incentivised to commission assets promptly, in order to earn a WACC return and depreciation rather than capitalise interest.</p>
<p><b>Components of Methodology</b> <b>Intangible Assets</b></p>	<p>Transpower may include in the RAB value assets permitted by NZ IAS 38, with the exception of goodwill, which Transpower must exclude from the RAB value.</p>	<p>Transpower agrees.</p>
	<p>The RAB value of intangible assets permitted by NZ IAS 38 must be established using the cost model for recognition, provided for under that standard;</p>	<p>Transpower agrees.</p>
	<p>As a result of applying NZ IAS 38, Transpower must exclude working capital from the RAB; and</p>	<p>Agreed.</p>

	<p>Transpower may include assets permitted by NZ IAS 17, that is finance leases, in the RAB value.</p>	<p>Transpower agrees. However, it is not clear whether or not operating lease assets can be included in the RAB, as they currently are under the administrative settlement. In Transpower’s view, operating lease assets should be included in the RAB and, accordingly, operating lease costs should be excluded from the opex allowance.</p> <p>Note: capitalised lease costs (either finance or operating leases) are included in the capex threshold.</p>
<p><b>Components of Methodology</b> <b>Treatment of additions &amp; disposals</b></p>	<p>Additions and disposals of assets in the RAB by Transpower should result in an adjustment to the RAB for information disclosure purposes on an annual basis.</p>	<p>Transpower agrees.</p> <p>However, providing this information in the compliance statement should be sufficient. Duplicating the information in a separate information disclosure is inefficient and a poor use of resources.</p> <p>As stated elsewhere in this submission, Transpower believes that the current information disclosures are a legacy from an earlier regulatory framework that now serve no useful purpose and should be discontinued. Preparation of these disclosures adds to compliance costs but provides no additional value.</p>
	<p>Only the following categories of capex may enter the regulatory asset base at cost ('assets commissioned' in the roll forward formula provided at paragraph 4.3.21):</p> <ul style="list-style-type: none"> <li>- major capex approved by the EC (or the Commerce Commission from 1 October 2010 if the Electricity Industry Bill is enacted);</li> <li>- commissioned minor capex up to the total minor capex amount approved by the Commission that has gone through all of Transpower’s approval processes;</li> <li>- commissioned minor capex in excess of the pre-approved level over the entire control period, where: Transpower seeks and receives ex-post approval from the Commission for that capex; or Transpower calculates the revenue impact of that capex, over the life of those assets, including a reasonable allowance for maintenance, and makes an adjustment to the relevant EV account to fully offset this cost, and includes in its compliance statement an independent opinion that verifies Transpower’s estimates are reasonable and calculations are correct.</li> </ul>	<p>The final decisions should make it clear that operating lease assets and finance lease assets are included in the assets that can be entered into the regulatory asset base at cost.</p>

	<p>Subject to any other decisions on specific types of transaction, capital additions should be included in the RAB at cost in the year of purchase (or commissioning, for constructed assets).</p>	<p>Transpower agrees in principle.</p> <p>However, under-recovery of a WACC return on assets commissioned part way through the year may result, unless the return on these assets is permitted to be adjusted to be NPV neutral. We recommend that the input methodologies determination should incorporate such adjustment, by way of an adjustment to the customer's EV account for any under-recovery for assets commissioned during a year. Not to permit this would leave Transpower in a negative economic value position and disincentivise investment.</p>
	<p>Additions may be included in the RAB from the date at which they are 'commissioned'.</p>	<p>Agreed, subject to the qualification noted above.</p>
	<p>For this purpose the term 'commissioned' for new capex will be defined to mean 'first used by Transpower to provide electricity transmission services'.</p>	<p>Transpower agrees, assuming "electricity transmission services" is interpreted broadly enough to include those assets which are not directly used in the transmission of electricity.</p>
<p><b>Components of Methodology</b></p> <p><b>Transmission Corridor, land and easements investments</b></p>	<p>The Commission's draft decision is Transpower should be able to include capex relating to 'transmission corridor investments' and 'land and easement investments', in its RAB before an active line uses them, provided their purchase has been approved by the EC or the Commission on a cost benefit basis.</p>	<p>Transpower agrees.</p>
	<p>This approach would not apply to Transpower purchasing land to gain an easement with the intention of on-selling some or all of the land. In this case the costs that are included in the regulatory asset base are the costs associated with establishing the easement as determined by an independent valuer.</p>	<p>Transpower proposes that, in future, the full efficient costs of securing necessary property rights should be included in the RAB or otherwise recovered from customers.</p> <p>If land is purchased in order to establish an easement that will permit an investment to proceed, with the expectation that the balance of the property purchased will be sold at a later date, and it can be shown that this is the cost efficient means by which to secure the easement, the full value of the property purchased should be able to be included in the RAB, and any profit or loss made on the ultimate sale of the balance of the property should be to the cost of the customer. The rationale for this treatment is that such a property purchase is undertaken in order to secure the easement and enable the investment to proceed efficiently, and maximise the overall net benefit of the investment to transmission customers.</p> <p>Similarly, if other forms of payment are utilised to acquire the necessary property rights, then these should be recoverable, subject to the necessary regulatory approval</p>

		<p>of the project as the project that delivers the greatest net benefits for consumers.</p> <p>Note: this position represents a significant departure from the position set out in the current Administrative Settlement.</p>
<p><b>Components of Methodology</b></p> <p><b>Asset lives</b></p>	<p>For an asset that comprises part of the initial RAB, Transpower must use the remaining economic life applying in respect of the thresholds regulatory asset base as at 30 June 2011.</p>	<p>Transpower agrees with the underlying principle but with some important clarifications.</p> <p>We should use the remaining asset life recorded by the Transpower asset register (which is maintained in accordance with GAAP and the administrative settlement) – this will necessarily accord with the “thresholds regulatory asset base” at 30 June 2011.</p> <p>Where the asset life is subsequently increased by refurbishment work, this should be reflected in the remaining useful life.</p>
	<p>For an asset that is commissioned, Transpower must use the asset lives set out in Table 4.1 below, to the extent they apply to the assets included in the RAB, subject to draft decisions in this paragraph.</p>	<p>Transpower disagrees with this proposal.</p> <p>Transpower submits that it should continue to use the asset lives that are used for financial accounting purposes and maintained in accordance with GAAP. A copy of the list of asset lives has been separately provided to the Commission.</p>
	<p>For assets not covered by the list of standard asset lives set out in Table 4.1, Transpower should be able to set asset lives provided those asset lives are no greater than standard asset lives for comparable assets, and are supported by an independent valuer’s report.</p>	<p>See above.</p>
	<p>Where Transpower has extended the life of an asset through refurbishment, Transpower should assign a new remaining asset life, effective from the time of refurbishment. The new remaining asset life should not be permitted to exceed the standard asset life for the same type of asset and must be supported by an independent engineer’s report detailing the refurbishment work undertaken and the basis for determining the new remaining life.</p>	<p>Transpower believes that GAAP should apply to any asset life extension. We do not believe that having an independent engineer sign off an extension to an asset life is practical or necessary. Any increase in asset life means that recovery of capital takes place over a longer period and thus is beneficial to consumers.</p> <p>For the avoidance of doubt, we confirm that we agree that refurbishment of an asset should not take the refurbished asset’s life beyond that of an equivalent new asset.</p>

	<p>The remaining asset life, in relation to any asset that is stranded, is that which is specified by the Commission in an approved forecast capex proposal.</p>	<p>See comments below relating to the treatment of “stranded assets”.</p>
<p><b>Components of Methodology</b> <b>Depreciation</b></p>	<p>The Commission’s draft decision is that the depreciation charge should be calculated using straight line depreciation based on the economic life of the underlying asset.</p> <p>The Commission considers that depreciation does not apply in relation to an asset that is land, or that is an easement, unless the easement has a limited legal life or is to be held by Transpower for a known and limited period of time, in which case the economic life is the legal life or limited period as the case may be.</p> <p>Treatment and depreciation of stranded assets is covered in paragraphs 4.4.86 to 4.4.93.</p>	<p>Transpower agrees.</p>
<p><b>Components of Methodology</b> <b>Stranded assets</b></p>	<p>The Commission’s draft decision is that Transpower should be compensated for impaired or stranded assets, when it is caused by factors that are outside of its control, such as changes in user consumption, by allowing accelerated depreciation of those assets, in the year in which assets become stranded. The onus would be on Transpower to provide evidence to the Commission to validate claims that assets will become stranded during a regulatory period, and that they have taken adequate steps to mitigate this risk. Transpower should not earn a return on capital for stranded or impaired assets after this accelerated depreciation is allowed. The assets should instead be written out of the RAB at that time.</p> <p>As set out in paragraph 4.4.65, only major capex projects approved by the EC (or the Commission) and minor capex up to the total minor capex amount approved by the Commission that has gone through all of Transpower’s approval processes, may enter the RAB. This prevents Transpower from recovering the costs of unapproved projects that become impaired or stranded.</p> <p>As discussed in paragraph 4.4.2, capex associated with NICs will not be entered into the asset base. In the event of</p>	<p>Transpower agrees that accelerated depreciation should apply to assets that are stranded. However, there should also be an adjustment to WACC, based on the actuarial risk of assets being stranded without compensation. This would be consistent with the s.52A(1) purpose statement that requires the promotion of outcomes that are consistent with outcomes produced in competitive markets. A firm in a competitive market, while not receiving compensation when an asset is stranded, would not undertake investment unless its expected return on the investment included a margin that recognised the risk of asset stranding.</p> <p>Transpower agrees that, in the event of the stranding or impairment of new investment contract assets, the treatment will be as specified in the contracts for the assets.</p>

	stranding or impairment of these assets the treatment will be as specified in the contract for those assets.	
<b>Components of Methodology</b> <b>Fully depreciated assets</b>	The Commission’s draft decision on fully depreciated assets is that for the purposes of individual price-quality regulation, no system fixed assets should be written off during a regulatory period. All such assets in service at the start of a period of individual price-quality regulation should be deemed to have, as a minimum, five years of remaining life.	Transpower agrees.
	Under information disclosure, fully depreciated assets should be written off at the time they become fully depreciated.	Transpower believes that the current information disclosures provisions should be discontinued for the reasons set out in this submission.
<b>Further issue (non Commission)</b>	Minor asset purchases (pooled assets). Transpower currently expenses such assets.	Transpower submits that expensing of minor asset purchases should continue to be permitted.

<b>Draft Decisions for the Treatment of Taxation (Chapter 5)</b>		
<b>Topic</b>	<b>Draft decision</b>	<b>Transpower comment</b>
<b>Overall Approach</b>	<p>The overall approach to taxation primarily requires definition of the appropriate depreciation deductions for regulatory tax purposes in the formula given in paragraph 5.1.4 (i.e. a tax expense—with or without a deferred tax balance—or a ‘tax payable’ approach).</p> <p>The Commission’s draft decision is that Transpower’s tax obligations should be estimated using a ‘tax payable’ approach. As noted in the IM Discussion Paper, this corresponds to the use of regulatory tax depreciation as a deduction for regulatory tax purposes (as opposed to regulatory depreciation).</p>	Transpower believes that the administrative settlement approach should remain, i.e. Transpower’s actual tax expense should be used for regulatory purposes.
<b>Components of the Methodology Deductions for regulatory tax purposes</b>	The cost allocation IM, and IRD tax rules (to the extent practicable, and subject to other relevant provisions in the IMs), are to be used to calculate the regulatory taxable income.	Refer above.
	Debt interest should be calculated using a notional leverage of 40 percent.	Transpower disagrees with this proposal. Transpower’s actual leverage should be used, consistent with Transpower’s recommended approach to setting WACC.
<b>Components of the Methodology Treatment of tax losses in the wider tax group</b>	Tax losses in Transpower’s wider tax group should be ignored when estimating tax costs. Any tax losses generated by Transpower in the supply of regulated electricity lines services should be notionally carried forward to the following disclosure year.	Transpower agrees.
<b>Components of the Methodology Tax Treatment of Acquisitions</b>	Like the RAB value, the regulatory tax asset value of acquired assets should remain unchanged in the event of an acquisition of assets used to supply services under Part 4 (i.e. from another supplier of services regulated under Part 4).	The tax value would be equal to the purchase price on the assets, which is the value on which Transpower would be allowed to charge tax depreciation. This could not be more than the RAB value.
<b>Establishing the Initial Regulatory Tax Asset Value</b>	The initial regulatory tax asset value should not exceed the initial RAB value.	Transpower agrees.

<b>Draft Decisions for Rules and Processes (Chapter 7)</b>		
<b>Topic</b>	<b>Draft Decision</b>	<b>Transpower comment</b>
<b>Overall Approach – Specification of Price</b>	The Commission’s draft decision is that price for Transpower is specified by a total revenue cap, which is given by a function of Price(s), net of Pass-Through Costs and Recoverable Costs.	Transpower agrees.
<b>Components of the Specification of Price IM</b> <b>Initial pass-through costs</b>	The Commission’s draft decision is that for a cost to be allowed as a Pass-Through Cost, it must meet the following criteria (the ‘Pass-Through Cost Criteria’), i.e. be: a) outside the control of the supplier; and b) unable to be accurately forecast; and c) approved as a Pass-Through Cost by the Commission.	Transpower agrees.
	The following are proposed to be the initial Pass-Through Costs for Transpower: a) local authority rates, meaning rates on system fixed assets paid or payable by Transpower to a territorial local authority under the Ratings Powers Act 1988 or the Local Government (Rating) Act 2002; b) Commerce Commission levies paid and payable under s 53ZE of the Commerce Act; and c) levies paid or payable under the Electricity Act, including EC levies (or equivalent).	Transpower agrees.
	100% of the costs that are classified as Pass-Through Costs may be passed-through, provided that Pass-Through Costs are limited to those costs associated with the provision of regulated services.	Transpower agrees.

	<p>To the extent that Pass-Through Costs are associated with both regulated and unregulated services, the Pass-Through Cost amount is limited to the amount of the cost that is allocated to the regulated services by applying the cost allocation IM.</p>	<p>Transpower agrees.</p>
<p><b>Components of the Specification of Price IM</b> <b>Recoverable costs</b></p>	<p>The Commission’s draft decision is that it may allow other costs that do not meet the Pass-Through Cost Criteria to be passed through to consumers. These have been termed ‘Recoverable Costs’.</p>	<p>Transpower agrees.</p>
	<p>The categories of cost that are proposed to be included in the initial list of Recoverable Costs for Transpower are:</p> <ul style="list-style-type: none"> <li>Instantaneous reserves availability charges, allocated under rule 11.5 of Section IV of Part C of the EGRs (or equivalent Rules under the Industry Participation Code), except for where the charges relate to outages of more than fourteen days duration (‘IR availability charges’). In this case, all charges for days fifteen onwards will be excluded from Recoverable Costs.</li> </ul>	<p>Transpower welcomes the Commission’s draft decision to include instantaneous reserves availability charges allocated under rule 11.5 of Section IV of Part C of the EGRs (or equivalent Rules under the Industry Participation Code) in the initial list of Recoverable Costs for Transpower. However, Transpower disagrees strongly with the proposed fourteen day (ten working days) qualification for “outages” beyond which instantaneous reserves availability costs allocated to Transpower as owner of the HVDC link would not qualify as recoverable costs. This limitation is impractical, unworkable and not adequately justified by the Commission.</p> <p>For the reasons set out below, Transpower recommends that the definition of “recoverable costs” not include any exclusion relating to “an asset remaining out of service” or “outages”.</p> <p>When Pole 3 of the HVDC link is commissioned, Pole 2 will be taken out of service for several months in order to replace control equipment. This will be done for good engineering reasons, but the provision proposed by the Commission would appear to expose Transpower to instantaneous reserves availability costs allocated to Transpower as HVDC owner during this period. On the face of it, the same problem would also seem to arise when Pole 1 of the link is decommissioned, which is expected to occur in October 2011.</p> <p>The Commission’s statement in paragraph 7.4.21 about “what may be expected for some of the larger annual planned maintenance outages (which generally tend not to be in excess of two weeks)” is factually incorrect. Transpower ensures that it has sufficient spares to manage realistic contingencies but there are many situations where plant will be out for longer, such as when a line is being reconducted, which could take many weeks, or an HVDC cable fails, which could take up to two years to repair.</p>

		<p>The construction in clause 3.1.4 of the Draft Determination “in relation to an asset remaining out of service” is rather loose and open to interpretation. It is not clear that the asset “out of service” must be an HVDC asset.</p> <p>The Input Methodologies draft reasons document refers at clause 7.4.10 to “outages” but the draft determination clause 3.1.4 (2) (b) refers to “out of service”, which is imprecise. Outages are events (planned or unplanned) where plant is unavailable for various reasons, including due to maintenance, project work or fault repairs. “Out of service” could conceivably refer to situations where plant was permanently removed from service (e.g. decommissioning of the remaining half pole of Pole 1 of the HVDC link).</p> <p>The Commission states that the rationale for the 14 day limitation is to provide an incentive to manage the length of planned and unplanned outages. No such incentive is necessary, as the Outage Protocol, currently contained in Schedule F7 to Section VII of Part F of the Electricity Governance Rules 2003 ensures that transmission plant outages are managed efficiently and expeditiously, taking account of transmission customer preferences.</p>
	<ul style="list-style-type: none"> <li>• The costs of developing and funding transmission alternative services where the costs: <ul style="list-style-type: none"> <li>– are opex and are in addition to the opex forecasts approved by the Commission prior to the regulatory period;</li> <li>– have been approved by the EC or the Commission under Part F of the EGRs or the Commission’s capex IM; and</li> <li>– are the lesser of actual transmission alternative operating costs incurred or the upper limit of transmission alternative operating costs as proposed by Transpower and approved by the EC or the Commission under Part F or the Commission under the capex IM; and</li> </ul> </li> </ul>	<p>Unless a clear process is established to allow Transpower to seek re-approval of approved transmission alternative operating costs, if the initial approval is likely to be exceeded, Transpower believes that <u>actual</u> transmission alternative operating costs incurred should be classified as Recoverable Costs. The approach proposed in the Commission’s draft decision will result in under-recovery of transmission alternative operating costs, which will disincentivise the development of transmission alternatives. The likely corollary of this disincentive will be an uneconomic pattern of investment to meet transmission needs.</p>
	<ul style="list-style-type: none"> <li>• the net incremental carry-forward amount under the IRIS.</li> </ul>	<p>Transpower agrees.</p>

	<p>The Commission proposes that Recoverable Costs will be reviewed prior to the commencement of each regulatory period, with a view to determining whether they should remain, in whole or in part, as Recoverable Costs for the next regulatory period.</p>	<p>It should be made explicit that any adjustment to recoverable costs is similarly compensated in an adjustment to operating cost allowances.</p> <p>For example, Transpower’s operating expenditure allowances are being adjusted down to reflect the classification of instantaneous reserves availability costs as “recoverable costs” (paragraph 4.3.13 of the Individual Price-Quality Path Draft Reasons document refers) , Transpower submits that, if any review of recoverable costs were to determine that instantaneous reserves availability costs allocated to Transpower as owner of the HVDC link were to be excluded from the definition of recoverable costs, a provision for instantaneous reserves availability costs should be added to the operating costs allowances.</p>
<p><b>Implementation of the Specification of Price Input Methodology</b></p>	<p>Transpower’s IPP will take the form of a total revenue cap, including the Pass-Through Costs and Recoverable Costs listed at paragraphs 7.4.3 and 7.4.10 respectively.</p>	<p>Transpower agrees.</p>
	<p>Additional Pass-Through Costs (after 31 December 2010) may be added to, and existing Pass-Through Costs deleted from, the list of allowed Pass-Through Costs by amending the relevant s 52P determination(s) and the IM determination. With the exception of levies, this can only occur at the time of setting the price-quality path. Within a regulatory period, additional Pass-Through Costs are limited to new, unforeseen levies charged under the Electricity Act or Commerce Act. Further Pass-Through Costs (in addition to levies) may be proposed by Transpower at any time but, if accepted, will not take effect until the next regulatory period.</p>	<p>Transpower disagrees. If additional pass-through costs (or recoverable costs) meet the required cost criteria, i.e. they are outside the control of the supplier, are unable to be accurately forecast and approved as a pass-through cost (or recoverable cost) by the Commission, it would be inequitable not to permit these costs to be passed through or recovered as soon as the Commission has approved their classification as such. Not to permit recovery as soon as the Commission has made its decision that the costs meet the required criteria would mean that the costs would be borne by a party (the supplier) other than the party or parties that the Commission had determined should bear the costs.</p>
<p><b>Overall Approach – Reconsideration of Price-Quality Paths</b></p>	<p>Transpower’s IPP may be reconsidered if one of the following events has occurred:</p> <ul style="list-style-type: none"> <li>• a catastrophic event, for which the costs of rectifying the impact of the event over the remainder of the regulatory period is material; or</li> </ul>	<p>Transpower agrees with the concept, but disagrees with the Commission’s definition of a material event, which would trigger reconsideration of the price-quality path.</p> <p>What the Commission considers is “<i>material</i>” is described at para 7.6.6:</p> <p><i>“7.6.6 In the context of the above descriptions, the concept of materiality is important. The Commission’s draft decision is that, in the context of deciding whether to reconsider a price-quality path, ‘material’ means the impact of the event over the remainder of the regulatory period is at least 5% of the allowed revenue for the year in which the event occurs, as determined by the Commission in its IPP determination. The Commission proposes taking into account the impact over the remainder of</i></p>

		<p><i>the period, rather than just the year in which the event occurs, as the importance of reconsideration from Transpower's perspective is likely to be greater the earlier it is in the period. Events occurring late in the period can be considered at the price reset."</i></p> <p>Enterprises in a competitive environment are likely to alter their prices (or exit the market) if there is a material event or a material error is found in their pricing. Regulated suppliers do not have that ability.</p> <p>The Commission, in the EDS Input Methodologies Reasons Paper, did see some parallels between regulated industries and long-term contracts in competitive markets. Such long-term contracts inevitably have widely drawn force majeure clauses that will not be dependent on a materiality test. They will also often have an annual price adjustment clause driven off CPI or some other index or at least periodic review and often both.</p> <p>Elsewhere in the Input Methodologies Reasons Paper the Commission has relied on Generally Accepted Accounting Principles. One relevant standard is the NZ IAS 1. That, at paragraph 7, gives a definition of "material" as being:</p> <p><i>"Material Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."</i></p> <p>That is, it is a matter of judgment with the note to the definition making it clear that it is the judgment of a person with a reasonable knowledge of business and economic activities and accounting and a willingness to study information with reasonable diligence. An earlier standard SSAP-6 gave more definitive guidelines. Under that a variation of 10 per cent or more in the appropriate base amount was generally material, 5 per cent or less was not with it being a matter of judgment where the variation was between 5 per cent and 10 per cent. Here the "appropriate base amount" would be pre-tax profit. Although under NZ IAS 1 it is more a matter of judgment, the previous standard should still "inform" that judgment.</p> <p>Using the revenue and earnings before tax for the year to 30 June 2009, Transpower had transmission revenues of \$629,880,000 and earnings before tax of \$124,523,000. On this basis, 5 per cent of one year's transmission revenue is \$31,494,000 which is approximately 25 per cent of earnings before tax. On the other hand, 10 per cent of</p>
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		<p>profit is equal to \$12.5m. We recognise that the Commission is looking at the revenue for the remainder of the Regulatory Control Period rather than one year but, clearly, an event could have a material impact on Transpower’s financial statements in terms of SSAP-6 without there being a re-opening of its price path. Even an event with a \$12.5m p.a. impact which occurred within 2½ years of the end of the period would not cross the threshold yet would be material for accounting purposes.</p> <p>Making matters worse is that, at least in relation to what the Commission is proposing to describe as catastrophic events, the 5 per cent is after allowance for insurance and the potential to substitute projects within the capital and operating budgets. Suppose the event costs are \$40m, well above the \$30m threshold, but by deferring some capital expenditure totalling \$11m to the next Regulatory Control Period the actual costs to be incurred in the Regulatory Control Period fall to \$29m. The deferred capital work is still required. The loss to Transpower is still \$40m. Yet there is no re-opening. This is unreasonable.</p> <p>There is also the issue of whether it is appropriate to defer the other capital works. It appears from paragraph 7.6.5 that this will be a decision made by the Commission at the time, but deferral of capital expenditure previously accepted as being appropriate is contrary to the thrust of s.52A(1)(a), the 2009 Government Policy Statement and the 2006 Policy Statement. Consequently, Transpower submits that compulsory deferral should not be required.</p> <p>In any event, when considering what is material, most people would focus more on the absolute amount rather than the percentage impact. That approach was evident in the decisions of the old Electricity Market Surveillance Committee and the Electricity Appeal Panel when considering whether or not a price already fixed for electricity could be re-opened which remedy was only available if the pricing error was such as to “<i>materially financially disadvantage any Spot Market Participant</i>” – Rule 4.5 of Section G of Part 2. See the Decision D4/100 of 4 July 2000 of the Market Surveillance Committee affirmed by the Appeal Board on 8 November 2000 – A2/100.</p> <p>In the Administrative Settlement the threshold was set at \$5m. The new threshold is about six times that. There has been no change in the regulatory requirements that would indicate the previous approach was wrong. Moreover, as the Commerce Commission acknowledges at para 2.5.7:</p> <p><i>“The settlement was finalised after extensive consultation with Transpower and with other interested parties, and will likely have informed the expectations of Transpower and interested parties as to how regulation of Transpower might be implemented under Part 4.”</i></p>
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		<p>It would also appear to be inconsistent with the Australian approach – see para 7.6.10 of the Input Methodologies Reasons Paper.</p> <p>The justification appears in para 7.6.23 where the Commission states that:</p> <p><i>“a materiality threshold should:</i></p> <ul style="list-style-type: none"> <li>• <i>be high enough to justify the costs that will be incurred in reopening a path, and provide appropriate incentives for suppliers to manage risk;</i></li> <li>• <i>provide for reasonable sharing of risk between a supplier and consumers; and</i></li> <li>• <i>be low enough so that a supplier's financial position is not severely damaged by an event that is outside its control.”</i></li> </ul> <p>In our view, the proposed threshold does not provide a reasonable risk sharing – Transpower’s upside is always controlled. It should not bear excessive downside.</p> <p>Nor is it appropriate that the downside protection only cuts in to avoid “<i>severe damage</i>” to Transpower’s financial position. The directors of a trading company in a competitive market would be justifiably criticised if they refrained from responding to adverse events until the financial position of their company was likely to be severely damaged.</p> <p>Relevantly, the threshold applies to each event. That is, two separate events each with a 4 per cent impact on revenue for the remainder of the Regulatory Control Period would not lead to a re-opening even although the total impact could be almost \$60m.</p> <p>The threshold is simply not consistent with the outcomes in competitive markets and appears to unduly fetter the power of the Commission as contained in ss.52Q and 52X, relating to an amendment to a s.52P determination and an amendment to input methodologies, as well as being inequitable if the cost arises as a result of regulatory change. Such a high threshold is also a discouragement to investment. While we accept that a supplier should have an incentive to manage risk, a \$30m threshold is well above any normal incentive.</p> <p>Transpower therefore submits that the materiality threshold for determining whether an event should trigger a reconsideration of a price-quality path should be that the impact of the event over the remainder of the regulatory period is at least 1 per cent of the allowed revenue for the year in which the event occurs, as determined by the Commission in its Individual Price Path determination.</p>
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	<ul style="list-style-type: none"> <li>• a material error is discovered in the determination; or</li> </ul>	<p>Transpower agrees with the concept, but disagrees with the Commission's definition of the material error threshold, which would trigger reconsideration of the price-quality path. We submit that the definition of the material error threshold should be that the impact of the error on the revenue calculation for the entire regulatory period must be at least 1% of the allowed revenue for the first year of the IPP regulatory period. The reasons for favouring a 1% threshold are set out in detail above and below, with respect to catastrophic events and legislative or regulatory requirements respectively.</p>
	<ul style="list-style-type: none"> <li>• Transpower has provided false or misleading information to the Commission, which the Commission has relied upon in making its determination; or</li> </ul>	<p>Transpower agrees.</p>

	<ul style="list-style-type: none"> <li>• a change in a legislative or regulatory requirement that has a material impact on costs.</li> </ul>	<p>Transpower agrees with the concept, but disagrees with the Commission’s materiality criterion. We submit that, for a change in a legislative or regulatory requirement, the materiality criterion should be that the impact of the event (e.g. costs associated with compliance, implementation or application of the change) over the remainder of the regulatory period must be at least 1% of the allowed revenue in the year that the event occurred.</p> <p>Transpower believes that the proposed 5% materiality criterion would not be consistent with the outcomes in competitive markets, would be inequitable, since the change in costs would be due to legislative or regulatory requirements entirely outside Transpower’s control and would unduly disincentivise investment, contrary to the intention of the Government Policy Statement on Electricity Governance.</p> <p>If there is a change in the legislative or regulatory requirement in a competitive market, that change is likely to affect all suppliers leading to all suppliers increasing their prices. The Commission, at section 7.6 of the Input Methodologies Reasons Paper, gives, as an example under this heading, a change in tax law. In a competitive market, all suppliers will be affected and are likely to respond accordingly within a short time of any such change.</p> <p>That position should apply all the more so to regulated entities like Transpower if the extra cost arises because of new industry specific regulation. Suppose the Electricity Commission were to proceed with its proposed unconditional service guarantee. It would be quite wrong if Transpower were than unable to pass on the cost because that cost was under the threshold. Indeed, there is a strong case for having no threshold before such a cost could be recouped.</p> <p>Against that background, the Commerce Commission’s definition of materiality appears very harsh even when allowing that the 5% relates to all revenues for the remainder of the Regulatory Control Period rather than in a single year.</p> <p>Transpower also disagrees with the proposed requirement in para 7.7.5 that, Transpower should generally bear the costs of price-quality path reconsideration on the basis that it would be applying for the reconsideration. In our view that obligation should not arise if the trigger for the reconsideration is regulatory or legislative change.</p>
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	<p>Detailed definitions of each of these events will be set out in the Draft Determination. Brief comment regarding each is provided below:</p> <ul style="list-style-type: none"> <li>• catastrophic events should be events that were outside the reasonable control of Transpower and unforeseen at the time when the path was determined. In considering the materiality of the event and the extent of the amendment to the path, the Commission will consider factors such as insurance income, potential to substitute projects within the capital and operating budgets, project timing, amount of capex and opex required to rectify the event within the current regulatory period, and so on;</li> </ul>	<p>Transpower submits that the reference to catastrophic should be replaced with “material”.</p>
	<ul style="list-style-type: none"> <li>• a material error event may have occurred if an error is discovered in information or calculations that were relied upon in making the determination, which resulted in the path being materially different than if the error had not occurred;</li> </ul>	<p>Transpower notes this description.</p>
	<ul style="list-style-type: none"> <li>• changes in legislative or regulatory requirements may provide grounds for amending the path if the change has had, or will have, a material impact on the costs of providing the service which is not (either explicitly or implicitly) provided for in the path.</li> </ul>	<p>Transpower submits that this test should be “a material impact on the provision of the service” and not restricted to a material impact on the costs of providing the service.</p>

	<p>In the context of the above descriptions, the concept of materiality is important. The Commission’s draft decision is that, in the context of deciding whether to reconsider a price-quality path, ‘material’ means the impact of the event over the remainder of the regulatory period is at least 5% of the allowed revenue for the year in which the event occurs, as determined by the Commission in its IPP determination. The Commission proposes taking into account the impact over the remainder of the period, rather than just the year in which the event occurs, as the importance of reconsideration from Transpower’s perspective is likely to be greater the earlier it is in the period. Events occurring late in the period can be considered at the price reset.</p> <p>For a catastrophic event, this would mean that the costs of rectifying the event over the remainder of the regulatory period would have an impact in revenue terms of at least 5% of the allowed revenue in the year that the event occurred. This is intended to take account of the differing impact of capex and opex on the calculation of revenue.</p> <p>For the material error threshold, the impact of the error on the revenue calculation for the entire regulatory period must be at least 5% of the allowed revenue for the first year of the IPP regulatory period.</p> <p>For the change in a legislative or regulatory requirement, the impact of the event (e.g. costs associated with compliance, implementation or application of the change) over the remainder of the regulatory period must be at least 5% of the allowed revenue in the year that the event occurred.</p>	<p>Transpower disagrees. Transpower believes that the materiality test for a material event should be set such that the impact (including lost revenue and the costs of rectifying the event over the remainder of the regulatory period) would, in revenue terms, be at least 1 per cent of the allowed revenue in the year that the event occurred. The reasons for this are set out in more detail above.</p>
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<p><b>Only permit catastrophic events to be recovered if they cannot be managed through insurance or by substitutions (in either opex or capex)</b></p>	<p>In terms of the proposed catastrophic event, the Commission considers that the definition will allow Transpower to seek an increase in its price cap or decrease in its quality standards if it suffers a catastrophic event such as an Act of God, extreme adverse weather event, or similar. However, it will only allow this where the impact on Transpower is substantial and cannot be managed through insurance or substitutions within the opex and capex budget.</p>	<p>Transpower disagrees. This proposal misses the point. Transpower is not permitted to insure against all possible eventualities within the revenue cap, because such a level of insurance would not be cost effective or economically efficient. Hence, the nature of material events is such that insurance is not a permitted management option. Of course, in instances where insurance cover is present, there would be no need to seek a re-opening of the price path determination.</p> <p>With respect to substitution between capital expenditure and operating expenditure, this is not the right response to a material event, as the nature of material events is such that substitution of this sort would result in an inefficient allocation of resources. The only correct response to a material event is to re-open the IPP.</p>
<p><b>Overall approach: incremental rolling incentive scheme (IRIS)</b></p>	<p>The Commission's draft decision is to implement an IRIS. The efficiency gain or loss for a particular regulatory year will be calculated as the difference between actual and forecast controllable opex for the current year, minus the difference in the preceding year, the result of which provides the incremental gain/loss for that year.</p>	<p>Transpower agrees.</p>
	<p>While both incremental gains and losses will be carried forward, only positive net balances will be carried forward (i.e. only net rewards will be carried forward).</p>	<p>Transpower agrees.</p>
	<p>The length of the carryover period (i.e. the length of time Transpower is allowed to retain the efficiency gain before it is shared with consumers) is five years.</p>	<p>Transpower agrees.</p>
	<p>The Commission's draft decision is that in the first year of RCP1 no IRIS will be implemented.</p>	<p>Transpower agrees.</p>

Submission to the  
Commerce Commission on:  
Individual Price-Quality Path Transpower  
Draft Reasons Paper

<b>Draft Decisions for Form of Control (Chapter 3)</b>		
<b>Topic</b>	<b>Draft Decision</b>	<b>Transpower comment</b>
<b>Length of Regulatory Control Period</b>	The length of the first regulatory period will be four years. Subsequent regulatory periods will be five years.	Transpower agrees. This is consistent with other comparable jurisdictions (e.g. Australia, UK).
<b>Pricing &amp; financial year differences</b>	Revenue received in the pricing year starting immediately prior to the start of a financial year will be deemed to have been received in the financial year. The revenue forecasts are based on the financial year, but are applied to the pricing year, which is three months earlier.	Transpower agrees. This is consistent with Transpower’s administrative settlement.
	For this reason, the Commission considers that ex post economic gains or losses in respect of the provision of electricity lines services by Transpower should 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. All other aspects of assessing compliance will be done on a financial year basis (such as operating costs and commissioned capital).	Transpower agrees. This is consistent with Transpower’s administrative settlement.
<b>Approach for Setting the Maximum Allowable Revenue</b>	The Commission’s draft decision is to require Transpower to calculate its MAR for each year of each RCP. Transpower must do this by applying the Commission’s specified building blocks, using the Commission-approved amounts for operating and capital expenditure specified in accordance with the process set out in this reasons paper, the applicable input methodologies, and any other requirements specified by the Commission’s s 52P determination.	This is satisfactory in concept, but see the comments below on practicality.
	Transpower will be required to provide to the Commission its calculated MAR for each year of the RCP, by the second Friday in the month of the September, prior to the first year of the RCP. In the case of RCP1, specifically, a MAR must be provided for the Transitional Year (Year 1) by 10 September 2010 and the MAR for years 2-4 (the Remainder Period) by 9 September 2011.	<p>Transpower’s original understanding was that the process for setting the MAR for the Transition Year would be a “roll over” of the terms of the existing administrative settlement in order to provide for a controlled process to change the method of calculation to the new requirements set by the Commission’s input methodologies. The Commission’s draft decision seems to indicate that the approach to setting the MAR for the Transition Year has now changed.</p> <p>The proposed requirements for the Transition Year are impracticable, because the Commission will not have made its s.52P determination setting out the required input methodologies until November 2010, so the MAR calculated for the Transition Year will necessarily be based on assumed values for the input</p>

		<p>methodologies. In particular, the Commission’s approved WACC will not be available when the MAR calculation is required to be made. Transpower recommends that the Commission amend its draft decision to provide that the terms of the administrative settlement as set out in the Commerce Act (Transpower Thresholds) Notice 2008, updated for the transitional operating expenditure allowance, shall be used to calculate the MAR for the Transition Year, in order to enable a controlled and orderly process of change to the new method of calculation. Even if this recommendation is accepted, the earliest that the indicative revenue calculation can be completed is the end of September (see time line below).</p> <p>The draft decision on the deadlines for calculating the MAR for the Remainder Period and subsequent RCPs is also impracticable, as it does not provide adequately for all the processes that must be completed before a final MAR can be calculated. For subsequent RCPs, the timing of the availability of the Commission’s WACC determination would seem to be a continuing problem. The timeline below demonstrates that the earliest that a final MAR can be calculated is 30 September (this applies to both the Transition Year and the Remainder Period). This calculation then requires approval by the Transpower Board before it can be submitted to the Commission and the earliest that this approval can be made is at the Transpower Board’s October meeting (usually in the third week of the month).</p> <ul style="list-style-type: none"> <li>• Complete annual accounts and audit – 15 August</li> <li>• Complete the EV wash-up calculation and audit – 15 September</li> <li>• Complete the revenue requirement calculation – 30 September</li> <li>• Approval by Transpower Board – towards the end of October</li> </ul> <p>Transpower therefore recommends that the draft decision be amended to:</p> <p>“Transpower will be required to provide to the Commission its calculated MAR for each year of the RCP, by the end of October prior to the first year of the RCP. In the case of RCP1, specifically, a MAR must be provided for the Transitional Year (Year 1) by 31 October 2010 and the MAR for years 2-4 (the Remainder Period) by 31 October 2011.”</p>
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	<p>The Commission will require that Transpower's MAR calculation is supported by the assurance of a Commission-approved auditor, that the formula, calculations, inputs and process followed by Transpower in calculating the MAR accurately applies the specified requirements of the Commission's s 52P determination.</p>	<p>Transpower agrees in principle, but notes that, for the Transition Year, the s.52P determination will be made after the MAR has been calculated. Consequently, Transpower recommends that the MAR for the Transition Year should be calculated in accordance with the terms of the existing administrative settlement as set out in the Commerce Act (Transpower Thresholds) Notice 2008.</p> <p>Transpower looks forward to working with the Commission approved auditor and anticipates that the auditor will set out expectations with respect to the process that should be followed to enable an orderly transition from the current to the new method for calculating Transpower's revenue. Transpower will seek independent verification from the Commission approved auditor that the new revenue calculations are consistent with the new requirements. To the extent that these processes incur additional costs, these will need to be reflected in future operating cost allowances.</p>
	<p>The Commission will make its decision on the MAR to be applied no later than 30 November in each instance.</p>	<p>Transpower is legally required to notify its prices to its customers before the end of the calendar year, which makes Christmas Eve the latest practicable date. In order to meet this deadline, Transpower will calculate its prices, complete the auditing of the price calculations and secure Board approval of its prices based on the calculated MAR submitted to the Commission at the end of October. If the Commission's MAR decision is different from Transpower's calculated and submitted MAR, the final processes required to calculate, obtain audit sign-off and Board approval of transmission prices will need to be repeated. In order for these actions to be completed in time for prices to be communicated to transmission customers before Christmas, the Commission will need to make its decision on the MAR by the end of the third week in November.</p>
	<p>Transpower will also be required to re-run its revenue model for the purposes of any wash-ups, as set out in the s 52P determination.</p>	<p>Transpower submits that the current method used to calculate the wash ups, which undertakes the calculations separately using inputs from the revenue model, is robust and audited and should continue to be permitted by the s.52P determination. Transpower will calculate the wash-up quantities and, if these vary from those originally calculated, then recalculate the transmission prices and obtain audit sign-off and Board approval of the new prices. Consequently, as noted above, it is essential that Transpower receive the final decision on the MAR and the s.52P determination by the end of the third week of November.</p>
<p><b>Calculating the Maximum Allowable Revenue</b></p>	<p>Transpower will be required to calculate its MAR for each year of the RCP, on the basis of:</p> <p>a) a separate operating expenditure cap set by the Commission for each year of the RCP;</p>	<p>Transpower agrees.</p>

	b) an ex-ante calculation of return on and of capital relating to the category of Minor capital expenditure that is expected to be commissioned during the regulatory period, taking into account the timing of the commissioning and the cap set by the Commission for each year of the RCP;	Transpower agrees.
	c) an ex-ante calculation of return on and of capital relating to approved Major capital projects that are expected to be commissioned during the regulatory period, taking into account the timing of commissioning;	Transpower agrees.
	d) an ex-ante calculation of return on and of capital on the closing balance of the RAB as at the 30 June immediately prior to the year for which the MAR is being set;	Transpower agrees.
	e) EV account adjustments to account for the reduction of the EV account to zero, over time, as specified by the Commission;	Transpower agrees in principle, but note that Transpower disagrees with the proposed 50% reduction of the HVAC EV account in the Transition Year and submits that the current HVAC and HVDC balances should both be returned to zero over two RCPs.
	f) the relevant input methodologies as set by the Commission.	Transpower agrees.
	The calculated MAR must not include approved pass-through costs or recoverable costs. Transpower will forecast these on an annual basis, these being added to its MAR. Any under or over recovery must be demonstrated in Transpower's annual compliance statement, and an adjustment to the EV account made equal to the over or under recovery. The treatment of pass-through costs and recoverable costs is set out in detail in Section 7.4 of the Input Methodologies (Transpower) Draft Reasons Paper.	Transpower submits that over and under-recovery of forecast pass-through and recoverable costs should be recovered or returned to customers via an adjustment to the MAR for the following pricing year.
<b>Single Maximum Allowable Revenue to Apply</b>	A separate MAR will be set for each year of the RCP at the start of the RCP. The MAR for each year will be the total of Transpower's approved annual HVAC revenue requirements and approved annual HVDC revenue requirements.	Transpower agrees that separate annual MARs should be set at the start of the RCP, but submits that these may be adjusted to account for major capital expenditure approved and commissioned during the RCP and for differences between forecast and actual pass-through and recoverable costs.
	Transpower will continue to be required to disclose its costs, adjustments and charges to both the HVAC and HVDC customers through annual compliance statements (refer section 3.7). For the purpose of compliance with the individual price-quality path, Transpower will be assessed against a single MAR only.	Transpower agrees with the Commission's draft decision that, for the compliance statements, assessment should be against a single MAR.

<p><b>MAR Updates</b></p>	<p>The Commission's draft decision is that:</p> <p>a) in RCP1, no updates of the MAR will be undertaken;</p>	<p>Transpower disagrees. We believe that annual MAR updates should be permitted, based on annual changes to the RAB, to account for major assets that are approved and commissioned during the RCP, including approvals of major investments that have been resubmitted because of changes to forecast costs. The MAR should be adjusted based on the annual wash ups for these major projects, and recovery of a return of and on the revised MAR values obtained via prices set for the following pricing year. The revised MAR values should also include wash ups of actual versus forecast pass-through and recoverable costs and the costs of approved transmission alternatives and force majeure events.</p> <p>Not to permit MAR adjustments of this sort could leave Transpower in a negative cashflow situation, necessitating additional borrowing at a time when its debt is already forecast to be high and increasing. Potentially, additional borrowing in this environment could put Transpower's credit rating at risk and disincentivise investment contrary to the purpose statement provision in s.52A(1)(a) of the Commerce Act.</p> <p>Transpower understands that the annual MAR adjustments will not apply to minor capex or capex approved prior to the start of the RCP and included in the forecast annual MAR values.</p> <p>Transpower notes that the Commission's proposed approach is inconsistent with the practice in Australia, which permits a "mini revenue cap" to be established for contingent projects that are approved after the start of the regulatory period.</p>
	<p>b) in subsequent RCPs, a maximum of two MAR updates will be undertaken, with the first being in Year 1, and the second being in either year 3 or 4;</p>	<p>Transpower supports a move to an AER style regime in which the vast bulk of capital expenditure is accommodated by an ex ante allowance, with only contingent projects added by way of a "mini revenue cap". If such a regime is adopted in RCP2 then a less frequent resetting of MAR may be acceptable (subject to exceptions for significant unforeseen events).</p> <p>However, whilst the Commission retains a process whereby significant capital expenditure is approved during the RCP, more frequent (i.e. annual) MAR updates should be permitted for new major capital expenditure, approved and commissioned during the RCP, the costs of transmission alternatives and force majeure events and also under or over recovery of forecast pass-through and recoverable costs. These MAR updates would be based on the annual wash ups.</p>
	<p>c) in each RCP, the first MAR update will be applied to the MAR from year two onwards; and</p>	<p>Transpower agrees – the return of and on the revised MAR estimate should be via the prices charged for the following pricing year.</p>



	The last wash-up will occur in the final year of the RCP. This wash-up will take into account expenditure during the RCP (using actual financial information for all but the final year of the RCP), as well as include forecast ex-post economic gains or losses for the final year of the RCP (using latest forecast information for the final year of the RCP). The amount of this wash-up will be applied as an adjustment to the EV account (the full amount of which is used in calculating the MAR for the next RCP).	Transpower agrees, but notes that this should exclude adjustments for pass-through costs, recoverable costs, major capital expenditure approved and commissioned since the start of the RCP and the costs of transmission alternatives and force majeure events as these should be accounted for by annual MAR adjustments.
	Each wash-up will contribute to calculating ex post economic gains or losses for the years to which it applies.	Transpower agrees, but notes this agreement is subject to adoption of the alternative proposals set out above.
	The following building block components will be subject to a full wash-up: a) pre-approved Minor capital expenditure, this being replaced by the lesser of the actual or approved and commissioned Minor capital expenditure (but not ex post approvals);	Transpower agrees.
	b) pre-approved Major capital expenditure, this being replaced by the lesser of actual or approved and commissioned Major capital expenditure (taking into account timing of commissioning, as well as approved additional expenditure); and	Transpower agrees, but submits that actual capital expenditure should be used to set asset values in the next RCP.
	c) pass-through costs, recoverable costs, asset sales, asset stranding, re-opener events, tax, depreciation and costs changes resulting from a and b above.	Transpower agrees, but note Transpower's alternative proposals set out above.
<b>Economic Value Framework</b>	The current approach of using separate EV accounts, for HVDC and HVAC customers, will be continued.	Transpower agrees. However, we note that this treatment may need to be reconsidered if the Electricity Commission or Electricity Authority decides to amend the way that HVDC costs are recovered under the transmission pricing methodology.
	All economic gains or losses must be calculated annually, and must be transferred to the relevant EV account.	Transpower agrees, but note Transpower's submission above that some EV adjustments should result in consequential amendments to the MAR for the following year.
	After RCP1, when setting the MAR for each RCP, the closing balance of each customer EV account from the previous financial year, plus forecast interest over the remainder of the RCP for which the MAR is being set, must be fully apportioned equally over each year of the RCP.	Transpower agrees, with the proviso that the tax effect must be taken into account to ensure full apportionment by the end of the RCP.

	Ex post economic gains or losses calculated for the last year of each RCP, these being calculated in Year 1 of the subsequent RCP, will be transferred to the appropriate EV account, and along with forecast interest charges over the remainder of the current RCP, must be apportioned equally over the remainder of the current RCP (i.e. over the remaining four years) when the MAR is updated in Year 1 of that RCP.	Transpower agrees with the exception of those items that it submits should be accounted for by consequential amendments to the MAR for the following year and with the proviso that the tax effect must be taken into account to ensure full apportionment by the end of the RCP.
	The balance of the HVAC and HVDC EV accounts will accrue interest at a rate equivalent to Transpower's cost of capital as specified by the Commission in the cost of capital input methodology.	Transpower agrees.
<b>Economic Value Framework HVAC</b>	The balance of the HVAC EV account, which is currently approximately \$109 million in credit (owed to customers), should be returned to customers by the end of the first regulatory control period (30 June 2015).	Transpower disagrees. Transpower submits that, in order to achieve cashflow symmetry, the balance of the HVAC EV account should be returned to customers over the same period that the balance of the HVDC account is recovered from customers, i.e. RCP1 and RCP2.
	Transpower must apply an adjustment of no less than 50% of the forecast 30 June 2011 closing balance of the HVAC EV account, when calculating its MAR for the Transition Period of RCP1.	Transpower disagrees with this proposed requirement. The proposal to return 50 per cent of the HVAC balance in a single year would be commercially difficult for Transpower to achieve at a time when its cashflow is under considerable pressure and debt levels are high. Rating agencies, for example, would be alarmed by such a "one-sided" regulatory intervention. The customer balance is net of tax, which means that the amount involved would be approximately \$55million/ (1-corp tax rate) or approximately \$76million. Transpower submits that the closing balance of the HVAC EV account should instead be returned to customers by way of equal installments over RCP1 and RCP2.
	The forecast 30 June 2012 closing balance of the HVAC EV account, along with forecast interest charges over the remainder of RCP1, must be apportioned equally over the remaining years of RCP1.	See comment above. Transpower submits that the forecast closing balance of the HVAC EV account at 30 June 2011 should be apportioned equally over the nine year period that comprises RCP1 and RCP2, including the Transition Year. Not to allow this could lead to a reduction in Transpower's credit rating and a consequential increase in the cost of borrowing. The Commission should also note the need to take the tax effect into account to ensure full apportionment by the end of the RCP.
	For each subsequent RCP, the forecast closing balance of the HVAC EV account, along with forecast interest, must be apportioned equally across each year of that RCP so as to return the HVAC EV account balance to zero by the end of that RCP.	Transpower agrees, with the proviso that the tax effect must be taken into account to ensure full apportionment by the end of the RCP.

	In respect of the HVDC EV account, the Commission's draft decision is that the balance, which is currently approximately \$103 million in debit (owed by certain generators that are HVDC customers), should be recovered by Transpower from HVDC customers by the end of RCP2.	Transpower agrees, with the proviso that the tax effect must be taken into account to ensure full apportionment by the end of the RCP and on the basis of a similar treatment for the HVAC customer account (refer above).  The Commission may need to review how this decision should be applied if the Electricity Commission or the Electricity Authority decides to change the way in which HVDC costs are recovered under the transmission pricing methodology.
	The forecast 30 June 2011 closing balance of the HVDC EV account, along with forecast interest charges over the remainder of RCP1 and RCP2, must be apportioned equally over each year of RCP1 and RCP2 (therefore spreading the cost over a nine year period).	Transpower agrees, with the proviso that the tax effect must be taken into account to ensure full apportionment by the end of the RCP, but note the qualification above.
	The forecast 30 June 2015 closing balance of the HVDC EV account, along with forecast interest charges over the remainder of the RCP1 and RCP2, must be apportioned equally over RCP2.	Transpower agrees, with the proviso that the tax effect must be taken into account to ensure full apportionment by the end of the RCP but note the qualification above.
	For each subsequent RCP, the forecast closing balance of the HVDC EV account, along with forecast interest, must be apportioned equally across each year of that RCP so as to return the HVDC EV account balance to zero by the end of that RCP.	Transpower agrees, with the proviso that the tax effect must be taken into account to ensure full apportionment by the end of the RCP.
<b>Compliance Framework</b>	Transpower must, on an annual basis and pursuant to s 53N of the Act, publish and provide to the Commission by the second Friday of each August, a written statement that confirms its compliance, or otherwise (Compliance Statement), with the individual price-quality path set by the Commission.	Transpower disagrees. It is not possible to complete this work by the second Friday of August. The work involved is substantially greater than that required by the current Commerce Act (Transpower Thresholds) Notice 2008 ("Thresholds Notice"), but clause 9 of the Thresholds Notice sets a deadline of 30 September for the Compliance Statement. Annual accounts sign-off, which occurs around the third Friday of August, will be needed before the EV wash-up and the Compliance Statement can be finalised. We also note that both the Listing Rules for the New Zealand Stock Exchange and the State-owned Enterprises Act allow three months for the year end audited accounts. A six week period for the audited Compliance Statement is too short. Transpower submits that the earliest achievable date is 30 September (refer below).
	Each Compliance Statement must be audited and must disclose Transpower's performance, and provide evidence to this effect that fully supports and explains the disclosure, with regard to:	If the requirements below are to be achieved, the earliest that the Compliance Statement can be completed is 30 September.
	a) the total year-end MAR for that period, calculated by providing separately its HVDC revenue requirement and HVAC revenue requirement, against actual costs and revenues;	See above.

b) capital spend (commissioned) versus approved capital spend (commissioned), and an explanation of changes from forecast, as well as reforecast annual spends for the remainder of the RCP;	See above.
c) actual operating expenditure versus approved expenditure, broken down by category, as well as reforecast annual spends for the remainder of the RCP;	See above.
d) quality performance, including:	See above.
– performance against the specified performance measures;	
– the impact of quality performance on revenue (i.e. the amount of any positive or negative adjustments to future revenue);	See above.
- an explanation of variances from initial forecasts; and	See above.
- provisions of reforecast performance for the remainder of the RCP, and reasons for any variance between initial and reforecast performance;	See above.
e) ex-post economic gains or losses for that period, and the net economic gains or losses over the RCP (movements over each year);	See above.
f) recoverable, pass through, and other costs and adjustments, as well as reforecast cost for the remainder of the RCP; and	See above.
g) all relevant performance data, such as those in (a), (b), (c), (e), and (f) above, as well as historical performance of the quality measures in (d) above, over the previous four years (thereby providing a rolling five years of performance for each compliance statement).	See above.
If Transpower's annual compliance statement identifies that Transpower has commissioned Minor capital expenditure in excess of the ex-ante approved level, Transpower may not seek ex post approval for the amount of that capital expenditure until the last compliance statement for that RCP.	Transpower submits that these amounts should be included in the annual wash-up, but identified separately pending ex post approval at the end of the RCP, and that interest at WACC should be added to the value of any ex post approval made.

	<p>If Transpower's final compliance statement for a given RCP identifies that Transpower has undertaken and commissioned Minor capital expenditure in excess of the combined level approved ex-ante, then:</p> <p>a) such expenditure must be excluded from Transpower's RAB unless:</p> <ul style="list-style-type: none"> <li>i. Transpower seeks and receives ex-post approval from the Commission for that capital expenditure; or</li> <li>ii. Transpower calculates the revenue impact of that capital expenditure, over the life of those assets, including a reasonable allowance for maintenance, and makes an adjustment to the relevant EV account to fully offset this cost, and includes in its compliance statement an independent opinion that verifies Transpower's estimates are reasonable and calculations are correct.</li> </ul>	<p>Transpower understands that where items are excluded from the regulatory asset base, then the tax treatment would mirror the regulatory treatment, i.e. tax depreciation benefits would not be passed back to customers on assets excluded from the RAB.</p>
	<p>Transpower's annual compliance statement must demonstrate each adjustment in respect of quality that must be made to the EV account. As the rewards/penalties for out-performing or under-performing with respect to the quality standards after RCP1 set by the Commission are made through an adjustment to the relevant EV account on an annual basis, these will, therefore, accrue interest at a rate equivalent to the cost of capital applied to Transpower.</p>	<p>Transpower agrees.</p>

<b>Draft Decisions for Operating Expenditure (Chapter 4)</b>		
<b>Topic</b>	<b>Draft Decision</b>	<b>Transpower comment</b>
<b>Operating Expenditure Definition</b>	The Commission's draft decision is that operating expenditure means expenditure incurred by Transpower in the provision of specified services that is not capital expenditure.	Transpower agrees, subject to the qualifications below.
	For the avoidance of doubt, operating expenditure: a) includes departmental costs, investigations, communications and control, IT&T operations, and transmission and substation maintenance; but	It should be made clear, for the avoidance of doubt, that operating costs include event charges, insurance premiums, black start costs and the cost of over-frequency arming.
	b) excludes depreciation; tax; revaluations; operating lease costs; pass-through costs; recoverable costs; any operating costs associated with transmission alternative services that have been approved by the EC (or any other regulatory body); operating expenditure that is the result of an insurance event and has been recovered by insurance income (or is expected to be recovered); and costs associated with unregulated businesses and expenses related to the system operator function.	Transpower agrees.
<b>Operating Expenditure Allowance for the Transition Year</b>	The Commission's draft decision is that: a) the operating expenditure allowance for the Transition Year (2011/12) will be \$231.67 million, comprising:	Transpower notes that the Commission's draft decision allows for an increased operating expenditure allowance for additional maintenance expenditure but submits that the operating expenditure allowance for the Transition Year (2011/12) should be <u>\$234.02</u> million, compared with the Commission's draft decision of \$231.67 million. The calculation of the transition year operating allowance in the draft decision double counts the adjustment for instantaneous reserve availability charges and so \$1.55m needs to be added back in. We propose also that there be a provision of \$800k included in base operating expenditure, for 2011/12, to reflect Transpower's ongoing and increased exposure to event charges.
	i) base operating expenditure under the settlement agreement escalated annually at CPI-0 (\$225.1 million);	Transpower notes that the figure of \$225.1m excludes the settlement provision for instantaneous reserves costs.

<p>ii.) an additional allowance of \$8.9 million, for Transpower's proposed increase in maintenance expenditure for the 2011/12 year;</p>	<p>The case for additional maintenance expenditure was presented to the Commission at the Transpower Workshop in March 2010.</p>																				
<p>iii) a reduction of \$0.78 million to exclude the provision in the base operating expenditure for Commerce Act levies, which have been defined as pass-through costs; and</p>	<p>Transpower agrees.</p>																				
<p>iv) a reduction of \$1.55 million to exclude the provision in the base operating expenditure for instantaneous reserves availability charges, which have been defined as 'recoverable costs'; and</p>	<p>Transpower notes base operating expenditure under the settlement agreement escalated annually at CPI (\$198.1m) has already excluded the provision for the cost of instantaneous reserves. Excluding it again here is double counting.</p> <p>Transpower also notes that, although instantaneous reserves availability costs have been classed as recoverable costs, Transpower as grid owner will continue to be exposed to the risk of Event Charges. Event Charges are only partly controllable by Transpower. However, there is an element that is outside Transpower's control insofar as an interruption or reduction in electricity from Transpower's assets, which causes and under-frequency event, may be due to actions by a third party (other than a generator or other grid owner). In these cases, Transpower is determined to be the causer of the event.</p> <p>The recent changes to the Electricity Governance Rules regarding event charge causer determination increase Transpower's potential exposure to Event Charges by making it more likely that Transpower as grid owner will be determined to be the causer of any event. Consequently, while Transpower accepts the exclusion of the \$1.55 million "availability charge" provision from base operating expenditure for the Transition Year, we propose that there be an appropriate provision included in base operating expenditure for the Transition year and the Remainder Period to reflect Transpower's ongoing and increased exposure to Event Charges.</p> <p>The Commission's proposed opex allowance for the Transition year (amended as described above) included no specific allowance for Event Charges, based on expected charges in 2006. Since 2006, annual Event Charges payable by Transpower have been:</p> <table border="1" data-bbox="1032 1121 2022 1359"> <thead> <tr> <th>Financial Year</th> <th>TP Event Total</th> <th>TP Event Rebates</th> <th>Net Event Charge</th> </tr> </thead> <tbody> <tr> <td>2006/07</td> <td>0</td> <td>0</td> <td>0</td> </tr> <tr> <td>2007/08</td> <td>110,000</td> <td>-71,385</td> <td>38,615</td> </tr> <tr> <td>2008/09</td> <td>515,000</td> <td>-119,659</td> <td>395,341</td> </tr> <tr> <td>2009/10</td> <td>893,750</td> <td>-246,895</td> <td>646,855</td> </tr> </tbody> </table>	Financial Year	TP Event Total	TP Event Rebates	Net Event Charge	2006/07	0	0	0	2007/08	110,000	-71,385	38,615	2008/09	515,000	-119,659	395,341	2009/10	893,750	-246,895	646,855
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		<p>The impact of the new rules and the level of Transpower’s increased future exposure to Event Charges is uncertain but we estimate that, initially, a provision of \$800,000 should be included in the Transition Year operating expenditure allowance.</p> <p>Moreover, if Event Charges are such that the amount provided for in the operating expenditure allowance is exceeded as a result of charges for events caused by circumstances outside Transpower’s control, Transpower submits that such over expenditure should be classified as a recoverable cost.</p>
	b) the incremental rolling incentive scheme for operating expenditure does not apply to the Transition Year. Any under-spend or over-spend relative to the allowance for the year will be to the benefit or cost of Transpower’s shareholder; and	Transpower agrees.
	c) operating expenditure will not be included in any wash-ups.	Transpower agrees.
<b>Operating Expenditure allowance for the Remainder Period</b>	<p>The Commission’s draft decision is to adopt the approach set out below for setting future operating expenditure allowances, beginning with the Remainder Period (2012/13 to 2014/15).</p> <p>Operating expenditure allowances will:</p> <p>a) be determined by the Commission after an ex-ante assessment of operating expenditure forecasts for the RCP submitted by Transpower;</p>	Transpower agrees. We assume that operating expenditure allowances will include provision for forecast changes to the consumers’ price index (CPI) and/or other relevant cost indices.
	b) reflect what the Commission considers to be a reasonable and efficient level of operating expenditure for Transpower;	Transpower agrees in principle.
	c) take into consideration Transpower’s performance in the previous regulatory period (or in the Transition Year in the case of the 2012/13-2014/15 allowances);	Transpower agrees in principle.
	d) be set in a manner to provide Transpower with incentives to improve efficiency and identify and realise appropriate cost savings;	Transpower agrees in principle. We assume this refers to a combination of the incremental rolling incentive scheme and Transpower’s ability to retain the benefit of operating expenditure efficiencies in the year in which they are achieved.

	e) consist of separate allowances set by the Commission for each year of the regulatory period; and	Transpower agrees.
	f) exclude pass-through costs and recoverable costs.	Transpower agrees.
	Incentives for Transpower to seek additional efficiency gains (relative to the allowance) will be provided through a combination of the operating expenditure allowance and the application of the incremental rolling incentive scheme. The carry forward period will be five years.	Transpower agrees.
	The Commission's draft decision is also that there will be no ex-post wash-up of operating expenditure, and that the operating expenditure review for the Remainder Period will be undertaken during the first half of 2011 (with consultation in July 2011).	Transpower agrees.

<b>Draft Decisions for Capital Expenditure (Chapter 5)</b>		
<b>Topic</b>	<b>Draft Decision</b>	<b>Transpower comment</b>
<b>Overall Approach</b>	The Commission’s overall approach to transmission capital expenditure.	<p>Transpower considers that the Commission’s overall approach to transmission capital expenditure has not had sufficient regard to the changes made to the purpose statement in s.52A of the Commerce Act, relative to the old s.57E. In particular, the Commission has not explained how its draft decisions on capital expenditure are consistent with the requirement in s.52A(1)(a) that suppliers of regulated goods or services should:</p> <p>“have incentives to innovate and to invest, including in replacement, upgraded, and new assets;”</p> <p>The Commission also has not explained how it has had regard to the May 2009 <i>Government Policy Statement on Electricity Governance</i> (GPS) which, at paragraphs 87 and 88, states that the division between major and minor capital expenditure should be at \$20 million. (Part of the rationale for the \$20 million threshold was a demonstrated lack of interest by stakeholders in projects of less than \$20 million.)</p> <p>In our view, these two provisions have a particular bearing on the Commission’s draft decision to classify, as Minor capital expenditure, enhancement projects of less than \$1.5 million during the Transition Year and less than \$5 million during the Remainder Period, but to classify all asset replacement and refurbishment expenditure as Minor capital expenditure. This scheme of classification has the following effects:</p> <ul style="list-style-type: none"> <li>• it creates an incentive to favour like for like replacement of existing transmission assets and the refurbishment of assets in preference to possible investment in innovative alternatives to existing assets, which might prove ultimately to provide services to consumers at better value, but which would involve expenditure which would be classified as Major capital expenditure;</li> <li>• as investment programmes and priorities evolve over time, it may not be possible to shift investment between projects in the, say, \$5-20 million range, even if to do so would prove more cost effective for, or provide better service to, consumers.</li> </ul> <p>These outcomes are not consistent with the s.52A(1)(a) requirement that suppliers of regulated goods or services should have incentives to innovate, and also to invest in new assets as well as replacement and upgraded assets.</p> <p>Consequently, Transpower submits that enhancement projects of less than \$20 million should be classified as Minor capital expenditure, consistent with the May 2009 GPS, and that this classification should apply to both the Transition Year and the</p>

		<p>Remainder Period, but, in any event, at least to the Remainder Period.</p> <p>In Transpower’s view, the restriction on Transpower’s ability to earn a return on major capital projects that are approved and commissioned during an RCP, until the commencement of the next RCP, is also inconsistent with the requirement in s.52A(1)(a) that suppliers of regulated goods or services should be incentivised to invest. While the Commission’s draft decisions appear to produce an NPV neutral outcome, they have negative cashflow consequences, which will require Transpower to borrow additional sums to cover the cashflow deficit. This creates a disincentive for Transpower to invest.</p> <p>We therefore submit that the Commission should revise this draft decision and permit Transpower to recover a return on major projects approved and commissioned during an RCP from the date of commissioning. Such treatment would also benefit customers insofar as the “price shock” effect of carrying over and recovering significant EV balances in the following RCP would be reduced.</p> <p>The Commission has also not clarified how approved project amounts will be determined and recovered. At present, approvals are at the P90 level, which means that one project in ten can be expected to overrun its approved costs. If Transpower is permitted to recover the lesser of the approved amount or actual expenditure, this would result in less than an economic return being recovered on Major investment, unless the approvals were based on, say, P99 forecasts, or the WACC determination specifically allowed for this risk. Not to provide compensation of this sort would create a disincentive to invest in Major capital, contrary to the requirement in s.52A(1)(a).</p> <p>Transpower submits that ultimately projects should be recovered at cost, there being no other form of compensation for the risk of project cost overruns provided by the draft decisions. This ex post adjustment – to reflect all projects at cost – could be made at the beginning of the following RCP to enhance the incentives “intra-RCP” that already exist on Transpower to deliver projects at least cost.</p> <p>We submit that the Commission should adopt capital recovery on an “as incurred” rather than an “as commissioned” basis. The key impact of the “as commissioned” approach is the cash flow deferral that results compared to “as incurred” . In addition, it requires regulation based on forecasts of project commissioning dates rather than forecasts of capital expenditure, which is harder to apply in practice. Accordingly, it contributes to the overall package of measures that act as a disincentive to investment.</p>
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<p>The Commission's draft decision is that a one-year Minor capital expenditure allowance will be reflected in Transpower's MAR for the Transition Year. This allowance will be \$225.6 million, and will be set using a similar process to that used under the settlement agreement.</p>	<p>Transpower disagrees with this draft decision and submits that, based on Transpower's 2009/10 performance and demonstrated ability to deliver its minor capital expenditure programme, the minor capital expenditure allowance to be included in the MAR for the Transition Year should be \$235 million, as previously proposed to the Commission.</p>
<p>A three year ex-ante allowance (return on and of capital) for Minor capital expenditure commissioned during the Remainder Period will be included in Transpower's MAR for the Remainder Period, as will an allowance for individually approved Major capital expenditure. Under this ex-ante approach Transpower will need to justify its Minor capital expenditure proposals by linking forecast expenditure to cost drivers, customer preferences, asset management strategies and good electricity industry practice, and in relation to Major capital expenditure, Transpower will need to demonstrate they meet the Grid Investment Test (GIT).</p>	<p>Transpower agrees in principle. Transpower understands that the minor capital expenditure review processes described in paragraphs 5.2.2 and 5.6.6 are intended to be equivalent.</p>
<p>The Commission considers that the degree of oversight of investment decisions should reflect the scale and complexity of a particular investment. Forecasts should demonstrate robust controls on expenditure and apply appropriate cost-benefit tests to planned expenditures.</p>	<p>Transpower agrees in principle.</p>
<p>In summary, the capital expenditure approvals processes for RCP1 will work as follows:  a) proposed projects will be assessed using two broad methods: for Minor capital expenditure, a process-based approach will apply; Major capital expenditure projects will be subject to individual review;</p>	<p>Transpower agrees in principle but reiterates its view that this approach should be revised in RCP2 to adopt a capital expenditure approval regime aligned with that applied by the AER.</p>
<p>b) there will a separate Minor capital expenditure allowance provided for the Transition Year and a Minor capital expenditure allowance (based on commissioned expenditure) provided for the Remainder Period;</p>	<p>Transpower agrees in principle.</p>

<p>c) individual approval is required for Major Projects, and approved costs on Major Projects cannot be substituted or applied to other projects;</p>	<p>As noted above, under the Commission’s draft decisions, Transpower faces project cost recovery risk for which there is no compensation. While allowing substitution of cost “overs and unders” might mitigate this risk, it is not a satisfactory solution to the exposure Transpower would face if the draft decisions were confirmed. Transpower therefore agrees that approved costs for Major projects not be substituted, but on the basis that the regime will be changed in other ways to eliminate project costs risk. As proposed above, this is best achieved by allowing projects into the RAB at cost either at commissioning or, at a minimum, at the beginning of the following RCP.</p> <p>As also noted above, Transpower submits that Major projects should be classified as projects with capital expenditure in excess of \$20 million, consistent with paragraphs 87 and 88 of the May 2009 GPS (see the comment on “Overall Approach” above).</p>
<p>d) Major capital expenditure will be included in the calculation of each MAR (via an estimate of the return of and on capital from the date of commissioning) on an individual project basis;</p>	<p>Transpower agrees in principle for the purposes of RCP1. However, we note that major capital assets can be commissioned progressively. The proposed approach would be satisfactory if the Commission accepts that “commissioned” means the first date on which the new assets provide services to customers, even if this is not the full complement of services comprising the overall project.</p> <p>Transpower’s proposed approach is consistent with GAAP as is applied currently under the Administrative Settlement.</p>
<p>e) the Minor capital expenditure review process commences with Transpower submitting process and policy information for review, followed by, for the Remainder Period, its multi-year proposal of Minor capital expenditure works (on a commissioned basis). The Commission will then review Transpower’s proposed programme of work and set an allowance for the multi-year regulatory period which will be reflected in the allowed MAR (via an estimate of the return of and on capital from the date of commissioning of projects);</p>	<p>Transpower agrees in principle, but note the comments above.</p>
<p>f) wash-ups of actual capital expenditure against allowances will occur immediately prior to setting the MAR in 2011/12 and 2014/15, covering all but the final year, with the outcome reflected in revenues for the Remainder Period and RCP2 respectively. Actual capital expenditure in the final year of RCP1 (2014/15) will be incorporated in the first wash-up in RCP2 (2015/16);</p>	<p>Transpower submits that wash ups should be an annual process for RCP1.</p>

	g) the wash-ups will take into account any additional expenditure approved by the Commission during the RCP;	Transpower submits that there should be annual wash ups that account for new Major capital expenditure approved and commissioned during the RCP and which permit a return on and of such capital expenditure to be recovered by way of transmission prices in the year following commissioning. (See the discussion under “Overall Approach” above for the reasons for this preference.)
	h) only projects forecast to be commissioned during a given RCP may be included in capital proposals for that RCP;	Transpower agrees with respect to the capital proposals made prior to the RCP (i.e. that the proposals must relate to projects forecast to be commissioned during the RCP). However, as noted above, Transpower submits that a return of and on additional major capital expenditure approved and commissioned during the RCP also be permitted to commence during the RCP.
	i) only approved and commissioned capital projects may be added to the RAB; and	Transpower agrees, but notes the need to clarify how the term “commissioned” will be interpreted and applied, given that major projects can be commissioned progressively (refer earlier comments).
	j) projects that have already been approved at the time any capital expenditure input methodology is determined (by 1 October 2011) will not be affected i.e. they will be allowed to enter the forecast MAR if forecast to be commissioned during the RCP and will not be subject to the new Capital expenditure input methodology. Unapproved projects, however, will be subject to any new processes set out in that input methodology.	Refer to earlier comments.
<b>Capital Expenditure Classification: Major &amp; Minor</b>	The Commission's draft decision is that for both the Transition Year and the Remainder Period, any capital expenditure that does not fit into the category of Minor capital is to be classified as Major capital.	Transpower agrees, but note the argument set out under “Overall Approach” above for the category “Minor capital” to include all enhancement projects with a value of less than \$20 million.
	The following expenditure is to be classified as Minor capital expenditure: a) asset replacement;	Transpower agrees.
	b) asset refurbishment;	Transpower agrees.
	c) during the Transition Year, enhancement projects less than \$1.5 million or enhancement programmes with a value of less than \$5.0 million;	Transpower disagrees. We submit that all enhancement projects with a value of less than \$20 million should be classified as Minor capital from the beginning of the Transition Year, for the reasons set out above in the comment on “Overall Approach”.
	d) during the Remainder Period, enhancement projects less than \$5.0 million or enhancement programmes with a value of less than \$5.0 million;	Transpower disagrees. We submit that all enhancement projects with a value of less than \$20 million should be classified as Minor capital, for the reasons set out above in the comment on “Overall Approach”.

<p>e) information and system technology (IST); and</p>	<p>Transpower agrees.</p>
<p>f) Business Support capital expenditure;</p>	<p>Transpower agrees, but notes that it should be made clear that this category includes all Minor capital expenditure not elsewhere specified.</p>
<p>These expenditure types are defined below.</p> <p><u>Asset Replacement</u> Asset replacement means capital expenditure which will be commissioned during the regulatory period due to the condition or performance of an asset but where replacement of the asset/works does not materially improve the original service potential (beyond that attributable to using the modern equivalent assets).</p> <p><u>Asset Refurbishment</u> Asset refurbishment means capital expenditure which will be commissioned during the regulatory period on an asset, or sub-component of an asset, and that materially extends its original economic life but does not improve its original service potential (e.g. tower painting).</p> <p><u>Minor Enhancements</u> Asset enhancement projects with an expected value of less than \$1.5 million (or programmes with a value of less than \$5.0 million) for the Transition Year, and any project or programme less than \$5.0 million in the Remainder Period, that will be commissioned during the regulatory period, and involve either work on existing assets or investment in new assets, in order to:</p> <ul style="list-style-type: none"> <li>• bring the performance of the asset up to the appropriate standard where asset performance is below a modern standard of service and/or industry good practice; or</li> <li>• in general, increase capacity, reliability, or quality of supply, consistent with customer needs.</li> </ul>	<p>Transpower submits that all enhancement projects with a value of less than \$20 million should be classified as Minor capital expenditure, for the reasons set out above in the comment on “Overall Approach”.</p> <p>We also submit that an additional Minor capital expenditure category “Transmission Corridor, land and easements” should be created.</p> <p>The 2009 GPS states that: “The [Electricity] Commission should encourage Transpower to identify and secure appropriate interests in land, designations and resource consents required for transmission corridors well in advance of urgent needs. Transpower should be able to recover the reasonable net costs of doing this work”.</p> <p>The input methodologies paper has indicated that Transpower should be able to include capital expenditure relating to ‘transmission corridor investments’ and ‘land and easement investments’, in its RAB before an active line uses them, provided their purchase has been approved by the Electricity Commission or the Commission on a cost benefit basis.</p> <p>Examples of transmission corridor investments (not linked to a particular project) are:</p> <ol style="list-style-type: none"> <li>(a) the purchase of land or easement to mitigate the risks of further development under Transpower’s lines, without which its future ability to undertake maintenance and upgrade works would be impeded or even prohibited;</li> <li>(b) acquiring land adjacent to an existing substation that is likely to be required in future (e.g. for expansion, entry of a new line) but which might otherwise be sold for alternative use, preventing the future development of the site.</li> </ol> <p>Often such property purchases need to happen quickly and opportunistically and requiring prior regulator approval would hinder efficient purchases that would be in the long term interests of consumers.</p> <p>Therefore, we submit that an explicit provision be made in the Minor capital expenditure category for a land asset classification e.g. “<i>Transmission corridor, land and easements</i>”. This would enable Transpower to include in the MAR an allowance for the forecast annual cost of obtaining property rights. A property rights strategy (covering the economic rationale and test, identifying locations, describing the purchase process and estimating the annual cost) would support this forecast,</p>

		<p>consistent with the evidence required to support other Minor capital expenditure.</p>
	<p>If, during the regulatory period, Minor enhancement projects receive scope or cost variations from that forecasted, Transpower will not be permitted to seek approval for additional funding. The Commission’s expectation is that Transpower will manage within its overall Minor Capital expenditure allowance.</p>	<p>Transpower agrees, with the proviso that price-quality paths may be re-opened should one or more of the following occur: a materialevent, a material error, false or misleading information has been provided to the Commission, a change to a regulatory or legislative requirement that has a material impact on costs. (These exceptions are covered by the input methodologies and Transpower has commented on them separately.)</p> <p>We further understand that ex-post approval for Minor capital expenditure may be provided in circumstances, where Transpower can demonstrate that it was unable to foresee it and that it was essential to maintain the security of supply of the national grid and could not be deferred.</p> <p>Transpower also submits that, if expenditure has been incurred because projects have been commissioned ahead of their planned completion dates, such costs should be recoverable by way of ex post review. Not to permit this would incentivise unnecessary project delays that would be contrary to the interests of consumers.</p>
	<p><u>Information System and Technology (IST)</u>                  IST capital expenditure relates to expenditure which will be commissioned during the regulatory period, relating to the upgrade or replacement of IST infrastructure where this is used in operating or supporting the operation of the grid, including:</p> <ul style="list-style-type: none"> <li>• telecommunications network;</li> <li>• SCADA EMS (including devices which provide data to SCADA); and</li> <li>• network systems.</li> </ul> <p>IST capital expenditure also includes capitalised TNP operating leases.</p>	<p>Transpower agrees, with the proviso that while SCADA is a grid asset, the SCADA EMS software system is a System Operator asset, and charged for accordingly.</p> <p>It should also be clarified that IST capital expenditure includes not just capitalised TNP operating leases but also associated connection fees.</p>
	<p><u>Business Support capital expenditure</u>                  Business Support capital expenditure means non grid-related capital expenditure that will be commissioned during the regulatory period, and is required for the efficient operation of transmission grid services. This may include expenditure such as on office furniture, computer hardware and software, and other such non-grid capital expenditure.</p>	<p>Transpower agrees, but submits that it should be made clear that this category includes all Minor capital expenditure not specified elsewhere.</p>

<b>Aggregation of Minor Projects</b>	The Commission's draft decision is that it will allow Transpower to combine minor works into programmes of work, for the purpose of seeking regulatory approval of Minor capital expenditure.	Transpower agrees.
	Once a programme has been approved by the Commission it will be treated as a single project under the Minor capital expenditure approval process. Programmes of work will be subject to sampling and review by the Commission in the same way as other projects in the Minor capital expenditure category.	Transpower agrees.
	Aggregated programmes will not be subject to a maximum value, except for that specified for enhancement projects (\$5 million), and can be freely substituted with other projects in the Minor capital expenditure category.	Transpower agrees, but note Transpower's submission that enhancement projects with a value of less than \$20 million should be classified as Minor.
<b>Transition Year Minor Capital Expenditure Allowance</b>	Transpower's Transition Year Minor capital expenditure allowance will be set at \$225.6 million.	As noted above, Transpower submits that the Transition Year minor capital expenditure allowance should be set at \$235 million as previously proposed to the Commission.
<b>Remainder Period Minor Capital Expenditure Allowance</b>	Transpower will be required to submit a Minor capital expenditure proposal for the capital expenditure it intends to carry out during each year of the Remainder Period. The proposal must be based on expected commissioned expenditure and include:	Transpower agrees in principle.
	a) an amount for each year of the Remainder Period;	Transpower agrees.
	b) a director's certificate assuring the Commission that its proposed Minor capital expenditure is reasonable and achievable; and	Transpower disagrees. This proposed requirement is superfluous as Transpower's Board will have approved the Minor capital expenditure proposal prior to its submission, and would have exercised due care and diligence when taking such a decision.
	c) a report by an independent expert verifying that this is the case.	Transpower disagrees. The cost of complying with this requirement would be large and the exercise could be expected to take at least two months. Given that the best conclusion that an independent expert could reach would be that the proposed Minor capital expenditure was "not unreasonable" it is hard to see how this additional process could be justified. If the Commission decides to proceed with this proposal, Transpower submits that the additional costs imposed should be provided for in future operating expenditure allowances.

	<p>The Commission will review Transpower's proposal, and determine an allowance for Minor capital expenditure for each of the three years of the Remainder Period. This will be included in the calculation of Transpower's MAR (via the return on and of the commissioned capital).</p>	<p>Transpower agrees in principle. One matter of concern is how Minor capital expenditure in excess of an approved MAR will be treated, if that expenditure has been incurred because projects have been commissioned ahead of their planned completion dates. Transpower submits that such costs should be recoverable by way of ex post review. Not to do so would incentivise unnecessary project delays that would be contrary to the interests of consumers.</p>
	<p>The Commission's draft decision is that all future Minor capital expenditure is expected to have completed Transpower's internal approval processes. Any capital expenditure not complying with this requirement must be fully excluded from the RAB.</p>	<p>Transpower wishes to clarify its understanding that Minor capital expenditure is to have completed its internal approval processes prior to being commissioned and included in the RAB. Projects included in the Minor capital expenditure proposal submitted to the Commission prior to the start of the RCP will be at various stages of Transpower's approval processes. The aggregated amount of expenditure will be approved by Transpower's Board as suitable for inclusion in the Minor capital expenditure proposal.</p> <p>It is not reasonable or practicable for all the Minor capital expenditure contained in the Minor capital expenditure proposal submitted prior to the start of the RCP to have completed all of Transpower's internal approval processes. This would be inconsistent with the Commission's draft decision that Minor capital expenditure projects should be able to be amended and substituted for one another as part of the efficient management of Transpower's overall Minor capital expenditure programme. It would be wasteful of resources and contrary to the purpose statement in s.52A(1)(a) of the Commerce Act for the Commission to require all the Minor capital expenditure projects in Transpower's Minor capital expenditure proposal to have been through all of Transpower's internal approval processes prior to being submitted to the Commission, when a good proportion of these projects will necessarily not proceed in their original forms or be replaced by other more innovative and/or cost effective projects as part of the efficient management of the business.</p>
<p><b>Appendix A: Approach for reviewing proposed minor capital expenditure</b></p>	<p><b>A1 Draft Decision on Review Approach for Remainder Period</b></p> <p>A1.1 In reviewing Transpower's forecast of the capital expenditure for Minor projects that will be commissioned each year of the RCP, documentation and evidence supporting the proposed level will be required by the Commission. As the approach is based on Transpower's application of approved processes to ensure the proposal is an efficient use of capital, Transpower must provide details of the policies and processes in effect, and a description of changes to these over time.</p>	<p>Transpower notes this proposed requirement.</p>

	<p>A1.2 By close of business on 14 February 2011, Transpower must provide policy and process information to the Commission, including, but not limited to:</p> <p>a. all material changes to its asset management, business planning, and capital works policies or processes relating to Minor capital expenditure that have occurred since the Commission’s previous review;</p>	<p>Transpower’s submission will include policy and process information as specified.</p>
	<p>b. a schedule that shows, for Minor projects completed in the second half of the 2010 calendar year, a comparison of actual expenditure in that period versus budgeted expenditure. Reasons for variations are to be provided for all projects that have exceeded 10% of budgeted cost;</p>	<p>The timeframe specified is onerous, given the time of year, and the work that must be completed to have the total submission compiled, certified by Directors, and ready by 14 February 2011. Transpower proposes that at least three months should be allowed between any cut-off date for reporting purposes, and the submission due date.</p> <p>The purpose of seeking at least a three month interval between the reporting cut-off date and the submission due date is to allow sufficient time for the compilation, review and checking of the reports, assembly together with the main submission documents, review by management and certification by the Board of Directors. This timeframe also takes into account the effect of statutory holidays in December and January, and the expected availability of staff over the holiday period.</p> <p>There is a need to clarify the specification for this schedule, to ensure that the requirements achieve the intended purpose.</p> <p>There is also a need to clarify whether the intent is to measure the final completed project cost against the total budgeted cost submitted for that project during the regulatory process, or to measure the expenditure on a project during a specified period compared with the project budget amount for that period.</p> <p>In addition, for clarity, there is a need to define “completed” as either “commissioned”, or “financially complete”. For most projects, financial completion is not achieved until several months after commissioning.</p> <p>Finally, it is assumed that the intent of this section is to focus on projects where the cost has exceeded the budget by a margin of 10%, rather than the specification as drafted. (which refers to “projects that have exceeded 10% of budgeted cost”).</p>

<p>c. a schedule which sets out significant movements of Minor capital expenditure projects into and out of the capital works plan which (those which were forecast to be commissioned) occurred during the second half of the 2010 calendar year as well as a forecast of similar movements for the first half of the 2011 calendar year;</p>	<p>The timeframe specified is onerous, given the context outlined above. Transpower proposes that at least three months should be allowed between any cut-off date for reporting purposes and the submission due date.</p> <p>Transpower proposes an alternative specification of requirements:          “A schedule which sets out significant movements of Minor Capital expenditure projects scheduled for commissioning in the 2010-2011 financial year (when compared with the regulatory submission for that period), as at a reporting date of 30 October 2010”.</p>
<p>d. evidence that Transpower has actively pursued and made process improvements, and sought to ensure appropriate least-cost, efficient, interventions;</p>	<p>Transpower proposes that the words “least cost” should be replaced by “optimal”. Asset management decisions must frequently be made within a context of constraints, obligations, and factors that cannot be easily reduced to a test of option cost alone. Transpower refers to the document PAS55-2:2008 <i>Asset Management Guidelines for the Application of PAS55-1</i>, and in particular, section 4.3.3.2 <i>Optimisation of asset management strategy and plans</i>. This internationally accepted document on asset management provides a useful overview of the need for asset management plans to optimise costs, risks and performance, in the face of conflicting stakeholder expectations.</p> <p>“Optimal” is preferred over “least cost” to avoid the risk that requiring “least cost” to be used as a criterion in isolation will lead to decisions that do not provide the best overall value for stakeholders, given their willingness to pay for particular outcomes.</p>
<p>e. evidence that Transpower has actively pursued project cost management and cost reduction strategies, ensuring that both internal and external (contractors and suppliers) have incentives to perform well and identify cost savings; and</p>	<p>Transpower notes this proposed requirement.</p>
<p>f. any other information the Commission requests in writing.</p>	<p>Transpower notes this proposed provision but submits that the wording be qualified to provide that such requests must be “reasonable”.</p>
<p>A1.3 By close of business on 14 February 2011, Transpower must also provide its Minor capital expenditure proposal (based on a forecast of commissioned capital expenditure only) for the Remainder Period, supported by:</p> <p>a. evidence that the proposal has been prepared in full accordance with its approved capital works and business planning processes and policies;</p>	<p>Transpower notes this proposed requirement.</p>

	b. evidence that contingency sums are adjusted to zero for all IST and RRE;	Transpower disagrees with this proposed requirement and submits that there needs to be some recognition of the greater uncertainty attached to IST projects, due to the fact that these projects often involve new processes with little or no history to provide guidance, whether this recognition is by way of including contingencies in the cost estimates or via a clear process for approving justifiable cost overruns. Transpower notes that project cost outcomes for IST projects, in particular, are unlikely to be symmetrical or normally distributed, because, while there is a downside limit (i.e. zero) there is no upside limit. Transpower therefore submits that, for IST projects, a project contingency of 7.5% be permitted, consistent with the terms of the current administrative settlement contained in the Commerce Act (Transpower Thresholds) Notice 2008.
	c. project approval documentation for all projects requested in writing by the Commission. This request will be provided to Transpower at least two weeks prior to the due date above; and	Transpower notes this proposed requirement. The availability of project approval documentation will vary depending on the stage the projects selected by the Commission are at in their planning and approval processes at the time of the request.
	d. a final schedule of all projects making up the Minor project capital expenditure proposal, together with the project approval status, in final (non-draft) form; and	Transpower notes this proposed requirement and submits that the Commission should clarify what is meant by “final (non-draft) form”.
	e. any other information the Commission requests in writing.	Transpower notes this proposed provision and submits that the wording be qualified to provide that such requests must be “reasonable”.
	A1.4 The Commission will review (or engage an independent third party to review) Transpower’s Minor project capital expenditure proposal for the Remainder Period. The Commission will take into account the information provided by Transpower in response to the requests outlined above, and will pre-approve an amount of Minor Capital expenditure for the purpose of inclusion in the MAR for the regulatory period. The Commission will consult on its preliminary decision, and after taking into account all submissions on this matter, will make its final determination.	Transpower notes these proposed provisions.
<b>Major Capital Expenditure Projects</b>	Major projects will be subject to individual approval utilising an economic investment test. Until the capital expenditure input methodology is determined, the GIT set out under Part F of the Electricity Governance Rules (EGRs) will be used. Projects will be reviewed by the Electricity Commission prior to 1 October 2010, and by the Commerce Commission from that date	Transpower agrees with this for the purposes of RCP1.

	(subject to the Bill passing into law).	
	Projects approved prior to the relevant MAR determination will be included in the MAR. Projects not approved prior to the relevant MAR determination will be excluded from the MAR for the remainder of the RCP, but will be included in the next wash-up, if commissioned during the RCP (and commissioned prior to that wash-up).	Transpower disagrees. Transpower believes that projects approved and commissioned during the RCP, including uplifts of expenditure approved prior to the commissioning of a project should be able to have a return of and on their capital values included in the MAR and recovered via the prices calculated for the pricing year following commissioning. For the rationale supporting this view, see the comment on “Overall Approach” above.
	Transpower must, at the time it provides to the Commission its operating and capital expenditure proposal, also provide to the Commission a list of any Major projects it considers should be recorded as contingent projects, that is, those projects whereby: <ul style="list-style-type: none"> <li>the costs of certain large investments are excluded from the MAR, where the need, timing, or cost of the project are uncertain;</li> </ul>	Transpower agrees. We understand that the purpose of this requirement is a “dry run” for the possible application of the Australian approach to contingent projects in RCP2. We note that there is a “mini MAR adjustment” when money is expended on contingent projects under the Australian regime.
	<ul style="list-style-type: none"> <li>the expenditure would only be recovered if the project proceeds.</li> </ul>	Transpower agrees.
	Major capital expenditure assets may only be included in the RAB if these receive ex-ante regulatory approval, once commissioned, and only at the lesser of approved or actual cost.	Transpower understands that the Commission intends that “ex ante regulatory approval” should include any projects that have been approved prior to the start of an RCP and then subsequently resubmitted to the Commission for further approval because of revised cost estimates, provided that further approval is granted and expenditure on the project has not already commenced.  With respect to how approved project amounts will be determined and recovered, please refer to the discussion under “Overall Approach” above.
	The Commission will not provide ex-post approval for any Major projects.	Transpower agrees, subject to the understanding of the meaning of “ex ante regulatory approval” noted above. Transpower submits that there should be a clear process for reviewing project approvals within the RCP to accommodate unanticipated cost changes (consistent with current Electricity Commission practice).
<b>Substitution of Approved Capital Expenditure</b>	For RCP1, Transpower will be provided the flexibility to: <ol style="list-style-type: none"> <li>fully substitute and reprioritise Minor capital expenditure within (i.e. between the subcategories of Minor enhancement, replacement and refurbishment and IST); and</li> </ol>	Transpower agrees. Transpower welcomes this draft decision and believes it is consistent with the requirement in s.52A(1)(a) of the Commerce Act that suppliers of regulated goods or services should “have incentives to innovate...”

	<p>b) fully substitute and reprioritise Minor capital expenditure within the Remainder Period, but not between the Transition Year and Remainder Period, nor between RCPs.</p>	<p>Transpower accepts that this may be a pragmatic if imperfect solution for RCP1 given its “hybrid” nature but notes that the principle of intra-RCP flexibility is important and requests that the Commission reconsider allowing for some substitution between the Transition Year and Remainder Period in its final decisions.</p>
	<p>In contrast, Transpower will not be able to substitute any capital expenditure approved for an individual Major project, to any other project.</p>	<p>As noted in the comment under “Overall Approach” above, under the draft decisions (and in the absence of a defined and streamlined “re-approval” process) Transpower would receive no compensation for the risk of project cost overruns. Allowing substitution of costs between Major projects would only partly mitigate this risk and is not Transpower’s preferred solution. Therefore, Transpower agrees with no substitution on the basis that other more effective mechanisms should be provided either to remove this risk or compensate Transpower fully for it. Above, we propose that one possible solution would be an ex post adjustment – to incorporate all projects’ costs into the MAR at actual cost from the beginning of the following RCP. This would be consistent with Australian practice.</p>
	<p>The approach to substitution for RCP2 onwards will be determined as part of the Commission’s capital expenditure input methodology by October 2011, if the Bill is enacted.</p>	<p>Transpower agrees.</p>
<p><b>Ex-post approvals for major and minor Capital Expenditure</b></p>	<p>Transpower should manage its level of Minor capital expenditure within the allowance determined by the Commission. The amount of any ex-post approval of Minor capital expenditure must not be included in any wash-up, but will be entered into Transpower’s RAB.</p>	<p>Transpower agrees.</p>
	<p>Accordingly, ex-post approval for Minor capital expenditure will only be provided in exceptional circumstances, where Transpower can demonstrate that it was unable to foresee it and that it is essential to maintain the security of supply of the national grid and cannot be deferred. This will apply from, and to RCP1.</p>	<p>Transpower agrees.</p>
	<p>The Commission does not intend to provide ex-post approval for Major capital expenditure. Any Major capital expenditure that does not receive ex-ante approval must not be included in any wash-up, and must not be entered into Transpower’s RAB.</p>	<p>Transpower agrees, subject to the understanding of the meaning of “ex ante regulatory approval” noted above. Transpower submits that there should be a clear process for reviewing project approvals to accommodate unanticipated cost changes (consistent with current Electricity Commission practice and paragraph 85 of the 2009 Government Policy Statement) and that Major capital expenditure should be permitted to enter the RAB at actual cost in the RCP subsequent to commissioning..</p>

<p><b>Foreign Exchange Hedging</b></p>	<p>Additional issue.</p>	<p>Transpower submits that an additional issue not canvassed by the discussion documents is the need for there to be appropriate incentives on Transpower to undertake hedging of foreign exchange and commodity price risks efficiently and in the best interests of consumers. Currently, it is far from clear whether or not the present or proposed capital approval regimes provide the right incentives.</p> <p>When the Commission approves project capital expenditure in New Zealand dollars, the decision should clearly set out assumptions made for foreign exchange rates and commodity prices, with the understanding that the final approved amount may be adjusted to reflect any material movements in these costs. This is particularly important for individual project approvals where there is little no scope to substitute or re-prioritise work or to offset cost variations against variations in the costs of other projects.</p> <p>In practice, for reasons of both efficiency and accounting, foreign exchange and commodity price risks will typically not be hedged at the time of project approval but only subsequently when contracts are let. The project value established in accordance with International Financial Reporting Standards will depend on whether or not any foreign exchange hedging undertaken meets the effectiveness test necessary to qualify for hedge accounting.</p> <p>If a foreign exchange hedge contract can be hedge accounted, the project value will include the “mark to market value” of the hedge contract. If not, the project value will reflect the spot exchange rate on the day that the good or service is received. In the former case, the commercial impact of the foreign exchange hedge contract is represented by the single accounting entry (i.e. the capitalised value of the project on the balance sheet calculated using the hedged foreign exchange rate). In the latter case, the commercial impact of the foreign exchange contract is represented by two accounting entries, i.e. the capitalised value of the project on the balance sheet calculated using the spot foreign exchange rate and an entry in the profit and loss account reflecting the difference (gain or loss) in project value due to the difference between the spot foreign exchange rate and the hedged rate.</p> <p>Unless the test for hedge accounting is met, the commercial costs of a project will be represented by two separate accounting entries: the project capital value calculated at the spot exchange rate and a profit and loss statement adjustment for the cost difference due to the variance between the spot and hedged exchange rates.</p> <p>At present, gains or losses on hedge contracts are borne by Transpower’s shareholder when hedge accounting is not able to be used. This is inappropriate, as it amounts to speculation on changes to foreign exchange rates, when the reason the hedge contracts are entered into is to minimise the variability of project costs due to foreign exchange rate movements. We propose that in such instances the hedge gain</p>
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		<p>or loss should be credited or debited to the customer account, through the wash-up process, as this is a legitimate component of the underlying economics of the transaction and a true cost of the project. The maximum approved amount for a project in such a situation should be compared to the total project cost +/- any hedged amounts not already included in the project. Contracts that qualify for hedge accounting (matched hedging) result in the underlying forward rate being charged to the project and so in these cases this issue does not arise.</p>
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<b>Draft Decisions for Quality Standards (Chapter 6)</b>		
<b>Topic</b>	<b>Draft Decision</b>	<b>Transpower comment</b>
<b>Revenue at Risk</b>	<p>The Commission's draft decision is that:</p> <ul style="list-style-type: none"> <li>the quality performance regime should be symmetrical, i.e. it should allow for both penalties and rewards as a result of performance below or above a set target (additional revenue over-and-above maximum allowable revenue);</li> </ul>	<p>Transpower agrees with the Commission's draft decision as an initial starting point, but we note that, as performance improves over time, it may no longer be appropriate for the rewards and penalties to be symmetrical around the target. This is because, as performance improves, performance measures would drop to a low value and the opportunities to improve further would be limited, but the risk of a low probability/high impact event that would lead to a value below the collar would remain essentially unchanged, i.e. the risks would become less symmetrical as performance improves. In this situation, it would be appropriate for the cap to be much closer to the target than the collar.</p>
	<ul style="list-style-type: none"> <li>penalties and rewards relating to quality performance should be based on a sliding scale, with the percentage of revenue that can be gained or lost set prior to the regulatory period;</li> </ul>	<p>Transpower agrees.</p>
	<ul style="list-style-type: none"> <li>for the first regulatory period, performance will be assessed and reported against a specified set of measures and levels, but the revenue at risk/reward will be set at 0%; and</li> </ul>	<p>Transpower agrees.</p>
	<ul style="list-style-type: none"> <li>for subsequent regulatory periods, the percentage of revenue at risk/reward will be set by the Commission prior to the start of Transpower's first pricing year of each regulatory period.</li> </ul>	<p>Transpower agrees.</p>
<b>Setting targets, caps and collars</b>	<p>The Commission's draft decisions are that:</p> <p>a) targets, caps and collars for each of the measures for the first regulatory period will be determined using historical performance data for the period 2004/05 to 2008/09, unless the data for the five years is skewed by a single event or year in which case the Commission will consider using a longer historic period of up to seven years;</p>	<p>Transpower agrees that the period 2004/05 to 2008/09 should be used to set the parameters, at least for the Transition Year (2011/12). We understand that Transpower may re-submit revised targets, caps and collars for each of the measures for the Remainder Period.</p> <p>However, we consider that setting a limit on the values included in the calculation of the targets, caps and collars would be more a more effective way of treating outlier events than extending the period used to set the parameters. The reasons supporting this view are set out in detail in the section responding to the Commission's "Quality Measures (Availability)" draft decisions below.</p>

	b) the starting point for setting targets will be average performance over that period, with caps and collars set at two standard deviations either side of the target, unless two standard deviations results in unrealistic numbers, such as greater than 100% or less than zero. In this case the cap and collar would be set at a lower value, for example, at one standard deviation. The Commission will also take into account any adjustments necessary to achieve desired future performance, or make allowances for activities on the grid;	Transpower agrees. As noted above, we understand that Transpower may re-submit revised targets, caps and collars for each of the measures for the Remainder Period.
	c) a sliding scale (slope) rewards or penalises performance relative to the target level for each measure, in proportion to the level of performance. Caps and collars reflect the performance levels beyond which further decreases (below the collar) or increases (above the cap) in performance result in no further penalty or reward;	Transpower agrees.
	d) targets, caps and collars will not be set for HVDC bi-pole availability for RCP1; however, Transpower will be required to disclose performance on this measure in its annual compliance statement;	Transpower agrees.
	e) dead-bands around target levels will not be used;	Transpower agrees.
	f) Transpower will provide forecasts of quality performance to the Commission, as well Transpower's views on what reasonable targets, caps and collars applicable to each of the quality measures prior to the start of the regulatory control period may be, supported by sufficient information and evidence, including, and in conjunction with, its proposed operating and capital expenditure forecasts; and	Transpower's interpretation of this draft decision is that Transpower will propose targets, caps and collars to apply to each of the quality measures, supported by sufficient evidence.
	g) the Commission will determine and set the targets, caps and collars for each RCP prior to the start of the first pricing year of each regulatory period.	Transpower agrees.
<b>Weightings</b>	Weightings set the relative impact of each quality measure on the revenue at risk. The Commission's draft decision is that: a) weighting factors will be applied to each of the quality measures to calculate the revenue reward or penalty for each year of the regulatory control period;	Transpower agrees with the Commission's draft proposals on the relative weightings of measures but notes that, for the transition year, all measures have been weighted equally.

	b) a higher weighting should be placed upon loss of supply measures relative to outage measures;	Transpower agrees, but notes that, for the transition year, all measures have been weighted equally.
	c) a higher weighting should be placed on HVAC availability relative to HVDC (in proportion to the value of the asset base);	Transpower agrees, but notes that, for the transition year, all measures have been weighted equally.
	d) Transpower will propose the weighting to be applied to each of the quality measures. The Commission will assess Transpower's proposal and determine and set the weightings it considers appropriate for the control period; and	Transpower agrees, but notes that, for the transition year, all measures have been weighted equally.
	e) When setting the weightings for each quality measure the factors the Commission takes into account will include (but will not be limited to: <ul style="list-style-type: none"> <li>i) the extent to which each quality measure provides an incentive to improve performance most valued by consumers;</li> <li>ii) the availability of accurate and reliable data for determining values for each quality measure;</li> <li>iii) scope that Transpower has to improve its performance, as measured by each of the quality measures; and</li> <li>iv) the extent to which the quality measures overlap.</li> </ul>	Transpower agrees, but notes that, for the transition year, all measures have been weighted equally.
	Transpower agreed that the consumer impact measures such as loss of supply event frequency should be more heavily weighted.	Transpower agrees, but notes that, for the transition year, all measures have been weighted equally.
<b>Quality Measures (Total Duration of Interruptions)</b>	Total duration of interruptions (both planned and unplanned) will be included in the performance incentive regime. The definition of the total duration of interruptions measure is the same as that used in the Transpower administrative settlement and is set out in Appendix B to this Paper.	Transpower disagrees with the use of the total duration of interruptions measure and has expressed its concerns on a number of occasions previously. As a point of clarification, we note that, although expressed as system “minutes”, this measure is a normalised estimate of the impact of interruptions, not of duration. The unserved energy (or total impact) of interruptions is calculated as the annual sum of the estimated MW not supplied multiplied by the duration of the events. This summed MW-minutes of non-supply is then normalised by dividing by the system peak MW for the year, which results in a weighted interruption duration for the system as a whole expressed as “system minutes”, i.e. a system minute is the equivalent of shutting down the entire system for 1 minute at peak load. Transpower disagrees with the inclusion of this measure because: <ul style="list-style-type: none"> <li>• the figure will inevitably vary markedly from year to year because of changes in weather patterns and other events outside Transpower’s control,</li> </ul>

		<p>regardless of any actions that Transpower might take, i.e. it is not a satisfactory measure of the effectiveness of actions taken by Transpower to improve quality;</p> <ul style="list-style-type: none"> <li>• a single high impact / low probability event can markedly skew the outcome;</li> <li>• use of the system minutes measure has been discontinued in Australia, following a review by Sinclair Knight Merz (SKM) in 2002, which found that the measure was statistically unsound. Australia has since applied the loss of supply event frequency measure instead;</li> <li>• the measure is misleading and potentially counter-productive, because the same event occurring at 3a.m. rather than 3p.m., or in summer rather than winter, or in one part of the country rather than another may result in very different system minute totals, which may in turn provide a misleading picture of grid performance and the need for investment;</li> <li>• actions by transmission customers may contribute to system minute events and actions which could reduce such events may be within the control of transmission customers rather than Transpower.</li> </ul>
	<p>Transpower will also be required to separately report total duration of interruptions (planned and unplanned), duration of planned interruptions and duration of unplanned interruptions within the information disclosures requirements.</p>	<p>It is not clear from the text whether this requirement is intended to relate to duration of interruptions in minutes or impact of interruptions in system minutes. Currently, under the Electricity information Disclosure Requirements Transpower is required to report “Electricity customer interruptions in system minutes” (total, planned and unplanned).</p> <p>Transpower disagrees with the inclusion of planned interruptions in the total duration of interruptions measure, because:</p> <ul style="list-style-type: none"> <li>• planned outages resulting in interruptions are generally needed because of particular characteristics of grid design, such as supply via a single circuit or a single transformer, and are not therefore related to the performance of the grid per se;</li> <li>• the only way of avoiding such interruptions is to invest in duplicate assets;</li> <li>• the arguments in paragraphs 6.7.34 to 6.7.37 for the exclusion of planned outages from the availability measure apply equally to the exclusion of planned interruptions from the “total impact of interruptions” measure.</li> </ul> <p>With respect to the arguments made in paragraph 6.7.14:</p> <ul style="list-style-type: none"> <li>• first bullet point – for four out of the seven years under consideration, planned system minutes contributed between 30 to 60 per cent approximately of the total system minutes;</li> <li>• second bullet point – as it is expected that the impact of planned system</li> </ul>

		<p>minutes going forward will be similar to the historical impact there would seem to be no reason to include planned interruptions in the performance measure. If these measures are intended to incentivise Transpower to improve its performance, and it is recognised that planned interruption performance is not expected to change going forward, including planned interruptions is inappropriate. This is because it blunts the effectiveness of the incentive by inflating the target, cap and collar with a “base load” figure.</p> <ul style="list-style-type: none"> <li>• The statements in the bullet points in paragraph 6.7.14 do not explain why including planned interruptions in the measure will not create an incentive for Transpower to limit planned work. Transpower considers that such an incentive will exist if planned interruptions are included.</li> </ul>
<p><b>Quality Measures (Loss of supply event frequency)</b></p>	<p>The Commission's draft decision is that loss of supply event frequency will be included in the performance incentive regime. This will comprise two sub-measures:</p> <ul style="list-style-type: none"> <li>• number of interruptions over 0.05 system minutes; and</li> <li>• number of interruptions over 1.0 system minutes.</li> </ul> <p>This measure includes only events which result in actual loss of supply. The detailed definition of the loss of supply event frequency measures is set out in Appendix B to this Paper.</p>	<p>Transpower agrees. This is our preferred loss of supply performance measure. For consistency with past usage and clarity Transpower proposes that the wording in Section 6.7.19 be changed to “number of loss of supply events ...” rather than “number of interruptions...”.</p> <p>With respect to determining whether or not performance has actually improved, customers are generally most concerned about whether or not the frequency of events has changed, rather than the absolute size of large events. By contrast, the system minutes measure is not useful for establishing performance trends, because a single large event can effectively obliterate the pattern set by all other events.</p> <p>For clarity, Transpower notes that this measure does not include interruptions caused by a connected customer, and is based on all assets operated as part of the grid.</p> <p>Transpower has a more detailed methodology for defining supply interruptions than that set out in Appendix B. Transpower can make this more detailed information available on request.</p>

<p><b>Quality Measures (Availability)</b></p>	<p>The Commission's draft decision is that availability will be included in the performance incentive regime, in the form of two measures:</p> <p>a) HVAC circuit unavailability (unplanned) (%), being the percentage of a year that HVAC circuits are unavailable, on average, due to unplanned outages; and</p> <p>b) HVDC bi-pole availability (%), being the proportion of energy that could have been transmitted, except for limitations of capacity, due to unplanned outages.</p>	<p>Transpower is not opposed to the unplanned unavailability measure proposed by the Commission, but notes that unplanned unavailability is an inherently unstable measure because of the considerable variability that may occur from year to year and the impact that could result from a very small number of extended events.</p> <p>This view is supported by the fact that, in Appendix B, the outage durations in the data used to generate the proposed target, cap and collar were limited to a maximum of seven days in order to achieve realistic values for these measures.</p> <p>Transpower recommends that, with respect to reporting HVDC bi-pole availability due to unplanned outages only:</p> <ul style="list-style-type: none"> <li>• the measure be renamed HVDC bi-pole unavailability (unplanned);</li> <li>• any period in excess of seven days be excluded, in order to avoid very long duration outages skewing the results.</li> </ul> <p>This is consistent with the treatment of HVAC circuit unavailability (unplanned).</p> <p>Transpower also wishes to record that, for HVDC reporting, an outage is considered unplanned if there is less than seven days' notice, which is a different definition from that used for HVAC outages and for interruptions where "unplanned" is based on 24 hours' (one day's) notice only.</p> <p>With respect to paragraph 6.7.33, Transpower does not calculate an aggregate HVDC and HVAC availability measure, so the statement about aggregate availability measures being "split" is incorrect.</p> <p>Transpower notes that the arguments used in paragraphs 6.7.34 to 6.7.38 for the inclusion of unplanned outages are at odds with the arguments in the previous section for the inclusion of both planned and unplanned interruptions, and where Transpower proposed basing interruption measures on unplanned interruptions only.</p>
	<p>As a transition measure, HVDC bi-pole availability will be reported during the first regulatory period, but targets, caps and collars will not be set and the measure will be excluded from the incentive mechanism. The detailed definition of availability is set out in Appendix B to this Paper.</p>	<p>Transpower supports the exclusion of HVDC availability measures from the first regulatory period for the reasons set out in the Commission's draft paper and that HVDC availability, in some form, will be included in later regulatory periods.</p>
<p><b>Quality Measures</b></p>	<p>The Commission's draft decision is that an average (unplanned) outage duration measure will not be included in the performance</p>	<p>Transpower agrees with the Commission's draft decision that an average (unplanned) outage duration measure will not be included in the performance</p>

<p><b>(Average unplanned outage duration)</b></p>	<p>incentive regime.</p>	<p>incentive regime for the reasons stated.</p> <p>Transpower agrees that an average outage duration measure based on equipment outages may play a role in the performance incentive scheme in future control periods.</p> <p>Transpower does not consider that an Average “Interruption” Duration measure is suitable for a performance incentive scheme, as it suffers from the same problems as System Minutes of Interruptions.</p> <p>Transpower has concerns around clarity of terms and definitions and the intention of this measure based on earlier sections of the document.</p> <p>With respect to paragraph 6.7.53, Transpower’s comments at the Commission’s workshop were based on the Australian regulatory definitions where average outage duration is based on equipment outages<sup>19</sup>. The measure that Transpower proposes to report in future is Average Unplanned Outage Duration for circuits and transformers, not interruptions. However, most of the Commission’s comments seem to use Average Unplanned Outage Duration to refer to durations of interruptions<sup>20</sup>.</p> <p>Transpower therefore considers that the statements in Sections 6.7.54 and 6.7.57 are incorrect, as well as confusing, as they assume an unusual definition of Average Unplanned Outage Duration. Further, with respect to paragraph 6.7.57, the EGRs require Transpower to report unserved energy in MWmin (which is equivalent to system minutes but not identical) not durations of interruptions. The EGRs also require Transpower to report the number of interruptions, not the number of events.</p>
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<sup>19</sup> AER final determination, “Electricity transmission network service providers’ service target performance incentive scheme”, March 2008.

<sup>20</sup> One company (Electranet) uses a modified measure which is based on duration of interruptions to supply.

<p><b>Setting targets for first year of RCP1</b></p>	<p>The Commission's draft decisions on quality measure targets, caps, collars and weighting for the first year (2011/12) of the RCP1 are set out in Table 6.1.</p>	<p>Transpower agrees that the stated target cap and collar parameters for the Loss of Supply Event Frequency and Availability measures are as calculated based on Transpower's historical data.</p> <p>However, there is an issue with the Total System Minute figures set out in Table 6.1, as the target has been stated to two decimal places but the caps and collars have been rounded to one decimal place although stated to two decimal places. For consistency, the figures should be respectively:</p> <ul style="list-style-type: none"> <li>• To one decimal place 16.7, 4.3 and 29.1; or</li> <li>• To two decimal places 16.69, 4.31, 29.07.</li> </ul> <p>With respect to paragraphs 6.8.2(d) and 6.8.2(e), Transpower considers that, as a general rule, the five year historical period should be applied to all the measures as there are alternative methods of addressing the skewing of data caused by a small number of very long events.</p> <p>Transpower considers that the most robust method of dealing with small numbers of events that skew the outcome is to cap these at a pre-agreed level. For example, this approach has been used for HVAC circuit unavailability (unplanned) – refer to Appendix B. HVAC outages used for calculating targets, caps and collars are limited to a maximum of seven days' duration to avoid skewing data.</p> <p>Capping individual interruptions events at 10 system minutes, while basing the target etc on 5 years of historical data, would result in:</p> <table border="0" style="width: 100%;"> <tr> <td>Target – average of 5 years</td> <td style="text-align: right;">16.26 system minutes</td> </tr> <tr> <td>Cap – set at 2 standard deviations below target</td> <td style="text-align: right;">3.74 system minutes</td> </tr> <tr> <td>Collar – set at 2 standard deviations above target</td> <td style="text-align: right;">28.79 system minutes</td> </tr> </table> <p>Note also:</p> <ul style="list-style-type: none"> <li>• The resultant target is very close to the target set using 7 years of historical data;</li> <li>• Limiting/ capping the system minutes would:             <ul style="list-style-type: none"> <li>○ allow the same methodology to be applied to calculating the parameters for all the proposed measures; and</li> <li>○ be consistent with the approach used for other measures.</li> </ul> </li> </ul>	Target – average of 5 years	16.26 system minutes	Cap – set at 2 standard deviations below target	3.74 system minutes	Collar – set at 2 standard deviations above target	28.79 system minutes
Target – average of 5 years	16.26 system minutes							
Cap – set at 2 standard deviations below target	3.74 system minutes							
Collar – set at 2 standard deviations above target	28.79 system minutes							
<p><b>Electricity Commission's</b></p>	<p>Paragraphs 6.2.8 and 6.2.9. refer.</p>	<p>With respect to the Electricity Commission's unconditional service guarantee concept, Transpower refers the Commerce commission to its submission on the</p>						

<p><b>/ Authority's unconditional service guarantee concept</b></p>		<p>Electricity Commission's consultation paper <i>Transmission Pricing Review: High-Level Options</i>. Transpower has many concerns about this concept, in particular:</p> <ul style="list-style-type: none"> <li>• the inappropriate incentives created by “no fault” compensation being payable by Transpower, regardless of whether Transpower, a transmission customer or a third party was responsible for an outage;</li> <li>• the risk of multiple penalties for the same incident, under the Commerce Commission's performance incentive regime, the unconditional service guarantee, the Benchmark Agreement and the interconnection rules;</li> <li>• the moral hazard created by compensating any loss of consumption at \$20,000/MWh, when, at this level, some customers may value the compensation more highly than the lost supply;</li> <li>• the fact that the proposal cuts across some existing contractual provisions, viz.:             <ul style="list-style-type: none"> <li>○ Clause 20.2 of the Benchmark Agreement expressly limits Transpower's exposure to a customer's direct loss and clause 20.3 caps Transpower's total exposure;</li> <li>○ Similar provisions are found in the new investment contracts and the same concept (but different limits) are in the Comalco Agreements;</li> <li>○ These contracts also cap customers' liability to Transpower for contractual breaches. This balance of liabilities is also present in the penalty provisions of the Electricity Governance Regulations 2003. If the unconditional service guarantee proposal were to be implemented, this balance of liabilities would be upset.</li> </ul> </li> </ul> <p>Transpower would be happy to expand on these points if the Commission were to decide, at some future time to consider the unconditional service guarantee concept further.</p>
<p><b>Executive summary</b></p>	<p>Points of clarification.</p>	<p><b>X11 (i)</b></p> <p>Transpower reporting is based on all assets that are operated as part of the Transpower system, i.e. if Transpower:</p> <ul style="list-style-type: none"> <li>• owns an asset and operates it as part of the transmission system it is included;</li> <li>• owns an asset but leases it to another party it is excluded;</li> <li>• does not own an asset but leases it from another party and operates it as part of the transmission system it is included.</li> </ul>

		<p>Transpower’s intention is to continue to base performance reporting on all assets it is operating as part of its system, i.e. assets that may have been excluded from the regulatory asset base will still be included in performance reporting.</p> <p><b>X11 (j)</b></p> <ul style="list-style-type: none"> <li>• Transpower reporting of interruptions to supply and unplanned outages of assets includes events caused by the System Operator;</li> <li>• Transpower reports Total HVAC Availability and HVAC Availability excluding planned outages required by the System Operator to meet its Principle Performance Objectives.</li> </ul> <p>Both the above are in line with what Transpower currently reports under the Electricity Information Disclosure Regulations, Interconnection Rules and Transmission Agreements.</p> <p>Transpower considers it appropriate that reporting under the price-quality path should be aligned with existing reporting to reduce the potential for confusion with respect to what is publically reported and to reduce the potential for errors.</p>
<p><b>Appendix B Detailed definitions of measures</b></p>	<p>Points of clarification.</p>	<p><b>Sections B1 and B3</b></p> <p>For the avoidance of doubt, Transpower would like to clarify that:</p> <ul style="list-style-type: none"> <li>• The term “third party” events refers to events where an outside agency (such as a member of the public) impacts directly on Transpower’s grid and causes an outage.</li> <li>• Transpower does not include events caused by the correct trippings of Transpower equipment as the result of fault in a connected customer’s system.</li> </ul> <p>As noted in earlier comments, Transpower has concerns about confusion around terminology used in the price-quality path document. Therefore Transpower proposes that it provide the Commission with more detailed definitions of terminology, inclusions, exclusions and methods of calculation based on Transpower’s internal documentation.</p>