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Transpower's individual price-quality path for the regulatory control period from 1 April 2025

Final Decision Attachment A – Revenue path design

Date of publication: 29 August 2024

Contents

Chapter 1 Introduction

Purpose

1.1 This document is part of the package of final decision documents on Transpower's individual price-quality path (IPP) for the fourth regulatory period starting on 1 April 2025 (RCP4).

1.2 This is one of five attachments to our main final decision paper, which sets out all the decisions as well as the context in which we are setting Transpower's RCP4 revenues.

1.3 The purpose of this attachment is to set out our review of Transpower's proposal and final decisions relating to the revenue path for Transpower's IPP reset, and to explain our reasons for those final decisions.[1]

Summary of our revenue path decisions

1.4 Our key final decisions relating to Transpower's revenue path are to:

1.4.1 smooth Transpower's annual revenue, consistent with the Transpower Input Methodologies 2012 (**Transpower IM**), by:

1.4.1.1 forecasting costs, including pass-through costs, recoverable costs, and an estimate of the economic value account (**EV account**) balance as at 30 June 2025, and building these into the forecast maximum allowable revenue (**forecast MAR**);

1.4.1.2 smoothing the resulting forecast MAR over RCP4 using growth rates of equal amounts in years one and two of RCP4 (resulting in an estimated 15.11% revenue growth for each of those years to illustrate this final decision),[2] and 5% for each of years three to five to produce an annual forecast smoothed maximum allowable revenue (**forecast SMAR**); and

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[1] The price path we set for Transpower under the IPP is set according to a revenue cap. We do not determine Transpower's pricing, which is instead set under the Transmission Pricing Methodology (TPM). For clarity we refer in this paper to the RCP4 price path as being a 'revenue path'.

[2] We will be applying this final decision to smooth the revenue path in November by applying the WACC rate for RCP4 which will be set in September 2024. This will change the revenue growth rate for years one and two of RCP4. We will make a final determination of the RCP4 IPP determination at that time.

1.4.1.3 annually washing up any variation between the forecast SMAR and Transpower's actual revenue, and including the result of the wash-up plus any incentive amounts in Transpower's EV account each year, and then accumulating the balance of the EV account over RCP4, with the closing RCP4 balance to be returned or recovered in Transpower's forecast revenues in RCP5;[3]

1.4.2 maintain the building blocks and inputs of the financial model used in RCP3, and now also include a revaluation building block for the purposes of calculating forecast revenue for pricing purposes and calculating the annual revenue wash-ups; and

1.4.3 include an additional transitional adjustment mechanism for an EV account entry arising from a deposit payment in RCP3 on the high-voltage direct current (**HVDC**) Cook Strait cable replacement project.

1.5 We have made an IM amendment to allow Transpower to use a different revaluation implementation approach than was specified in our IM Review 2023. We discuss this in our IM Amendment final decision paper which is published alongside this revenue paper.

Why the revenue path design is important

1.6 The design of Transpower's revenue path determines the timing of how it will recover its allowable transmission revenue over RCP4, which will in turn be reflected in the prices paid by Transpower's customers and end users of electricity.

1.7 The shape and design of the revenue path will determine the level of any year-to-year variability of Transpower's transmission revenues.

1.8 In RCP3, we decided to amend the IMs to smooth Transpower's revenue path for each year of the regulatory period, in order to minimise the volatility in revenue between regulatory periods and across the regulatory period. Transpower proposed a smoothed revenue path for RCP4 which is similar to RCP3.

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[3] Amounts will be carried forward from year to year in the Economic Value (**EV**) account at the Weighted Average Cost of Capital (**WACC**) rate, to compensate Transpower for the time value of money.

1.9 Revenue smoothing is not intended to change the economic value to Transpower of the total revenue it may recover, only the timing of that revenue recovery.

Our process in designing the RCP4 revenue path

1.10 In preparation for Transpower's RCP4 proposal, we issued a Section 53ZD information-gathering notice under the Commerce Act 1986, requesting Transpower to provide information and forecasts of different revenue smoothing scenarios.[4]

1.11 In its proposal,[5] Transpower forecast nominal revenue of $6,474 million over RCP4, which would have been an increase of 59% in RCP4 when compared with RCP3 revenue. This forecast revenue was based on the applicable IMs at the time of Transpower's submission of its proposal. Accordingly, it did not include the effect of our IM Review 2023 decision on indexation of the regulatory asset base (**RAB**) and our decision to apply the 65th percentile estimate of the weighted average cost of capital (**WACC**) when setting the IPP.[6, 7]

1.12 Transpower has since provided a revenue forecast that included the effect of RAB indexation and a 65th percentile estimate of WACC, consistent with the IM Review 2023 decision. The impact of these changes reduced Transpower's estimate of the forecast RCP4 nominal revenue to $5,798 million.

1.13 One of the revenue path scenarios provided by Transpower was its proposed and preferred revenue smoothing profile, which included a single step change of 24.9% at the start of RCP4, with a 5.0% per annum revenue increase thereafter.

1.14 Our draft decision was to adopt a price path smoothing profile with a two-year step change of equal percentage amounts for years one and two of RCP4 and 5% growth rate per annum for years three to five of RCP4. We considered this approach would moderate price impacts to consumers in years one and two compared to the initial 24.9% step change proposed by Transpower.

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4 Commerce Commission, "Notice to supply information to the Commerce Commission under section 53ZD of the Commerce Act 1986 – RCP4 revenue model and forecast revenue calculations" (**s53ZD Revenue model and forecast calculation**) (04 September 2023).

5 Transpower New Zealand Limited, "Regulatory control period 4 proposal April 2025 – March 2030" (21 November 2023) (**Transpower RCP4 proposal**).

6 Transpower, Transpower RCP4 proposal, p. 208.

7 For our IM decisions, see Commerce Commission, "Report on the IM Review 2023 – Part 4 Input Methodologies Review 2023 – Final decision" (13 December 2023).

1.15 Our draft decision was published on 29 May 2024. We then consulted on our draft decision through a four-week consultation period for submissions and a two-week period for cross-submissions. Our final decision takes into account submissions and cross-submissions received through that consultation process.

1.16 Our final decision is to adopt a price path smoothing profile with a two-year step change of equal percentage amounts for years one and two of RCP4 and a 5% growth rate per annum for years three to five of RCP4. This results in an estimated growth rate of approximately 15.11% for years one and two based on our final expenditure decisions and other decisions set out in this paper. While the estimated growth rate for years one and two is different to our draft decision, our approach to setting and calculating the growth rates are the same as for our draft decision. The growth rate for years one and two may change once we determine the WACC and finalise our revenue path in November.

The Transpower IPP financial model and how it has changed since RCP3

1.17 Transpower develops and maintains the IPP financial model which we rely on. The model outputs and underlying calculations that will be provided to us for our final RCP4 IPP determination in November 2024 will be independently audited.

1.18 To help inform our decisions we have used a simplified version of Transpower's financial model, which we have reviewed. We consider this approach provides a sufficiently accurate set of revenue outcomes to inform stakeholders of our decisions. We have updated the inputs for the simplified model used at draft for our final decisions on expenditure inputs to the revenue path. This has enabled our publication of a revised draft IPP determination alongside this revenue paper.

1.19 One of the key changes from RCP3 to the financial model for the purpose of informing our final decisions is the inclusion of RAB indexation.

1.20 In our draft decision, we noted that one of the changes from RCP3 included using a simplifying assumption in respect of the timing of capex commissioning (with Transpower's use of the half-yearly commissioning assumption). We stated in our draft decision that we would expect Transpower to forecast monthly capex commissioning. We have since revisited the RCP3 modelling and confirm the half-yearly capex commissioning assumption was used. Our final decision is to allow Transpower to use the half-yearly commissioning assumption for the purposes of calculating forecast capex.

1.21 Other changes that Transpower has made to its financial model include:

1.21.1 removing the high-voltage alternating current/high-voltage direct current (**HVAC/HVDC**) revenue split, which is no longer required given the implementation of the Transmission Pricing Methodologies (**TPM**);

1.21.2 removing the tax goal-seek macro to allow for a more dynamic model;

1.21.3 enabling the modelling of our IM Review 2023 decisions, particularly indexation of Transpower's RAB;

1.21.4 enabling depreciation modelling of new assets within the model to assist with sensitivity analysis and the revenue impact of uncertain capex; and

1.21.5 allowing for capacity to run multiple scenarios at once using Excel's data table function.

We will require Transpower to finalise the financial model for RCP4 by October 2024

1.22 As indicated in our Process framework and approach paper, we will issue an information request to Transpower to provide us with final RCP4 revenue outcomes using the full financial model in October 2024.[8]

1.23 Transpower will finalise its financial model to take account of our final decisions in this decision package. Transpower will incorporate our expenditure decisions and apply the regulatory WACC, which we will determine in September 2024. Transpower will then receive independent assurance of the model and submit it to us for our final review.

We will finalise the IPP determination for RCP4 by November 2024

1.24 Once we have reviewed the finalised financial model submitted by Transpower, we will then finalise the IPP determination to incorporate the finalised forecast MAR, forecast SMAR and growth rate for years one and two.

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8 Commerce Commission, "Transpower's individual price-quality path for 2025 to 2030 – Our process, decision-making framework, and approach for setting expenditure allowances, quality standards and the price path" (9 October 2023), table 1.

1.25 As part of the process to finalise the RCP4 IPP determination, we will undertake a separate technical consultation on the deliverability reopener mechanism in Schedule EA of the determination. This is to seek further stakeholder views on how the delivery risk reopener mechanism achieves our policy intent. We will provide separate notification to stakeholders on this consultation.

Chapter 2 Smoothing Transpower's revenue over a five-year period

Purpose of this chapter

2.1 This chapter discusses our final decision on how we will smooth Transpower's revenue over RCP4.

2.2 The building blocks approach to setting Transpower's forecast maximum allowable revenue (**MAR**) can produce step changes and volatility in the revenue we allow Transpower to recover from customers from year to year, and when transitioning between RCPs, particularly when we calculate the annual revenue wash-ups. These are reflected in the prices Transpower charges its customers unless we smooth the forecast MAR.

2.3 We set out our final decision and the indicative growth rates and forecast MAR and forecast SMAR, set out our reasons for our selected revenue smoothing profile and discuss the methodology and inputs for the revenue path. We also discuss how we will treat pass-through costs and recoverable costs.

2.4 In September, we will determine the WACC for Transpower's RCP4 price-quality path. Following this, we will finalise the price-quality path in November.

Our final decision

2.5 Our final decision is to set Transpower's annual RCP4 revenue using building blocks forecast MAR values, and then apply smoothing of the revenue path using annual revenue growth rates over the five-year regulatory period.

2.6 We have used the same methodology applied in our draft decision by allocating the resulting annual revenue between Transpower's pricing years (ie, the resulting annual revenue will be smoothed to give forecast SMAR amounts), to reduce some of the initial price shock from the revenue step change up from RCP3.

2.7 Our final decision is to set Transpower's annual RCP4 revenue path with an initial two-year step change of equal growth rates followed by a constant growth rate of 5.0% for years three to five of RCP4. This results in the following estimated rates of increase:[9]

[9] Our estimated rate of increase for the initial step changes in the revised draft determination (15.11%) is indicative and based on our internal interpretation of Transpower's model and estimated WACC. This may change for the final RCP4 IPP determination after the RCP4 WACC rate has been set in September 2024.

2.7.1 15.11% per annum in each of years one and two of RCP4; and

2.7.2 5.0% per annum in each of years three to five of RCP4.

2.8 Based on this approach, we have calculated updated estimates of the RCP4 forecast SMAR values, which we show in Table 2.1 below.

Table 2.1 Estimates of RCP4 Forecast SMAR

	2025/2026	2026/2027	2027/2028	2028/2029	2029/2030
Forecast SMAR ($m nominal)	967.2	1,113.3	1,169.0	1,227.4	1,288.8

2.9 Differences between the forecast SMAR, which we will set in the final RCP4 IPP determination and the revenue that Transpower earns will be washed up annually and any difference will be included as an entry in Transpower's EV account. The closing balance of the EV account for RCP4 will be recovered or repaid by Transpower over the RCP5 regulatory period.

2.10 Our final decision methodology is the same as our draft decision that we consulted on.

2.11 In coming to our final decision, we considered alternatives proposed in submissions on our Issues paper (**Issues paper**) and our draft decision to defer recovery of revenue to other regulatory periods or weight more of the recovery to later years in RCP4. However, we consider that our final decision best provides a balance between the consumer impacts by providing a degree of smoothing of large price rises, and maintaining Transpower's incentives to invest in a safe and reliable transmission network.

The length of the regulatory control period

2.12 In our Issues paper we noted we are required to decide the length of regulatory period and that we did not consider there were reasons causing us to consider a shorter regulatory period than the default five-year period.[10]

2.13 The Act requires us to set a five-year RCP, unless a shorter period would better meet the purpose of Part 4 of the Act (however, a period may not be shorter than four years).[11]

[10] Commerce Commission, "Transpower's individual price-quality path for the next regulatory control period – Issues paper" (25 January 2023) (**RCP4 Issues paper**), paras 10.57-10.59.

[11] *Commerce Act 1986,* s 53M.

Submissions on the length of the regulatory period

2.14 In its submission on the Issues paper, Transpower noted: [12]

> In our view any decision to reduce the regulatory period should be made prior to the start of the Transpower's submission proposal process, as the length of the regulatory period dictates investment and operational decisions (including accounting for the expenditure incentives). Our proposal is focused on a five-year period, and our expenditure plans and proposed initiatives reflect this.
>
> A shorter control period would also create consequential effects on both Transpower and Commission processes and their timing, such as the E&D reopener, listed project application, and ability to respond to any specific investigation query under a s53ZD notice. In addition, the decision would mean the control period ended March 2029 and leave an overhang period under the order-in-council (which expires September 2030) 3 that provides for Transpower's IPP.

2.15 We received a submission from MEUG on our draft decision to set a five-year period, noting its support of the five-year period.[13]

Reasons for our final decision

2.16 We considered whether a shorter period would be appropriate and have concluded that, taken as a package, the features of a shorter period would not better meet the purpose of Part 4 than those of a five-year period. Therefore our final decision is to set the Transpower RCP4 IPP at the default five-year regulatory period prescribed under s 53M(4) of the Act.

Our approach to determining Transpower's allowable revenue

2.17 Clause 3.1.1 of the Transpower IM states the revenue cap for Transpower must not exceed the forecast SMAR, for each pricing year of the RCP.

2.18 Clause 3.1.1(3) states the forecast SMAR must equal the net present value (**NPV**) of the aggregated forecast MARs of the RCP. It also that the IPP revenue growth rate must be applied when calculating each forecast SMAR. [14]

2.19 The first practical step in deriving the smoothed forecast revenue is to set the forecast MARs.

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[12] Transpower, Transpower "Submission on RCP4 Issues paper" (21 February 2024) (**Transpower's submission on Issues paper**), p. 1-2.

[13] Major Electricity Users' Group (**MEUG**), "Submission on RCP4 Draft decision" (26 June 2024), para 5.

[14] Given that the forecast MAR and forecast SMAR must have the same net present value (when applying the WACC as the time value of money factor), describing the rate of growth will be sufficient to determine the resulting forecast SMAR series.

Setting Transpower's forecast MARs

2.20 Our final decision is to set the forecast MARs using an unsmoothed building block approach. The building blocks consist of:

2.20.1 Capital charge building block (inclusive of the prior years' revaluation balance for calculating the opening RAB value);

2.20.2 Depreciation building block (inclusive of depreciation on the opening RAB balance, inclusive of prior year's revaluation);

2.20.3 Revaluation building block;

2.20.4 Operating expenditure building block;

2.20.5 Tax building block;

2.20.6 Term credit spread differential (**TCSD**) allowance building block;

2.20.7 Forecast EV adjustment building block (which is specified in the Transpower IM);

2.20.8 Pass-through costs building block (which is specified in the Transpower IM); and

2.20.9 Recoverable costs building block (which is specified in the Transpower IM).

2.21 This is consistent with the building blocks approach used in RCP3, plus the inclusion of the new RAB indexation. The revaluation of the RAB under RAB indexation is a separate building block for setting the forecast MAR and forecast SMAR, and also a separate building block for the purposes of the annual revenue path wash-ups. The amount of each year's total revaluation will be treated as revenue received by Transpower consistent with the requirements of the Transpower IM.

2.22 The forecast MAR for each disclosure year is combined with forecast pass-through costs and forecast recoverable costs to set the annual revenue Transpower can charge. The forecast MARs are then smoothed into the forecast SMAR values.

Setting Transpower's forecast SMAR

2.23 Clause 3.1.1(3) of the Transpower IM states we must determine the IPP revenue growth rate for each pricing year for the purposes of setting a forecast SMAR.[15] However, it does not specify a methodology for how we must set the IPP revenue growth rate.

2.24 In 2023 we issued a s 53ZD information notice to Transpower requesting it model and provide us with specified smoothing scenarios.[16] Transpower modelled 16 different revenue paths in response to our notice. In our Issues paper, we identified that a number of these revenue paths were no longer applicable due to our IM Review 2023 final decisions.[17]

2.25 We considered the following smoothing profile options:[18]

2.25.1 Option 1 – Transpower's proposed smoothing profile with a 24.9% step change between the last year of RCP3 and the first year of RCP4, plus a 5.0% p.a. growth rate after the first year of RCP4; and

2.25.2 Option 2 – two-year step change approach, with equal step changes (calculated at the time of the initial modelling to be 16.62% and later revised to 15.43% for our draft decision) in years one and two of RCP4, and a 5.0% p.a. growth rate from year three onwards.[19]

2.26 Our final decision is to use Option 2. We provide an illustration in Figure 2.1 of our final decision (Option 2), compared to Transpower's proposal and a fully smoothed variation (labelled as 'For reference – SMAR, CPI – x approach'), which demonstrates the scope within which we could smooth the revenue path profile.

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15 The forecast MAR values are calculated for each of the disclosure years commencing 1 July. However, we then use these forecast MARs to set Transpower's forecast SMAR revenue cap values based on pricing years commencing 1 April, with the first year of RCP4 commencing on 1 April 2025. This is primarily so that the allocation of Transpower's revenues under the Transmission Pricing Methodology will line up with the pricing years for which the electricity distribution businesses set their pricing for domestic consumers.

16 Commerce Commission, s53ZD Revenue model and forecast calculation.

17 Commerce Commission, "RCP4 Issues paper", Attachment A.

18 Note that our options analysis growth rates are based on the draft decision expenditure profile and may vary from our final decision as a result of the impacts of our final decision on base capex and opex and WACC.

19 The two steps of 16.62% in our options analysis vary from our draft decision where we estimated two steps at 15.43% as a result of the impacts of our draft decisions on base capex and opex.

2.27 The fully smoothed variation illustrates an approach that entirely favours customers initially and potentially disadvantages Transpower, with large increases at the end of RCP4. This is due to future major capex projects (**MCPs**) and listed projects we may approve during RCP4, which would translate to further revenue increases above what is currently shown.

2.28 The illustration in Figure 2.1 is an indicative estimate of how the price paths look based on Transpower's proposed price path design options and expenditure. While figure 2.1 may not reflect the actual numbers of the forecast SMAR for our final decision, we consider it to be a useful illustration.

2.29 In Figure 2.2, we illustrate how our final decision compares to the building block totals for each pricing year. This figure reflects the revenue effects of our final decisions on opex and capex for RCP4.

Figure 2.1 Forecast SMAR ($ million nominal)

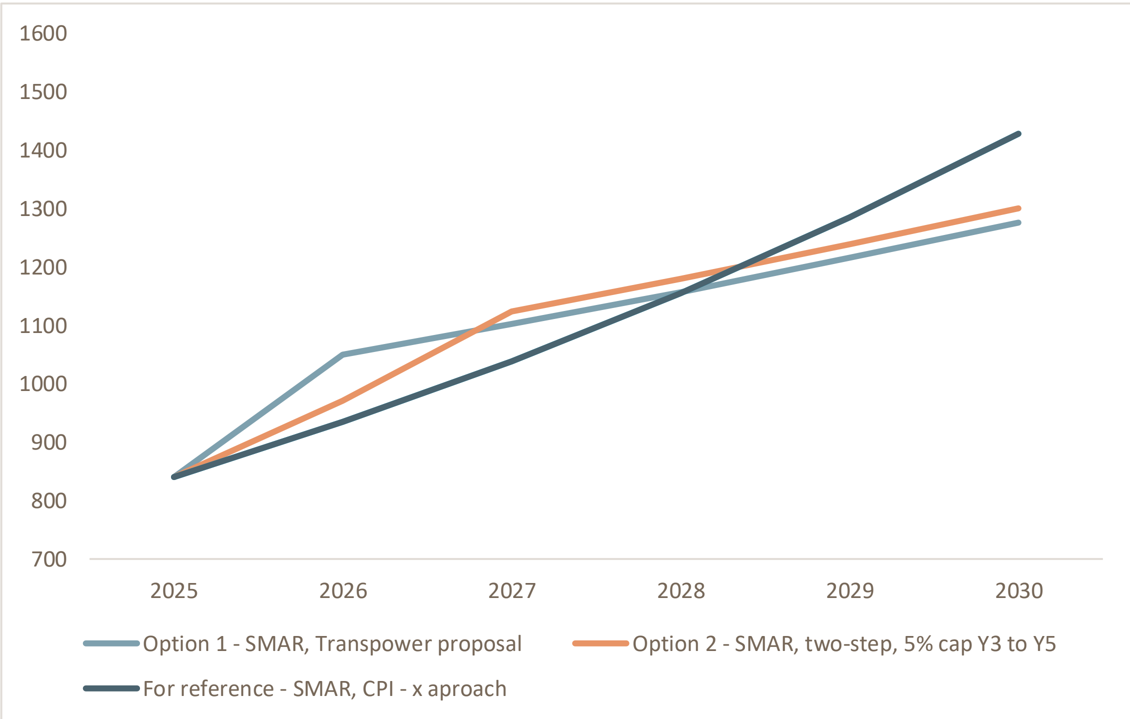
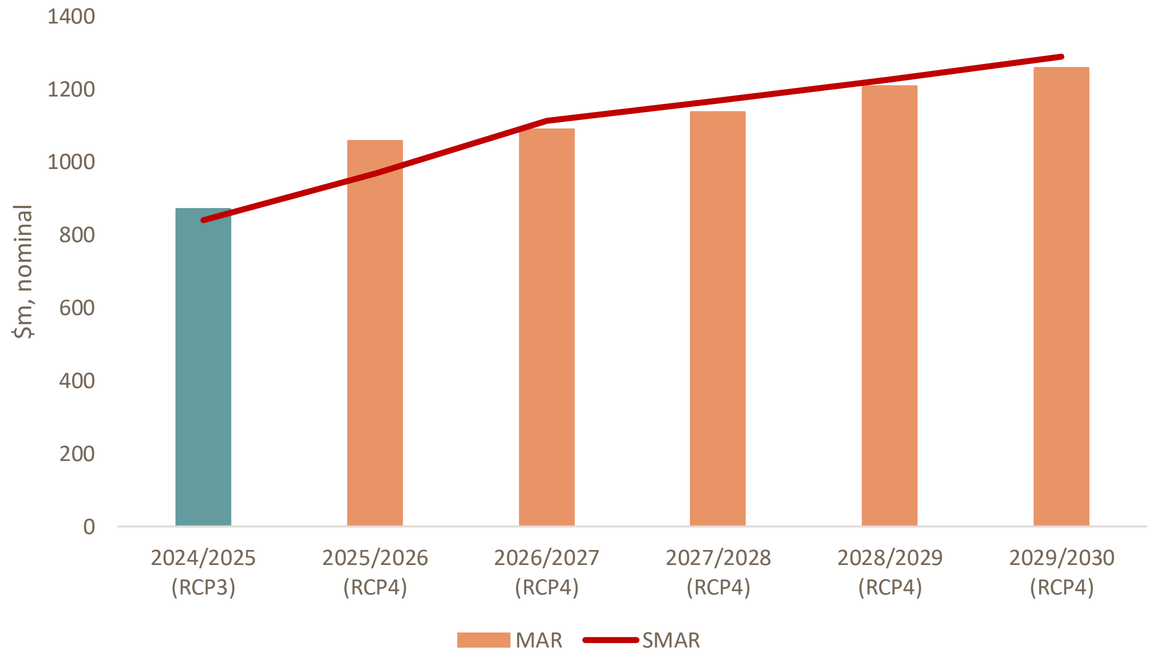


Figure 2.2 Forecast SMAR vs Forecast MAR ($ million nominal)



Factors guiding our assessment of the revenue path profile options

2.30 In guiding our assessment of which forecast SMAR to determine, we must consider a revenue path profile that is consistent with promoting the Part 4 purpose.

2.31 In implementing revenue smoothing, we consider a number of factors, including:[20]

2.31.1 minimising price shock risks to Transpower's customers and ultimate consumers; and

2.31.2 not imposing undue financial hardship on Transpower in deferring its recovery of revenue.

Assessment of smoothed revenue path profiles

2.32 Transpower's proposed approach was to have a single step change with a flatter year-on-year growth rate for the remaining years. This resulted in a significant increase of 24.9% for year one of RCP4.

[20] Commerce Commission, "RCP4 Issues paper", para 10.7.

2.33 As noted in our draft decision, our concern with Transpower's proposal (Option 1) was the extent of the increase caused by the step change in year one of RCP4, as this may not be the best option for consumers who are currently experiencing financial challenges.

2.34 For our final decision, we have favoured an approach that mitigates that price impact by spreading out the increase. There are two factors in considering how much we should defer recovery of revenue:

2.34.1 maintaining Transpower's incentives to invest in a safe and reliable network; and

2.34.2 the likelihood of Transpower seeking approvals for listed projects and MCPs during RCP4, and the associated possible price impacts of those later approvals.

2.35 In assessing these two factors, we considered:

2.35.1 whether the 'decoupling' of the profile of the forecast SMARs from the profile of the forecast MARs may affect incentives to invest; and

2.35.2 whether the quantum of listed projects and MCPs during RCP4 would cause a price impact and whether a flatter growth rate later in the period would be beneficial. It would help cushion some of the impact of price increases in the later years of RCP4, from commissioning of any MCPs or listed projects we later approve during RCP4.

2.36 From the options set out, Transpower's proposal (Option 1) achieves a forecast SMAR profile that is closest to the profile of the forecast MARs.

2.37 While Option 2 has some degree of 'decoupling', it has a lower difference between forecast MARs and forecast SMARs compared to approaches where we spread the initial step change over two years with a higher growth rate for year one and a lower growth rate for year two or a fully smoothed approach. Under Option 2, Transpower will recover revenue greater than its forecast MARs from years three of RCP4 onwards.

2.38 Based on the regulatory templates provided to us by Transpower, it forecasted that a large portion of additional capex on MCPs and listed projects would be incurred and commissioned in mid-to-late RCP4, if the expenditure/projects are later approved.[21]

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[21] Based on the preliminary figures, Transpower expects that it will commission $246.8 million in year three and $256.9 million in year four, compared to $94.8 million in year one and $183.5 million in year two. Note these values are in constant $2022/2023.

2.39 We consider a lower growth rate in the later years of RCP4 is likely to better promote the Part 4 purpose, as it takes into account possible price increases resulting from approved additional commissioned capex during RCP4.

2.40 Based on our assessment in balancing the consumer impacts and providing incentives to invest in safe and reliable networks, our final decision is to adopt Option 2. In our view it best provides a balance between providing a degree of smoothing of large price rises, and maintaining Transpower's incentives to invest.

Alternatives considered for the step between RCP4 and RCP5

2.41 We received submissions on our Issues paper from stakeholders on deferring the recovery of revenue from RCP4 into the next RCP (RCP5).

2.42 Contact Energy submitted:[22]

> […] There should also be scenarios that spread the significant increase in costs over more than one regulatory period […]
>
> Smoothing revenue increases over more than one regulatory period remains consistent with preserving NPV, and there is regulatory precedent for doing so:
>
> > • In the first reset under the Part 4 regime in 2012 the Commission smoothed revenue increases for Alpine Energy, Centralines, The Lines Company, and Top Energy over two regulatory periods. Due to the shortened nature of the first regulatory period this meant costs were recovered over a 7-year period.
> >
> > • The regulation of fibre services under Part 6 of the Telecommunications Act 2001 established a 'financial losses asset'. This was to account for losses incurred during the construction of the UFB network. It therefore functions in a similar way to multiperiod smoothing as there was a period of under-recovery followed by a period where revenues are allowed to increase to maintain long term NPV. […]
>
> We are sensitive to the financeability concerns of spreading costs over multiple periods. It is in consumers long-term interests that Transpower has sufficient cashflows to undertake necessary investment.
>
> *[submission footnotes omitted]*

22 Contact Energy "Submission on RCP4 Issues paper" (21 February 2024) (**Contact's submission on Issues paper**), p 2.

2.43 Transpower submitted:[23]

> Our view is that, to the extent possible, today's consumers should pay for today's costs. Any long-term deferral of revenue is unlikely to be consistent with a workably competitive market. Customers are charged our regulated rate of return on deferred revenue recovery.
>
> We consider the price-path most appropriate is that which allows a supplier to recover its costs as closely as possible to when they have been incurred.
>
> …
>
> In addition, the Commission's decision to index our RAB has deferred a significant proportion of our RCP4 revenue into the future. Further deferrals for smoothing purposes, not in line with the purpose of Part 4, may impact our financing needs.

2.44 In the subsequent Issues paper cross-submission stage, Vector submitted:[24]

> We note Contact's submission suggested the Commission also consider price smoothing scenarios that spread cost increases across regulatory periods.
>
> We do not consider a revenue path that deferred cost recovery across regulatory periods would support the long-term benefit of consumers. Transpower's submission explains: "Our view is that, to the extent possible, today's consumers should pay for today's costs. Any long-term deferral of revenue is unlikely to be consistent with a workably competitive market. Customers are charged our regulated rate of return on deferred revenue recovery… the Commission's decision to index our RAB has deferred a significant proportion of our RCP4 revenue into the future. Further deferrals for smoothing purposes, not in line with the purpose of Part 4, may impact our financing needs."

2.45 We have considered whether there was merit to further deferring some of Transpower's revenue recovery into the next RCP.

2.46 While this might mitigate some of the price effects of the forecast expenditure, we considered this approach undesirable, as it might have had a negative impact on consumers in the future and on Transpower's incentives to invest.

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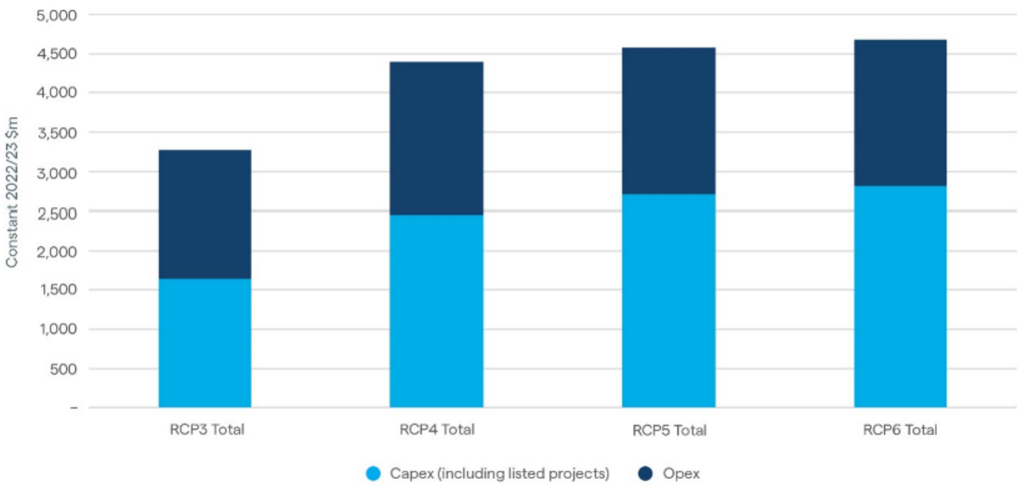
23 Transpower, "Transpower's submission on RCP4 Issues paper", (21 February 2024).

24 Vector Energy, "Vector Cross-submission on RCP4 Issues paper" (13 March 2024) (**Vector's cross-submission on Issues paper**).

2.47 In our draft decision, we noted in Transpower's proposal, its RCP5 expenditure is forecast to further increase from RCP4 levels (shown in figure 2.3).[25] We did not assess those expenditure forecasts, as this is outside of our RCP4 revenue path setting. However, taking into account this information from Transpower under a deferred revenue forecast profile for RCP4, it is possible that minimisation of RCP4 price effects, by deferring Transpower's revenue recovery from the current period into the next, may actually exacerbate future price increases for Transpower's customers and its ultimate consumers.

Figure 2.3 Transpower long-term expenditure forecast



2.48 Significant deferral of cashflows is likely to undermine Transpower's incentives to invest, which could end up being contrary to consumers' long-term interests.[26] For these reasons, our final decision is not to defer any RCP4 revenue recovery by Transpower into RCP5.

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25 Transpower, Transpower RCP4 proposal, figure 15.

26 As mentioned by submitters on our Issues paper, a significant deferral of revenue recovery may not support the long-term interest of consumers. We noted in the DPP4 reset Financeability issues paper that our decisions under Part 4 of the Act are intended to provide the expectation of a normal return for investors. Deferral of revenue recovery may not reflect the expectation of a normal return and, as such, may not be reflective of the ex-ante financial capital maintenance principle (which is that regulated supplies should have the expectation of earning their risk adjusted cost of capital, and of maintaining their financial capital in real terms over timeframes longer than a single regulatory period). See Chapter 4 of Commerce Commission, Part 4 IM Review 2023 Framework paper, (13 October 2022).

2.49 We consider not deferring allowed revenue to a later period is appropriate in this case, as on balance this is likely to better promote the Part 4 purpose by allowing Transpower the opportunity to recover its expenditure in a manner that reflects the expectation of a normal return. It will possibly also provide a degree of protection against future price impacts.

Submissions on our draft revenue path decision, analysis of submissions and our final decision

2.50 We received submissions on our draft decision from Fonterra, Meridian and MEUG on our smoothing profile.

2.51 Fonterra noted that it was "supportive of revenue smoothing with the majority of revenue being recovered in later years, due to deliverability and future demand uncertainty".[27]

2.52 Meridian noted it was "very supportive of [our] proposal to smooth Transpower's revenue."[28] It submitted that:

> Meridian understands the underlying drivers of these regulated revenue increases – the cost of capital, inflation, aging assets, and expectations of increased investment – these are all valid issues affecting electricity distribution businesses (EDBs) and Transpower.
>
> We have to acknowledge that the cost to consumers of not supporting network investment could be even greater in the long run. It is critical that the impact of these increases on consumers is softened to the extent possible. In this respect, Meridian is very supportive of the Commission's proposal to smooth Transpower's revenue path. This will go some way to alleviating price shocks for consumers.

2.53 MEUG suggested an alternative smoothing profile. It submitted that:[29]

> We appreciate that there are several ways that revenue could be smoothed across the period (as per Transpower's modelling), balancing the impact on consumers versus revenue recovery for Transpower. We would prefer a smoothing profile that weighted a higher proportion of funding to be recovered in the later years, enabling Transpower to address deliverability concerns and demand uncertainty first, while acknowledging the compounding cost pressures facing electricity consumers.

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[27] Fonterra, "Fonterra submission on Transpower's Regulatory Control Period Consultation" (26 June 2024), p 1.

[28] Meridian, "Meridian Submission on RCP4 Draft decision" (26 June 2024) (**Merian submission on Draft Decision**), p 2.

[29] Major Electricity Users' Group, "MEUG Submission on RCP4 Draft decision" (26 June 2024) (**MEUG submission on Draft Decision**), para 8.

2.54 We consider an approach to recovery of revenue to account for deliverability is not appropriate given our decision to make recovery of some of Transpower's expenditure contingent on achieving its forecasted full-time equivalent staff (**FTE**) recruitment.[30] Any additional adjustments to the revenue path may result in an overadjustment to address the deliverability risk. We consider demand uncertainty to be less of a factor when smoothing the price-path as Transpower's work programme is driven largely by asset replacement and renewals rather than demand growth.

2.55 Our view is the suggested approach of deferring recovery of revenues is not the best approach to promote the Part 4 purpose for consumers for the following reasons:

2.55.1 the possible approval and commissioning of MCPs and listed projects in the later years of RCP4 is expected to further increase prices in those years. If we were to weight more of the revenue recovery to these years now, this would be exacerbated by these later projects, causing a higher consumer pricing impact; and

2.55.2 The smoothing profile we have adopted is more aligned with Transpower's forecasted expenditure profile, which better promotes the incentives to invest by more closely aligning to its expected expenditure than the submitted alternative.

2.56 Our final decision is to confirm our draft decision on the smoothing profile.

Other submissions on points related to our draft revenue path decision and our final decision/responses

2.57 We received submissions on our draft decision on the following points related to the overall revenue path approach:

2.57.1 pricing impact on solar panel owners; and

2.57.2 building blocks commissioning assumptions;

2.57.3 Transpower's profitability; and

2.57.4 illustrations of revenue impacts of MCPs and listed projects.

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[30] See Commerce Commission, "Transpower RCP4 IPP Final Decision – Attachment E - Deliverability topic paper" (29 August 2024), available at https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-transmission/transpowers-price-quality-path/2025-transpower-individual-price-quality-path.

Pricing impact on solar panel owners

2.58 Mr. Jeff Davies in his submission noted that he would like us to consider the case of homeowners with solar panels in respect of transmission charges. Specifically, he noted that "Such owners [of solar panels] actually reduce the need for transmission lines and so should not be hit with the same increases as others."[31]

2.59 In response to the submission on solar panel owners in residential contexts, we note that how Transpower's transmission charges are allocated to consumers is a function of Transpower's TPM, the distribution pricing methodologies of electricity distribution businesses (**EDBs**), and ultimately a retail pricing decision. This is within the Electricity Authority's regulatory remit rather than ours. We have informed the Authority of Mr Davies' submission.

Building blocks commissioning assumptions

2.60 Transpower submitted regarding the forecast commissioning assumptions used for the purposes of its forecast revenue under our proposed building blocks methodology. It submitted that:[32]

> We encourage the Commission to continue to allow us to forecast capex commissioning on a mid-year basis.
>
> …
>
> We do not forecast commissioning monthly (especially four to six years into the future). Forecasting on a monthly basis would be an exercise in false precision and unlikely to significantly alter the revenue profile. Due to our comprehensive wash-up mechanism, any forecast error would be corrected for and returned to or recovered from customers in RCP5.

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31 Jeff Davies, "Jeff Davies Submission on RCP4 Draft decisions" (26 June 2024) (**Jeff Davies submission on Draft Decision**)

32 Transpower, "Transpower Submission on RCP4 Draft decision" (26-June-2024) (**Transpower submission on Draft Decision**), paras 16-18.

2.61 Our final decision is to allow Transpower to assume a half yearly capex commissioning assumption in a disclosure year for the purposes of calculating its forecast revenue for each relevant pricing year. This is a change from what we signalled in our draft decision.[33] This approach does not require a drafting change to the Transpower IPP determination, as Transpower will be able to calculate its forecast revenue for a pricing year in accordance with IPP Schedule D (ie, apply the cash-flow timing factor for month 6 and month 12 in the building blocks model for the forecast MAR).

2.62 We consider the commissioning assumption on a monthly basis is not likely to have a material beneficial impact on revenue compared to a half-yearly approach and may be (as Transpower has noted) an exercise in false precision, given the forecast horizon and the requirement is likely to increase regulatory burden that we do not consider is outweighed by any potential benefit. As Transpower notes in its submission on our draft, any forecasting error would be washed up and returned to or recovered from customers due to the monthly commissioning wash-up (which is returned to or recovered from customers in RCP5).

2.63 We consider our final decision of using the half-yearly commissioning assumption would not detract from the Part 4 purpose and would result in lower regulatory burden compared to the approach signalled in our draft decision.

2.64 While we accept Transpower's submission with respect to the forecast commissioning, Transpower must continue to calculate its actual assets commissioned on a monthly basis for the purposes of the wash-up in Schedule E of the IPP.

Transpower's profitability

2.65 Consumer Advocacy Council (**CAC**) submitted:[34]

> Transpower's financial statements for the five years from 2019 to 2023 show it earned a combined net profit (before tax) of $1.298 billion (Table 1). This is equivalent to 31% of the proposed capital and operating expenditure that Transpower will be able to recover from consumers for the 2025-2030 period.
> …
> Such a return for a monopoly supplier is arguably inconsistent with the purpose of Part 4 of the Commerce Act to "promote the long-term benefit of consumers," particularly in light of evidence that shows a significant proportion of households are already experiencing energy hardship.

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[33] Commerce Commission, "Draft Decision Attachment A Revenue path design for Transpower IPP commencing 1 April 2025" (29-May-2024) (**Draft Decision Revenue Path**), para 1.18.

[34] Consumer Advocacy Council, "Consumer Advocacy Council Submission on RCP4 draft decision" (26 June 2024) (**CAC's submission on draft decision**), paras 7-8.

2.66 Transpower also cross-submitted in response to the CAC submission on its profitability. Transpower submitted:[35]

> The Consumer Advocacy Council has raised concerns that its estimate of our return is arguably too high for a monopoly provider. The Consumer Advocacy Council's estimate is based on a calculation of historical earnings before tax divided by our forecast RCP4 operating and capital expenditure. This is not a recognised accounting or regulatory approach to calculating a return on investment.
>
> The Commission requires us to report our return on investment as part of its Information Disclosure regime. Our percentage (vanilla) return on investment for RCP3 has been 5.00%, 5.31%, and 4.35% for June end 2021, 2022 and 2023 respectively. These returns compare to the Commerce Commission's WACC setting of 4.57%. The return should be assessed against the whole RCP period as the return is affected by the timing of capex and opex.

2.67 We agree with Transpower that the approach taken by CAC to calculate profitability and rate of return does not reflect a recognised accounting or regulatory approach to calculate a return on investment (as an example, not taking into account return on its existing asset base).

2.68 Transpower's submission and information disclosure shows its profitability is similar to the regulatory WACC.

Illustration of revenue impacts from MCPs and Listed Projects

2.69 MEUG submitted that:[36]

> Consumers will also face increased transmission charges resulting from Major Capital Projects, listed projects and possible re-openers over the coming regulatory period. The consultation paper is unfortunately silent on the impact of all these transmission components on end consumers, as well as the forecast lift in wholesale, distribution and retail components.

2.70 In response to MEUG's submission requesting additional information demonstrating the price path with the effects of the MCP and Listed Projects, we refer to the illustration in Figure 2.3 provided by Transpower in its proposal, which shows additional bars illustrating indicative revenue impacts of listed projects and MCPs.[37]

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35 Transpower, "Transpower Cross-submission on RCP4 draft decision" (15 July 2024) (**Transpower cross-submission on draft decision**), paras 4-5.

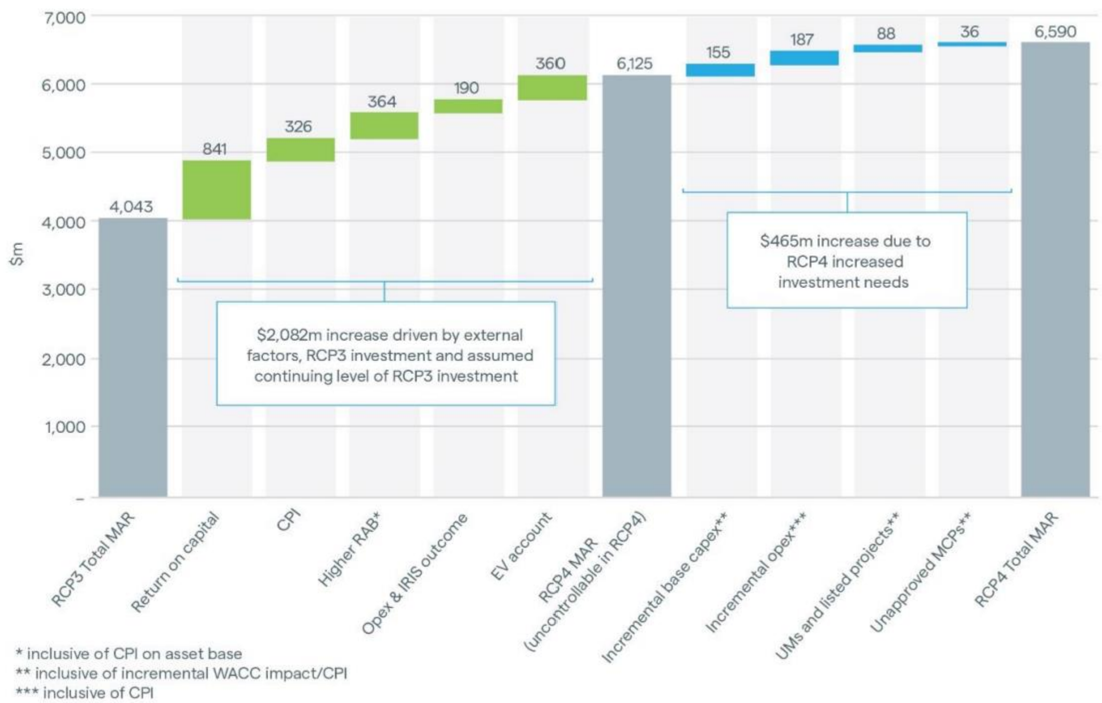
36 Major Electricity Users' Group, MEUG submission on draft decision, para 5.

37 Transpower, Transpower RCP4 proposal, Figure 9.

2.71 We note this is very much indicative only and should not be relied upon to determine price impacts, as it does not factor in the revenue impacts of our final decisions and the timing and scale of approved expenditure and commissioning of the MCPs and listed projects is at this stage also variable.

Figure 2.3 Transpower estimate of proposed revenue impact of unapproved Listed Projects and MCPs[38]

Revenue movement forecast from end of RCP3 to RCP4 ($ million nominal)



WACC

2.72 The WACC has a significant impact on the revenue Transpower can earn over an RCP, as it determines the return Transpower earns on its RAB (this appears in the Return on Capital forecast MAR building block).

2.73 We do not set the WACC as part of our IPP input decisions. The final WACC that will apply for RCP4 will be published in a separate determination in September 2024.

2.74 In its RCP4 proposal, Transpower calculated an estimate of the WACC based on the risk-free rate and average debt premium from our August 2023 ID WACC determination, amended to incorporate our draft IM Review 2023 decisions (though Transpower did not update the standard error of the WACC).

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[38] Transpower, Transpower RCP4 proposal, Figure 9.

2.75 This estimated WACC rate does not include recent movements in the risk-free rate and average debt premium, and changes to the fixed WACC parameters from the draft to final decision of our IM Review 2023.

2.76 We applied our most recent estimates of WACC of 7.37% (65th percentile vanilla WACC) and 6.67% (65th percentile post-tax WACC) to estimate revenues for the purpose of our revised draft decisions. This is based on the risk-free rate and average debt premium set out in our April 2024 EDB ID WACC determination, and the updated fixed WACC parameters following the final decision on our IM Review 2023.

2.77 These vanilla and post-tax estimates of the WACC should be seen as illustrative only and should not be relied upon as an indication of the WACC rate we will determine for the RCP4 revenue path in September 2024.

2.78 For the purposes of illustrating an estimated revenue path, we used the following WACC rates as an estimate to model our revised draft revenue path:

2.78.1 65th percentile vanilla WACC – 7.37%; and

2.78.2 65th percentile post-tax WACC – 6.67%.

2.79 These are the same values and approach as we used to illustrate our draft decision.

Our reasons

2.80 The Transpower IMs are silent on the WACC to be applied for the purposes of a revised draft revenue path estimation. However, to illustrate the revenue impacts of our final input decisions on capex, opex and deliverability, we have used the above estimated values in order to provide a revised draft revenue path. We will use the September 2024 RCP4 WACC estimate in our final RCP4 IPP determination, in accordance with clause 3.5.1 of the Transpower IM.

2.81 We set out below the submissions we received on the WACC methodologies prescribed by the IMs. As discussed below, none of the submissions have caused us to change our approach for the purposes of estimation for our final decision.

2.82 We set out in Table 2.2 the parameters we have used to calculate the estimate of the WACC for the purposes of our revised draft price path decision.

Table 2.2 Parameters for estimate of WACC

Parameter	Updated estimate of WACC
Nominal risk-free rate	4.53%
Average debt premium	1.39%
Debt issuance costs	0.20%
Asset beta	0.360
Tax adjusted market risk premium	7.00%
Average corporate tax rate	28.00%
Average investor tax rate	28.00%
Leverage	41.00%
Equity beta	0.61
Cost of equity	7.53%
Cost of debt	6.12%
Standard error of mid-point WACC	0.0108
z-Score	0.385

Submissions on our draft decision and our response

2.83 We received submissions related to the WACC from Fonterra and MEUG. Their submissions relate to a change in the methodology to the WACC, especially related to a change in the WACC percentile.

2.84 We note the methodology for determining the WACC, including the WACC percentile, is out of scope of our consideration for this IPP reset process. Our methodologies related to WACC (including the percentile) were extensively reviewed in our IM Review 2023.[39]

[39] See Commerce Commission, "Cost of capital topic paper – Part 4 Input Methodologies Review 2023 – Final decision" (13 December 2023).

Our revised draft WACC and our process for the final determination

2.85 The Transpower IM requires us to use the WACC estimate determined by us no later than six months prior to the start of RCP4 in our final RCP4 IPP determination in November 2024, which is consistent with clause 3.5.6 of the Transpower IM. This will be published in September 2024.

2.86 For the purpose of the revised draft determination published alongside this paper, we have used the same WACC as we used in our draft decision as an approximation of the final WACC.

Smoothing recovery of pass-through costs and recoverable costs

2.87 In RCP3, as part of our wider decision to smooth Transpower's forecast MAR, we decided to smooth the recovery of pass-through costs and recoverable costs. As a part of the RCP3 IPP reset process, we made an amendment to the Transpower IM applying to RCP3 by codifying the requirement to smooth the forecast MAR. By virtue of the drafting in the IMs, the forecast pass-through costs and recoverable costs are also smoothed.

Our final decision

2.88 Our final decision is to:

2.88.1 smooth Transpower's recovery of forecast pass-through costs and forecast recoverable costs and include a forecast amount of pass-through and recoverable costs in the revenue path and forecast SMAR consistent with cl 3.1.1(4) of the Transpower IM; and

2.88.2 include in the EV account the difference between the forecast and actual pass-through costs and recoverable costs.

2.89 This is the same as our draft decision.

Submissions

2.90 We did not receive any submissions on our draft decision regarding the approach to smoothing the recovery of pass-through costs and recoverable costs.

Analysis

2.91 Consistent with clause 3.1.1(4) of the Transpower IM, we will include forecast pass-through costs and forecast recoverable amounts in the forecast MAR. The forecast MAR will then be smoothed into the forecast SMAR consistent with clause 3.1.1(4) of the Transpower IM.

2.92 A forecast of these amounts for RCP4 will therefore be included in the forecast SMAR. The Transpower IM does not specify the inputs for the EV account or annual wash-up process – these are specified in the IPP. As these amounts are not set, and can only be forecast, we consider any forecasting inaccuracy needs to be washed up.

2.93 Our final decision is to implement the same approach taken in RCP3, which is to wash-up the difference between the building block values in the forecast MAR and actual costs annually, with the variances being included in the EV account.

2.94 Transpower already performs an annual wash-up calculation on its forecast MAR and its cost building blocks, and the difference between forecast and actual pass-through costs and recoverable amounts can be included in this wash-up calculation. These would be disclosed when Transpower provides us with its other wash-up calculations.

Chapter 3 Accumulation of revenue path wash-up and incentive amounts

Purpose of this chapter

3.1 The recovery of EV account amounts is specified in the Transpower IMs and allows Transpower to recover the EV account balance (as at the end of the period) in the next RCP or, where there is a large accumulation of EV account balance, during the RCP, rather than recover on an annual basis during the period.[40]

3.2 This chapter sets out our views on the accumulation of revenue path wash-up and incentive amounts for RCP4 and our decision on how we will deal with the disparity between the forecast closing EV account balance for RCP3 and the actual balance.

3.3 We also set out decisions related to our setting of incentive amounts that may have effect in the RCP4 price path.

3.4 This chapter also describes the additional transitional adjustment mechanism for any EV account entry arising in RCP3 from deposit payments on the HVDC Cook Strait cable replacement project.

Our final decision

3.5 In setting our forecast SMAR values, the Transpower IM requires us to set a forecasted closing EV account balance for the disclosure year ending on 30 June 2025.[41]

3.6 Our final decision is to maintain the revenue wash-up approach used in RCP3, which is to wash-up for the difference between the forecast closing EV account balance for RCP3 and the actual balance calculated as at 30 June 2025, subject to adjustments for the RCP4 HVDC transitional EV account adjustment mechanism. This EV account wash-up difference will be rolled forward in the EV account in RCP4 and any net balance in the account at the end of RCP4 will be reflected in Transpower's revenue in RCP5.

3.7 This is the same as our draft decision.

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40 Commerce Commission, *Transpower Input Methodologies Determination 2012* [2012] NZCC 17 (as amended) (**Transpower IM**), Clause 3.1.1(5).

41 Transpower IM, Clauses 3.1.1(4) and (5).

3.8 Our final decision is also to introduce the RCP4 HVDC transitional EV account adjustment mechanism to address a one-off specific issue. This issue is that Transpower expects to pay a large deposit in RCP3 to secure the manufacturing of new and replacement Cook Strait cables. This is before the expected time of our assessment of the capex project in early to mid-RCP4. As a result, a permanent negative base capex incentive penalty would arise, creating a disincentive on Transpower to secure the manufacturing capacity. Our final decision is to introduce a mechanism to address this issue by:

3.8.1 amending the Transpower IM;[42] and

3.8.2 introducing the 'RCP4 HVDC transitional EV account adjustment' into the RCP4 IPP determination to:

3.8.2.1 separately identify in the closing RCP3 EV account balance any EV account entry relating to the cable deposit, so it is not recovered from Transpower (as a negative revenue amount) in the forecast SMAR across RCP4; and

3.8.2.2 allow us to determine an offsetting entry in the EV account in RCP4 in the first disclosure year of RCP4, which will have the effect of eliminating any base capex incentive penalty relating specifically to the HVDC cable deposit.

3.9 These are the same as our draft decisions.

Background on the EV account

3.10 Transpower's EV account is used to accumulate EV account entries that arise from time to time with respect to various revenue wash-ups and incentive calculations. For example, we expect some variation between the revenue Transpower forecasts and the revenue it actually earns over time. The difference is calculated annually and included in the EV account. Other amounts, such as incentive amounts that have not yet been recovered from or returned to Transpower's customers, are also included in the EV account.

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[42] Commerce Commission, "Amendments to input methodologies for Transpower's individual price-quality path for the regulatory control period commencing 1 April 2025 – Final decision paper", (29 August 2024), available at https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-transmission/transpowers-price-quality-path/2025-transpower-individual-price-quality-path.

3.11 In RCP1 and RCP2, the balance in the EV account was recovered from, or returned to, Transpower's customers annually when Transpower set its prices. In RCP3 we implemented an EV account recovery approach, where the EV account entries are calculated annually and accumulated in Transpower's EV account, with recovery (or repayment) of wash-up and incentive amounts being deferred until the next regulatory period (in that case, RCP4), when the net balance would be recovered in the smoothed revenue path for that period.

3.12 The EV account recovery mechanism is accompanied by a price path reopener mechanism in clause 3.7.3A of the Transpower IM. This allows some of the EV account balance to be spread over the remaining years of the current RCP when the forecasted accumulated balance becomes sufficiently material that it could cause a price shock to Transpower's customers if it was carried forward and spread over the subsequent RCP.

3.13 These EV account features were implemented in clause 3.1.1(4) and (5) of the Transpower IM for RCP3, and will also be applied in RCP4 and later regulatory periods.

Analysis

3.14 As the revenue path must be set before the closing balance will be available, we will use the EV account balance as forecasted by Transpower in its proposal (which is currently forecasted to be $146.7 million at the end of RCP3). Some fluctuation in annual EV account balance amounts is expected. Any difference between this forecast and the actual balance will be washed up and rolled forward with the EV account.

3.15 We received a submission on our Issues paper from Transpower advocating for a return to the annual EV account balance drawdown and resetting revenue annually. [43]

3.16 We considered the EV account balance drawdown and resetting of revenue paths in our IM Review 2023 and maintained our approach to EV account balance drawdowns and revenue path resets. We do not consider the annual EV account balance drawdown and resetting revenue annually better meets the Part 4 purpose as it would reintroduce volatility into the revenue path, and is not in the long-term benefit of consumers.

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[43] Transpower, Transpower "Submission on RCP4 Issues paper" (21 February 2024) (**Transpower's submission on Issues paper**), paras 47-50.

RCP4 transitional EV account adjustment for HVDC Cook Strait cable replacement project

3.17 A problem is created by the required timing of a contract deposit payment to an overseas cable manufacturer by Transpower in RCP3, which is before the expected timing of our consideration of the capex project in early to mid RCP4. Transpower stated the need for and size of a deposit will be subject to negotiations, but it has indicated that it could be as much as $60 million (and possibly higher). The timing of the payment means our IMs could result in a base capex incentive penalty, which would be approximately $14 million on a $60 million deposit paid in RCP3.

3.18 This could result in Transpower bearing a reduction in its RCP4 allowable revenue as a result of incurring capex (ie, the cable replacement deposit) when it does not yet have approval of its project capex. The problem is created by the nature of regulatory periods , and Transpower would bear a significant efficiency penalty for something that is purely a timing issue. The lead time for securing manufacture of HVDC cables is unexpectedly long and is not within Transpower's control. If the deposit fell within RCP4 after we approve the cable replacement listed project, the issue would not arise.

3.19 We consider this to be a one-off specific situation and have considered possible solutions in this context. We do not intend to repeat this adjustment.

3.20 We considered three options for dealing with the contract deposit:

3.20.1 Do nothing, which means Transpower would permanently bear the financial cost of the negative base capex incentive amount from RCP3;

3.20.2 Amend the RCP4 IPP only, which is workable, but we consider would require a strained interpretation of the EV account spreading rule in the Transpower IM; or

3.20.3 Amend the RCP4 IPP and the IMs.

3.21 Consistent with our draft decision, we consider the first option would be contrary to the Part 4 purpose in s 52A. Although it meets the Part 4 purpose in s 52A of the Act better than the first option, our decision is not to implement the second option, because we consider it potentially relies upon a strained interpretation of the IMs and therefore is inconsistent with our obligation under s 52S. This is consistent with our draft decision.

3.22 Consistent with our draft decision, our final decision is to amend the RCP4 IPP and the IMs (ie, the third option above).[44] We consider this approach properly complies with our legal obligation under s 52S to apply the IMs as determined, as well as being consistent with the Part 4 purpose in s 52A.

3.23 Our final decision is to separately identify any EV account entry relating to the payment of the HVDC cable deposit at the end of RCP3, so it is not recovered from Transpower (as a negative revenue amount) in the forecast SMAR across RCP4.

3.24 We will also create an offsetting entry in the EV account, in the first disclosure year of RCP4, determined by the Commission, which will have the effect of eliminating the value of any base capex incentive penalty relating specifically to the HVDC cable deposit from the EV account. This entry will have no revenue effect for Transpower. This means there will be no net revenue effect from any incentive penalty that would otherwise arise from the payment of the HVDC cable deposit.

3.25 The purpose of the transitional EV account adjustment for the HVDC Cook Strait cable is for there to be no net revenue impact on Transpower arising from the timing of the payment of the deposit for the HVDC cable manufacture.

3.26 The deposit itself is part of the capex cost of the cable assets and that element of expenditure will enter the RAB when the relevant assets that it relates to are commissioned.

3.27 We have made an IM amendment (in our IM Amendment final decision paper) and have decided to make a related RCP4 IPP determination drafting change to separate the EV account entry from the RCP3 closing EV account balance in this way.[45]

3.28 Another relevant part of our final decision is to show the project in the RCP4 IPP Schedule I as a listed project (see Table 4 in Chapter 7 below).

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44 See Commerce Commission, "Amendments to input methodologies for Transpower New Zealand Limited related to the 2025 Transpower individual price-quality path – Final decision paper" (29 August 2024), available at https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-transmission/transpowers-price-quality-path/2025-transpower-individual-price-quality-path.

45 We discuss the IM amendment further in our "Amendments to input methodologies for Transpower New Zealand Limited related to the 2025 Transpower individual price-quality path – Final decision paper" and set out the drafting in the *Transpower input methodologies (RCP4 IPP Reset 2024) amendment determination 2024*. We set out our drafting in the *Transpower Individual Price-Quality Path Determination 2025*. These documents are released as part of this final decision package available at https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-transmission/transpowers-price-quality-path/2025-transpower-individual-price-quality-path.

3.29 During RCP4 we expect to receive from Transpower a listed project application for the three replacement cables and we will likely receive an MCP proposal for an additional fourth HVDC cable. We will assess them under the listed project and MCP requirements respectively in the Capex IM determination.

3.30 In summary, the effects of our final decision and the IM amendments on this matter will be to:

3.30.1 reclassify any base capex expenditure adjustment attributable to the Cook Strait cable deposit as an 'RCP4 HVDC transitional adjustment' and exclude the value of this EV account entry from the calculation of the RCP4 forecast EV adjustment when setting the forecast SMARs; and

3.30.2 in the first disclosure year of RCP4, offset the EV account entry by an opposite EV account entry inclusive of any accrued interest up to the time of offset on the original base capex expenditure adjustment.

3.31 We received submissions in support of the EV account adjustment for the HVDC Cook Strait cable replacement project from Fonterra, MEUG and Transpower.[46, 47, 48]

3.32 We did not receive any submissions opposing our draft decision.

Opex incentive amount setting

3.33 The incremental rolling incentive scheme (**IRIS**) is an incentive scheme to encourage Transpower to achieve opex efficiency gains over time and to then share the benefits of those gains with its customers when it sets its pricing. To do this, the IRIS requires a 'link' between regulatory periods so the progress on improving efficiency between periods can be measured. This link is a baseline value of expenditure from the proceeding regulatory period against which the IRIS measures future expenditure.

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46 Fonterra, "Fonterra Submission on RCP4 draft decision papers" (26 June 2024) (**Fonterra submission on draft decision**), p. 1.

47 Major Electricity Users' Group, MEUG submission on draft decision, para 9.

48 Transpower, Transpower submission on draft decision, para 8.

3.34 To set this baseline expenditure value, we need to determine a 'non-recurrent amount' of non-repeating operating expenditure and/or savings so the baseline expenditure amount does not include past expenditure or savings which are not expected to be incurred again in a future period.[49] The non-recurrent opex amount ensures the assumptions in the opex IRIS model are consistent with how we set Transpower's opex allowance for an IPP and sets the link between regulatory periods. This opex non-recurrent amount then becomes one of the inputs in future calculations of Transpower's IRIS rewards or penalties.

3.35 Our draft decision was to set the non-recurrent amount at a $(14.7) million dollars reduction, reflecting adjustments made to Transpower's actual 2022/2023 opex to form its base year.[50]

3.36 We consulted with stakeholders on our draft decision separately from our other RCP4 draft decisions.[51]

3.37 We received a submission from Transpower on our draft decision regarding the non-recurrent amount. We did not receive other submissions.

3.38 Transpower submitted:[52]

> Transpower supports the Commission's draft determination of the non-recurrent amount as -$14.7m and can corroborate this is consistent with atypical (i.e., non-recurrent) costs included in the base year.

3.39 Our final decision is therefore to confirm our draft decision and set the non-recurrent amount at a $(14.7) million reduction, reflecting adjustments made to Transpower's actual 2022/2023 opex to form its base year.

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49 Clauses 3.6.3(5) and 3.6.4 of the *Transpower Input Methodologies (IM Review 2023) Amendment Determination 2023* [2023] NZCC 8.

50 Commerce Commission, "Transpower's individual price-quality path for the regulatory period commencing 1 April 2025 – Draft decision on non-recurrent amount for Incremental Rolling Incentive Scheme" (30 July 2024), at para 2.7.

51 Commerce Commission, "Transpower's individual price-quality path for the regulatory period commencing 1 April 2025 – Draft decision on non-recurrent amount for Incremental Rolling Incentive Scheme" (30 July 2024), at para 1.8.

52 Transpower New Zealand Limited, "Non-recurrent amount: draft decision" (9 August 2024), at para 5, available at https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-transmission/transpowers-price-quality-path/2025-transpower-individual-price-quality-path.

Chapter 4 EV account entries

Purpose of this chapter

4.1 This chapter discusses our decisions and reasons on amounts that may enter the EV account for the purposes of the annual revenue wash-up mechanism.

Background

4.2 While we have specified how the EV account will operate in Chapter 3, we must make decisions on what amounts may be classified as an EV account entry for the purposes of revenue wash-ups.

4.3 Clause 1.1.4 of the Transpower IM states the definition of EV account entry has the meaning as defined in an IPP determination. We must therefore specify the entries that may enter the EV account and the mechanisms used to calculate those entries for the purposes of the wash-up mechanism.

Our decision on additional revenue path mechanisms

4.4 Our final decision is that the definitions used to specify the entries that may enter the EV account for RCP3 should be retained. Our final decision on the definition of EV account entries is:

4.4.1 an RCP4 ex-post economic gain or loss comprising the after-tax difference between the capital charge and the net operating profit or loss after tax for that disclosure year;

4.4.2 an after-tax gain or loss on capital expenditure commitments;

4.4.3 an after-tax economic gain or loss calculated for a base capex expenditure adjustment, grid output adjustment, or major capex expenditure and output adjustment;

4.4.4 an after-tax economic gain or loss calculated for a major capex sunk costs adjustment;

4.4.5 an ex-post economic gain or loss calculated for the final disclosure year of RCP3 comprising the after-tax difference between the capital charge and the net operating profit or loss after tax for that disclosure year;

4.4.6 an after-tax gain or loss in respect of an instrument that ceases to be an effective hedge for the final disclosure year of RCP3;

4.4.7 an after-tax gain or loss in respect of a commodity instrument that is not an effective hedge for the final disclosure year of RCP3; and

4.4.8 an ex-post economic gain or loss resulting from revenue wash-up for inflation.

4.5 Our final decision is the same as our draft decision, and we did not receive submissions on our draft decision related to the definition of EV account entries.

4.6 Our final decision is to maintain the building blocks approach to calculating the ex-post economic gain or loss, with the addition of a revaluation building block, as well as an inflation wash-up for revenue building blocks.

4.7 We consider the mechanism used in RCP3 promotes the Part 4 purpose by maintaining the incentives to invest for Transpower by accounting for the differences between capital charges and net operating profit or loss. This allows Transpower to recover its actual expenditure while promoting long-term benefit of consumers by applying incentives for Transpower to seek efficiencies in expenditure.

4.8 We consider the definitions used in RCP3 remain fit for purpose for RCP4, and as such, our decision is to maintain these.

4.9 The recovery of ex-post economic gains or losses for the final disclosure year of RCP3 reflects the timing of when the wash-up for the final year of a regulatory period is calculated (ie, in the first year of the next regulatory period). Consistent with our draft decision, our final decision is to retain this feature for RCP4 so that gains or losses for the final year of RCP3 would enter the EV account in RCP4.

Building blocks for revenue path wash-up mechanism

4.10 We have considered additional building blocks (such as the RAB revaluation wash-up). We consider the additional building blocks fall within the calculation of the annual ex-post economic gain or loss.

4.11 In terms of how the revenue path wash-up adjustments will be calculated, our final decision is that we will use the building blocks approach as used in RCP3.

4.12 Our primary focus for this section is the reasons for our final decisions to add additional building blocks for the purposes of:

4.12.1 the RAB revaluation; and

4.12.2 the Consumer Price Index (**CPI**) wash-up for revenue.

Building blocks final decision

4.13 Consistent with the approach undertaken in RCP3, our final decision is that the ex-post economic gain or loss will be calculated using a building blocks approach. This is consistent with our draft decision.

4.14 We did not receive any submissions to our draft decision on this matter.

4.15 We consider this approach remains fit for purpose and as such we are maintaining this approach for RCP4 along with an additional building blocks for revaluation to implement RAB indexation and CPI wash-up for revenue.

4.16 The building blocks for the purposes of calculating the ex-post economic gain and loss will comprise (at a high level):

4.16.1 Capital charge building block (inclusive of revaluation balance for calculating the opening RAB);

4.16.2 Depreciation building block (inclusive of depreciation on the revaluation balance);

4.16.3 Revaluation building block;

4.16.4 Operating expenditure building block;

4.16.5 Tax building block;

4.16.6 TCSD allowance building block;

4.16.7 EV adjustment building block;

4.16.8 Pass-through costs building block; and

4.16.9 Recoverable costs building block.

4.17 In contrast to the building blocks for the forecast MAR, none of these building blocks are mandated in the Transpower IM.

RAB revaluation building block

4.18 Under clause 2.2.8(4) of the Transpower IM, we are required to undertake a revaluation of the RAB each year to take account of the differences between forecast CPI and outturn CPI. The revaluation amount is to be treated as income, as specified in clause 2.2.9 of the Transpower IM.

4.19 Given any differences are treated as income, we consider this amount would enter the EV account as part of the ex-post economic gain or loss, which is calculated in Schedule E of the IPP determination. Changes have been made to Schedule E in the revised draft IPP determination to reflect the inclusion of the revaluation building block.

4.20 We received no submissions on our draft decision on the implementation of the RAB revaluation building block. Our final decision (consistent with our draft) is the actual RAB revaluation will enter the EV account through the calculation of the ex-post economic gain or loss in Schedule E of the IPP determination.

CPI wash-up for revenue

4.21 In its cross-submission on our RCP4 Issues paper, Transpower submitted that the building blocks CPI wash-up approach in the RCP3 IPP, in conjunction with our RAB indexation decision would only partially protect Transpower's revenue against inflation forecast risk.[53] Transpower considered the capital charge portion would be excluded from the CPI wash-up process.

4.22 Transpower suggested the following approach, which is a variation from how the EDB CPI revenue wash-up works in the EDB IM:[54]

> B14. Our proposed wash-up approach would wash up for the differences between:
>
> > B14.1. The return on Transpower's forecast RAB using the determined nominal WACC and Transpower's actual RAB using the derived 'restated' nominal WACC.
> >
> > B14.2. The revaluation amount on Transpower's forecast RAB using forecast CPI and the revaluation amount on Transpower's actual RAB using actual CPI.
> >
> > B14.3. Forecast depreciation and actual depreciation.
> >
> > B14.4. Forecast and actual inflation in the operating expenditure allowance.
> >
> > B14.5. Forecast and actual pass-through and recoverable costs.
> >
> > B14.6. The difference between the allowed tax building block and a recalculated tax allowance, based on the effect of the above.

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53 Transpower, Transpower "Cross-submission on RCP4 Issues paper" (13 March 2024) (Transpower's cross-submission on Issues paper), para B5.

54 Transpower, Transpower's cross-submission on Issues paper, para B14.

4.23 As well as this suggestion, we have also considered applying the approach taken for EDBs, which is to apply an inflation wash-up for Transpower's total revenue for each year.

Our final decision

4.24 Our final decision is to apply an inflation wash-up within each MAR building block rather than make an inflation wash-up to the annual revenue as a whole.

4.25 Consistent with our draft decision, our final decision is to wash up the capital charge building block by way of a CPI disparity adjustment between the forecast CPI and the actual CPI.

4.26 We have amended the CPI disparity adjustment formula to target a real return (ie, equal to the real WACC), as the wash-up mechanism in our draft decision did not fully compensate for the inflation exposure on the capital charge.

Our analysis

4.27 We consider Transpower's proposal in its cross-submission on our RCP4 Issues paper to apply some form of inflation wash-up for revenue has merit, as it promotes incentives to invest.

4.28 We consider that some form of inflation wash-up will achieve the intent of the IM change for RAB indexation, to adequately protect Transpower against inflation risk by ensuring that all components of the building blocks have sufficient adjustment mechanisms to account for the difference between forecast and actual inflation.

4.29 However, in its cross-submission on the Issues paper, Transpower suggested a wash-up approach that differs from the EDB CPI wash-up approach, by including use of a derived restated nominal WACC being applied to the actual RAB, as well as existing forms of wash-up adjustments.[55] The general concept of the wash-up is similar between the EDB form of revenue CPI wash-up and the proposed Transpower wash-up, but we note the Transpower annual revenue wash-up has been carried out in RCP1 to RCP3 at a more granular MAR building blocks level, whereas the EDB wash-up is done at an aggregate forecast net allowable revenue level. As a result, our draft decision was to make the inflation wash-up within each MAR building block.

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[55] Transpower, Transpower "Cross-submission on RCP4 Issues paper" (13 March 2024) (**Transpower's cross-submission on Issues paper**).

CPI wash-up approach in the EDB IM – aggregate revenue approach

4.30 The relevant clauses of the EDB IM for the CPI revenue wash-up are:

4.30.1 clause 3.1.4(3):

> (3) For the purposes of subclause (1), the 'wash-up accrual amount' for a **disclosure year** is an amount equal to:
>
> (a) **actual allowable revenue** for the **disclosure year**; minus
>
> (b) **actual revenue** for the **disclosure year**.

4.30.2 clauses 3.1.4(4)(a), (b) and (d):

> (4) For the purposes of subclause (3), and subject to subclause (10), 'actual allowable revenue' for a **disclosure year** means an amount calculated on the same basis as the **forecast allowable revenue** for the **disclosure year**, adjusted (as specified by the **Commission** in a **DPP determination** or **CPP determination**) by substituting:
>
> (a) actual **pass-through costs** for forecast **pass-through costs**;
>
> (b) actual **recoverable costs** for forecast **recoverable costs;…**
>
> (d) in respect of each **disclosure year** of the **regulatory period** after the first **disclosure year**, actual **CPI** for **forecast CPI** used for the purposes of determining **forecast net allowable revenue** for that **disclosure year**.

4.31 We note that wash-up adjustments in the EDB IM clauses 3.1.4(4)(c) and (e) to (i) are not relevant to Transpower's annual wash-up, primarily because the Transpower RAB is rolled forward on an annual basis for the purposes of its wash-up, and it therefore does not require these adjustments.

Practical application of the approach in the EDB IM to the Transpower IPP

4.32 The RCP3 IPP already applies the high-level wash-up approach set out in the EDB IM clauses 3.1.4(3) and (4):

4.32.1 Transpower is able to recover up to its forecast SMAR each pricing year, which is the ex-ante smoothed revenue path based on the series of forecast MAR building blocks (Schedule D of the RCP3 IPP);

4.32.2 The forecast MAR building blocks are calculated (where relevant) using the forecast CPI;

4.32.3 Transpower is then required to wash-up the difference between its total regulated income and the sum of the recalculated MAR building blocks on an ex-post basis by using actual values (where relevant) to calculate the building blocks; and

4.32.4 The difference (referred to as the “after-tax ex-post economic gain or loss”) is an entry into Transpower’s EV account.

Applying the EDB IM approach and our current RCP3 IPP wash-up approach to Transpower’s submission

4.33 The RCP3 IPP already includes the following wash-up steps suggested by Transpower:

4.33.1 **Depreciation**: forecast depreciation (Schedule D, formula E) versus actual depreciation (Schedule E, formula O);

4.33.2 **Opex**: forecast opex allowance applying forecast CPI (Schedule D, formula F) versus an opex allowance adjusted for the disparity between the forecast CPI and the actual CPI (Schedule E, formula N);

4.33.3 **Pass-through costs and recoverable costs**: forecast pass-through costs (Schedule D, formula J) and forecast recoverable costs (Schedule D, formula K) versus actual pass-through costs and actual recoverable costs (Schedule E, formula Q); and

4.33.4 **Tax**: forecast tax (Schedule D, formula G) versus actual tax (Schedule E, formula S).

4.34 **RAB indexation**: The RCP3 IPP does not currently include a wash-up of the RAB indexation calculation. However, our draft decision is to allow for differences between the total forecast revaluation amount (to be drafted in Schedule D) with the total actual revaluation amount (to be drafted in Schedule E), to be washed up. This would take into account the difference between the forecast and actual revaluation rates (ie, adjusting between the forecast CPI and the actual CPI).

4.35 **WACC rate each year for outturn CPI**: Consistent with our draft decision, we have decided not to apply Transpower’s cross-submission to effectively wash-up the WACC rate each year for outturn CPI. Our reason for deciding not to implement a WACC wash-up for inflation is that it is inconsistent with our IM Review 2023 decisions, particularly:

4.35.1 on the risk-free rate, where we maintained our 2010 decision to "set a nominal risk-free rate (as part of the overall nominal WACC) at the beginning of a regulatory period, and then we update the price path for actual inflation".;[56] and

4.35.2 on inflation risk and compensation, where we made the following final decisions to:[57]

4.35.2.1 make no change to the EDB and Gas Transmission Businesses (**GTB**) IMs to introduce a cost of debt washup (**CODW**) and instead maintain the status quo under the current IMs;

4.35.2.2 confirm our draft decision to amend the EDB and GTB IMs to wash-up allowable revenue for the first year of a regulatory period when inflation differs from expected inflation; and

4.35.2.3 confirm the change we proposed to our draft decision (in our further consultation) to the EDB and GTB IMs to ensure the most up-to-date CPI inflation (actual and forecast) is used when determining forecast net allowable revenue at the start of each regulatory year.

4.36 In our IM Review 2023 we reviewed the annual wash-up process and made four main findings, which the above inflation risk and compensation decisions were based on. The first finding states:[58]

> 4.83.1 The first finding was that the effect of our revenue wash-ups on suppliers' financing costs depends on their financing choices - which we refer to as 'debt management choices'. To explain, our approach to indexing the RAB together with setting a nominal WACC effectively sets a real WACC at the beginning of the regulatory period. Using the building blocks model, this produces an ex-ante revenue allowance for the period that targets a real return (ie, equal to the real WACC). Subsequently, we annually wash up allowed revenue for actual inflation. This maintains the real value of allowed revenues to suppliers (and prices to consumers) and delivers a real return during the regulatory period. While the wash-up adjusts the revenue side, we do not recalculate the building blocks costs side – the WACC and its underlying risk-

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[56] Commerce Commission, "Cost of capital topic paper, Part 4 Input Methodologies Review 2023 – Final decision" (13 December 2023), paras 3.20 to 3.23.

[57] Commerce Commission, "Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Final decision" (13 December 2023) para 4.79.

[58] Commerce Commission, "Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Final decision" (13 December 2023), para 4.83.

free rate. The effect on suppliers' financing costs depends on their debt management choices. Given inflation outturns, the returns that equity holders receive will be driven by these debt management choices (we referred to the effects on suppliers as 'windfall gains and losses' in earlier consultations in this IM Review process).

4.83.1.1 For example, if a supplier fully fixes the nominal risk-free rate component of the cost of debt for the length of the regulatory period, and actual inflation is higher than forecast, then its equity holders will receive higher real returns. This is because the revenues it receives are fully adjusted for higher actual inflation, while the debt costs it faces remain the same (at the lower level at which it hedged, consistent with the lower expected inflation at that time). Conversely, if a supplier issues inflation-indexed bonds or uses floating debt, then its equity holders' real returns will be broadly unchanged when actual inflation is higher than expected. This is because the debt costs it faces will more closely track inflation, as will the revenues.

4.37 Our draft decision was not to include a WACC rate wash-up for inflation as proposed by Transpower, and to instead make an equivalent adjustment in the IPP by way of a CPI disparity adjustment between the forecast CPI and the actual CPI to the IPP capital charge building block consistently with the revenue CPI adjustment formula in the EDB IM.

Submission on our draft decision

4.38 Transpower submitted on our draft decision on the CPI revenue wash-up in Appendix F of its submission on our draft decision.[59] It provided a MS Excel wash-up demonstration model in support of its submission.[60] Transpower submitted:

4.38.1 our proposed amendment to Transpower's wash-up mechanism modelled on the approach in the EDB IM results in outcomes that are contrary to the policy objective. It suggests a revenue wash-up like that applied to the EDBs is not transferrable to Transpower due to pre-existing differences in the regulatory regimes;

59 Transpower, "Transpower Individual Price-Quality Path for the regulatory period commencing 1 April 2025 (RCP4): Draft decision" (26 June 2024), Appendix F, pp. 14-16

60 Transpower, "Transpower Submission on RCP4 Draft decision Wash-up demonstration model" (26 June 2024) (Transpower Wash-up demonstration model).

4.38.2 the policy intent is to provide inflation compensation through indexation of the RAB and, as noted in our IM Review final decision, “an ex-ante revenue allowance for the period that targets a real return (ie, equal to the real WACC).”[61] It argues this real return, provided for via a nominal WACC return offset by the revaluation amount, is indifferent to inflation and therefore should be consistent across all inflation outcomes;

4.38.3 the approach, which was set out in our draft decision, does not achieve this, as the wash-up mechanism did not fully compensate for the inflation exposure on the capital charge;

4.38.4 an alternative approach that it considers achieves the policy intent, as it provides a normal return for the notional benchmark firm across all inflation scenarios by making the following changes to the draft IPP determination:

4.38.4.1 determining the ‘CPI disparity on cost of capital’; and

4.38.4.2 applying a new term, being the sum of the WACC and the ‘CPI disparity on the cost of capital’, in the wash-up building blocks.

Our analysis of Transpower’s submission on our draft decision

4.39 The policy intent of our CPI wash-up is to protect against inflation forecast risk exposure in the regulatory period by making adjustments to target a real return (ie, equal to the real WACC). We accept Transpower’s submission that the implementation approach we proposed in our draft decision did not fully achieve this policy intent as the wash-up mechanism in our draft decision did not fully compensate for the inflation exposure on the capital charge.

4.40 Our final decision is to make the inflation wash-up within each MAR building block, which is the same as our draft decision. As we noted in our draft decision, a direct application of the EDB CPI revenue wash-up mechanism (which is washed up at an aggregated revenue level) is not appropriate for Transpower.

61 Commerce Commission, “Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Final decision” (13 December 2023), para 4.83.1.

4.41 Our final decision is to implement the MAR building block wash-up by making a CPI disparity adjustment between the forecast CPI and the actual CPI within the IPP capital charge building block in a way that is similar to the way the revenue CPI adjustment formula works in the EDB IM.

4.42 While we have maintained our policy decision from the draft decision, we have amended the drafting in the revised draft IPP determination by updating the formula used to reflect for the disparity adjustment in the capital charge. This is reflected in the drafting of clause 32.3 and Schedule E in the revised draft IPP determination.

4.43 Consistent with our draft decision, our final decision is not to include a WACC rate wash-up for inflation.

4.44 While we have not adopted Transpower's proposed approach, we accept that an effective way of implementing the capital charge wash-up is by applying the CPI disparity adjustment through the cash flow timing factors that are applied to the nominal value inputs in Schedule E.

4.45 We tested Transpower's suggested changes to the draft IPP determination in respect of the inflation adjustment of the capital charge to work out how well it met the policy intent described above.

4.46 We then compared Transpower's proposed changes against our own updated CPI wash-up implementation approach in Schedule E, which is a CPI disparity adjustment to the capital charge we consider is more consistent with the building blocks decision. We have concluded from our analysis that our updated drafting in the IPP will achieve the same financial outcome as Transpower's submitted drafting.

CPI values used in determining RCP4 nominal forecast opex and capex values

4.47 Our final nominal forecast input values for RCP4 opex and capex allowances are based on constant $2022/23 values. Consistent with the approach in past IPP resets,[62] we have converted those values to nominal values for the purposes of the revenue path in the revised draft IPP determination using Transpower's provided independent input cost inflators and the following CPI factors:[63]

4.47.1 RCP3 disclosure year 2024: 3.3% actual CPI;

4.47.2 RCP3 disclosure year 2025: 2.3% forecast CPI;

4.47.3 RCP4 disclosure year 2026: 2.0% forecast CPI;

4.47.4 RCP4 disclosure year 2027: 2.0% forecast CPI;

4.47.5 RCP4 disclosure year 2028: 2.0% forecast CPI;

4.47.6 RCP4 disclosure year 2029: 2.0% forecast CPI; and

4.47.7 RCP4 disclosure year 2030: 2.0% forecast CPI.

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62 Commerce Commission, "Setting Transpower's individual price-quality path for 2015-2020 [2014] NZCC 23", Attachment H.

63 Transpower New Zealand Limited, "RCP4 Proposal" (November 2023), p. 221.

Chapter 5 Revenue path reporting features

Purpose of this chapter

5.1 To help us ensure compliance with the IPP, and to enable scrutiny from interested persons, there should be access to accurate information about Transpower's price path performance and EV account (and other) calculations.

Our final decisions

5.2 Our final decisions in Table 5.1 are to support our substantive decision made in relation to the price path, and are intended to help ensure compliance (and visibility of compliance) with the price path, while not being onerous or expensive to comply with.

Table 5.1 Price path reporting features

Item	Description
Pricing compliance statement (ex-ante)	Statement of compliance with the price path when setting annual pricing. Certified by Directors. Provided each November, within 5 working days after Transpower announces its forecast revenue for the purpose of setting charges under the TPM for a pricing year
Compliance with price path (ex-post)	Report on compliance with price path and wash-up calculations. Certified by at least two Transpower Directors and is accompanied by an independent assurance report. Provided within 105 working days of the end of the disclosure year.
Wash-up calculation, incentive calculations, and EV account disclosure	Disclosure and publication of the wash-up calculation, incentive calculations,[64] and the EV account, including an updated forecast EV account balance at end of RCP4. Enables interested persons to form view on likely impact in RCP5.
Other summaries	Disclosure of the forecast MAR. Summary of actual pass-through costs and recoverable costs for a pricing year. Explanations for voluntary revenue reductions (if any).[65]

5.3 We did not receive submissions related to these reporting features and our final decisions remain unchanged from our draft decisions.

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64 This includes amounts of incentives from IRIS, incentives arising under the Capex IM, and incentives relating to Grid Output Measures and Quality Standards.

65 Transpower can voluntarily price below the revenue cap, subject to reporting on the reasons why. Transpower has no incentive to under-recover (for reasons other than price smoothing).

Chapter 6 Other policy features

Purpose of this chapter

6.1 This chapter sets out our decisions and reasons for policy features that we have changed from the RCP3 revenue path for the RCP4 revenue path. These changes are:

6.1.1 removal of independent assurance requirements from forecast MAR and forecast SMAR reconsiderations; and

6.1.2 change of certification requirements for updates to the forecast MAR and forecast SMAR from the current director certification standard to CEO certification.

Removal of independent assurance requirements from forecast MAR and forecast SMAR reconsiderations

6.2 The RCP3 IPP specifies an independent assurance report must be provided for any updates during the regulatory period to the forecast MAR and forecast SMAR. For example, price path reopener applications.

6.3 This approach provided assurance that Transpower had calculated updates to the forecast MAR and SMAR correctly, in line with its financial model and our decision allowing an update to the forecast MAR and SMAR.

6.4 In its draft IM Review 2023 submission, Transpower submitted it should be able to update its revenue to reflect allowed expenditure from a reopener without a separate audit engagement.[66] Transpower considers the requirement is largely redundant and an unnecessary cost, given Transpower's improved modelling of the price-quality path and our resulting improved capability to scrutinise that modelling.

Our final decision

6.5 Our final decision is to remove the requirement for Transpower to procure an independent assurance report for updates to a forecast MAR and forecast SMAR. We consider the removal of the independent assurance requirement from updates of forecast MARs and forecast SMARs is consistent with the purpose of Part 4 by reducing long-term compliance costs.

[66] Transpower New Zealand Limited, "Submission on IM Review 2023 draft decision" (19 July 2023), p. 25.

Submissions on our draft decision, analysis of submission and final decision

6.6 We received one submission from MEUG on our draft decision to remove this requirement. MEUG submitted that:[67]

> We are comfortable with the process that Transpower and the Commission have established for reviewing and auditing Transpower IPP financial model.

6.7 Taking this submission into account, our final decision is to confirm our draft decision and draft reasons in our final decision and final reasons.

6.8 As set out in our draft decision, while a requirement to procure an independent assurance report when there is an update of the forecast MAR and forecast SMAR does provide additional assurance as to the accuracy of Transpower's proposed update, we are also able to scrutinise Transpower's proposed update and the accompanying modelling.

6.9 Given the number of adjustments that are now being made across each regulatory period as a result of decisions on listed projects and major capex proposals, having an assurance requirement for each adjustment is repetitive and does not add value to our decision-making. We consider our final decision to remove the requirement will result in reduced compliance costs for Transpower as it will not have to engage an independent assurance provider every time it applies for an update to the forecast MAR and forecast SMAR.

6.10 While this may slightly increase the risk that Transpower's updates to the forecast MAR and forecast SMAR may not accurately reflect our decision to amend the forecast MAR and forecast SMAR, we consider this risk is slight, as we can internally scrutinise the modelling informing the proposed updates on a risk-assessed basis. We also consider the risk to consumers is also somewhat minimised, as there is an independent assurance process each year on the wash-ups for the ex-post economic gain or loss associated with the updated forecast MAR and forecast SMAR.

6.11 We consider our final decision, the reduced compliance costs that result, justifies this change from RCP3. We also consider our final decision is likely to reduce long-term costs for consumers, consistent with the Part 4 purpose.

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67 MEUG "Major Users' Electricity Group, "MEUG Submission on RCP4 Draft decision" (26 June 2024) (MEUG submission on Draft Decision), para 9.

CEO certification for updates to the forecast SMAR

6.12 Clause 30.1.4 of the RCP3 IPP requires at least two directors of Transpower to certify a proposal to update forecast MAR and forecast SMAR updates, for the purposes of a price-path reopener.

Our final decision

6.13 Our final decision is to change the certification requirements for updates to the forecast MAR and forecast SMAR from the current director certification standard to CEO certification only.

6.14 This is the same as our draft decision.

Our analysis

6.15 In our draft decision, we considered whether CEO certification is sufficient for a proposal by Transpower to update the forecast MAR and forecast SMAR. Under the current RCP3 IPP, Transpower may apply for amendments to the forecast MAR and forecast SMAR to take account of the revenue impacts arising from:

6.15.1 catastrophic event;

6.15.2 regulatory change event;

6.15.3 error event;

6.15.4 provision of false or misleading information by Transpower;

6.15.5 our approval of major capex;

6.15.6 our approval of additional base capex for listed projects; and

6.15.7 our approval of Enhancement and Development (**E&D**) projects.

6.16 Our draft decision considered there was merit in changing the requirement for forecast MAR and forecast SMAR updates from director certification to CEO certification on the basis of consistency with the above list of other revenue adjustments.

6.17 We consider director certification will continue to be used to certify Transpower-produced information that is not subject to our regular scrutiny or verification. Examples include annual disclosure reports, and annual compliance statements.

6.18 Applications from Transpower on matters like MCPs and listed projects only require CEO certification. The key feature of these applications is that we are not solely relying on Transpower's information, but rather we routinely scrutinise material and information provided by Transpower for the purposes of our decision-making.

6.19 Similarly, proposals to amend the revenue path are also scrutinised by the Commission independently of what Transpower is proposing, including the quantum, and modelling of the revenue path updates and amendments. We internally scrutinise the modelling.

6.20 As we have the ability to scrutinise revenue path update proposals, our final decision to require only CEO certification in these circumstances

6.21 In our draft decision, we raised that the risk of making this change is that we do not benefit from director oversight in the forecast SMAR values we rely upon to make our price path reconsideration decisions, and we cannot have recourse to that director's certification. However, we considered the risk of any practical negative outcomes for the Commission is slight. Further, for the reasons explained above, we considered it is outweighed by our ability to scrutinise this information.

6.22 In the draft decision submission process, we received a submission from MEUG noting that:[68]

> We are comfortable with Chief Executive (rather than Director) assurance of the forecast MAR and SMAR. This seems prudent and will reduce compliance costs for Transpower. However, it is important that the Commission is adequately resourced to do the review of the information once received.

6.23 In coming to our final decision, we have considered MEUG's submission and reiterate that we have the ability to scrutinise these applications.

6.24 We consider our final decision will help to reduce some of the regulatory burden for Transpower by reducing some of the certification steps required in a revenue path update application, while also being consistent with the Part 4 purpose. Our final decision ensures there is adequate scrutiny of the revenue path updates to limit the ability for Transpower to extract excessive profits, while balancing a consideration to ease some of the regulatory burden and resulting cost for Transpower.

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68 MEUG "Submission on Transpower IPP 2025 – Draft decision" (26 June 2024), para 9.

Chapter 7 Listed projects

Purpose of this chapter

7.1 This chapter discusses our final decisions on Transpower's proposed listed projects to be included in the revenue path for application and approval in RCP4, and our reasons for these decisions.

Our final decision

7.2 Our final decision on listed projects for inclusion in Schedule I of the revised draft RCP4 IPP determination is set out in Table 7.1. This does not include the Redclyffe 220kV Switchyard Re-build project as a listed project.

7.3 This is the same as our draft decision.

Table 7.1 Final decision on listed projects[69]

Line name (Section)	Project estimated cost RCP4 ($ million nominal)
Huntly–Ōtāhuhu A (OTA–DRY) reconductoring	43.5
Haywards bus rationalisation	49.8
Rangipō gas insulated switchgear replacement	67.9
HVDC cables replacement	78.7
Otahuhu-Whakamaru (OTA-WKM) A&B reconductoring	61.7
Total estimated cost	301.6

Background

7.4 Transpower initially estimated it would need $261.5 million ($ constant 2022/2023) for base capex Listed Projects.[70] Listed projects are asset renewals projects with an estimated project cost that is estimated to exceed the base capex threshold, and which will be considered for approval as base capex outside of this IPP reset decision.[71]

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69 Note that the project estimated costs in Table 7.1 reflect Transpower's proposed nominal estimates for the listed projects. We have not updated these nominal amounts, as these only represent early estimated costs. Transpower will be required to provide updated project forecasts when it applies for approval of each listed project.

70 Transpower, Transpower RCP4 proposal, p. 118.

71 Following the IM Review 2023 decision, that will take effect for Transpower from 1 April 2025, the Capex IM base capex threshold will increase from $20 million to $30 million.

7.5 In its RCP4 proposal, Transpower proposed five listed projects with the following estimated costs (in constant $2022/2023):

7.5.1 Huntly–Ōtāhuhu A (OTA–DRY) reconductoring – $37.2 million;

7.5.2 Haywards bus rationalisation – $44.1 million;

7.5.3 Rangipō gas insulated switchgear replacement – $58.7 million;

7.5.4 HVDC cables replacement – $67.3 million; and

7.5.5 Brownhill–Pakuranga A cable joint replacements – $54.2 million.

7.6 In addition, in response to our request for information (**RFI**), Transpower then proposed additional amendments to its listed projects:

7.6.1 recategorisation of the Otahuhu – Whakamaru (OTA-WKM) A&B reconductoring from base capex to a listed project;

7.6.2 inclusion of the Redclyffe 220kV Switchyard re-build; and

7.6.3 removal of Brownhill – Pakuranga A (BHL-PAK-A) cable joint replacements project as a listed project.

Our draft decision

7.7 Our draft decision on listed projects for inclusion in Schedule I of the draft IPP determination was to include the following projects (in constant $2022/2023):

7.7.1 Huntly–Ōtāhuhu A (OTA–DRY) reconductoring – $37.2 million;

7.7.2 Haywards bus rationalisation – $44.1 million;

7.7.3 Rangipō gas insulated switchgear replacement – $58.7 million;

7.7.4 HVDC cables replacement – $67.3 million; and

7.7.5 Otahuhu-Whakamaru (OTA-WKM) A&B reconductoring - $55.0 million.

7.8 Our draft decision was to not include the Redclyffe 220kV Switchyard re-build project as a listed project as we did not consider this project would meet the listed project criteria.

Our analysis

Listed project criteria

7.9 Under clause 2.2.2(7) of the Capex IM, a project may be determined to be a listed project if:

7.9.1 we consider the project:

7.9.1.1 will require capex over $30 million;[72]

7.9.1.2 is reasonably required by Transpower; and

7.9.1.3 at least one asset is likely to have a commissioning date in the RCP;

7.9.2 forecast capex to be incurred is in relation to asset replacement and/or refurbishment;

7.9.3 the commencement date of the project within the RCP is anticipated but cannot be forecast with specificity; and

7.9.4 the project capex is not already accommodated in the RCP base capex allowance.

7.10 In order for Transpower to include a listed project in the calculation of the revenue path in RCP4, it must qualify to be listed in Schedule I of the IPP determination under clause 2.2.2(8) of the Capex IM, Transpower must apply for approval of the listed project to be included in the base capex allowance under clause 3.2.3 of the Capex IM, and we must consider that application and reopen the revenue path in accordance with clauses 3.7.4 and 3.7.5 of the Transpower IM.

Verifier's review

7.11 The Verifier reviewed the proposed listed projects. In its review, the Verifier took into account the Terms of Reference evaluation criteria, which was based on the criteria set out in clause 2.2.2(7) of the Capex IM.

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[72] Termed in the *Transpower Capital Expenditure Input Methodology (IM Review 2023) Amendment Determination 2023* [2023] NZCC 39 as "base capex threshold" which will be $30 million from 1 April 2025.

7.12 The Verifier considered that each of the listed projects in Transpower's proposal satisfied the listed project criteria in the Capex IM, as each of the projects:[73]

7.12.1 require capex greater than $30 million;

7.12.2 are reasonably required by Transpower, determined by factors including asset condition and assets, safety concerns, or assets reaching end of life and no longer being supported by original equipment manufacturers;

7.12.3 are likely to commence in RCP4 for example, assets are likely to be commissioned in RCP4 regardless of solution, long lead times, or work would likely be undertaken alongside base capex; and

7.12.4 are refurbishment or replacement projects based on current plans.

Our view on the Cook Strait HVDC cables replacement

7.13 Our final decision is that we consider the Cook Strait HVDC cables replacement project is likely to meet the listed project criteria under clause 2.2.2(7) of the Capex IM and should be included as a listed project in Schedule I of the RCP4 IPP. This is the same as our draft decision. We consider Transpower has demonstrated that:

7.13.1 the project is likely to be over $30 million, with the estimated cost being $67.3 million ($2022/2023);

7.13.2 the project is reasonably required based on Transpower's assessment that the cables are deteriorating and will need replacement by the early 2030s;[74]

7.13.3 the cable replacement is a replacement project;

7.13.4 it is expected that while the cables themselves will not be commissioned until 2032, Transpower will need to commission related assets in RCP4 including a cable storage facility;[75] and

7.13.5 the expenditure has not already been accommodated for in the base capex allowance for RCP4.

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73 GHD Advisory and Castalia "Independent verification report – RCP4 base expenditure and service measures 2025-2030 proposal - Transpower New Zealand Limited" (12 September 2023) (**IV Report**), s 19.4.

74 Transpower New Zealand Limited, "RCP4 proposal", p. 120.

75 Transpower New Zealand Limited, "RCP4 proposal", p. 120.

Response to RFI

7.14 Based on its response to our RFI, Transpower proposed the following amendments to its proposed listed projects:

7.14.1 recategorisation of the Otahuhu – Whakamaru (OTA-WKM) A&B reconductoring from base capex to a listed project;

7.14.2 inclusion of the Redclyffe 220kV Switchyard re-build; and

7.14.3 removal of Brownhill – Pakuranga A (BHL-PAK-A) cable joint replacements project as a listed project.

7.15 Our final decision is that we consider the OTA-WKM A&B reconductoring project is likely to meet the listed project criteria under clause 2.2.2(7) of the Capex IM and should be included as a listed project in Schedule I of the RCP4 IPP. This is the same as our draft decision. We consider Transpower has demonstrated that:

7.15.1 the project is likely to be over $30 million (with a midpoint estimate of $55 million);

7.15.2 the project is reasonably required based on Transpower's assessment that the cables are approaching Transpower's replacement criteria (being condition in this instance) and that the asset condition is expected to require replacement from 2025 onwards;

7.15.3 the cable replacement is a replacement project;

7.15.4 the replacement project is expected to be fully commissioned by the start of 2028; and

7.15.5 we have not approved the proposed base capex for this project as part of our RCP4 expenditure approval, so it will not be accommodated in the base capex allowance for RCP4.

7.16 Transpower explained it is removing the BHL-PAK A cables as a listed project, as the cable replacement is no longer required. We accept this reasoning and our final decision is to not include the BHL-PAK A cables as a listed project. This is the same as our draft decision.

Redclyffe substation rebuild project as a listed project

7.17 Our final decision is to not include the Redclyffe 220kV Switchyard re-build project as a listed project. This is the same as our draft decision.

7.18 During our review of its RCP4 proposal Transpower notified us that it wanted to amend its proposed listed projects. It informed us in an RFI that the Redclyffe substation rebuild project was a listed project.[76]

7.19 However, in our draft decision we did not consider that the Redclyffe substation rebuild project was a listed project because we were not convinced it met the listed project criteria. In particular, we did not consider that the project can be fully defined as an asset replacement or asset refurbishment (consistent with clause 2.2.2(8) of the Capex IM) as there is a reliability improvement component to it following the resilience mitigation works.

7.20 The Redclyffe substation rebuild project is a resilience capex project and depending on the cost of the works, is either E&D capex or an MCP. In its submission on our draft decision, Transpower agreed with our draft decision and will "undertake the Redclyffe 220kV substation rebuild as an E&D project. If the project is below $30m we will fund it out of base capex, if the project is over $30m we will treat it as a major capex project (**MCP**)".[77]

7.21 Further, Transpower states in its submission that its substation resilience workstream does not include funding for the Redclyffe substation, and if it did fund the Redclyffe substation rebuild under base capex (if the project cost was estimated to be less than the base capex threshold of $30 million), it would leave other E&D projects unfunded. In that case Transpower submitted it will use the E&D reopener provision to seek additional funding for the unfunded projects.

7.22 Following our review of submissions, our final decision is that the Redclyffe 220kV Switchyard rebuild project is not included as a listed project as it does not meet the listed project criteria.

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[76] Commerce Commission, "Draft Decision Attachment A Revenue path design for Transpower IPP commencing 1 April 2025" (29-May-2024) (Draft Decision Revenue Path), para 7.4

[77] Transpower, **Transpower submission on draft decision**, paras 13-15.