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Keston Ruxton  
Manager, Regulation Branch  
Commerce Commission

By email: [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz)

Dear Keston

## **Input Methodologies: scoping the statutory review**

We welcome the opportunity to comment on the Commission's *Open letter on our proposed scope, timing and focus for the review of the input methodologies* published 27<sup>th</sup> February 2015.

We appreciate the extension to the submission date from 20<sup>th</sup> March to 31<sup>st</sup> March. This has allowed us time to reflect on a critical gap in the current framework the bridging of which should be a precursor to the current review. That gap is the lack of a coherent and clear policy and framework governing review and change of the IMs.

This gap is an impediment to the pending review and source of concern to Transpower. It limits the efficacy of the IMs in meeting the section 52R purpose because parties simply do not know how and when the Commission will decide to review and change an IM, including for fundamental matters (such as cost of capital). A consequence is that the scope of the pending review is potentially very broad and arbitrary – when ideally, in our view, it should be contained and focused.

In this submission we:

1. recommend that the Commission should pause at this point to better establish:
  - a. a coherent and clear policy governing IM change processes and thresholds: this will simplify and enhance the value of the statutory review and improve the ability of the IMs to promote the purpose of sections 52A and 52R
  - b. an environmental scan: what if any problems need to be addressed now (in context of an evolving technology and commercial challenges).
2. comment on scope, focus and approach to the statutory review including to:
  - a. agree that substantial changes are unlikely to be desirable at this point: particularly in light of the section 52R purpose
  - b. suggest scope and focus of the review should be tightly contained and 'business as usual' improvements, such as those we have previously proposed, be dealt with separately
  - c. observe that the optimal review timing is a function of scope and approach, but that December 2016 seems over-optimistic .

We expand on these points below.

## 1. The right time to pause and reflect

The Commission is emerging from a frantic period of project oriented IM development and the first round of IPP and DPP resets. In parallel the Commission has been heavily committed in the telecommunications sector and with its general competition functions. We encourage the Commission to pause and reflect before embarking on the statutory review.

Two areas in particular stand out as requiring careful reflection before embarking on the statutory review. We comment on these below.

### IM review thresholds: the missing piece in the IM puzzle

The IMs provide an important piece of the puzzle but cannot, on their own, achieve the certainty that section 52R seeks. Rather, certainty (or stability and predictability) is a product of the rules established in the IMs *and* the:

- ‘form’ of the Commission in exercising its discretion to review and change the IMs: are the thresholds it applies to different types of decision appropriate and are its decisions robust?
- transparency and coherency of its IM review policy and procedures: are the policy and procedures for reviewing the IMs clearly articulated and coherent in context of section 52R?

This is important for all IMs; but is particularly important for significant and investment critical matters such as WACC methodology and RAB valuation. Put simply, the section 52R purpose, and likely the section 52A purpose, will be undermined if the threshold for review and change adopted by the Commission is incorrect or unclear. For example, if the Commission:

- too readily changes, or entertains change, for value shifting aspects of the IMs then this heightens investment risk for suppliers and consumers
- without good reason, dismisses or avoids timely consideration of non-value-shifting improvements proposed by suppliers (and potentially consumers<sup>1</sup>)
- has no clear and consistently applied policy and procedures governing when and how it will review different aspects of IMs and the threshold it will apply to change

It is clear that the Commission recognises this risk<sup>2</sup> and has taken some steps to mitigate it.<sup>3</sup> However, with the benefit of the last few years’ experience, our key (and increasing) concern is that those steps do not go far enough and that the Commission is at risk in each of the three areas identified above. This presents an impediment to the pending review and, moreover, to the achievement of the purpose of the IMs as described in section 52R.

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<sup>1</sup> Consumers are most likely to be interested in price and quality where suppliers also experience workability issues first hand, bear compliance cost and therefore are most likely to be the proponent for this type of improvement.

<sup>2</sup> The Commission regularly observes the importance of certainty (or its derivatives: stability and predictability) in context of the IMs.

<sup>3</sup> See: Commerce Commission, Process for amendments and clarifications of Part 4 determinations, March 2011

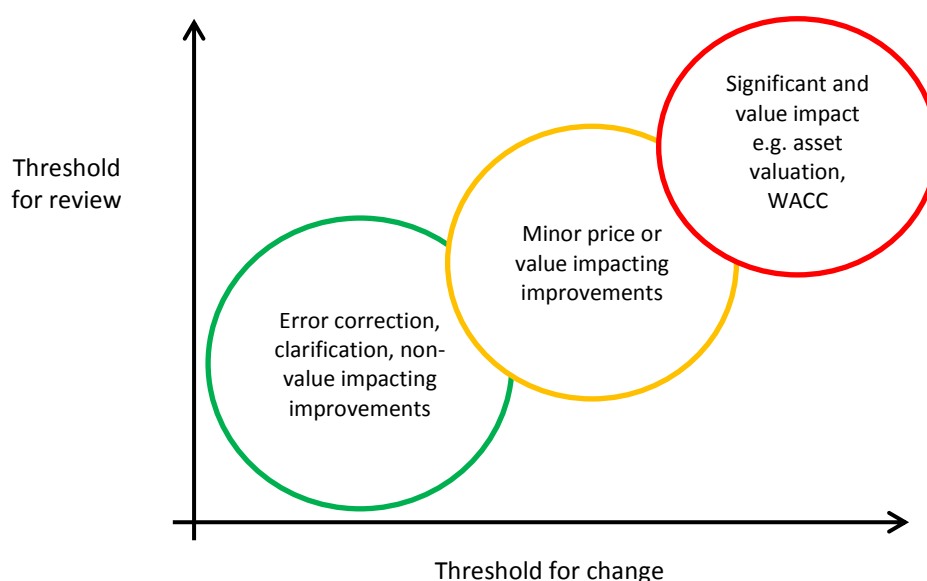
*A clear opportunity exists to better promote sections 52R and 52A*

We think the Commission has the perfect opportunity to address these concerns and, in doing so, to remove an impediment to the pending review and better promote the purpose of sections 52R and 52A (and to make life easier for itself and its stakeholders). In our view, formulating and documenting the IM review policy should be a relatively straightforward exercise that can be completed within a few months.

As well as providing confidence to affected parties it will simplify the scoping and execution of the statutory review – including because ‘business as usual’ matters can be addressed separately – and greatly reduce the risk of a messy, protracted and potentially arbitrary review that leaves all parties dissatisfied.

In Appendix A we provide initial thoughts on an IM review policy and framework. In summary we support an approach that differentiates between IMs components and establishes sensible ‘entry thresholds’ for IM review and change. This recognises that while review and change thresholds for some aspects should be very high the IMs are complex instruments covering a multitude of specific issues and in some areas should be allowed to evolve more freely.

Figure 1: IM change thresholds



For example, taking too literal an interpretation of ‘certainty’ will eventually result in the IMs becoming (or unnecessarily remaining) unfit for purpose over time for no valid reason:

1. In many cases suppliers, and potentially consumers or the Commission, will identify options to simplify the IMs that can reduce cost with little or no substantive impact on prices; in these circumstances the threshold for review and change should be low.

2. In other circumstances an issue may be identified that should be addressed but that will impact prices and in these circumstances the threshold for review might be low but the threshold for change (or at least the implementation of change) might be restricted by the current price path.
3. There will also be issues that have significant impacts on suppliers or consumers, most obviously WACC methodology and RAB valuation where decisions can have a retrospective effect, for which a high threshold should apply both to review and change.

In this context it doesn't seem controversial that different thresholds should apply to different categories of IM change. It also follows, we think, that the Commission should think about reviewing the IMs in three contexts:

1. Annual 'business as usual' review covering the green circle in Figure 1. Any matters that have more than a small price path impact may require deferred implementation (e.g. those in the orange circle in Figure 1). These reviews could include:
  - a. error correction and drafting clarifications
  - b. changes to improve the operation of the IMs (accepting that if there are value or substantial price path impacts that implementation may need to be deferred until the next reset).
2. Price control reset review. To implement any substantive amendments emerging from the price control reset process and more substantive and price or value impacting changes identified during the annual reviews for next price path. These reviews could include:
  - a. new mechanisms (e.g. IRIS) and the refinement of existing provisions (e.g. catastrophic event provisions)
  - b. changes to improve the operation of the IMs.
3. Statutory review. To address strategy level issues that do not easily fit within or are consciously excluded from categories 1 and 2. The reviews could:
  - a. introduce, remove or substantially change the scope of individual IMs
  - b. address any considerations relating to 'core components' of the framework, such as WACC.

Critically, any review of the 'core components' of the Part 4 framework, such as asset valuation and cost of capital, should only take place in specific circumstances and where clearly signalled and the threshold for change is high. We think this is particularly important now because the balance of power has shifted further in the Commission's favour and this has had a corresponding impact on its accountability to regulated suppliers.<sup>4</sup>

We think an industry group could work with the Commission to develop the IM review policy and procedure – to work through key criteria, evidential burdens, etc.

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<sup>4</sup> After the merits review decision and the subsequent decision by the Commission' to review and change the WACC percentile.

## Situational awareness: defining the problem before developing solutions

It is no secret that long established beliefs and assumptions are in question and that these potentially herald a different future for the sector. It does not seem contentious that an informed and balanced view of recent developments and the insights emerging from expert bodies, suppliers, regulators and industry groups should be vital inputs to the scoping of the statutory review.

We encourage the Commission to pause at this point and, parallel with work to develop an IM review policy, undertake an environmental scan that brings together recent analysis and insight with sector experts to better understand the latest thinking and the potential implications for Part 4 and the IMs.

We consider that work by the ENA, the Electricity Authority and the smart grid forum would be useful inputs. Transpower will of course share its own thinking.

## 2. Scope, approach and timing

It follows from the comments above that we think more work is needed before the scope, approach and timing of the review are locked down. However, we comment briefly below on the specific points made in the open letter.

### We agree substantial changes to the IMs are undesirable

The development and implementation of the IMs for gas transmission and distribution, for electricity transmission and distribution and for airports has been a significant achievement. The IMs have improved certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation of proposed regulation of goods and services under Part 4.

Some of the IMs have only recently been introduced and / or have recently been substantially modified. In relation to the Transpower IMs, for example, we note the Transpower Capex IM was introduced in 2012 and substantially modified to permit 'listed projects' in 2014 (listed projects mechanism yet to be applied). We also note that a number of refinements were made to the other Transpower IMs in November 2014.

Consequently, we agree with the Commission's remarks at paragraphs 27 and 28 – specifically its conclusion that substantial changes of the current IMs are unlikely to be desirable, particularly in light of the purpose of the IMs in Section 52R. While we generally support the notion that all the IMs should be reviewed together we consider the Capex IM to be an exception: it is unique to Transpower, the newest of the IMs and has recently been amended. We propose that it is decoupled from the wider IM review and take place once all the main operative elements of that IM have been applied in full.

### The statutory review should be contained and focused on strategic issues

Until the Commission has established the IM review policy and completed its environmental scan the scoping exercise is of limited value. For example, it is possible that the form of price control may need amendment in response to the potential impact of disruptive technologies but it would be useful to better understand the 'problem' we are trying to address before identifying solutions.

We suggest that the statutory review should be focussed on strategic 'framework' issues and addressing, to the extent necessary, matters at the heart of the Part 4 regime such as cost of capital. To that end we suggest the Commission should:

1. concentrate on addressing the issues with debt costs under current WACC settings. For example
  - a. the determination window (being too short)
  - b. use of the government bond rate (rather than the swap rate)
  - c. derivation of the debt premium (comparator selection and sample size)
  - d. leverage

We would be happy to brief the Commission on our assessment of these issues in light of experience with the 2014 reset.

2. explore alternative cost of debt methodologies that could reduce cost for suppliers and consumers, for example the trailing average cost of debt adopted in other jurisdictions.<sup>5</sup>

We note the Commission's observations in relation to the High Court's comments on cost of capital. We consider the Commission's remarks at paragraph 28 particularly relevant here and have little appetite for protracted debates on cost of capital that seem likely to yield little beyond uncertainty and wealth transfers. In our view the Commission has already placed more than enough weight on the remarks of the High Court and should give short shrift to the remaining points – most of which have been addressed to a greater or lesser extent through the 2014 percentile review (including by the Commission's own experts).

We agree that consideration should be given to how complexity and compliance costs could be reduced through the statutory review. The product of that consideration should flow into business as usual practices including adoption of a KPI for the Commission related to removing complexity and reducing compliance costs.

#### *IRIS and the IPP opex reset*

In our 20 March submission on IRIS we recommended that:

... the Commission re-examines IRIS for IPP firms as part of the pending IM reviews and in conjunction with considering IPP opex reset policy. In the interim, we recommend the Commission revert to semi-symmetric IRIS arrangements for the RCP2 period (potentially with modifications to address the final year issue).

Whether this issue is best addressed as part of the statutory review, as part of a business as usual IM review or outside the IMs altogether is for discussion.

#### *Too soon to say on other matters*

We do not have a strong view on the items listed at 31.4, 31.7 and 31.8 but suggest at least some of these may be better addressed separately through the business as usual IM review processes. Similarly, we suggest consideration of outstanding IM amendment proposals from Transpower may best be done through a business as usual process.

We strongly encourage the Commission to revisit the scoping exercise later in 2015 when it has established the IM review policy and completed an environmental scan.

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<sup>5</sup> We presume this is what the Commission refers to as "indexation of debt costs"

## Timetable

We do not consider the rationale for the 18 month timeframe proposed (all done by December 2016) being driven by one reset timing in one sub-sector to be strong. In particular it seems strange that the Commission should bring forward and compress the statutory review to meet the gas sector reset timing. We suggest that price control reset and IM review scheduling be addressed as part of the IM review policy and procedure work.

At a substantive level, and with 2014 fresh in our minds, we are wary of again finding ourselves in a resource and 'headspace' crunch that places unnecessary pressure on the Commission and interested parties and detracts from the quality of analysis and decision making.

We recommend that the Commission pause at this point to establish a coherent and clear policy governing IM change processes and thresholds and to undertake an environmental scan to better inform itself of what, if any, issues need to be addressed now. A firmer assessment of the scope (and timetable) can then be made – and it is possible that this may still indicate December 2016.

We would welcome the opportunity to discuss the issues and suggestions raised in this submission.

Yours sincerely

A handwritten signature in black ink, appearing to be 'JC' followed by a long horizontal stroke.

Jeremy Cain  
**Regulatory Affairs Manager**

## Appendix A: Initial thoughts on IM review policy and framework

1. The objectives of the IM review policy and framework should be clearly articulated and derived from an intelligent interpretation of the section 52R purpose.

To the extent there are tensions with the section 52A purpose then these should be made explicit (along with guidance on how any tension should be resolved).

2. IM 'components' should be distinguished– for example:
  - a. core components of the regime that have a fundamental impact on certainty (and therefore risk, incentives to invest and total cost) such as asset valuation and WACC
  - b. investment rules and incentive mechanisms
  - c. the administrative expression or mechanics elements e.g. accounting rules
3. Thresholds for review and change of components should be distinguished - for example distinguishing thresholds for review of different IM components and changing different IM components recognising that in different circumstances certainty may be enhanced by:
  - a. reviewing and amending an IM
  - b. not reviewing or amending and IM
  - c. Including differentiating between changes which have a prospective effect versus those with a retrospective impact.
  - d. The extent to which review and change thresholds should be influenced by the proponent of change. For example, where a single party is affected then we suggest that part should have elevated influence relative to other stakeholders and (in our view) the Commission should not be able to unreasonably refuse to amend the IM.
4. Frequency of review: as suggested in this submission we consider three types of IM review with a degree of overlap. It may transpire that a scheduled review is not required. The circumstances in which the Commission might initiate an unscheduled or out of cycle review should be clearly and narrowly defined.
5. The standing of the status quo. For example, what should have standing, as one might infer from the wording of section 52R and statements from the Commission, or not as one might infer from the Commission's WACC percentile decision?
6. Analytical framework e.g. problem definition > IMs options identification > assessment criteria > options assessment > section 52R overlay > section 52A overlay > decision