

Amendments to input methodologies for Transpower New Zealand Limited

Reasons paper

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1. Introduction

Purpose of paper

- 1.1 This paper provides our decisions and supporting reasons on amendments to the input methodologies (**IMs**) for Transpower New Zealand Limited (**Transpower**) contained in the:
 - 1.1.1 *Transpower Input Methodologies Determination 2010* (**Transpower IM determination**);¹ and
 - 1.1.2 *Transpower Capital Expenditure Input Methodology Determination 2012* (**Transpower Capex IM determination**).²
- 1.2 The IM amendments primarily relate to:
 - 1.2.1 changes to the Transpower IM determination and Transpower Capex IM determination relevant to the individual price-quality path (**IPP**) for Transpower's regulatory period commencing from 1 April 2020 (**RCP3**); and
 - 1.2.2 correcting certain errors.
- 1.3 We published notices of intention for these IM amendments in May 2019.³ We then proposed these amendments and sought stakeholder views in:
 - 1.3.1 our first IM amendments reasons paper "Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited – Reasons paper" – 29 May 2019;⁴ and

¹ Prior to the IM amendments outlined in this paper, the principal determination was most recently amended in 29 June 2017 by *Transpower Input Methodologies Amendments Determination 2017* [2017] NZCC 17. The most recent consolidation of the principal determination and all amendments was published by us on 10 June 2019.

² Prior to the IM amendments outlined in this paper, the principal determination was most recently amended in 25 May 2018 by *Transpower Capital Expenditure Input Methodology Amendments Determination* [2018] NZCC 8. A consolidation of the principal determination and all subsequent amendments was published by us on 1 June 2018.

³ Commerce Commission "Notice of intention: Proposal to consider amending input methodologies for electricity distribution services and Transpower New Zealand Limited" (16 May 2019), Commerce commission "Notice of intention: Proposal to consider amending input methodologies for Transpower New Zealand Limited" (29 May 2019).

⁴ Commerce Commission "Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited – Reasons paper" (29 May 2019).

- 1.3.2 our second IM amendments reasons paper “Proposed further amendments to Transpower IMs” – 18 July 2019.⁵
- 1.4 In reaching the decisions outlined in this paper, we have taken into account submissions and cross-submissions received from stakeholders in response to the draft decisions referred to in paragraphs 1.3.1 and 1.3.2.⁶
- 1.5 This Chapter sets out:
 - 1.5.1 the structure of this paper;
 - 1.5.2 the decision-making framework we have applied to reach our decisions;
 - 1.5.3 when the IM amendments are to take effect; and
 - 1.5.4 what materials have been released alongside this paper.

Structure of paper

- 1.6 Chapter 2 of this paper describes our changes to the Transpower IM determination.
- 1.7 Chapter 3 of this paper describes our changes to the Transpower Capex IM determination.
- 1.8 In Chapters 2 and 3 we set out:
 - 1.8.1 the previous IM requirements;
 - 1.8.2 the IM amendments and why we have made these changes; and
 - 1.8.3 how the IM amendments meet the decision-making framework.

Decision-making framework we have applied

Statutory compliance

- 1.9 The IM amendments described in this paper are in accordance with s 52X of the Commerce Act 1986 (**Act**).

⁵ Commerce Commission “Proposed further amendments to Transpower IMs” (18 July 2019).

⁶ These submissions and cross-submissions can be found here: <https://comcom.govt.nz/regulated-industries/input-methodologies/projects/amendments-necessary-to-implement-transpowers-2020-individual-price-quality-path-and-future-price-quality-paths>

- 1.10 In accordance with ss 52V(1) and 52X of the Act, we published a notice of intention relevant to the IM amendments set out in this paper on 16 May 2019.⁷

2016 IM Review decision-making framework

- 1.11 We are using a framework that we have developed over time to support our decision-making under Part 4. This has been consulted on and used as part of prior processes, and it helps provide consistency and transparency in our decisions.
- 1.12 Consistent with the decision-making framework adopted in our 2016 IM Review⁸ and in the 2018 Transpower Capex IM review, we have considered each IM amendment by asking whether it:
- 1.12.1 promotes the Part 4 purpose in s 52A of the Act more effectively than the current IM;
 - 1.12.2 promotes the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
 - 1.12.3 significantly reduces compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).⁹
- 1.13 We refer to the outcomes specified in paragraph 1.12 as the **‘IM amendments framework outcomes’** in this paper.

Effective dates for IM amendments

- 1.14 The IM amendments will come into force the day on which notice of the final amended Transpower IM determination and Transpower Capex IM determination is given in the New Zealand Gazette in accordance with s 52W of the Act.

⁷ Notice of Intention: Proposal to Consider Amending to Input Methodologies for Electricity Distribution Services and Transpower New Zealand Limited (16 May 2019). We also issued a Notice of Intention: Proposal to Consider Amending Input Methodologies for Transpower New Zealand Limited on 29 May 2019, but this notice is not relevant to the IM amendments set out in this paper.

⁸ Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016), paragraphs 66-67.

⁹ Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016), paragraph 59.

- 1.15 The IM amendments will apply:
- 1.15.1 under Transpower's information disclosure (**ID**) requirements, immediately upon the IM amendments coming into force; and
 - 1.15.2 for Transpower's IPP, from the next regulatory period commencing 1 April 2020.
- 1.16 In practical terms, we are setting Transpower's IPP determination in November 2019 for the next regulatory period from 1 April 2020 to 31 March 2025 (**RCP3**). Therefore, the amended IMs need to apply for RCP3.

Materials released alongside this paper

- 1.17 Alongside this paper, we have published:
- 1.17.1 Transpower Input Methodologies Amendments Determination 2019 (**Transpower IM amendments determination**);¹⁰ and
 - 1.17.2 Transpower Capital Expenditure Input Methodology Amendments Determination 2019 (**Transpower Capex IM amendments determination**).¹¹
- 1.18 On 29 August 2019 we will publish our revised draft IPP determination for RCP3, together with our final IPP RCP3 reasons paper setting out our decisions on key inputs regarding expenditure allowances and quality standards for RCP3. These decisions will apply the relevant IM amendments that are set out in this paper. We are seeking technical submissions on this revised draft IPP determination, which are due on 12 September 2019.
- 1.19 Today, we also published our draft decision on the treatment of operating lease payments, in which we proposed further amendments to the Transpower IM determination. Those amendments will be to take account of recent changes to the New Zealand Equivalent to International Financial Reporting Standard 16 Leases (**NZ IFRS 16**). Submissions on those proposed amendments are due by 18 September 2019.

¹⁰ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019).

¹¹ *Transpower Capital Expenditure Input Methodology Amendments Determination 2019* [2019] NZCC 11 (28 August 2019).

2. Amendments to the Transpower IM determination

Purpose of this chapter

- 2.1 This chapter describes our changes to the Transpower IM determination.
- 2.2 For each of these changes, we explain:
 - 2.2.1 the previous IM requirement (ie, before the IM amendment);
 - 2.2.2 our proposed IM amendment, as provided in our draft decisions;¹²
 - 2.2.3 submitters' views on our draft decision;
 - 2.2.4 our final decision; and
 - 2.2.5 how the amendment is likely to promote an IM amendments framework outcome.

Summary of IM amendments

- 2.3 We have amended the Transpower IM determination as follows:

Specification of prices

- 2.3.1 the introduction of a new recoverable cost for Fire Emergency New Zealand (**FENZ**) levy payable by Transpower;
- 2.3.2 the introduction of a new pass-through cost for Transpower for levies payable by all members of the Energy Complaints Scheme operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010; and
- 2.3.3 the introduction of a new provision to allow an economic value (**EV**) account balance to be carried forward from one regulatory period to the next, and for that carried forward balance to be applied in the setting of Transpower's maximum allowable revenue for that next regulatory period

Circumstances when IPP may be reconsidered

- 2.3.4 amendments to the circumstances in which an IPP may be reconsidered:
 - 2.3.4.1 each year within a regulatory period to recover/return incentive and wash-up amounts through 'forecast EV adjustments',¹³ and

¹² Our draft decisions are those noted at paragraph 1.3 of this paper.

¹³ In the revised draft Transpower IPP determination we have updated the term 'EV adjustment' to 'forecast EV adjustment' to reflect the fact that from RCP3 and in later regulatory periods, the EV adjustment

2.3.4.2 when Transpower seeks additional funding when projects arise in the Enhancement & Development (**E&D**) base capex¹⁴ portfolio that were either:

2.3.4.2.1 not reasonably foreseeable at the time of setting Transpower's IPP; or

2.3.4.2.2 foreseeable, but the costs and/or timing were uncertain at the time of setting Transpower's IPP.

Implementation changes

2.3.5 an amendment in respect of the definition of 'operating costs', specifically that court or statutory imposed fines or penalties cannot be treated as 'operating costs'; and

2.3.6 correcting implementation errors in the Incremental Rolling Incentive Scheme (**IRIS**) drafting applying to Transpower.

2.4 We expand on each of these IM amendments below.

New recoverable cost in respect of FENZ levies

Previous IM requirement

2.5 Previously, the FENZ levy paid by Transpower was borne within its opex allowance. The FENZ levy is used to fund Fire and Emergency New Zealand and applies to certain contracts of insurance.

Draft decision

2.6 The FENZ levy payable by Transpower is largely outside of its control since Transpower does not set the levy and the Minister of Internal Affairs has announced a review of the levy-based funding model.¹⁵ Therefore, for RCP3 and later regulatory periods, we proposed to include FENZ levy amounts as a recoverable cost, instead of including a forecast within Transpower's opex allowance.¹⁶ As the quantum of these

building block in the forecast MAR will include some forecasted amounts that will later be subject to a wash-up calculation based on actual values.

¹⁴ Base capex is defined in clause 1.1.5(2) of the *Transpower Capital Expenditure Methodology Determination* [2012] NZCC 2. In general terms it refers to capital expenditure projects carried out by Transpower that have a total expenditure of less than \$20 million.

¹⁵ Hon. Tracey Martin "Fire and Emergency New Zealand funding to be reviewed" (press release, 15 March 2019). See also the Cabinet paper "Fire and Emergency New Zealand: a funding review", redacted copy released proactively under the Official Information Act, and available at: [https://www.dia.govt.nz/vwluResources/Cab-paper-FENZ-funding-review-scope/\\$file/Cab-paper-FENZ-funding-review-scope_Redacted.pdf](https://www.dia.govt.nz/vwluResources/Cab-paper-FENZ-funding-review-scope/$file/Cab-paper-FENZ-funding-review-scope_Redacted.pdf)

¹⁶ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 3.1.3(1)(f).

levies is largely outside of the control of Transpower, we consider the nature of these costs is more akin to recoverable costs than operating costs.

Submitter's view

- 2.7 Transpower submitted that FENZ levies should be a pass-through cost, rather than a recoverable cost, in order to apply a consistent treatment of industry levies.¹⁷

Final decision

- 2.8 Our decision is to amend clause 3.1.3 of the Transpower IM determination to include the FENZ levy as a new recoverable cost.¹⁸ We consider that retaining the previous IM treatment of FENZ levies could result in consumers over-paying, or us setting an insufficient expenditure allowance for Transpower.

- 2.9 We consider that the nature of the FENZ levy is more akin to a recoverable cost than a pass-through cost. The FENZ levy is a levy on insurance contracts and not a levy directly on Transpower, so it does not meet the definition of a pass-through 'levy'.¹⁹ The main difference between pass-through and recoverable costs is that recoverable costs are not fully controllable by Transpower, but are not completely outside the control of Transpower, and there may be judgement involved as to how much should be passed through.²⁰ Practically speaking, there is little difference between our treatment of the categories, because the mechanism for recovering the pass-through and recoverable costs is the same.²¹

How the amendment is likely to promote an IM amendments framework outcome

- 2.10 Retaining the previous treatment of the FENZ levy could result in consumers over-paying their transmission charges (if the Government was to discontinue the levy-based funding model following its current review, or if the forecast liability was over-forecast), or could result in us setting an insufficient expenditure allowance for Transpower for RCP3 (if the actual liability was higher than forecast).
- 2.11 Defining all recoverable cost terms under the Transpower IM determination supports long-term certainty of the regulatory regime.

¹⁷ Transpower "Proposed amendments to input methodologies" (5 July 2019), at 1.

¹⁸ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.1.3(1)(f).

¹⁹ The definition for 'levy' was previously in clause 3.1.2(4) of the Transpower IM determination, however we have moved this definition to clause 1.1.4(2).

²⁰ Input Methodologies (Transpower) Reasons Paper (December 2010), paragraph 7.3.16

²¹ Input Methodologies (Transpower) Reasons Paper (December 2010), paragraph 7.3.15

New pass-through cost in respect of levies payable by members of the Energy Complaints Scheme operated by Utilities Disputes Limited

Previous IM requirement

- 2.12 Transpower is a member of the Energy Complaints Scheme, operated by Utilities Disputes Limited, which provides consumers with a free and independent dispute resolution service for electricity, and other complaints. The Energy Complaints Scheme is an approved scheme under Schedule 4 of the Electricity Industry Act 2010. Members pay an annual levy to fund the service. Under the previous IM requirement, this levy was not included in the Transpower IM determination. Forecast amounts for the levy formed part of Transpower's opex allowance.
- 2.13 This previous IM treatment differed from the treatment for Electricity Distribution Services contained in the *Electricity Distribution Services Input Methodologies Determination 2012 (EDB IM determination)*, where the levy is treated as pass-through costs.

Draft decision

- 2.14 Our draft decision was to amend clause 3.1.2 of the Transpower IM determination to include Energy Complaints Scheme levies charged to Transpower as a pass-through cost for Transpower.²²

Submitter's view

- 2.15 Transpower supported levies payable by members of the Energy Complaints Scheme becoming a pass-through cost.²³

Final decision

- 2.16 Our decision is to amend clause 3.1.2 of the Transpower IM determination to include levies payable under Schedule 4 of the Electricity Industry Act 2010 as a new pass-through cost.²⁴

How the amendment is likely to promote an IM amendments framework outcome

- 2.17 As the actual amount of levy paid is outside of Transpower's control, difference between the forecast and actual amounts of the levy being retained or borne by Transpower. The levy meets the criteria for a 'levy' that may be considered a pass-through cost in accordance with clause 3.1.2 of the Transpower IM determination. Treatment as a pass-through cost will remove the risk of consumers paying more than necessary, or Transpower's expenditure allowance being insufficient.

²² [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 3.1.2(2)(b).

²³ Transpower "Proposed amendments to input methodologies" (5 July 2019), at 1.

²⁴ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.1.2(2)(b).

- 2.18 This amendment will be consistent with the treatment of Energy Complaints Scheme levies under the EDB IM determination.

EV account balance to be carried forward between regulatory periods and smoothing of maximum allowable revenue

Previous IM requirement

- 2.19 Under the Transpower IPP for the regulatory period from 1 April 2015 to 31 March 2020 (**RCP2**), the Transpower EV account is a memorandum account maintained by Transpower on an after-tax basis to record each EV account entry not yet returned to or recovered from Transpower's customers through Transpower's allowable revenue.²⁵
- 2.20 An 'EV account entry' is to be defined in each IPP determination.²⁶ The EV account entries should include:
- 2.20.1 an ex-post economic gain and loss arising from annual price path wash-ups of building block revenue calculations (including the ex-post economic gain or loss for the final disclosure year of RCP2), as specified in the Transpower IPP determination applying to each regulatory period;
 - 2.20.2 an after-tax economic gain or loss arising from annual incentive calculations under the Transpower Capex IM determination;
 - 2.20.3 an after-tax economic gain or loss arising from a major capex sunk costs adjustment;
 - 2.20.4 an after-tax gain or loss on capital expenditure commitments; and
 - 2.20.5 an after-tax economic gain or loss in respect of an instrument that ceases to be an effective hedge, or on a commodity instrument that is not an effective hedge.
- 2.21 The EV account also records interest calculated on the rolling balance of the account for each disclosure year using the post-tax estimate of interest corresponding to the weighted average cost of capital (**WACC**) rate applicable to the regulatory period.
- 2.22 Because EV account entries are recorded in the EV account on an ex-post basis, there is a delay in Transpower being able to recover or return the amount to customers through its price-setting under the transmission pricing methodology (**TPM**).

²⁵ Transpower Individual Price-Quality Path Determination 2015, as amended and consolidated as at 28 February 2017, at [7] (definition of 'EV account').

²⁶ The revised draft Transpower IPP determination for RCP3 will set out the EV account entries for RCP3. *[REVISED DRAFT] Transpower Individual Price-Quality Path Determination 2020 [2019] NZCC [XX]*, to be published 29 August 2019.

- 2.23 In the Transpower IPP determination we will refer to the application of the EV account balance in the price path for a later year as a 'forecast EV adjustment'.
- 2.24 In the first two regulatory periods (RCP1 and RCP2), the price path was updated annually and the EV account balance was progressively cleared by EV adjustments.
- 2.25 We did not consider it necessary to also set out in the Transpower IM determination how the EV account recording and clearing process was to take place because:
 - 2.25.1 the RCP1 and RCP2 Transpower IPP determinations set out the process requirements within each regulatory period for the updating of the price path; and
 - 2.25.2 material combined rolling balances for multiple years of the regulatory periods were not being carried forward into a subsequent regulatory period.

Draft decision

- 2.26 Our draft decision was to amend the Transpower IM determination to explicitly allow an EV account balance to be carried forward from one regulatory period to the next, and for that carried forward balance to be applied in the setting of Transpower's maximum allowable revenue for that next regulatory period.
- 2.27 In our draft decisions on Transpower's IPP determination for RCP3, we proposed that EV account entries would not be cleared from the EV account through annual updating of the maximum allowable revenue in the RCP3 price path as soon as possible after the entries arise.²⁷
- 2.28 We proposed that wash-up gains and losses and of incentive amounts would continue to be calculated annually and would be entries into the EV account during the regulatory period, but the combined balance comprising these entries would be rolled forward from that regulatory period until we next reset the IPP. This would be in 2024 for the IPP commencing 1 April 2025. The EV account balance at that time would be applied in setting the next IPP.
- 2.29 The issue raised by this approach is that a balance comprising multiple entries in the EV account would be rolled forward for recovery from or returned to customers in the subsequent regulatory period, but an IM did not exist that specified how this balance would be rolled forward in subsequent regulatory periods.
- 2.30 We proposed an amendment to clause 3.1.1 of the specification of price IMs that sets out how the smoothed price path in RCP3 and later regulatory periods should be calculated, and we introduced definitions of 'forecast SMAR', 'forecast MAR', 'IPP

²⁷ Commerce Commission "Transpower's individual price-quality path from 1 April 2020: Draft decisions and reasons paper" (29 May 2019), at Table 3.1, [69] and Attachment J, [DRAFT] *Transpower Individual Price-Quality Path Determination 2020*, at 17.1.10, [27] and Schedule B.

revenue growth rate’ and ‘forecast EV adjustment’ to give effect to this proposed amendment.

- 2.31 To complete the updated regime within the Transpower IM determination, we also proposed to bring across from the Transpower IPP determination the definitions of ‘code’, ‘consumer’, ‘customer’, ‘electricity transmission services’, ‘grid’, and ‘TPM’.

Submitter’s view

- 2.32 Transpower supported our draft decision to explicitly allow an EV account balance to be carried forward from one regulatory period to the next, subject to revised drafting of the formula in the definition of ‘forecast EV adjustment’ to ensure the closing post-tax EV account balance is cleared over the following regulatory period.²⁸

Final decision

- 2.33 Our decision is to introduce IM amendments that explicitly allow an EV account balance to be carried forward from one regulatory period to the next.
- 2.34 In RCP3 and future regulatory periods we will set Transpower’s building blocks-based forecast MAR values and smooth those values into forecast SMAR maximum allowable revenue values. We will allocate the resulting annual revenue between pricing years to meet a constant rate of change over the next regulatory period (ie, the resulting annual revenue will be smoothed to give ‘forecast SMAR’ amounts).
- 2.35 Differences between the forecast MAR and the revenue Transpower actually earns for a disclosure year will then be washed up annually and included in the EV account.
- 2.36 To give effect to this decision in Transpower’s future regulatory periods, we will require in the revised draft Transpower IPP determination that Transpower will:
- 2.36.1 set Transpower’s annual revenue cap over the next regulatory period (ie, RCP_t) using a smoothed building blocks approach; and
 - 2.36.2 smooth Transpower’s annual revenue by:
 - 2.36.2.1 forecasting costs, including pass-through costs, and recoverable costs for the next regulatory period (RCP_t), and the closing EV account balance for the current regulatory period (ie, RCP_{t-1}), and building these into the calculation of the ‘forecast MAR’;
 - 2.36.2.2 smoothing the resulting forecast MAR numbers over the next regulatory period (RCP_t) to produce annual forecast smoothed

²⁸ Transpower “Proposed further amendments to input methodologies for Transpower” (1 August 2019), at 1.

maximum allowable revenue amounts (ie, the ‘forecast SMAR’) for the next regulatory period (RCP_t); and

- 2.36.2.3 wash-up any variation between the forecast MAR and the actual revenue, and any incentive amounts, into the EV account and accumulating this over the next regulatory period (RCP_t), with the balance in the EV account to be spread over the subsequent regulatory period (ie, RCP_{t+1}).
- 2.37 Consistent with our proposed approach of carrying EV account balances to a later regulatory period, the balance in Transpower’s EV account at the end of the current regulatory period will be included in the forecast SMAR calculations for the next regulatory period which will spread it over that period, via an estimate of the closing EV account balance for the current regulatory period (ie, RCP_2). The difference will be washed up and rolled forward within the EV account for later recovery or return.
- 2.38 We agree with Transpower’s proposed revised formula in the definition of ‘forecast EV adjustment’, and we have incorporated this change into our IM amendments.

How the amendments are likely to promote the IM amendments framework outcomes

- 2.39 We consider that explicitly allowing an EV account balance to be carried forward from one regulatory period (RCP_{t-1}), to the next (RCP_t), and for that carried forward balance to be applied in the setting of Transpower’s maximum allowable revenue promotes the Part 4 purpose in s 52A of the Act more effectively than the current Transpower IM determination, and is consistent with s 52R of the Act.
- 2.40 In particular, the IM amendments aim for Transpower to share with consumers the benefits of efficiency gains in the supply of electricity transmission services, including through lower prices over regulatory periods.²⁹
- 2.41 As we expect some variation between the revenue Transpower forecasts and the revenue it actually earns, as part of our draft RCP3 IPP determination the difference will be required to be calculated annually and will then be included in the EV account. Other amounts, such as incentive amounts that have not yet been recovered from, or returned to, Transpower’s customers will also be included within the EV account.³⁰
- 2.42 In the current regulatory period (ie, RCP_2), the forecast MAR was updated annually for these revenue wash-up and incentive amounts, and the EV account balance was carried forward (being adjusted at the WACC rate) until the next available pricing

²⁹ Section 52A(1)(c) of the Act.

³⁰ EV account entries that are relevant for RCP3 and future regulatory periods will include those listed at paragraph 2.6 above.

year. For future regulatory periods, we have determined to apply the different approach.

- 2.43 The building blocks approach to setting Transpower's forecast MAR can produce volatility from year to year, and when transitioning between regulatory periods. This volatility is reflected in the prices Transpower charges its customers.
- 2.44 Volatility in annual prices can potentially lead to increased difficulty of budgeting for transmission lines charges. Transpower's customers have supported price path smoothing to avoid a large, temporary, change in revenue.³¹
- 2.45 Also, consistent with the approach of setting an ex-ante expectation of earning the WACC rate, and of providing incentives for meeting quality measures (and penalties for failure to do so), Transpower should be able to recover wash-up and incentive amounts (or required to repay, where it has over-recovered or incurred penalties). However, annual recovery of these amounts would reintroduce volatility to a smoothed price path.
- 2.46 It is therefore appropriate that recovery (or repayment) of wash-up and incentive amounts be deferred until the regulatory period after ' RCP_t ' (ie, in RCP_{t+1}) when the net balance will be recovered. Wash-up and incentive amounts will be calculated annually during the next regulatory period (ie, RCP_t) and will accumulate within Transpower's EV account for later recovery from, or return to, customers in that subsequent regulatory period (ie, RCP_{t+1}).³²
- 2.47 We have introduced a new price path reopener provision in the Transpower IM determination. This enables Transpower's IPP to be reopened in the event that any unexpected material build-up in the balance of the EV account during a regulatory period. This is described in the next section of this paper.
- 2.48 As the next price path (RCP3) will be set on or before 30 November 2019, this means it will be set before the actual closing balance of the EV account at the end of the final RCP2 disclosure year (on 30 June 2020) is known to Transpower or us.³³ Under our proposed approach of applying a forecast balance in the setting of the forecast

³¹ Commerce Commission "Transpower's individual price-quality path from 1 April 2020: Draft decisions and reasons paper" (29 May 2019), at Attachment J.

³² As part of our revised draft Transpower IPP determination for RCP3, the annual value of the EV account will be disclosed so that interested persons can form a view on the likely impact of this EV account accumulation effect on RCP4 revenues. This will be supplemented by an independent assurance requirement by an auditor to provide interested persons with assurance on those calculations.

³³ As a practical matter, when applying s 53M(7) and s 53ZC(2)(a) of the Act, in order for the next IPP to apply from 1 April 2020, the next IPP must be reset at least four months before the end of the current IPP regulatory period on 31 March 2020 (ie, it must be reset on or before 30 November 2019).

SMAR, Transpower will need to estimate the closing balance for the current regulatory period so we can set the price path for RCP3. Any difference between this forecast and the actual balance will be washed up and rolled forward to the next reset (eg, RCP4) in the EV account.

No annual reconsideration of the ‘forecast MAR’ to include an ‘EV adjustment’

Previous IM requirement

2.49 Previously, we would reconsider an IPP in each disclosure year of a regulatory period (other than the last disclosure year) to take account of the effect of the following things on the forecast maximum allowable revenue (**forecast MAR**):³⁴

2.49.1 the revenue impact of ‘major capex’ approved by us;

2.49.2 the revenue impact of ‘base capex’ approved by us for a ‘listed project’; and

2.49.3 an ‘EV adjustment’.³⁵

2.50 However, the building blocks approach we used to update Transpower’s forecast MAR could produce revenue volatility for Transpower from year to year, and when transitioning between regulatory periods. This volatility was generally reflected in the prices Transpower charged its customers. The effect was potentially amplified by the reopening of the price path during the regulatory period for these three reconsideration factors.

2.51 Volatility in revenues (and therefore prices to customers and end-use consumers) can potentially lead to increased difficulty of budgeting for transmission lines charges. Transpower’s customers have supported ‘smoothing’ of annual revenues across the regulatory period to avoid a large, temporary, change in revenue.³⁶

Draft decision

2.52 Our draft decision was that smoothing annual revenues was appropriate. However, in contrast to smoothing within a regulatory period, we considered there would be significant difficulties with attempting to partially close the step changes when

³⁴ *Transpower Input Methodologies Determination 2010* [2012] NZCC 17, as amended and consolidated as at 10 June 2019, at 3.7.4(4).

³⁵ In the revised draft Transpower IPP determination to be published on 29 August 2019, we have updated the term ‘EV adjustment’ to ‘forecast EV adjustment’ to reflect the fact that from RCP3 (and subsequent regulatory periods) the EV adjustment building block in the forecast MAR will include forecasted amounts.

³⁶ For example, in the December 2017 update of the RCP2 forecast MAR, there would have been an initial large reduction in the forecast MAR, followed by a bounce back up in the forecast MAR for the following years. Transpower’s customers supported smoothing the forecast MAR for the remaining years.

transitioning between regulatory periods, due to the different underlying causes (in particular, the forecast change in WACC between resets of price paths).

- 2.53 In our draft decision, we proposed amending the Transpower IM determination to remove an 'EV adjustment' from the reconsideration provision to limit one cause of price path volatility.³⁷
- 2.54 Under the proposed revenue smoothing approach, the balance in the EV account at the end of a regulatory period would be smoothed across the allowable revenues for the next regulatory period (ie, up to five years) in circumstances where the accumulation of EV account entries during a regulatory period may result in a build-up in the balance of the 'EV account' to levels that would be likely to cause a price shock to Transpower's customers when we set Transpower's total forecast revenues for the next regulatory period.

Submitter's view

- 2.55 Transpower agreed with our proposal to amend the circumstances in which an IPP may be reconsidered each year within a regulatory period to recover incentives and wash-up amounts through 'forecast EV adjustments'.³⁸

Final decision

- 2.56 After taking account of Transpower's submission, our decision is to amend the Transpower IM determination to provide that Transpower's IPP may be reconsidered to take account of a large build-up in the EV account balance only in circumstances where:
- 2.56.1 a large build-up in the EV account is likely to occur:³⁹ A 'large build-up in the EV account' means a situation where the EV account balance as of the last day of a regulatory period would be, when divided by the number of years in that regulatory period, greater than 10% of the forecast smoothed maximum allowable revenue (ie 'forecast SMAR') for the final pricing year in that regulatory period;⁴⁰

³⁷ The reconsideration provision refers to clause 3.7.4(4) of the Transpower IM determination.

³⁸ Transpower "Proposed amendments to input methodologies" (5 July 2019), at 1.

³⁹ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.7.4.

⁴⁰ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.7.3A.

- 2.56.2 we consider (or Transpower applies and we are satisfied) that it is necessary for the price path to be reopened in order to take account of this likely large build-up in EV account balance;⁴¹
- 2.56.3 the forecast that a large build-up in EV account balance is likely to occur is made prior to the commencement of a pricing year in a regulatory period and the proposed amendment to the forecast SMAR is to be made in respect of the remaining complete pricing years of that regulatory period;⁴² and
- 2.56.4 if it is Transpower which applies for reconsideration of the IPP for this reason, that application:⁴³
- 2.56.4.1 relates to the remaining complete pricing years in the regulatory period; and
- 2.56.4.2 is made within 80 working days after 30 June following the first or second disclosure year in the regulatory period, or within 80 working days after 30 June of the third disclosure year of the regulatory period where the regulatory period is more than 4 years.
- 2.57 In these circumstances, the IPP may be reopened to spread some of the EV account balance over the remaining years of the regulatory period (ie, in RCP_t ⁴⁴) and the forecast number of years in the next regulatory period (ie, also in RCP_{t+1} ⁴⁵).⁴⁶ This spreading of the EV account balance over a greater number of years will result in revenue smoothing for Transpower and reduce the degree of price shock for consumers.

⁴¹ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.7.4(1)(v).

⁴² *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.7.4(5).

⁴³ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.7.4(5).

⁴⁴ See definition of 'forecast EV adjustment' in clause 1.1.4(2) of *Transpower Input Methodologies Amendments Determination 2019*. As per that definition, ' RCP_t ' refers to the regulatory period for which the forecast MAR has been calculated for the setting of the IPP price path.

⁴⁵ Above n 40. In accordance with that definition, ' RCP_{t+1} ' would refer to the subsequent regulatory period after the regulatory period for which the forecast MAR has been calculated, and which would be recalculated under the reopening of the price path. For the avoidance of doubt, ' RCP_{t+1} ' is not a term used in the *Transpower Input Methodologies Amendments Determination 2019*, and is used here only for illustrative purposes.

⁴⁶ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 3.7.3A, clause 3.7.4(1)(a)(v), clause 3.7.4(5), and clause 3.7.5(3).

How the amendment is likely to promote an IM amendments framework outcome

- 2.58 We consider that the policy change to defer the recovery of the balance in the EV account through annual EV adjustments to the smoothed maximum allowable revenue, if this can be done without causing a price shock for consumers in the next regulatory period, will promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose). This will give consumers greater certainty about how our rules (ie, in the IMs and IPP) will apply to forecast prices for transmission services to be provided by Transpower.
- 2.59 We consider that this change will result in more predictable transmission pricing for consumers from year to year, reduce compliance costs for Transpower, and reduce the effects of complexity for consumers (without detrimentally affecting the promotion of the s 52A purpose).

New reopener for E&D base capex

Previous requirement

- 2.60 Transpower is able to seek a reconsideration of an IPP within a regulatory period for a range of external factors that are reasonably outside of its control, such as catastrophic events, change events and error events.⁴⁷
- 2.61 In the 2017-18 Capex IM determination review,⁴⁸ we introduced a base capex allowance adjustment mechanism (**BCAM**) that was intended to account for the inherent uncertainty in the E&D base capex portfolio.
- 2.62 However, in its RCP3 IPP proposal Issues Paper submission, Transpower stated that it was unable to satisfy the requirements of the BCAM because it could not find any projects that the BCAM applied to. Transpower noted that:⁴⁹

We did not find it possible to identify E&D projects with sufficient certainty to a level of detail that would allow the base capex allowance adjustment mechanism to be used.

For near-term projects (2-3 years out), we have sufficient certainty on costs and the triggers have either already been met or we are confident they will be met. This removes the need for the base capex allowance adjustment mechanism.

⁴⁷ *Transpower Input Methodologies Determination 2010* [2012] NZCC 17, as amended and consolidated as at 10 June 2019, at clause 3.7.3 to 3.7.5.

⁴⁸ Commerce Commission “Transpower capex input methodology review - Decisions and reasons” (29 March 2018).

⁴⁹ Transpower “Transpower’s individual price-quality path for the next regulatory control period: issues paper” (28 February 2019), at 18-19.

- 2.63 We indicated in our draft decision for the IPP for RCP3 that the BCAM “likely needs amending to appropriately balance the risks to consumers and Transpower that the ultimately approved E&D amount is too high or too low”.⁵⁰ We noted that we intended to publish an amendment to the Capex IM determination with our proposed amendments to the BCAM.⁵¹

Draft decision

- 2.64 Our draft decision was to amend the Transpower IM determination to introduce a new reopener for E&D base capex. We intended to address the inherent uncertainty of projects in the E&D base capex portfolio to allow funding for those projects that:
- 2.64.1 had not been approved at the time the IPP is reset; and
 - 2.64.2 are unforeseeable when the IPP is reset, or that are foreseeable but are unknown in their scope, cost and/or timing.
- 2.65 Notwithstanding the scope, cost and timing uncertainties, Transpower’s RCP3 proposal material highlighted that most E&D projects are driven by external factors that could reasonably be considered outside of Transpower’s control, such as:
- 2.65.1 new connections that result in significant demand step changes (or possibly demand reductions);
 - 2.65.2 new generation connections (or decommissioning of generation); and
 - 2.65.3 any other existing or potential connected party developments that require interconnected grid transmission network enhancement or development.⁵²
- 2.66 In our RCP3 draft decision, we proposed to approve a funding amount for only those projects in the E&D portfolio that Transpower is confident are reasonably certain to proceed (**initial E&D approval amount**).⁵³
- 2.67 We proposed that after the end of the second disclosure year (ie, second reporting year ending June 30) of a regulatory period, Transpower would have a single

⁵⁰ Commerce Commission “Transpower’s individual price-quality path from 1 April 2020: Draft decisions and reasons paper” (29 May 2019), at [C5].

⁵¹ Commerce Commission “Transpower’s individual price-quality path from 1 April 2020: Draft decisions and reasons paper” (29 May 2019), at [C6].

⁵² Interconnection assets on the transmission grid are defined in the Electricity Industry Participation Code 2010 (EIPC 2010), at Part 12, Subpart 6 and Schedule 12.4, available at: <https://www.ea.govt.nz/code-and-compliance/the-code/>.

⁵³ Commerce Commission “Transpower’s individual price-quality path from 1 April 2020: Draft decisions and reasons paper” (29 May 2019), at 235-241.

opportunity to propose and seek additional funding approval (**additional E&D approval amount**).

2.68 This timing was chosen because:

- 2.68.1 it is a defined process date that Transpower can use as a submission reference;
- 2.68.2 it gives Transpower time to ascertain if the initial E&D approval amount is likely to be sufficient over a regulatory period;
- 2.68.3 it gives us sufficient time to consider the proposed additional amount for approval; and
- 2.68.4 if approved, it will allow this amount to be reflected in Transpower's prices in the penultimate and final years of a regulatory period.

2.69 We proposed that Transpower could seek this additional funding in the E&D capex portfolio when:

- 2.69.1 it is reasonably confident that it will exceed the initial E&D approval amount in the final two years of the regulatory period; and
- 2.69.2 it can demonstrate that the projects that comprise the additional E&D approval amount:
 - 2.69.2.1 are E&D projects (but excluding those E&D projects that are to be funded by the initial E&D approval amount);
 - 2.69.2.2 are projects that are reasonably outside of Transpower's control such as demand step changes, generation developments (or decommissioning) and any other existing or potential grid connected party development that requires a transmission network enhancement or development;
 - 2.69.2.3 were either unforeseeable when the IPP was reset, or were foreseeable but were unknown in their cost and/or timing; and

2.69.2.4 are comprised of two or more E&D projects that amount to a total project cost of at least \$20 million. The two or more projects may be either or both ‘unforeseeable’ or ‘foreseeable’ E&D projects.⁵⁴

2.70 These proposed IM amendments for Transpower are similar to those proposed for the Electricity Distribution Businesses (**EDBs**) to account for major connection projects on distribution networks to address uncertainty in the existence, timing, or scope of such connection projects.⁵⁵

2.71 We proposed not to make any changes to the BCAM provisions in the Capex IM, as we considered they could continue to provide for an automatic mechanism to allow for additional expenditure allowance where E&D projects can be specified at the time of the reset (ie, where there is less uncertainty).

Submitter’s view

2.72 Transpower submitted that it does not fully support the E&D reopener IM amendments as proposed in our draft decision.⁵⁶

2.73 Transpower stated that its preference is for us to approve their RCP3 proposed amount of \$76.4 million for E&D base capex, which it considered was an amount seen “as prudent, efficient and consistent with Good Electricity Industry Practice by the Independent Verifier”.⁵⁷

2.74 Transpower considered that the proposed threshold of at least \$20 million is a significant barrier to application and instead proposed a \$5 million threshold. Transpower also did not support the requirement for an application to contain at least two E&D projects. Transpower considers that these proposals create an incentive to push investment into a subsequent regulatory period.⁵⁸

⁵⁴ For example, the projects that comprise the ‘additional E&D approval amount’ may be one ‘foreseeable’ E&D project and two ‘unforeseeable’ E&D projects, which when taken together must amount to a total project cost of at least \$20 million.

⁵⁵ Commerce Commission “Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited: Reasons paper” (29 May 2019), at 2.35 to 2.62.

⁵⁶ Transpower “Proposed further amendments to input methodologies for Transpower” (1 August 2019), at 1.

⁵⁷ Transpower “Proposed further amendments to input methodologies for Transpower” (1 August 2019), at 3.

⁵⁸ Transpower “Proposed further amendments to input methodologies for Transpower” (1 August 2019), at 1.

- 2.75 Transpower also considered that the E&D reopener process should “mirror the approach of existing regulatory instruments (e.g. major capex, listed projects) and describe the needs or reasons for the investment funding sought”.⁵⁹
- 2.76 Further, while Transpower agreed with the single application window within a regulatory period and the application timing (at the end of the second disclosure year of a regulatory period) it sought further clarification regarding the approvals process, the level of investigation needed and the forecast project cost estimate accuracy in support of an E&D reopener application.⁶⁰
- 2.77 Transpower also submitted that incremental upgrades (which are usually E&D projects) are economic in deferring larger works, but the reopener approach as proposed is an additional step that “would increase the investigation overhead and the lead time for the incremental works and risks the new generation being constrained due to insufficient transmission capacity”.⁶¹

Final decision

- 2.78 Our decision is to amend the Transpower IM determination to introduce a new reopener for Transpower to use to seek additional funding when projects arise in the E&D base capex portfolio that were either:
- 2.78.1 not reasonably foreseeable at the time of setting the price-quality path; or
 - 2.78.2 foreseeable but the costs and/or timing were uncertain at the time of setting the price-quality path.
- 2.79 Transpower can seek this additional funding in the E&D capex portfolio in circumstances where:
- 2.79.1 an allowance for that E&D project was not included in the base capex allowances for the current regulatory period because that E & D project was not forecast to commence in that regulatory period when the IPP determination was made;
 - 2.79.2 it was either unforeseeable, or was foreseeable but was unknown in its cost and/or timing, that the E&D project was likely to commence during the current regulatory period when the IPP determination was made;

⁵⁹ Transpower “Proposed further amendments to input methodologies for Transpower” (1 August 2019), at 4.

⁶⁰ Transpower “Proposed further amendments to input methodologies for Transpower” (1 August 2019), at 4-5.

⁶¹ Transpower “Proposed further amendments to input methodologies for Transpower” (1 August 2019), at 5-6.

- 2.79.3 the project has one or more specific E&D drivers eg, demand step changes, generation developments or decommissioning;
 - 2.79.4 the application must relate to a minimum of two E&D projects that must in aggregate cost at least \$20 million; and
 - 2.79.5 Transpower can demonstrate that the E&D projects are reasonably likely to commence in the regulatory period.
- 2.80 These IM amendments are intended to align, as much as possible, with the Transpower Capex IM determination treatment of base capex projects, while providing certainty around the types of E&D expenditure that should be captured by the new reopener.
- 2.81 By allowing Transpower the opportunity to seek additional funding later in the regulatory period, it reduces the risk that Transpower's E&D expenditure proposal is too high or too low, as outlined in paragraph 2.89.
- 2.82 We note Transpower's suggestions regarding the definition of the technical drivers of E&D base capex and in response our decision is to better align our definition of E&D with the Capex IM. Additionally, we have clarified that an E&D reopener application can contain a range of projects each with different drivers.
- 2.83 We have also considered Transpower's request for more clarification regarding the level of investigation needed and the forecast project cost estimate accuracy in support of an application. In response, our decision is to amend the Transpower IM determination to provide some clarification for Transpower.
- 2.84 We have drawn from the Transpower Capex IM determination, which requires that the "rigour and comprehensiveness of the analysis must be commensurate with estimated expenditure and complexity of that option".⁶²
- 2.85 While this Transpower Capex IM determination application is specific to information in support of major capex proposals, we consider that a similar approach of commensurate information, supporting analysis and forecast costs should be applied for E&D projects in support of an E&D reopener application.

⁶² *Transpower Capital Expenditure Input Methodology Determination 2012 (Principal Determination)* consolidated as at 1 June 2019, Part 7 Subpart 4 clauses 7.4.1(3)(a) and (b).

- 2.86 Consistent with our other reopener provisions, we have not specified an approvals process. We consider that the application timing gives us sufficient time to assess an E&D reopener application and notify Transpower of a decision in time for Transpower to announce price changes to its customers.⁶³ Also, we consider that the clarification we are introducing and our application of the proportionate scrutiny principle will assist the approval process.
- 2.87 While we agree with Transpower that incremental upgrades are economic in deferring larger works, we do not agree that a reopener approach introduces increased investigation overhead.

How the amendments are likely to promote the IM amendments framework outcomes

- 2.88 We consider that the amendments promote the IM amendments framework outcomes because there is considerable uncertainty surrounding E&D expenditure for projects required later in a regulatory period (ie, when considered at the time a RCP proposal is submitted).
- 2.89 We consider that, by allowing Transpower the opportunity to seek additional funding later in the regulatory period, it:
- 2.89.1 reduces the risk to consumers that Transpower's E&D expenditure proposal amount at the time a RCP proposal is submitted is too high, and that this may lead to inefficiencies across the base capex programme; and
 - 2.89.2 reduces the risk to Transpower that the E&D expenditure proposal amount is too low at the time a RCP proposal is submitted, and this may lead to base capex from other projects and programmes being used instead to fund E&D. This will impact on other project and programme deliverability and may increase asset failure risk overall.
- 2.90 If we were to approve projects that were uncertain at the time where we consider an RCP proposal, Transpower may earn excessive profits where these projects do not eventuate. The IM amendments provide Transpower with an incentive to invest, consistent with the Part 4 purpose.
- 2.91 The IM amendments may create additional compliance costs for us and Transpower, but we consider that these costs are more than offset by the Part 4 benefits. Further,

⁶³ Transpower state in its submission that "We agree with an application window once within an RCP, by the end of the disclosure year of the second year of the RCP (i.e. for RCP3, by the end of June 2022). To reflect the revenue uplift in our announcement of prices in November 2022 (for prices from April 2023), the Commission would need to approve the application by around September 2022." Transpower submission "Proposed further amendments to input methodologies for Transpower" 1 August 2019.

the IM amendments limit when Transpower can make an application for reconsideration to only once and within a set time period (by the end of the second disclosure year of a regulatory period).

- 2.92 The minimum threshold of at least \$20 million for the new reopener is consistent with our intention to apply proportionate scrutiny principles.⁶⁴ We consider that proportionate scrutiny should guide our evaluation of Transpower's expenditure proposals as well as the setting of IPPs more generally.

Other submissions we received regarding reopener provisions

Submitter's view

- 2.93 Transpower proposed an amendment that would allow for a price path reopener because of additional costs caused by the implementation of the revised TPM Guidelines.⁶⁵

Our view

- 2.94 We did not propose this amendment in our May 2019 or July 2019 draft Transpower IM determination or draft Transpower Capex IM determination amendment consultation rounds.
- 2.95 We understand that changes may occur to the TPM that could result in some incremental cost during RCP3. There is a range of possible costs that could arise, which we consider will be below the threshold for major capex and would therefore not qualify for the major capex reopener provision.
- 2.96 However, we do not consider it necessary to introduce a provision to explicitly allow for a reopener due to additional costs caused by the implementation of the revised TPM Guidelines. This is because s 54V(5) of the Act provides for a reopener provision outside of the IMs in conjunction with the Electricity Authority, and have effect without us having to apply the 1% revenue requirement that would apply if we otherwise used clause 3.7.2 of the IMs (ie, change event reopener) to reopen the price path.⁶⁶

⁶⁴ In broad terms, 'proportionate scrutiny' means that we will apply the level of scrutiny that is commensurate with potential price and quality impacts of forecast expenditures on Transpower's customers and where we consider the benefits of such scrutiny to customers outweigh the associated costs over time. We consider that a minimum threshold of at least \$20 million for the additional E&D approval amount is consistent with the Capex IM framework where more focussed and detailed reviews would be carried out for major capex proposals and listed projects, including their more extensive consultation requirements.

⁶⁵ Transpower "Proposed amendments to input methodologies" (5 July 2019), at 2.

⁶⁶ Section 54V(5) of the Act provides that the Commission must, if asked by the Electricity Authority to do so, reconsider a section 52P determination (eg an IPP) to take account of certain matters, including those decisions affecting the pricing methodologies or performance requirements applicable to Transpower.

Court or other statutory imposed penalties cannot be treated as ‘operating costs’

Previous IM requirement

2.97 Previously, clause 1.1.4(2) of the Transpower IM determination defined ‘operating costs’ as:

a cost incurred by Transpower relating to the supply of electricity transmission services, and excludes-

- (a) a cost that is treated as a cost of an asset by GAAP;
- (b) amounts that are depreciation, tax, subvention payments, revaluations or an interest expense, in accordance with their meanings under GAAP;
- (c) debt issuance costs;
- (d) pass-through costs; and
- (e) recoverable costs;

Draft decision

2.98 Our draft decision was that the previous definition of operating costs (which is also used in the Transpower IM determination for determining opex IRIS incentives) did not provide sufficient certainty about the treatment of pecuniary penalties.

2.99 For clarity, we proposed an additional exclusion in the definition of “operating costs” for “payment of any **pecuniary penalties**”,⁶⁷ and a new defined term ‘pecuniary penalties’,⁶⁸ defined as:

finest or penalties imposed:

- (a) by a court; or
- (b) by any other body with a statutory power to impose such fines or penalties

2.100 We proposed an identical amendment to the EDB IM determination.

Submitters’ views

2.101 Most of the arguments raised in submissions were focussed on how the proposed amendment would apply to EDBs. However, those arguments could equally apply to Transpower.

⁶⁷ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 1.1.4(2), definition of ‘operating cost’.

⁶⁸ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 1.1.4(2), definition of ‘pecuniary penalties’.

- 2.102 Transpower supported this proposed amendment, however the Electricity Networks Association (**ENA**), Unison and Vector did not.
- 2.103 The ENA considered that the proposed amendment is a policy change and is not a correction, and therefore any change must be applied consistent with the requirements of s 53ZB and must not be applied retrospectively. The ENA also believes that the proposed definition is too broad and will capture a range of penalties, some of which should be able to be calculated as operating costs.⁶⁹
- 2.104 Unison was also of the view that the proposed amendment is a policy change and needs to be further considered in context of the opex IRIS scheme. Unison agreed with the ENA that most businesses would operate very low risk tolerances for breach of laws and regulations, although there is always more that can be done to strengthen controls. Unison considered that the change should apply from the commencement of the next disclosure year (ie, from 1 April 2020) and strongly disagreed that the change is a “clarification” and therefore should not be applied retrospectively.⁷⁰
- 2.105 Vector submitted that the definition of costs is clear, and that fines and penalties are operating expenses incurred from time to time in the course of carrying out the business of conveying electricity by line. Therefore, Vector argues that this proposal should be considered as a change in the IMs rather than a clarification.⁷¹

Final decision

- 2.106 We consider that the previous definition of operating costs (which is used in the Transpower IM determination for determining the ‘forecast MAR’ and the ‘forecast SMAR’, and calculating the opex IRIS incentive amounts) did not provide sufficient certainty about the treatment of pecuniary penalties. To address this lack of clarity, we have introduced an additional exclusion in the definition of ‘operating costs’ for “payment of any **pecuniary penalties**”,⁷² and a new defined term ‘**pecuniary penalties**’.⁷³

⁶⁹ Electricity Networks Association “EDB and Transpower IM amendments” (5 July 2019), at 1 & 2.

⁷⁰ Unison submission on DPP Input Methodology Amendments (7 July 2019), at 2.

⁷¹ Vector “Submission to Commerce Commission on changes to the Input Methodologies for Electricity Distributors and Transpower due 5th July” (5 July 2019), at 34.

⁷² *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 1.1.4(2), definition of ‘operating cost’.

⁷³ *Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC 10 (28 August 2019), clause 1.1.4(2), definition of ‘pecuniary penalties’.

- 2.107 We acknowledge submitters' views that the previous definition of operating costs could have been clearer. Therefore, we have decided to amend the definition to make it clear.
- 2.108 For the purpose of determining Transpower's forecast operating costs in an IPP for a regulatory period (RCP_t), we will remove any actual pecuniary penalties from the base year opex of the previous regulatory period (RCP_{t-1}), which will ensure that we get our best estimate of the forecast opex for RCP_t on a pecuniary penalty exclusive basis. This amendment will also apply to all opex IRIS incentive amounts that will be calculated with respect to 'forecast opex' for RCP3 onwards.
- 2.109 We are currently consulting on the new financial reporting standard NZ IFRS 16, and its affects on IRIS. We expect to reach a final decision on IM amendments resulting from this change in November 2019.⁷⁴ To the extent any additional changes to IRIS are required to give effect to the change to the treatment of pecuniary penalties in the definition of operating costs, we will also finalise these amendments in November.
- 2.110 We are still to finalise our decision on the treatment of pecuniary penalties in respect of EDBs and we will address their submissions in our final EDB IM amendments decision which we will publish in November 2019.

How the amendment is likely to promote an IM amendments framework outcome

- 2.111 This IM amendment provides more certainty for suppliers on the treatment of pecuniary penalties. Therefore, the amendment better promotes the IM purpose in s 52R of the Act. As Transpower's opex disclosed under ID informs both the opex forecasts we set,⁷⁵ and the opex IRIS recoverable costs, we want to provide certainty as to how these fines and penalties should be treated.
- 2.112 If pecuniary penalty costs were able to be included in Transpower's forecast opex allowance, approximately 75% of the cost would be passed through to consumers via the opex IRIS mechanism. This would be a perverse outcome; pecuniary penalties and fines are intended to penalise lines companies, including Transpower, for conduct contravening standards that apply to them. We do not consider that there is a sound policy argument for these costs to be shared with consumers.

⁷⁴ For more information see: <https://comcom.govt.nz/regulated-industries/input-methodologies/projects/operating-leases?target=documents&root=152107>

⁷⁵ *Transpower Information Disclosure Determination*, as amended, Schedule F2.

Correction to implementation errors in the IRIS drafting

Previous requirement

- 2.113 Our previous Transpower IM determination included ‘opex incentive amounts’ for the purposes of the ‘IRIS incentive adjustment’.⁷⁶
- 2.114 As a result of the 2016 IM review, we amended the ‘opex incentive amount’ calculation to “fit the purpose of the ‘adjustment to the opex incentive’ by using a modified version of the ‘capex incentive adjustment’ calculation”.⁷⁷
- 2.115 As part of drafting the amendments resulting from the 2016 IM review, we inadvertently made implementation errors in the ‘opex incentive amount’ calculation time value of money adjustment.

Draft decision

- 2.116 In our draft decision, we proposed amending the calculation of the ‘opex incentive amount’ for Transpower to correct this implementation error made in the 2016 IM review.⁷⁸

Submitter’s view

- 2.117 Transpower agreed with the intent of our proposed amendment. However, Transpower raised a question regarding the economic rationale for using the cost of debt ‘*r*’ as the time value of money in clause 3.6.2(1)(b) of the Transpower IM determination, whereas other aspects of the IRIS provisions in the Transpower IM determination use the WACC.

Final decision

- 2.118 Our decision is to correct the implementation error in the opex IRIS mechanism.⁷⁹
- 2.119 We note that we use the cost of debt rather than the WACC in clause 3.6.2(1)(b) of the Transpower IM determination to reflect the fact that this return is guaranteed.

⁷⁶ Transpower Input Methodologies Determination 2010 [2012] NZCC 17, as amended and consolidated as at 10 June 2019, clause 3.6.2.

⁷⁷ Commerce Commission “Input Methodologies review decisions: Report on the IM review” (20 December 2016), at 114-115.

⁷⁸ [DRAFT] Transpower Input Methodologies Amendments Determination 2019, clause 3.6.2.

⁷⁹ Transpower Input Methodologies Amendments Determination 2019 [2019] NZCC 10 (28 August 2019), clause 3.6.2.

Therefore it is inappropriate for the full WACC rate to be earned by Transpower. This is consistent with the EDB opex IRIS.

How the amendment is likely to promote an IM amendments framework outcome

- 2.120 This implementation change gives effect to the policy intent of the opex IRIS mechanism. We consider that correcting this implementation error will promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose), as it will ensure the correct treatment of permanent and temporary opex efficiency savings (or overspends).
- 2.121 The change will also provide more accurate guidance for interested persons on how to calculate the 'opex incentive amount' component of the 'IRIS incentive adjustment'.

3. Amendment to the Transpower Capex IM determination

Purpose of this chapter

- 3.1 This chapter describes our change to the Transpower Capex IM determination in respect of the 'base capex standard incentive rate'.
- 3.2 For this change, we explain:
 - 3.2.1 the previous IM requirement (ie before the IM amendment);
 - 3.2.2 our proposed IM amendment, as provided for in our draft decision;⁸⁰
 - 3.2.3 submitters' views;
 - 3.2.4 our final decision; and
 - 3.2.5 how the amendment is likely to promote an IM amendments framework outcome.

Base capex standard incentive rate

Previous IM requirement

- 3.3 Under the Transpower Capex IM determination, we set specific incentives that are intended to encourage Transpower to invest and operate efficiently. We set an allowance that is fixed at the beginning of a regulatory period with the intention of allowing Transpower to cover its costs. Transpower can earn increased profits by delivering services more efficiently than assumed when the allowance was set.
- 3.4 The fixed allowance feeds into a revenue path. Once a path is set, Transpower has incentives to outperform that path and over time the incentives lead to lower actual costs. The reduced costs are then reflected in future decisions about the opex and capex needs of Transpower and consumers gain from the subsequent lower revenue allowances provided for Transpower (leading to lower prices for consumers).
- 3.5 We can adjust the strength of the incentives for cost efficiency by adjusting the share of the benefits retained by Transpower versus that passed on to consumers (the 'incentive rate').
- 3.6 There are separate incentive rates for capex and opex, and the difference between these incentive rates can affect the relative incentive for Transpower to favour opex over capex or vice versa, when there is the potential for substitution. We can also

⁸⁰ Our draft decision is noted in paragraph 1.3.1 of this paper.

ensure the incentives for efficiency are constant throughout the period using mechanisms such as IRIS.

- 3.7 Although this mechanism provides Transpower with an incentive for cost efficiency once a revenue path (or capex or opex allowance) is set, it also provides Transpower with an incentive to overstate the opex and capex allowance it needs to recover at the time we set the IPP or when we set a major capex allowance.
- 3.8 We made changes to the Transpower Capex IM in 2018 to recognise these different trade-offs and, in particular, between promoting incentives to improve efficiency, innovate and invest, and limiting Transpower's ability to earn excessive profits.⁸¹
- 3.9 In the 2018 review of the Transpower Capex IM we decided to modify the base capex incentive rates and apply two incentive rates for base capex projects:⁸²
 - 3.9.1 a standard rate of 33% for base capex projects; and
 - 3.9.2 a lower rate of 15% for large base capex projects that meet specified criteria (namely that project costs are likely to exceed \$20 million).
- 3.10 The changes made in 2018 were not considered to be a change in the intent of the incentives regime. Rather, they were considered refinements to improve incentive effectiveness.

Draft decision

- 3.11 Our draft decision proposed that the 'base capex standard incentive rate' in the Capex IM determination be changed from 33% to 26% to align with the opex IRIS incentive rate (based on the WACC assumptions used in our draft decision).⁸³
- 3.12 Our regime intends to provide efficiency incentives for Transpower to improve on its opex and capex allowances. The efficiency savings are then shared between Transpower and consumers, with the retention factor for both opex and capex being set for this purpose. At the time of our draft decision, the IPP opex and base capex incentive rates were different:
 - 3.12.1 the opex incentive rate, as calculated for our draft decision, using an estimate of the RCP3 WACC rate, in accordance with the Transpower IM determination and our draft RCP3 decision was 26%; and

⁸¹ Commerce Commission "Transpower capex input methodology review - Decisions and reasons" (29 March 2018).

⁸² Commerce Commission "Transpower capex input methodology review - Decisions and reasons" (29 March 2018), paragraphs 39-72.

⁸³ *Transpower Capital Expenditure Input Methodology Amendments Determination 2019* [2019] NZCC 11 (28 August 2019), clause 4.

3.12.2 the 'standard incentive rate for base capex' was 33%.

- 3.13 The opex and base capex incentive rates were different before our final decision because the opex IRIS incentive rate is determined in the Transpower IM determination based on the length of the period and the WACC rate for the period. Therefore, in RCP3, without a change to the base capex incentive rate, the forecast change in the WACC rate for RCP3 would be expected to cause the opex IRIS incentive rate to be different from the base capex incentive rate.

Submitters' views

- 3.14 We received no submissions on this proposed amendment.

Final decision

- 3.15 Our decision is to provide for the equalisation between the opex and capex incentive rates to provide Transpower with equal incentives to find efficiencies regardless of whether these are through opex or capex solutions.
- 3.16 Based on changing financial market conditions between our draft and final decisions, the WACC rate has reduced from our earlier estimate of 5.13% (based on the assumptions used in our draft RCP3 decision) to 4.87% as at 31 July 2019.⁸⁴ Based on this new WACC estimate, the opex incentive amount would be approximately 25% (applying this latest WACC rate estimate to the IRIS calculation formula in the Transpower IM determination).
- 3.17 Due to the ongoing changes in the WACC rate and the possibility that the estimate of 4.87% could materially change between our IPP expenditure decisions on 29 August 2019 and when the final IPP price path WACC for RCP3 is published in October 2019, our decision is to amend the 'base capex standard incentive rate' in the Capex IM determination from 33% to an incentive rate based on a formula applied to the WACC rate to be set for the IPP price path in accordance with the Transpower IM determination, to align as closely as possible with the opex IRIS incentive rate.⁸⁵
- 3.18 This amendment will take effect from the commencement of RCP3 and the incentive rate will be calculated and published once the IPP WACC rate has been published.

⁸⁴ Cost of capital determination for disclosure year 2020 – For Transpower, gas pipeline businesses and suppliers of specified airport services (with a June year-end) [2019] NZCC 8.

⁸⁵ *Transpower Capital Expenditure Input Methodology Amendments Determination 2019* [2019] NZCC 11 (28 August 2019), clause 4.

How the amendment is likely to promote an IM amendments framework outcome

- 3.19 We consider that this change promotes the Part 4 purpose in s 52A of the Act more effectively than the current IM because it intends to provide equal efficiency incentives between opex and capex.
- 3.20 Providing consistent incentive rates across opex and base capex ensures that Transpower will have equal incentives to find efficiencies regardless of whether these are through opex or base capex solutions (as we consider opex and base capex to be generally substitutable).