Amendments to input methodologies for Transpower 2014

Reasons paper

Amendments made under s 52X and s 52V(2) of the Commerce Act 1986 to the input methodologies for electricity lines services supplied by Transpower New Zealand Limited.

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<table>
<thead>
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<th>Reference no</th>
<th>Status</th>
<th>Document name</th>
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<tbody>
<tr>
<td>28 August 2014</td>
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</tr>
<tr>
<td>4 June 2014</td>
<td>n/a</td>
<td>Consultation Draft</td>
<td>Proposed amendments to input methodologies for Transpower: Consultation paper</td>
</tr>
<tr>
<td>11 March 2014</td>
<td>n/a</td>
<td>Consultation Draft</td>
<td>Proposed amendments to input methodologies for Transpower: Consultation paper</td>
</tr>
<tr>
<td>10 February 2014</td>
<td>n/a</td>
<td>Notice of Intention</td>
<td>Proposed amendments to input methodologies for Transpower</td>
</tr>
</tbody>
</table>

Regulation Branch
Commerce Commission

Confidential material in this report has been removed. Its location in the document is denoted by [ ].
CONTENTS

1. INTRODUCTION .......................................................................................................................... 3
   Purpose of this paper .................................................................................................................. 3
   Amendments to input methodologies ...................................................................................... 3
   Overview of the amendments .................................................................................................. 3
   Overview of the process used to make the amendments ........................................................... 4

2. REMOVING THE REQUIREMENT TO SPREAD DEPRECIATION FOR ‘END-OF-LIFE’ ASSETS ...... 7
   Implementation of the amendment .......................................................................................... 7

3. LAND PURCHASES WHICH ARE BASE CAPEX – “COMMISSIONED” WHEN ACQUIRED ........ 8
   Implementation of the amendment .......................................................................................... 8

4. UPDATING QUALITY STANDARDS TERMINOLOGY IN PRICE-QUALITY PATH RECONSIDERATION PROVISIONS ......................................................................................... 9
   Implementation of the amendment .......................................................................................... 9

5. TREATMENT OF OPEX ORIGINALLY FORECAST TO BE APPROVED MAJOR CAPEX ........... 10
   Implementation of the change ................................................................................................. 11

6. ADDITIONAL NET OPEX INCURRED AS A RESULT OF A CATASTROPHIC EVENT .............. 12
   Background to the amendment .............................................................................................. 12
   Implementation of the change ................................................................................................. 13

7. FORECAST CPI FOR THE PURPOSES OF SETTING CAPEX ALLOWANCES ......................... 15
   Implementation of the amendment .......................................................................................... 15

8. DEFINITION OF ‘RELATED PARTY’ ............................................................................................ 16
   Implementation of the amendment .......................................................................................... 16

9. REGULATORY DEPRECIATION FOR ASSETS IN THE YEAR OF COMMISSIONING ............ 17
   Transitional adjustment ........................................................................................................... 17

10. ISSUES CONSIDERED BUT NO AMENDMENT MADE TO INPUT METHODOLOGIES ......... 19
   The treatment of ancillary services (black start costs and over-frequency arming costs) ........... 19
   The treatment of Consumer Guarantees Act indemnity costs .................................................. 20
   Price-quality path reconsideration catastrophic event threshold test ......................................... 21
   The ‘commissioned’ vs ‘expenditure’ basis for setting the base capex allowance ....................... 23
1. Introduction

Purpose of this paper

1. This paper provides reasons for amendments to the input methodologies for electricity lines services supplied by Transpower New Zealand Limited.

Amendments to input methodologies

2. We have amended the input methodologies for Transpower through decision NZCC 22.¹ This decision affects the input methodologies set out in:

   2.1 Transpower Input Methodologies Determination [2012] NZCC 17, and

   2.2 Transpower Capital Expenditure Input Methodology Determination [2012] NZCC 2.

3. The amendments are made under s 52X and s 52V(2) of the Commerce Act 1986.

Overview of the amendments

4. The amendments we have made address issues relevant to the determination of Transpower’s individual price-quality path (IPP) to apply from 1 April 2015.

5. A brief overview of these amendments is set out in Table 1 overleaf. An explanation of the reasons for each amendment is provided in the chapters that follow.

6. Transpower also requested additional amendments that we considered but did not make. Our reasons for not making these amendments are provided in Chapter 10.

Table 1: Overview of amendments made to input methodologies

<table>
<thead>
<tr>
<th>Input methodology</th>
<th>Amendment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Specified asset lives in clause 2.2.6(2)</td>
<td>Removal of requirement to spread depreciation for ‘end-of-life’ assets across a regulatory period.</td>
</tr>
<tr>
<td>Definition of ‘commissioned’ in clause 1.1.4(2)</td>
<td>Clarifying that land which is base capex enters the regulatory asset base upon acquisition.</td>
</tr>
<tr>
<td>Reconsideration of an individual price-quality path in clauses 3.7.1-3.7.5</td>
<td>Terminology change to remove references to ‘quality targets’ and adopt revenue-linked grid output measures instead.</td>
</tr>
<tr>
<td>Recoverable costs in clause 3.1.3(1)</td>
<td>Allowing expenditure classified as opex under generally accepted accounting practice (GAAP) to be treated as recoverable costs if originally forecast as approved major capex.</td>
</tr>
<tr>
<td>Recoverable costs in clause 3.1.3(1)</td>
<td>Allowing for recovery of prudent additional net opex incurred as a result of a catastrophic event.</td>
</tr>
<tr>
<td>Definition of ‘forecast CPI’ in Capex IM clause 1.1.5(2)</td>
<td>Align methodology for forecasting CPI with other regulated energy sectors for purposes of setting capex allowances.</td>
</tr>
<tr>
<td>Definition of ‘related party’ in clause 1.1.4(2)</td>
<td>Updating the definition of ‘related party’ to exclude parties that are related to Transpower by virtue of Crown ownership.</td>
</tr>
<tr>
<td>Calculation of depreciation in clause 2.2.5 and adjustment to asset values in new clause 2.2.9</td>
<td>Allowing for part year depreciation for newly-commissioned assets and a transitional adjustment for prior depreciation treatment.</td>
</tr>
</tbody>
</table>

Overview of the process used to make the amendments

7. We are required to follow the process in s52V of the Act for engaging with interested parties when making amendments to input methodologies. This process provides an opportunity for interested persons to give their views on draft methodologies before any decisions are made. We must have regard to any views received from interested persons within the relevant time frames.

8. The s52V process commenced when we issued a notice of intention on 10 February 2014. This notice set out our proposed process and timeframes for making amendments to the input methodologies applicable to Transpower.²

² Commerce Commission “Proposed amendments to Input Methodologies for Transpower” 10 February 2014.
9. As outlined in the notice of intention, we published two separate documents asking interested parties for their views on the proposed amendments.3

10. We received submissions from Transpower on both documents, and from Powerco and Vector for the 11 March 2014 paper.4 Transpower also made a cross-submission in response to Powerco and Vector’s submissions.5

Overlap with consultation on the individual price-quality path

11. As well as the input methodologies amendments process, we have separately consulted on Transpower’s IPP for 2015-2020. As the proposed amendments to the input methodologies apply to the individual price-quality path, there has been some overlap of submissions on the two processes.

12. In particular, there was an overlap of submissions on the ‘listed project’ mechanism for approval of additional base capex during the second regulatory period. These listed projects relate to reconductoring projects which Transpower excluded from its December 2013 expenditure proposal.

13. Where submissions on the IPP were relevant to the input methodologies amendments process we have had regard to those submissions in making our decision on the input methodology amendments.

Further consultation to be undertaken on ‘listed projects’ processes

14. Our earlier policy view on which we consulted in the draft IPP was that the process requirements for the application by Transpower and approval by the Commission of base capex relating to listed projects should form part of the IPP.6 Our current view is that those process requirements should instead be set out in the Capex IM, as this is more consistent with s 54S of the Act. We will therefore further consult on where the processes for approving base capex relating to listed projects should be determined.

15. We previously consulted on a proposed input methodology amendment to the ‘Reconsideration of an individual price-quality path’ input methodology to give effect to the revenue impact of approved base capex of a listed project. That amendment will form part of the package of input methodology amendments for listed projects on which we will further consult.

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3 Commerce Commission “Proposed amendments to input methodologies for Transpower (11 March 2014); and Commerce Commission “Proposed amendments to input methodologies for Transpower (4 June 2014).

4 Vector “Proposed amendments to input methodologies for Transpower” (31 March 2014); Transpower “Proposed amendments to input methodologies for Transpower” (31 March 2014); Powerco “Powerco submissions on proposed amendments to input methodologies for Transpower” (31 March 2014); and Transpower “Submission on proposed Transpower IM amendments” (27 June 2014).

5 Transpower “Proposed amendments to input methodologies for Transpower cross submission” (7 April 2014).

Guidance on the review of input methodologies

16. We also note that Transpower’s submission on our proposed amendments requested that we provide guidance on how and when we will consider reviewing and changing input methodologies in the future.7

17. We anticipate that we will have a separate process to formally seek the views of interested parties on this in due course.

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7 Transpower “Submission on proposed Transpower IM amendments” (27 June 2014), page 3.
2. Removing the requirement to spread depreciation for ‘end-of-life’ assets

18. We have removed the requirement in the asset valuation input methodology to spread the regulatory depreciation allowance for assets that reach the end of their depreciable life, across the remainder of a regulatory control period.

19. The amendment is expected to reduce Transpower’s compliance costs by more closely aligning the regulatory treatment of depreciation to that applying under generally accepted accounting practice (GAAP).

20. The original requirement was included in the input methodologies to avoid incentives to depreciate assets too quickly, ie, before the end of their useful lives.\(^8\)

21. Removing the requirement should not detract from the incentives relating to capital expenditure because Transpower’s asset replacement plans are subject to scrutiny and approval by the Commission under the Capex IM.

22. Transpower requested the requirement be removed, and Powerco supported the change.\(^9\)

Implementation of the amendment

23. This amendment is given effect by deleting clause 2.2.6(2) of the input methodologies.

Application

24. The amendment affects the input methodologies relating to information disclosure regulation and individual price-quality path regulation for Transpower.

25. It will apply to depreciation calculated in respect of assets from 1 July 2015, which corresponds to the commencement date of the first disclosure year for RCP2.

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\(^8\) Commerce Commission “Input Methodologies (Transpower) Reasons Paper” (22 December 2010), paragraphs 4.4.142-4.4.143.

\(^9\) Powerco “Powerco submissions on proposed amendments to input methodologies for Transpower” (31 March 2014), page 1; and Transpower “Proposed amendments to input methodologies for Transpower” (31 March 2014).
3. Land purchases which are base capex – “commissioned” when acquired

26. We have amended the definition of ‘commissioned’ in the input methodologies to clarify that land which is base capex may enter Transpower’s regulatory asset base when acquired, as opposed to when it is first used to supply electricity lines services.

27. Base capex is capital expenditure with a forecast cost of less than $20 million or which relates to specified types of projects or programmes such as asset replacement or asset refurbishment.

28. Previously, uncertainty existed over whether the base capex allowance approved by the Commission under the Capex IM would amount to ‘approval’ of land purchases necessary to allow such land to be considered ‘commissioned’ when acquired.

29. The amendment removes this uncertainty by providing simply that land which is base capex is ‘commissioned’ when acquired.

30. We consider that allowing land which is low cost (ie, less than $20 million) or of specified types, and which is subject to expenditure approval processes (including policies set in place by Transpower), to enter the asset base when acquired is consistent with the incentive framework for base capex expenditure approvals in the Capex IM.

31. Transpower has confirmed that it has a documented management-approved strategy for land acquisitions which meets the definition of a base capex ‘policy’ under the Capex IM and will be complied with pursuant to clause 3.2.2 of the Capex IM.

32. Transpower submitted that the clarification “would be helpful and low cost and therefore worth doing.”10 Powerco submitted that definition of ‘commissioned’ was not sufficiently clear and should be amended.11

Implementation of the amendment

33. This amendment is given effect by amending the definition of ‘commissioned’ in the input methodologies.

Application

34. The amendment affects the input methodologies relating to information disclosure regulation and individual price-quality path regulation for Transpower.

35. It will apply to land assets acquired from 1 July 2015, which corresponds to the commencement date of the first disclosure year for RCP2.

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10 Transpower submission on the proposed amendments to input methodologies for Transpower (31 March 2014).
11 Powerco submission on the proposed amendments to input methodologies for Transpower (31 March 2014).
4. Updating quality standards terminology in price-quality path reconsideration provisions

36. We have amended the provisions relating to reconsideration of Transpower’s individual price-quality path by replacing the term ‘quality targets’ with terminology that reflects the quality standards framework applying under the Capex IM.

37. The new terminology is ‘revenue-linked grid output measures’, involving ‘grid outputs’, ‘grid output targets’, ‘caps’, ‘collars’ and ‘grid output incentive rates’, whereas the previous terminology reflected the quality targets set in the 2010 IPP.

38. The change allows the revenue-linked grid output measures specified in an IPP determination to be amended following a catastrophic event, error, or change event, as provided for in the price-quality path reconsideration provisions in the input methodologies.

39. Transpower supported the amendment in its submission.\(^\text{12}\)

**Implementation of the amendment**

40. The amendment is given effect by changes to clauses 3.7.1, 3.7.4, and 3.7.5 of the input methodologies, and corresponding new definitions added to clause 1.1.4(2).

**Application**

41. The amendment affects the input methodologies relating to individual price-quality path regulation for Transpower.

42. It will apply with effect from 1 July 2015, which corresponds to the commencement date of the first disclosure year for RCP2.

\(^{12}\) Transpower submission on proposed Transpower IM amendments, 27 June 2014, Appendix A.
5. Treatment of opex originally forecast to be approved major capex

43. We have added a new recoverable cost to the specification of price input methodology to allow Transpower to recover operating costs that were originally forecast and approved as components of major capex projects.

44. The amendment caters for the situation where the expenditure forecast in respect of approved major capex projects is ultimately required to be accounted for under GAAP as operating expenditure (such as project feasibility costs).

45. It is appropriate that this type of expenditure is able to be recovered by Transpower through revenues within the limits of the expenditure approvals made for a price-quality path. However, it can be difficult to accurately forecast the accounting treatment that governs the opex component of major capex projects in advance.

46. In addition, the efficiency incentives for major capex are asymmetric (ie, only overspends are penalised) whereas we are currently consulting on making the incremental rolling incentive scheme (IRIS) for opex symmetric for Transpower.

47. To simply allow such opex to be accounted for in line with its accounting treatment will therefore distort the respective incentive regimes for expenditure.

48. The amendment seeks to preserve the neutrality of efficiency incentives irrespective of the accounting treatment ultimately adopted by:

48.1 removing the operating costs originally approved as major capex from the operation of the IRIS (by classifying such costs as recoverable costs);

48.2 leaving the relevant major capex allowance unchanged; and

48.3 limiting the amount of recoverable costs such that the opex being claimed and actual major capex, taken together, do not exceed the major capex allowance for the major capex project under the Capex IM.

49. No similar mechanism is required for changes in forecast accounting classification between base capex and opex because the respective expenditure incentives are both symmetrical and the incentive rates are approximately aligned.

50. Transpower supported the amendment in its submission.\textsuperscript{13} It suggested that the definition of ‘capital expenditure’ in the Capex IM could be clarified to ensure that the relevant opex was eligible to first be approved as major capex. We do not consider that a drafting change is necessary to give effect to our decision.

51. The new recoverable cost will be subject to the criteria set out in clause 3.1.3(3) whereby the eligible operating costs are:

51.1 limited to the operating expenditure component allocated to electricity transmission services;

\textsuperscript{13} Transpower submission on proposed Transpower IM amendments, 27 June 2014, Appendix A.
51.2 incremental to the operating expenditure allowance specified for the price-quality path; and

51.3 incurred after the date that the relevant major capex proposal is approved by the Commission under the Capex IM.

**Implementation of the change**

52. This decision is given effect by adding a new recoverable cost to clause 3.1.3(1) of the input methodologies.

**Application**

53. The amendment affects the input methodologies relating to the individual price-quality path regulation of Transpower.

54. It will apply immediately, with the practical effect of allowing recoverable costs to be calculated in this way from the first disclosure year for RCP2.
6. Additional net opex incurred as a result of a catastrophic event

55. We have amended the specification of price input methodology to allow Transpower to recover, as a recoverable cost, prudent net additional operating expenditure incurred in the period between the date of a catastrophic event and the effective date of any resulting amended individual price-quality path arising from a reconsideration of the individual price-quality path.

56. The addition of the new recoverable cost ensures that the overall framework established in respect of catastrophic events is appropriate, whereby Transpower should be:

56.1 compensated through the future amended individual price-quality path for prudent additional net costs that are forecast to be incurred after the price-quality path is reset (ie, existing reconsideration provisions);

56.2 compensated through an amount in future revenues for prudent additional net costs incurred as a result of the catastrophic event before the price-quality path is amended (ie, new recoverable cost).

57. We have amended the definition of ‘recoverable costs’ to allow Transpower to recover its prudent net additional operating costs incurred in the period up until the amended individual price-quality path takes effect.

Background to the amendment

58. Under the Transpower input methodologies, an IPP may be reconsidered if there is a catastrophic event that imposes material costs. If, as a result of a catastrophic event, Transpower expects to earn below-normal returns under its existing individual price-quality path, a reconsidered individual price-quality path allows for Transpower to have an alternative path determined on an ex ante basis, based on the best information available at that time. This requires a reconsideration of Transpower’s opex and base capex allowances for future years of the regulatory period. This would occur through:

58.1 an adjusted base capex allowance; and

58.2 the recoverable costs included in the reconsidered individual price-quality path.

59. Transpower may incur additional costs between the time of the catastrophic event and the reconsidered individual price-quality path taking effect. There is currently no mechanism for recovery of any prudent net additional opex incurred before a reconsidered individual price-quality path takes effect and that Transpower might incur as a direct result of the catastrophic event.

60. We will allow Transpower to recover its prudent net additional operating costs that arise in the period between a catastrophic event and a reconsidered individual price-quality path taking effect. A new recoverable cost term will allow Transpower to
recover prudent net additional expenditure, as well as any unrecovered pass-through and recoverable costs, arising since the catastrophic event.

61. We consider it appropriate to provide compensation for additional net costs incurred in responding to future catastrophic events because:

61.1 allowing compensation for additional net costs will allow Transpower to focus on restoring its network in the aftermath of a catastrophic event; and

61.2 additional expenditure made after a catastrophic event may be vital to meet demand in an affected region. Consumers benefit from this expenditure because it helps mitigate any deterioration in quality of service.

62. Our view is that Transpower may recover in its revenues any approved net additional prudent opex that arises in the period between a catastrophic event and a reconsidered individual price-quality path taking effect.

63. In deciding the amount of prudent net additional opex we would allow as a recoverable cost, we would take into account, among other things:

63.1 the extent that Transpower has appropriately considered substitution of any opex already allowed for in the opex allowance for the applicable years of the regulatory period; and

63.2 the extent that Transpower has offset projected insurance proceeds or other projected compensatory amounts recoverable from third parties in calculating the net additional costs.

64. We would make our determination of the allowable recoverable costs in the amended individual price-quality path determination.

65. Transpower supported the amendment in its submission.\(^4\)

66. We also note that a similar adjustment mechanism is not required for base capex because the Capex IM allows the Commission to make a discretionary adjustment that will allow Transpower to add base capex without the base capex incentive applying.

**Implementation of the change**

67. This decision is given effect by adding a new recoverable cost to clause 3.1.3(1) of the input methodologies.

**Application**

68. The amendment affects the input methodologies relating to individual price-quality path regulation for Transpower.

\(^4\) Transpower submission on proposed Transpower IM amendments, 27 June 2014, Appendix A.
69. It will apply immediately, with the practical effect of allowing the recovery of prudent net additional operating expenditure following a catastrophic event occurring from the commencement of RCP2.

70. The first pricing year in which the amendment may therefore be applied in the setting of Transpower’s transmission revenue under the transmission pricing methodology (TPM) is the pricing year commencing 1 April 2016.
7. Forecast CPI for the purposes of setting capex allowances

71. We have amended the definition of ‘forecast CPI’ used for setting Transpower’s capex allowances to apply the Reserve Bank’s mid-point inflation target for periods beyond which the Reserve Bank has made a forecast of annual inflation.

72. The following definition of ‘forecast CPI’ will be used:

72.1 For the years covered by the Reserve Bank’s inflation forecast, the forecast of annual changes in the CPI that are contained in the Reserve Bank’s forecast is applied; and

72.2 For all other years, the forecast will move in three equal steps to the mid-point of the Reserve Bank’s inflation target, ie, the value applying from the start of the third year will be equal to the mid-point of the target range.

73. The amendment uses forecasts from a reputable forecaster extended using a simple and transparent rule for periods beyond the last available forecast.

74. The methodology will align with that used by the other energy sectors regulated under Part 4 of the Act in respect of default price-quality paths.

75. Transpower supported the amendment in its submission.15

Implementation of the amendment

76. The amendment is given effect by replacing paragraph (b) of the definition of ‘forecast CPI’ in the Capex IM.

Application

77. The amendment affects the input methodologies relating to the approval of expenditure proposals for individual price-quality path regulation of Transpower.

78. It will apply immediately, with the practical effect of allowing the new definition of forecast CPI to be used in determining capex allowances with effect from the first disclosure year for RCP2.

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15 Transpower submission on proposed Transpower IM amendments, 27 June 2014, Appendix A.
8. Definition of ‘related party’

79. We have amended the definition of ‘related party’ to exclude those parties that are related to Transpower solely by virtue of the Crown’s ownership of Transpower.

80. The term ‘related party’ is used in a number of places in the input methodologies, such as determining the regulatory value of assets acquired by Transpower from a related party under clause 2.2.7(1).

81. The current definition draws on the meaning of ‘related’ under GAAP which has the effect of including Transpower’s shareholder (the Crown), the arms of the Crown (eg, Government departments) and State-Owned Enterprises such as Meridian Energy.

82. Limiting the definition to specifically exclude parties related to Transpower via the Crown is expected to reduce Transpower’s costs from complying with related party requirements, while still upholding the policy intent of the requirement.

83. Transpower supported the amendment in its submission.\(^\text{16}\)

*Implementation of the amendment*

84. The amendment is given effect by modifying the definition of ‘related party’ in clause 1.1.4(2) of the input methodologies.

*Application*

85. The amendment affects the input methodologies relating to information disclosure regulation and individual price-quality path regulation for Transpower.

86. It will apply with effect from 1 July 2015 which corresponds to the commencement date of the first disclosure year for RCP2.

\(^{16}\) Transpower submission on proposed Transpower IM amendments, 27 June 2014, Appendix A.
9. Regulatory depreciation for assets in the year of commissioning

87. We have amended the input methodologies governing asset valuation to allow depreciation to be calculated for assets in the year in which those assets are commissioned.\textsuperscript{17} The calculation of depreciation will be pro rated to reflect the portion of the year that the assets are commissioned.

88. The change will more closely align the calculation of regulatory depreciation with depreciation under GAAP, and is expected to reduce some of the costs and risk of error arising from Transpower reconciling its regulatory reports to its accounting asset books under GAAP.

89. In seeking views from interested persons we noted that the change would bring forward permitted cash flows under Transpower’s individual price-quality path.\textsuperscript{18} We also noted that no other sectors regulated under Part 4 of the Act currently have input methodologies allowing depreciation in the year of asset commissioning.

90. None of the interested persons who submitted on the proposed amendments opposed making the change to the input methodologies for Transpower.

91. The amendment aligns the timing of regulatory depreciation with depreciation calculated under GAAP. Differences with GAAP established deliberately by the input methodologies (such as asset life requirements) will remain however.

Transitional adjustment

92. If the treatment had applied from 2011 when Transpower’s initial regulatory asset base was determined then regulatory asset values in 2015 would be approximately $50 million less. Transpower requested that its regulatory asset values be adjusted to eliminate this difference from 2015.

93. To achieve this in an NPV neutral manner the input methodologies require regulatory asset values to be decreased, and the amount of the decrease to be established as an ‘RCP2 pseudo asset’ as at the first day of the 2016 disclosure year (ie, 1 July 2015). The pseudo asset will then be depreciated over a period of 31 years, which Transpower has advised is the average remaining asset life of affected assets.

Implementation of the amendment

94. To implement the change clauses 2.2.3(2) and 2.2.4 are modified, and amendments are made to the definition of ‘unallocated depreciation’, ‘remaining asset life’, and ‘depreciation’ in clause 1.1.4(2).

\textsuperscript{17} Depreciation calculations under the existing input methodologies commence for regulatory purposes in the year following the year of commissioning of new assets.

\textsuperscript{18} This is a result of the depreciation allowance building block increasing in the year of an asset’s commissioning. The treatment, however, would be NPV neutral because it would have the compensating effect of reducing the return on the regulatory asset base over the life of the relevant asset.
The adjustment to existing asset values and establishment of the RCP2 pseudo asset in the 2016 disclosure year is implemented through new clause 2.2.9. An asset life of 31 years for the pseudo asset is specified in clause 2.2.6(1)(j).

Application

96. The amendment affects the input methodologies relating to information disclosure regulation and individual price-quality path regulation for Transpower.

97. The new depreciation treatment applies to assets commissioned on or after 1 July 2015. The RCP2 pseudo asset is also established on that date. This corresponds to the commencement date of the first disclosure year for RCP2.
10. Issues considered but no amendment made to input methodologies

98. Transpower also requested further amendments to input methodologies that we considered but did not make. These amendments were requested to be made prior to the determination of the individual price-quality path for the second regulatory period and relate to: 19

98.1 the treatment of some ancillary services (black start costs and over-frequency arming costs);

98.2 the treatment of Consumer Guarantees Act indemnity costs;

98.3 the threshold test for when the individual price-quality path may be reconsidered following a catastrophic event; and

98.4 the ‘commissioned’ vs ‘expenditure’ basis for setting the base capex allowance.

99. This chapter explains our reasons for not making amendments in relation to the issues above. Each issue, and our reasons for not making an amendment, is discussed in its own section below.

The treatment of ancillary services (black start costs and over-frequency arming costs)

100. Transpower submitted that the operating costs of black starts and over-frequency arming should be treated as recoverable costs. In response, we indicated to Transpower that we would consult on changes to the input methodologies and individual price-quality path, to test whether it would be necessary and appropriate to reclassify the costs of black start and other ancillary services as recoverable costs. 20

101. We have had insufficient time to fully consider the benefits and implications for incentives and consistency of the regime. There are several issues to be considered, and as such, we have decided to defer this decision with a view to considering it at a future time, for instance, as part of the seven year review of the input methodologies.

102. We further note that we have had previous extensive discussions with Transpower on the classification of these items of expenditure in respect of the first regulatory period, with the result at that time of the costs being classified within the opex allowance.

103. We do not consider this to be an issue that requires urgent attention, as the relevant forecast expenditure Transpower included in its December 2013 expenditure proposal for the second regulatory period has been included in the opex allowance.

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20 Letter to Transpower, 14 March 2014.
for the individual price-quality path, a result which is consistent with the current input methodologies.

The treatment of Consumer Guarantees Act indemnity costs

104. The Consumer Guarantees Act (CGA) requires that Transpower indemnify retailers for payments that retailers make to their customers to remedy breaches of an ‘acceptable quality guarantee’. The indemnity applies if the event giving rise to the breach arose on Transpower’s network. The indemnity applies to Transpower’s grid management and system operator functions.

105. Transpower has argued that the risk is hard to quantify and that the cost of any claims should be a pass-through cost or recoverable cost for the second regulatory period. However, the costs do not currently qualify in the definition of pass-through costs in the input methodologies. Our decision is not to treat CGA indemnity costs as recoverable costs.

106. We note that we have made an expenditure allowance in the opex allowance in the individual price-quality path determination for the second regulatory period to cover Transpower’s prudent and efficient estimate of the amount to insure the CGA indemnity costs.

Background

107. In our issues paper on the setting of the individual price-quality path for the second regulatory period we sought views on the materiality of Transpower’s exposure to the new indemnity obligations arising under the CGA. We also sought views on how Transpower’s exposure should be treated. We received submissions from Transpower and MEUG and cross-submissions from Transpower, Powerco and Genesis on this matter.

108. In its submission MEUG commented that in a workably competitive market environment no business could immunise itself from some risk of exposure to CGA indemnity obligations. This exposure creates an incentive on businesses to actively manage this risk. MEUG also argued that the onus to forecast any costs should be on Transpower. This position was supported by Genesis.

109. Conversely, both Transpower and Powerco argued that the risk is hard to quantify and that the cost of any claims should be a pass-through or recoverable cost.

110. We do not agree that these costs should be treated as recoverable costs. This would have the effect of immunising Transpower from any need to manage the risk. This would clearly undermine the intent of policy makers who expressly subjected suppliers of electricity lines services to the CGA.

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21 The indemnity applies to Transpower’s grid management and system operator functions.
22 Major Electricity Users’ Group “Transpower RCP2 submission” (3 March 2014), response to questions 37 and 38.
24 Powerco “RE: Cross submission on the Issues Paper on Transpower’s individual price-quality path and proposal for the next regulatory control period” (10 March 2014).
111. Transpower proposed that if it were subjected to these costs, it should be provided with a self-insurance allowance. Transpower stated that the statutory indemnity creates a new and difficult to quantify commercial risk. Transpower proposed an allowance to manage the risk through its own captive insurer Risk Reinsurance Limited (RRL). We accepted Transpower’s forecast. We considered this to be a prudent and efficient way to manage Transpower’s exposure.

**Price-quality path reconsideration catastrophic event threshold test**

112. The Transpower input methodologies include a reconsideration provision that applies if Transpower’s revenues under the individual price-quality path are impacted by the costs of a catastrophic event. Transpower has proposed that the current revenue-based threshold test for reconsideration be amended to a fixed $10 million cost threshold. It considers this alternative threshold would be appropriate because:

112.1 it exceeds the deductible amounts for Transpower’s material damage insurance;

112.2 it approximates the revenue at risk through revenue-linked grid output measures; and

112.3 is roughly equivalent to 1% of its annual transmission revenue and 2% of its average annual expenditure.

113. We do not consider that an input methodology amendment is required to give practical effect to the catastrophic event provisions for the individual price-quality path for the second regulatory period. As a policy matter, we may consider revisiting our position at a future time, for instance, as part of the seven year review of the Transpower input methodologies.

**Background**

114. The threshold test is a ‘materiality’ test that provides Transpower with the ability to seek reconsideration of the individual price-quality path as a consequence of the catastrophic event, and it does not prescribe the amounts by which the individual price-quality path may be adjusted once a reconsideration process is initiated.

115. If that threshold is reached, the Commission may reconsider the individual price-quality path if it is satisfied that the event constitutes a catastrophic event. Any reconsideration of the price-quality path would then be made in accordance with all relevant input methodologies.

116. We note that the catastrophic event reconsideration provision only sets an initial minimum threshold for reconsideration of the price-quality path. Absolute certainty as to the costs of remediation is not necessary (or arguably even possible) in order to test whether the threshold is met: it merely establishes a basis on which the forecast

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25 Transpower Input Methodologies Determination [2012] NZCC 17, clause 3.7.1
revenue impacts of an event are sufficient, in our view, to justify reconsidering changes to the price-quality path.

117. We differ from Transpower in our interpretation of the threshold test and its potential proportionate revenue impact on Transpower in the event of a catastrophic event. Assuming all of clauses 3.7.1(a) to (c)(iii) are satisfied, the event will constitute a ‘catastrophic event’ if the forecast revenue impact of the expected net costs of remediation over the relevant forecast affected disclosure years would exceed 1% of the total of the forecast MAR used to set the price path for those forecast affected disclosure years.

118. For this purpose we consider that the net costs of remediation would include the forecast impact on the price path of both expected capex and opex, but less the forecast amounts of expected insurance recoveries or other compensatory entitlements.

119. Transpower’s proposed absolute threshold of $10 million for the remediation costs over remaining years of the individual price-quality path would mean that the threshold could be triggered where the impact on revenues of the forecast costs falls far short of the 1% aggregate level required by the aggregated revenues test.

120. Transpower submitted that in practice the threshold test for the Commission to reconsider the individual price-quality path in the Transpower IMs is erratic for the first three years of a regulatory period and that there is no amount of capital expenditure that could trigger the catastrophic event mechanisms in the final two years.

121. It appears that the claim that the threshold test is erratic arises from Transpower’s assumption that base capex expenditure and major capex overspend adjustments apply to this estimation of the price path impact. Transpower also seems to assume that the capex spend for remedial capex following a catastrophic event is entirely incremental to forecast capex (ie, does not provide for any project substitution following the catastrophic event).

122. It also suggests the absence of a wash-up process for opex under the IPP means there is necessarily no amount of operating expenditure that would alter the price path and qualify as ‘catastrophic’.

123. However, as we note above, our view is that the threshold test is an ex ante assessment of the forecast revenue impacts of the net costs of the event against the future forecast MAR of the IPP, rather than an ex post assessment of actual revenue impacts against the current IPP that would otherwise take into account all applicable incentive mechanisms (ie, Capex IM and IRIS) and the limitation on the opex allowance. We consider that neither the incentive mechanisms nor the limitation on

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26 Commerce Commission “Input Methodologies (Transpower) Reasons Paper” (22 December 2010), paragraph 7.4.3 and “Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper (22 December 2010), paragraphs 8.4.5 to 8.4.8.

27 Transpower “Response to IPP Draft Decision” (27 June 2014), page 54.
the opex allowance would apply to the calculation of the relevant forecast revenue impacts when measuring the cost effects against the threshold test.

124. Transpower also asserted that the threshold test should be based on costs incurred rather than price impact, and should be independent of the level of insurance cover. This is because:

124.1 the threshold test as the Commission interprets it is net of insurance entitlements, meaning it cannot be assessed with confidence until after insurance claims are resolved; and

124.2 an event must give rise to costs significantly in excess of Transpower’s insurance cover before the catastrophic event mechanism is available.

125. We do not agree with the proposition that expected insurance recoveries cannot be estimated *ex ante*.\(^\text{28}\)

126. We therefore conclude that there is no technical reason that prevents the application of the current threshold test to Transpower. We consider that any refinements could be considered at a future time, for instance, as part of the seven year review of the Transpower input methodologies.

**The ‘commissioned’ vs ‘expenditure’ basis for setting the base capex allowance**

127. The base capex allowance has been set for RCP2 on a ‘commissioned’ basis, which is consistent with the basis used for capitalising assets to the regulatory asset base in the Transpower IMs and is used for the capex incentive mechanisms in the Capex IM.

128. Transpower submitted that we should approve an amount of base capex directly, rather than approving an amount for forecast commissioned expenditure.\(^\text{29}\)

129. Transpower notes:

   The challenges associated with managing to a commissioned-value allowance will become more acute in RCP2 due to the high value at risk through the Base Capex incentive regime. Shifting to an expenditure based allowance would allow a tighter link between corporate governance actions and regulatory outcomes – producing more predictable and less volatile outcomes, and simplifying management of our capital programme at all levels of the business.

130. Practical concerns described to us by Transpower relate to the adjustments for the disparity between the forecast CPI and the actual CPI and to the disparity between

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\(^{28}\) The estimation of insurance recoveries and other compensatory entitlements would initially only be for the purpose of deciding whether the threshold has been met for the Commission to reconsider the individual price-quality path. The estimates would therefore be expected to have a relatively high degree of estimation error, given anticipated issues of settling actual insurance amounts in due course. The evaluation of the actual and forecast net expenditure for the purposes of setting the reconsidered path would be expected to have a higher level of estimation accuracy, as they would form a formal proposal from Transpower for reconsideration of the remaining years of the individual price-quality path for the regulatory period.

\(^{29}\) Transpower “Response to IPP Draft Decision” (27 June 2014), page 60, section 7.1.4.
131. Because the base capex allowance for a year is a fungible pool of allowed expenditure, it is not possible to make those disparity adjustments to the degree of accuracy that can be achieved for individually approved major capex projects.

132. We consider these practical implementation issues can be overcome by treating the base capex commissioned in any one year as one large project and to then carry out the necessary disparity adjustments on a commissioned basis. This may require some form of extrapolation of an expenditure basis adjustment for the forecast CPI and forecast foreign exchange rates.

133. We do not consider that the matter requires the Capex IM to be amended from a commissioned to a ‘spend’ basis, and can feasibly be handled by the Commission working with Transpower on a practical protocol for applying the base capex expenditure adjustment.

134. In our 2010 IPP Reasons Paper, we moved away from providing approval based on forecast capital expenditure for a given period, in favour of approving a level of capital expenditure that is forecast to be commissioned during a given period.

135. Previously, under the Administrative Settlement, Transpower’s revenue requirement was based upon approved forecasts of capital expenditure, with the year-end wash-up taking into account actual assets commissioned. We concluded that an approach based on commissioned capital expenditure provides consistency of approach between the forecasts and that used at year-end.\(^\text{30}\)

136. This is an issue that was considered on a cross-sector basis when the input methodologies for Transpower, electricity distribution services and gas pipeline services were determined in 2010. We noted then in our reasons paper that the requirement that a new asset must be ‘used’ in the definition of ‘commissioned’ is a practical way of ensuring that only assets that are used to provide their regulated services are included in the RAB value.\(^\text{31}\)

137. Whether an asset is ‘used’ is a purely factual matter within the knowledge of the regulated suppliers, which can be objectively assessed by the regulated suppliers and interested parties.\(^\text{32}\)

138. In respect of the individual price-quality path determination for the first regulatory period and the issue of financing costs, Transpower submitted that, while it would be happy to continue with the approach taken under the settlement agreement, it would prefer to record the timing of capex on an ‘as incurred’ basis (reflecting the

\(^{30}\) Commerce Commission “Individual Price-Quality Path (Transpower) Reasons Paper” (22 December 2010), paragraphs 5.2.6 and 5.4.11.

\(^{31}\) Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper” (22 December 2010), paragraph E4.4.

\(^{32}\) Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper” (22 December 2010), paragraph E4.4.
time at which it pays for a particular project). This is because of the impact on cash flows, especially at a time of significant capital investment. Harding Katz (in a report for Transpower) also submitted in 2010 that the Commission should consider whether the cash flow and forecasting benefits of an ‘as incurred’ approach outweigh the theoretical purity of an ‘as commissioned’ approach.

139. We noted in the 2010 IPP Reasons Paper that in workably competitive markets, assets that have not been commissioned would not normally be expected to earn a return on the capital expended. Our approach was therefore to allow Transpower to include capex along with financing costs incurred during construction in the RAB value from the time the asset is commissioned.

140. This approach is consistent with GAAP. Under GAAP, finance costs are calculated from the ‘commencement date’ to the date at which ‘substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete’.

141. We note that under the Transpower Input Methodologies Determination, Transpower’s closing RAB value for a disclosure year includes the ‘value of commissioned assets’ in that disclosure year. Provided an asset created in a base capex project meets the above GAAP requirement that ‘substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete’, it may be included in the RAB and will receive a return at the WACC rate and may be depreciated.

142. It is therefore not an essential requirement that a ‘project’ or ‘programme’ be ‘commissioned’ in order for Transpower to receive a return on an asset.

143. Base capex is less ‘lumpy’ in its expenditure profile over time than major capex projects, with fewer projects or programmes expected to cross more than one disclosure year. This appears to be the most significant factor in differentiating the expenditure that would be directly recognised (i.e. ‘spend’ basis of recognition) from the expenditure recognised in the RAB on a commissioned basis.

144. In workably competitive markets, firms have incentives to complete capital works in a timely and efficient manner. This includes minimising the costs (including financing costs) of completing the works on time, and to a given standard. Promoting improved efficiency is one of the regulatory objectives set out in the Part 4 Purpose (at s 52A(1)(b)).

145. When the Capex IM was determined in January 2012, we noted:

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33 Commerce Commission “Individual Price-Quality Path (Transpower) Reasons Paper” (22 December 2010), paragraphs 4.4.35 and 4.4.36.
34 Transpower Input Methodologies Determination [2012] NZCC 17, clause 2.2.3(2)(f).
35 Transpower Input Methodologies Determination [2012] NZCC 17, clause 2.2.7(1).
37 Commerce Commission “Transpower Capital Expenditure Input Methodology Reasons Paper” (31 January 2012), paragraph 2.3.3.
2.3.3: On an annual basis, the forecast MAR, which takes into account forecasts of the timing of assets to be commissioned, is updated for actual timing and actual costs of commissioned capital projects. This will remove forecasting errors and ensures that Transpower recovers exactly the cost of capital set by the Commission (plus or minus the incentive effects).

146. In respect of the operation of the capex incentives, we said:\textsuperscript{38}

4.1.4: While the full amount of expenditure on assets that are commissioned will enter the RAB, the overall outcome of the Commission's decisions on Major capex incentives is that Transpower will only earn a full return on that capital expenditure, determined by WACC, where:

a. expenditure is equal to, or lower than, the Major capex project allowance (which may have been the subject of an amendment), and

b. the Major capex output measures have been delivered (including delivery to alternate outputs approved by the Commission), and

c. the project was commissioned prior to the approval expiry date.

147. Although the above reference is to the major capex allowance, it has equal application to the base capex allowance as applied in the base capex expenditure adjustment.\textsuperscript{39}

148. Our conclusion is therefore that the base capex allowance will continue to be determined on a forecast commissioned basis for the second regulatory period. However, as this is an approach applied in the Capex IM incentives, this is a matter that may be reviewed at a future time, for instance, as part of the seven year review of the input methodologies.\textsuperscript{40}

\textsuperscript{38} Commerce Commission “Transpower Capital Expenditure Input Methodology Reasons Paper” (31 January 2012), paragraph 4.1.4.


\textsuperscript{40} Commerce Act 1986, s52Y(1).