



COMMERCE COMMISSION

# **Transpower Process and Recommendation Discussion Paper**

Network Performance Branch  
Commerce Commission  
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NEW ZEALAND

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## EXECUTIVE SUMMARY

### Purpose

- X1 The purpose of this paper is to set out the Commerce Commission's (Commission's) preliminary views on:
- the relevant provisions in relation to the regulation of Transpower New Zealand Limited (Transpower) under Part 4 of the Commerce Act 1986, as amended by the Commerce Amendment Act 2008 (the Act);
  - the process that the Commission proposes to follow in making its recommendation to the Minister of Commerce (the Minister) on the type of price-quality regulation to apply to Transpower;
  - the type of price-quality regulation that should apply to Transpower following the expiry of the existing settlement agreement on 30 June 2011; and
  - the parameters, in summary, that would apply under individual price quality regulation if this is recommended.

### Background

- X2 Transpower is the sole owner and operator of the New Zealand national electricity transmission grid. To address aging transmission assets and low levels of investment in the transmission grid over an extended period of time, Transpower is planning to undertake capital expenditure totalling more than \$3 billion over the next five years. This investment includes large projects that are uncertain with respect to project costs and timing and are currently subject to review and approval by the Electricity Commission under Part F of the Electricity Governance Rules.
- X3 On 13 May 2008, the Commission accepted an administrative settlement from Transpower in respect of breaches of the thresholds under Part 4A of the Act. Although Part 4A has now been repealed under Part 4 of the Act Transpower continues to be subject to this administrative settlement until it expires on 30 June 2011.
- X4 Before Transpower's administrative settlement expires, the Commission must recommend to the Minister of Commerce that Transpower be subject to either default/customised or individual price-quality regulation. Transpower will be subject to price-quality regulation once the Governor-General makes an Order in Council declaring which type of price-quality regulation applies to Transpower and the Commission makes a s 52P determination applying the regulation to Transpower. Transpower is also subject to information disclosure regulation under Part 4 of the Act.
- X5 The Commission must determine input methodologies for the goods or services regulated under Part 4 no later than 30 June 2010. As Transpower is not subject to price-quality regulation until the Commission makes its s 52P determination, the Commission is only required to determine the input methodologies applicable to information disclosure regulation of Transpower by 30 June 2010.

- X6 However, the Commission also considers that it should determine all input methodologies applicable to the type of price-quality regulation recommended for Transpower under s 52U before the Commission makes its Recommendation to the Minister.

#### **Proposed process for recommendation to the Minister**

- X7 In preparing the draft process for making the recommendation to the Minister and the s 52P determination on how the regulation applies to Transpower the Commission has considered:
- the level of information that should be provided in the Commission's recommendation to the Minister;
  - the steps following the Commission's recommendation to the Minister that need to occur before the appropriate regulation can be imposed; and
  - the timing of Transpower's pricing year in relation to the expiry of the administrative settlement.
- X8 The proposed process includes preparing the Commission's recommendation to the Minister in parallel with the Commission determining input methodologies for Transpower and the other sectors. That is, input methodologies for Transpower will be determined by 30 June 2010 with the Commission's recommendation to the Minister being made soon after 30 June 2010. After the Commission makes its recommendation to the Minister there are a number of steps to be completed before the s 52P determination setting out how the regulation applies to Transpower can be made. The steps with proposed timing are:<sup>1</sup>
- the Commission makes a recommendation to the Minister that Transpower be subject to either default/customised or individual price-quality regulation in Q2 2010;
  - the Minister considers the Commission's recommendation, consults with the Minister of Energy, requests further information or advice from the Commission (if required) and decides which type of regulation is to apply to Transpower in Q4 2010;
  - the Governor-General makes an Order in Council stating the type of regulation to which Transpower is subject to in Q4 2010; and
  - the Commission consults on and makes a determination specifying how this type of regulation applies to Transpower in Q1 2011.
- X9 The Commission is proposing that the s 52P determination includes a transition period following the expiry of the existing administrative settlement on 30 June 2011 and the end of the 2011/12 financial year on 30 June 2012. The price-quality path during this transition period would be based on the existing settlement agreement, with the revenue received during

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<sup>1</sup> The proposed dates for the Minister undertaking a review of the Commission's recommendation and making a decision and the Governor-General making an Order in Council are dependent on the process adopted by the Minister and the Governor-General.

the 2011/12 pricing year deemed to have been received in the 2011/12 financial year. During this period, the Commission would undertake a review of Transpower's expenditure for the purposes of setting provisions relating to the remaining years of the individual price-quality path or for setting a customised price-quality path if default/customised price-quality regulation applies and Transpower has applied for a customised price-quality path.

### **Proposed type of regulation**

- X10 The main features of default/customised price-quality regulation are:
- a default set of regulatory provisions (e.g. starting prices, rates of change and quality standards) that apply for the regulatory period and are set in a “relatively low cost way” using readily available information;
  - the ability for individual suppliers to make proposals to the Commission for a customised price-quality path; and
  - penalty provisions for a breach of default/customised price-quality regulation provisions.
- X11 The provisions for individual price-quality regulation, set out in subpart 7 of Part 4 of the Act, are less prescribed than the default/customised provisions. The provisions give the Commission the discretion to set individual price-quality paths using any process, and in any way, it thinks fit, but must use the input methodologies that apply to the supply of those goods or services.
- X12 Transpower considers that the Commission should recommend to the Minister that individual price-quality path regulation should apply to Transpower after 30 June 2011.

### **Commission's preliminary view**

- X13 The Commission has considered whether default/customised or individual price-quality regulation is suitable for Transpower. The Commission concludes that, in order to set a price-quality path that adequately reflects Transpower's forecast expenditure, a full building blocks type analysis, including expenditure review, supplemented by the inclusion of approval of uncertain projects during the regulatory period would be required
- X14 A full building blocks type analysis is unlikely “to provide a relatively low-cost way of setting price-quality paths” as provided in the purpose statement for default/customised price-quality regulation.
- X15 A full building blocks type analysis could be undertaken as part of setting either a customised or individual price-quality path for Transpower. However, setting an individual price-quality path is likely to be more effective as it could allow for inclusion of uncertain projects approved by either the Commission or another regulatory agency; could include an ex-post review to address any forecasting error; would not be subject to a restrictive time constraint in reviewing Transpower's forecast expenditure; and the Commission would not first have to consult on and develop a default price-quality path.
- X16 Ensuring that Transpower's forecast revenue requirement is reflected in the price-quality path is necessary to provide the appropriate incentives for

Transpower to continue to invest in the transmission assets. The inclusion of an ex-post review would limit Transpower's ability to extract excess profits during a regulatory period as well as ensure that Transpower is held accountable for making investments that have been provided for in the revenue requirement. These outcomes can be achieved under individual price-quality regulation and are consistent with the s 52A purpose statement and the 2006 GPS on incentives to invest.

- X17 The Commission's preliminary view is that it recommend to the Minister that Transpower be subject to individual price-quality regulation following the expiry of the administrative settlement on 30 June 2011 and that the Commission's recommendation include:
- that individual price-quality regulation should apply;
  - what input methodologies apply; and
  - the material provisions that apply under individual price-quality regulation.
- X18 The proposed input methodologies and rules and processes under individual price-quality regulation are set out in the Commission's paper entitled Input Methodologies Discussion Paper.

## CHAPTER 1: INTRODUCTION

### 1.1 Purpose

- 1.1 The purpose of this paper, being the Transpower Process and Recommendation Discussion Paper (Discussion Paper), is to set out the Commerce Commission's (Commission) preliminary views on:
- the relevant provisions in relation to the regulation of Transpower New Zealand Limited (Transpower) under Part 4 of the Commerce Act 1986, as amended by the Commerce Amendment Act 2008 (the Act);
  - the process that the Commission proposes to follow in making its recommendation to the Minister of Commerce (the Minister) on the type of price-quality regulation to apply to Transpower;
  - the type of price-quality regulation that should apply to Transpower following the expiry of the existing settlement agreement on 30 June 2011; and
  - the parameters, in summary, that would apply under individual price quality regulation if this is recommended.
- 1.2 The Commission invites submissions on its proposed process and its preliminary view on the type of regulation to apply to Transpower.

### 1.2 Background

#### New regulatory instruments

- 1.3 The Commerce Amendment Act 2008, which received Royal assent on 16 September 2008, introduced significant changes to the provisions of the Commerce Act relating to the economic regulation of goods and services in New Zealand.<sup>2</sup> This legislation amends the regulatory provisions in Parts 4, 4A, 5 and 6 of the Act, putting in place a new regulatory framework for New Zealand. The amendments directly affect the scope and role of the Commission in regulating electricity lines and gas pipeline services and extend the Commission's responsibilities to include the regulation of specified airport services.
- 1.4 The key features of the new regulatory framework are:
- a new overall purpose statement common to all regulatory provisions under the Act, as well as the additional purpose statements relating to specific subparts;
  - a broader range of "fit-for-purpose" regulatory instruments actually (or potentially) applying to regulated goods or services;

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<sup>2</sup> Most of these changes came into force on 14 October 2008, with the exception of the majority of provisions relating to the supply of electricity lines services, which take effect from 1 April 2009.



- amended provisions for the Commission to undertake Part 4 inquiries into “whether to”, and if so, “how to” regulate services not already automatically subject to regulation under the Act;
- new obligations for the Commission to set upfront regulatory methodologies, rules, processes, requirements and evaluation criteria (collectively and/or individually referred to as “input methodologies”) that are directly (or indirectly) relevant for applying the regulatory instruments and for undertaking Part 4 inquiries;
- new appeal provisions relating to Commission determinations on input methodologies, and to customised and individual price-quality path determinations; and
- new and amended penalty, compensation and offence provisions.

1.5 Previous instruments for regulation of electricity lines services, including those applying to Transpower, comprised of information disclosure and a targeted control regime under Part 4A of the Act. The targeted control regime consisted of a set of performance thresholds for electricity lines businesses; the potential for control of prices, revenues and quality following a threshold breach; and the potential for a threshold breach to be resolved by an administrative settlement. The regulatory instruments now available under Part 4 are:

- information disclosure regulation;
- negotiate/arbitrate regulation;
- default/customised price-quality regulation; and
- individual price-quality regulation.

1.6 The focus of this Discussion Paper is on the process for the regulation of Transpower under Part 4 of the Act and the suitability of either default/customised or individual price-quality regulation for Transpower following the expiry of the existing Transpower settlement agreement on 30 June 2011.

### **1.3 Structure of this paper**

1.7 Chapter 2 of this Discussion Paper outlines the Commission’s statutory obligations in making its recommendation to the Minister on the type of price-quality regulation to apply to Transpower. Chapter 3 sets out the process that the Commission intends to follow in making this recommendation. Chapter 4 examines default/customised and individual price-quality regulation, their suitability for application to Transpower and the Commission’s preliminary view on the appropriate type of price-quality regulation.

### **1.4 Consultation on this paper and next steps**

#### **Other relevant Commission consultation papers**

1.8 The Commission is also releasing a number of other relevant papers for consultation at the same time as this Discussion Paper. These are:

- Input Methodologies Discussion Paper;

- Revised Draft Cost of Capital Guidelines; and
- 2010 Default-price Quality Paths for Electricity Distribution Businesses Discussion Paper.

1.9 Inter-relationships between this paper and these other consultation papers are discussed throughout this paper.

### **Submissions**

1.10 Submissions are invited on all the issues raised in this Discussion Paper. To assist interested parties in making submissions, the Commission has identified a number of questions throughout this paper on which it invites comment. These questions are collated in Appendix A.

1.11 Submissions on this paper should be received by the Commission no later than 5pm on Friday, 31 July 2009 (due date). All submissions should be supported by documentation and evidence, where appropriate.

1.12 In order to meet the time-frames prescribed in the Act, the Commission relies on submissions being provided by the due date. The Commission will only allow extensions beyond the due-date if the submitter provides good reasons in writing. Unless an extension has been granted, the Commission may not be in a position to adequately consider submissions for the next stages of the project if received after the due date.

1.13 To foster an informed and transparent process, the Commission intends to publish all submissions on its website. Accordingly, the Commission requests an electronic copy of each submission and requests that hard copies of submissions not be provided (unless an electronic copy is not available). Submissions should be sent to:

NPB@comcom.govt.nz;  
or  
Alex Sim  
Network Performance Branch  
Commerce Commission  
P.O. Box 2351  
Wellington

### **Confidentiality**

1.14 The Commission discourages requests for non-disclosure of submissions, in whole or in part, as it is desirable to test all information in a fully public way. It is unlikely to agree to any requests that submissions in their entirety remain confidential. However, the Commission recognises there will be cases where interested parties making submissions may wish to provide confidential information to the Commission.

1.15 If it is necessary to include such material in a submission the information should be clearly marked and preferably included in an appendix to the submission. Interested parties should provide the Commission with both confidential and public versions of their submissions in both electronic and hard-copy formats. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

- 1.16 Parties can also request that the Commission makes orders under s 100 of the Act in respect of information that should not be made public. Any request for a s 100 order must be made when the relevant information is supplied to the Commission and must identify the reasons why the relevant information should not be made public. The Commission will provide further information on s 100 orders if requested by parties, including the principles that are applied when considering requests for such orders. Any s 100 order will apply for a limited time only as specified in the order. Once an order expires, the Commission will follow its usual process in response to any request for information under the Official Information Act 1982.

### **Cross-submissions**

- 1.17 Once submissions on this Discussion Paper have been received, the Commission will invite cross-submissions on matters raised in those submissions. Cross-submissions will be due at 5pm on Monday, 17 August 2009.

### **Conference**

- 1.18 The Commission plans to hold a conference with interested parties on the Input Methodologies Discussion Paper during the week commencing 14 September 2009. The Commission may include a session within that conference on the issues set out in this Discussion Paper. Parties are requested to provide all of their views in the submissions due on 31 July 2009 and cross-submissions due on 17 August 2009. The introduction of new materials at the conference will not be permitted.
- 1.19 The Commission does not consider that it is necessary, or the best use of time, to allow parties to make detailed oral submissions at the conference that would largely repeat material already disclosed in the written submissions. The Commission will have carefully considered all submissions made by interested parties and identified the key issues that it wishes to address at the conference. If a session at the input methodologies conference is to be held on this Discussion Paper, then the Commission will send out details of the arrangements and agenda for the conference in due course.

- |   |
|---|
| (1) Do you consider that the Commission should hold a session at the input methodologies conference to discuss this Discussion Paper in September 2009? |
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## CHAPTER 2: STATUTORY FRAMEWORK

### 2.1 Introduction

2.1 This chapter outlines the key provisions relating to the regulation of Transpower under Part 4 of the Act.

### 2.2 Purpose of regulatory provisions and instruments

2.2 Amongst the changes introduced by the CAA is a new purpose statement for Part 4 of the Act (s 52A):

*(1) The purpose of this Part is to promote the long-term benefit of consumers in markets where there is little or no competition and no likelihood of a substantial increase in competition by promoting outcomes that are consistent with outcomes produced in competitive markets so that suppliers of regulated goods or services—*

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and*
- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and*
- (c) share with consumers the benefits of efficiency gains in the supply of all or any regulated goods or services, including through lower prices; and*
- (d) are limited in their ability to extract excessive profits.*

#### Commission's interpretation of the new purpose statement

2.3 The Commission has interpreted the new purpose statement as follows:<sup>3</sup>

- first, there is the central purpose, to promote the long term benefit of consumers in markets where there is little or no competition and little or no likelihood of a substantial increase in competition; and
- second, there is the means of achieving that purpose, by promoting outcomes that are consistent with those produced in competitive markets. In particular, these outcomes must be such that suppliers of regulated goods or services:
  - i. have incentives to innovate and invest, including in replacement, upgraded, and new assets;
  - ii. have incentives to improve efficiency and provide services at a quality that reflects consumer demands;
  - iii. share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
  - iv. are limited in their ability to extract excessive profits.

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<sup>3</sup> More discussion concerning the Commission's preliminary views on the purpose statement, the proposed regulatory framework and implementation principles are set out in Chapter 2 of the Input Methodologies Discussion Paper.

## Regulatory instrument purpose statements

- 2.4 The following regulatory instruments have their own secondary purpose statement, as do the provisions for input methodologies:
- **Input Methodologies:** to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of services under Part 4 (s 52R).
  - **Information Disclosure Regulation:** to ensure that sufficient information is readily available to interested persons to assess whether the purpose of Part 4 is being met (s 53A).
  - **Default/Customised Price-Quality Regulation:** to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances (s 53K).
  - **Negotiate/Arbitrate Regulation:** to encourage a supplier and its customers to reach agreement, through negotiation, on the supplier's prices and quality standards during a specified regulatory period (s 53G).
- 2.5 Although there is no specific purpose statement for individual price-quality regulation, the Commission considers that the purpose for default/customised price-quality regulation, is relevant when setting individual price-quality paths. In particular, the Commission is given flexibility under individual price-quality regulation to set a price-quality path that better meets an individual's circumstances. As discussed later in this paper, the Commission considers that there are similarities between customised price-quality paths and individual price-quality paths.
- 2.6 The provisions for individual price-quality regulation are less prescribed than those for default/customised price-quality regulation, giving the Commission the discretion to set price-quality paths as it sees appropriate (s 53ZC(1)):

the Commission may set the price-quality path for that supplier using any process, and in any way, it thinks fit, but must use the input methodologies that apply to the supply of those goods or services.

## 2.3 Regulation of Transpower

- 2.7 Transpower is the sole owner and operator of the New Zealand national electricity transmission grid. On 13 May 2008, the Commission accepted an administrative settlement from Transpower in respect of previous breaches of the thresholds set under Part 4A of the Act. Under subpart 9 of Part 4 of the Act, Transpower continues to be subject to this administrative settlement until it expires on 30 June 2011.
- 2.8 As a supplier of electricity lines services, Transpower is subject to information disclosure regulation (subpart 4) under Part 4 of the Act. Transpower will be subject to price-quality regulation once an Order in Council is made declaring the type of price-quality regulation that Transpower will be subject to, and the Commission makes a s 52P determination applying the relevant regulation to Transpower. Part 4 of the Act requires the Commission to set input methodologies for Transpower by

30 June 2010 (subpart 3 of Part 4). Price-quality regulation, input methodologies and information disclosure are discussed below.

### **Price-quality regulation**

- 2.9 Part 4 of the Act does not specify which type of price-quality regulation will apply to Transpower. Section 54M(3) requires that, before Transpower's administrative settlement expires on 30 June 2011, the Commission must recommend to the Minister that an Order in Council be made under s 52N declaring that Transpower be subject to either:
- default/customised price-quality regulation, under subpart 6; or
  - individual price-quality regulation, under subpart 7.<sup>4</sup>
- 2.10 Transpower will be subject to price-quality regulation once the Governor-General (upon the Minister's recommendation) makes the Order in Council declaring the type of price-quality regulation to apply to Transpower and the Commission makes a s 52P determination applying the regulation to Transpower.
- 2.11 Section 54M(4) provides that Subpart 2 of Part 4 (Regulating Particular Goods or Services), except the provisions relating to inquiries, applies to the process for imposing price-quality regulation and making the s 52P determination for Transpower. This is discussed in paragraphs 2.15 to 2.27 of this paper.
- 2.12 Section 54M(5) provides that if the Order in Council declares that Transpower is subject to default/customised price-quality regulation, the Commission must set a default price-quality path in accordance with s 53P. If the Order in Council declares that Transpower is subject to individual price-quality regulation, the provisions under subpart 7 (individual price-quality regulation) apply.
- 2.13 Section 54M(6) provides that the only requirements that may be set in respect of Transpower's quality standards are requirements that give effect to quality standards set by the Electricity Commission.
- 2.14 The appropriate type of price-quality regulation will be applied to Transpower once the Commission makes its s 52P determination. This determination must be made as soon as practicable after the Order in Council is made (s 52P(2)). To avoid a gap in the price-quality regulation of Transpower, the determination will also have to be made prior to the expiry of the existing administrative settlement.

### Application of Subpart 2 of Part 4 of the Act

- 2.15 As stated above, s 54M(4) provides that Subpart 2 of Part 4 (Regulating Particular Goods or Services), except the provisions relating to inquiries,

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<sup>4</sup> Section 52C states price to mean any one or more of individual prices, aggregate prices, or revenues (whether in the form of specific numbers, or in the form of formulas by which specific numbers are derived).

- applies to the process for imposing price-quality regulation and making the s 52P determination for Transpower.
- 2.16 The Commission considers that s 52G (When Goods or Services May be Regulated) does not apply to the recommendation process. This is because the electricity lines services supplied by Transpower are already subject to regulation under the Act.
- 2.17 The Commission considers that s 52H to s 52J clearly relate to inquiries, and therefore do not apply to the Commission's recommendation process. However, consistent with s 52J(3), the Commission will consult with interested parties during the recommendation process and have regard to any views received within the due dates for submissions.
- 2.18 Section 52K applies to the Commission's recommendation at the end of an inquiry. If s 52K is a provision 'relating to inquiries', it does not apply to the s 54M(3) process.
- 2.19 It could be argued that s 52K does not relate to inquiries and therefore applies to the Commission's recommendation, as:
- Section 52K applies to the Commission's recommendation "at the end of an inquiry", rather than during an inquiry. Similarly, the heading to s 52K reads 'Commission's recommendation *following inquiry*'.
  - Subsection (3) requires the Minister to publish the Commission's recommendation, and this subsection does not refer to an inquiry.
  - Section 52P(4) refers to a determination made "following an inquiry and a recommendation under s 52K".
- 2.20 However, the following matters suggest that s 52K does relate to inquiries and therefore does not apply to the Commission's recommendation:
- The phrase 'relating to inquiries' is broad. Although s 52K applies at the end of an inquiry, the recommendation is based on the Commission's inquiry and therefore does 'relate' to an inquiry. In particular, s 52K(1) provides that the Commission's recommendation is made "after considering the matters in s 52I", which specifies the matters that the Commission must consider in conducting an inquiry.
  - The heading for s 52H to s 52K reads "Commission Inquiry" while the heading for s 52L to s 52O reads "Order in Council imposing regulation".
- 2.21 The Commission considers that the better interpretation is that s 52K does not apply to the s 54M(3) recommendation process. However, the Commission considers that s 52K provides guidance on the matters that need to be included in a recommendation to enable the Minister to make a decision. There is no other guidance in the Act on what a recommendation to the Minister should contain.
- 2.22 Specifically, in line with s 52K, the Commission considers that all input methodologies applicable to the Commission's recommendation should be determined by the time the Commission makes its recommendation. In addition s 52K(2)(b) (which type or types of regulation should apply) must be included in the Commission's recommendation by virtue of s 54M(3).

- 2.23 The Commission considers that if default/customised price-quality regulation is recommended, the Commission's recommendation should state the default price-path and quality standards, consistent with s 52K(2)(f). Similarly, if the Commission recommends individual price-quality regulation, the Commission should state the material provisions to apply, consistent with s 52K(2)(g).
- 2.24 If the Commission does not provide sufficient detail on the proposed form of regulation in its recommendation, the Minister may not have sufficient information to decide which type of regulation should apply to Transpower. Setting out what input methodologies apply and satisfying the requirements of s 52K(2)(f) or (g) are likely to assist the Minister in making a timely decision by reducing the need to request further information or advice from the Commission.
- 2.25 The Commission considers that s 52L to s 52O clearly relate to the process for imposing regulation and, as discussed above, the heading to these sections support this view. These sections must be applied by the Minister and the Governor-General when considering the Commission's recommendation on the type of regulation to apply to Transpower and making an Order in Council. In particular, the Minister must consult with the Minister of Energy as part of considering the Commission's recommendation, and the Minister may request further information or advice from the Commission, in accordance with s 52L(2).
- 2.26 In addition, s 52L provides that if the Minister proposes that the goods or services should be subject to a type of regulation not recommended by the Commission, the Minister must ask the Commission for written advice on what the material provisions of the relevant s 52P determination would be likely to be (s 52L(3)). The requirement for advice on the material provisions aligns with the Commission providing the default price-path and quality standards or material provisions to apply to individual price-quality regulation of Transpower (s 52K(f) or s 52K(g)) as part of its recommendation to the Minister.
- 2.27 Under s 52P(2)(a), the Commission must make a determination specifying how the relevant form of price-quality regulation applies to Transpower as soon as practicable after the Order in Council is made. However, there are a number of steps between the Commission making its recommendation and making a s 52P determination imposing the appropriate type of regulation on Transpower. These steps are discussed in paragraphs 3.6 to 3.7.

### **Input methodologies**

- 2.28 Section 52U provides that the Commission must determine input methodologies for the goods or services regulated under subparts 9 to 11 of Part 4 no later than 30 June 2010, to the extent applicable to the type of regulation. The Minister may extend this deadline by up to 6 months.
- 2.29 As Transpower is not subject to price-quality regulation until the Commission makes its s 52P determination, the Commission considers that, in accordance with s 53F, it is required to set only the input methodologies relevant to information disclosure regulation of Transpower by 30 June 2010. However, as set out in paragraphs 2.15 to 2.27, the Commission considers



that it should determine the input methodologies applicable to the type of price-quality regulation recommended for Transpower under s 52U before making its recommendation to the Minister. The Commission considers this approach is consistent with the purpose of input methodologies set out in s 52R, being to promote certainty in relation to the rules, requirements and processes applying to regulation or proposed regulation.

- 2.30 The Commission considers that it is not required to determine input methodologies for matters relating to proposals, by Transpower, for a customised price-quality path (i.e. s 52T(1)(d)), by 30 June 2010. Transpower is not currently subject to this form of regulation, and the Commission's preliminary view is that individual price-quality regulation would be more appropriate for Transpower than default/customised price-quality regulation (see Chapter 4 of this paper). If, following consultation, the Commission decides to recommend default/customised price-quality regulation, the Commission would consult on and determine the matters in s 52T(1)(d).
- 2.31 For further details on input methodologies, see the Input Methodologies Discussion Paper. Chapter 12 of that paper focuses on Transpower.

- (2) Do you agree that all input methodologies applicable to the regulation of Transpower should be determined prior to the Commission making its recommendation to the Minister? If not, which input methodologies do you consider should be determined before the Commission makes its recommendation, and why?
- (3) Do you agree that the Commission is not required to determine input methodologies for a customised price-quality path at the time of making its recommendation, if the Commission recommends that individual price-quality regulation should apply to Transpower?

### **Information disclosure**

- 2.32 Transpower is subject to information disclosure regulation under Part 4 of the Act. The s 52P determination to specify how the new information disclosure regulation will apply to Transpower must be made as soon as practicable after 1 April 2009. The Commission intends to set new information disclosure requirements after the applicable input methodologies have been determined.
- 2.33 The information disclosure requirements that were set by the Commission under Part 4A of the Act in October 2008 will continue to apply until such time as the Commission makes new requirements under the new legislative provisions.

## CHAPTER 3: PROPOSED PROCESS

### 3.1 Introduction

- 3.1 This chapter sets out the process that the Commission intends to follow in making its recommendation to the Minister on the type of price-quality regulation to apply to Transpower.

### 3.2 Factors impacting on process

- 3.2 The process for implementing Part 4 regulation for Transpower needs to schedule:
- making a recommendation to the Minister on the type of price-quality regulation to apply to Transpower;
  - making a s 52P determination on how the type of regulation applies to Transpower; and
  - determining input methodologies applying to the electricity lines services supplied by Transpower under s 52U and making a s 52P determination applying information disclosure to Transpower.
- 3.3 There are several factors, driven by Part 4 of the Act or parties external to the Commission, that impact on this process. These include the application of subpart 2 of Part 4 of the Act, which includes the level of information provided in the Commission's recommendation to the Minister; the required steps following the Commission's recommendation to the Minister; the timing of Transpower's pricing year; and the review of Transpower's expenditure. These factors are discussed below.

#### Information provided in recommendation to Minister

- 3.4 As stated in chapter 2 the Commission considers it should be guided by s 52K in relation to matters that need to be included in a recommendation to the Minister to enable the Minister to make a decision. Therefore the Commission considers that its recommendation to the Minister should include:
- which type or types of regulation should apply (s 52K(2)(b) – this is also required under s 54M(4));
  - what input methodologies apply (s 52K(2)(c));
  - if default/customised price-quality regulation is recommended, the default price path and quality standards (s 52K(2)(f)); and
  - if individual price-quality regulation is recommended, the material provisions to apply (s 52K(2)(g)).
- 3.5 This requires the Commission to develop Transpower's input methodologies and details of the form of regulation prior to, or in parallel with, developing its recommendation to the Minister on the type of price-quality regulation to apply.

#### Required steps following Commission's recommendation

- 3.6 The Commission has until Transpower's administrative settlement expires on 30 June 2011 to make a recommendation to the Minister on which type of

price-quality regulation should apply. There are, however, a number of steps that must follow the Commission's recommendation before this regulation can be imposed and implemented. The main steps are as follows:

- i. The Commission makes a recommendation to the Minister that Transpower be subject to either default/customised or individual price-quality regulation (s 54M). As set out in paragraphs 2.22 the Commission considers that all applicable Transpower input methodologies should be determined prior to the Commission's recommendation to the Minister.
  - ii. The Minister considers the Commission's recommendation, consults with the Minister of Energy and requests further information or advice from the Commission, if required (s 52L).
  - iii. The Minister decides which type of regulation is to apply to Transpower and makes a recommendation to the Governor-General (s 52M).
  - iv. The Governor-General makes an Order in Council stating the type of regulation to which Transpower is subject (s 52N).
  - v. The Commission consults on and makes a determination specifying how this type of regulation applies to Transpower, including setting out the requirements that apply to Transpower, the timeframes that must be met and the input methodologies that apply (s 52P).
  - vi. The Commission provides a copy of the determination to Transpower, publishes a summary of it in the Gazette and makes it publicly available (s 52P).
- 3.7 To ensure the smooth transition from the existing Transpower administrative settlement to price-quality regulation under Part 4 of the Act, the Commission must deliver its recommendation to the Minister in time to allow all the above steps to be completed before the existing administrative settlement expires on 30 June 2011.

### **Transpower's pricing year and review of Transpower's expenditure**

- 3.8 Transpower has a pricing year running from 1 April to 31 March while, in common with most Crown-owned entities, Transpower's financial year runs from 1 July to 30 June. Transpower currently sets its revenue requirement for a pricing year in October/November, based on its business plan projections, and notifies its customers of the new prices in November/December. This provides customers with a three month notice period, as required by the Electricity Governance Rules,<sup>5</sup> prior to prices coming into effect on 1 April.
- 3.9 Under the administrative settlement the revenue recovered during a Transpower pricing year is deemed to be recovered in the financial year starting on 1 July following the start of that pricing year. This approach is

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<sup>5</sup> Electricity Governance Rules, Part F Section II, Schedule F2 Benchmark Agreement, clause 41.5.

adopted to address the mismatch between Transpower's pricing and financial years. Under Part 4, the Commission proposes to continue the approach of deeming the revenue received in a pricing year to have been received in the financial year.

- 3.10 The Commission is proposing that the s 52P determination includes a transition period between the expiry of the existing administrative settlement on 30 June 2011 and the end of the 2011/12 financial year on 30 June 2012, irrespective of which type of price-quality regulation is applied. The price-quality path during this transition period would be based on the existing settlement agreement, with the revenue received during the 2011/12 pricing year deemed to have been received in the 2011/12 financial year.
- 3.11 If individual price-quality regulation applied to Transpower from 1 July 2011, it is likely that a review and approval of Transpower's forecast expenditure (both capital and operating) by either the Commission and/or the Electricity Commission would be required in order to set Transpower's revenue requirement and associated prices for the regulatory period. If the default price-quality path applied to Transpower from 1 July 2011, Transpower could make a customised price-quality path application during the transitional period.
- 3.12 The Commission is proposing to conduct any capital expenditure reviews required under the appropriate price-quality path during the transition period to allow the Commission to set Transpower's revenue requirement and for Transpower to calculate and notify its customers of any price changes for the 2012/13 pricing year by December 2011.

(4) What other matters should the Commission consider when developing the process for the regulation of Transpower under Part 4 of the Act?
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### 3.3 Proposed process

#### Transpower submission

- 3.13 In its submission to the Commission on the *Regulatory Provisions of the Commerce Act 1986 Discussion Paper* (Provisions Paper), Transpower considered that the Commission needed to make its recommendation to the Minister as soon as possible in 2009, unless a transitional arrangement can be implemented for the 2011/12 year. Transpower considered that the Commission's proposal to make the recommendation to the Minister and determine the input methodologies in the second quarter of 2010 would be too late for Transpower to determine a revenue path prior to the end of August 2010, which is when Transpower must finalise the revenue requirement used to calculate the prices that will apply to customers in the 2011/12 pricing year.
- 3.14 However, Transpower went on to state that, while it would not be Transpower's first preference, the heavy workload faced by the Commission over the next two years may make it expedient to roll over the existing thresholds for another year, if this were permitted by the legislative provisions. Such an extension would also allow Transpower more time to develop a multi-year forecasting and planning regime. The thresholds could be reviewed and adjusted as necessary to ensure they continued to be

appropriate. Given that such a rollover would apply for a single further year, the work involved to set the constraints would be considerably less than that required for a multi-year regulatory period.

**Commission preliminary view**

- 3.15 The Commission has considered the factors set out in paragraphs 3.2 to 3.12 and Transpower's submission on the Provisions Paper. The Commission's proposed process for making its recommendation to the Minister on the type of price-quality regulation to apply to Transpower is set out in the following table.

**Table 3.1 Proposed process**

<b>Phase</b>	<b>Task</b>	<b>Indicative date</b>
Commission recommendation (undertaken in parallel with process for determining input methodologies)	Release Transpower Process and Recommendation Discussion Paper. Release Input Methodologies Discussion Paper.	19 June 2009
	Submissions on Transpower Process and Recommendation Discussion Paper and Input Methodologies Discussion Paper.	31 July 2009
	Cross submissions on Transpower Process and Recommendation Discussion Paper and Input Methodologies Discussion Paper.	17 Aug 2009
	Input Methodologies Conference. Option for session on Transpower process and recommendation.	Week of 14 Sept 2009
	Release draft Transpower recommendation, input methodologies draft determination, draft content of s 52 P determination.	Q1 2010
	Submissions on draft recommendation, input methodologies draft determination and s 52P content.	Q1 2010
	Cross submissions on draft recommendation, input methodologies draft determination and s 52P content.	Q1 2010
	Finalise input methodology determinations. <sup>6</sup>	Q2 2010
	Commission final recommendation to Minister.	Q2 2010
Minister and Governor-General <sup>7</sup>	Minister's decision on regulation to apply to Transpower.	Q4 2010
	Governor-General's Order in Council.	Q4 2010
Commission determination	Commission releases draft s 52P determination.	Q4 2010
	Submissions on technical drafting of s 52P determination. <sup>8</sup>	Q1 2011
	Final s 52P determination published in the Gazette (including transitional period).	Q1 2011
Transpower set prices	Transpower prices (based on current settlement agreement) apply for the 2011/12 pricing year.	Q2 2011
Expenditure review (if individual or customised price-quality regulation <sup>9</sup> )	Transpower submits expenditure information.	Q2 2011
	Commission's draft decision on expenditure.	Q3 2011
	Submissions on draft decision.	Q3 2011
	Commission's final decision on expenditure.	Q4 2011
Transpower pricing	Transpower calculates prices for 2012/13, based on applicable price-quality regulation and path.	Q4 2011
	Transpower advises customers of prices.	Q4 2011
	Transpower prices apply for 2012/13 pricing year.	Q2 2012

<sup>6</sup> See the Input Methodologies Discussion Paper for the approach for determining input methodologies.

<sup>7</sup> The proposed dates for the Minister undertaking a review of the Commission's recommendation and making a decision and the Governor-General making an Order in Council are dependent on the process adopted by the Minister and the Governor-General. Any change to these dates will impact all subsequent dates set out in table 3.1.

<sup>8</sup> The material provisions relating to the type of price-quality regulation applying to Transpower would have been consulted on during the Commission's process for making a recommendation to the Minister.

<sup>9</sup> An expenditure review for a customised price-quality path would occur only if Transpower was subject to a default price-quality path and made a proposal to the Commission for a customised price-quality path.

- 3.16 The above dates are based on the Commission's proposed approach to determine input methodologies for Transpower prior to making a recommendation to the Minister and to make the determination specifying how the appropriate type of price-quality regulation applies to Transpower before the administrative settlement expires on 30 June 2011.
- 3.17 The proposed process is intended to allow sufficient time for the Minister to consider the Commission's recommendation and to make a recommendation to the Governor-General, for the Governor-General to make the Order in Council, and for the Commission to make the s 52P determination applying the regulation to Transpower.
- 3.18 The Commission's proposed approach to determine input methodologies prior to making a recommendation to the Minister precludes the Commission from making the recommendation to the Minister in 2009, as suggested in Transpower's submission on the Provisions Paper. The Commission agrees with Transpower that if the recommendation to the Minister is made in July 2010 a transition period would be required to allow Transpower to prepare and submit multi-year capital expenditure forecasts and the Commission to assess these forecasts.
- 3.19 The Commission is proposing to use the period between the expiry of the settlement agreement and the start of the 2012/13 Transpower pricing year to set Transpower's revenue requirement and for Transpower to calculate and notify its customers of any price changes so that those prices take effect from 1 April 2012.

(5) Do you agree with the Commission's proposed process for making the recommendation to the Minister and making the s 52P determination? If not, what changes do you consider should be made, and why?
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### **Links with other processes**

#### Input methodologies

- 3.20 The Commission intends to align the process for determining Transpower's input methodologies with the process for determining input methodologies for other sectors. The Commission considers there to be benefits in consulting on and determining Transpower's input methodologies together with those for other sectors.
- 3.21 The Commission expects to make significant progress in developing the appropriate form and content of the Transpower input methodologies in preparing the initial Input Methodology Discussion Paper and subsequent consultation undertaken early in the input methodologies process.
- 3.22 For further details of the proposed process for setting input methodologies, see the Input Methodologies Discussion Paper.

#### Information disclosure

- 3.23 The Commission intends to set new information disclosure requirements once the applicable input methodologies have been determined.
- 3.24 The process, although not necessarily the timing, for developing new information disclosure requirements for Transpower will be consistent with

that adopted for other sectors. The Commission plans to set out its preliminary views on information disclosure for all suppliers regulated under Part 4, including Transpower, in a discussion paper to be released shortly.



## CHAPTER 4: PROPOSED TYPE OF REGULATION

### 4.1 Introduction

#### Type of regulation under Part 4

- 4.1 Part 4 of the Act does not specify which type of price-quality regulation will apply to Transpower. It requires that, before Transpower's administrative settlement expires on 30 June 2011, the Commission must recommend to the Minister that an Order in Council be made under s 52N declaring that Transpower be subject to either (s 54M(3)):
- default/customised price-quality regulation (subpart 6); or
  - individual price-quality regulation (subpart 7).
- 4.2 Every price-quality path, whether default, customised or individual, must specify (s 53M(1)):
- (a) *in relation to prices, either or both of the following with respect to a specified regulatory period:*
    - (i) *the maximum price or prices that may be charged by a regulated supplier;*
    - (ii) *the maximum revenues that may be recovered by a regulated supplier; and*
  - (b) *the quality standards that must be met by the regulated supplier; and*
  - (c) *the regulatory period.*
- 4.3 Default/customised and individual price-quality regulation are discussed from paragraph 4.12.

#### Government Policy Statements

##### GPS on incentives to invest

- 4.4 In August 2006, the Government provided the Commission with a statement of its economic policy relating to the incentives of regulated businesses to invest in infrastructure (the 2006 GPS).<sup>10</sup> The 2006 GPS states that the Government's economic policy objective is for regulated businesses to have incentives to invest in replacement, upgraded and new infrastructure and in related businesses for the long-term benefit of consumers.
- 4.5 The 2006 GPS states that the Government considers this objective will be achieved by: (a) regulatory stability, transparency and certainty giving businesses the confidence to make long-life investments; (b) regulated rates of return being commercially realistic and taking full account of the long-term risks to consumers of underinvestment in basic infrastructure; and (c) regulated businesses being confident they will not be disadvantaged in their regulated businesses if they invest in other infrastructure and services.

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<sup>10</sup> New Zealand Government, Statement to the Commerce Commission of economic policy of the Government: Incentives of regulated businesses to invest in infrastructure, 7 August 2006. Although this GPS will need updating to reflect the passage of the CAA, the principles still apply in the meantime.

- 4.6 The 2006 GPS also states that the Government considers it is important that regulatory control ensures that: (a) the consumers of regulated businesses are not disadvantaged by the investments of regulated businesses in other infrastructure and services; (b) regulated businesses are held accountable for making investments in that business where those investments have been provided for in regulated revenues and prices; and (c) regulated businesses provide infrastructure at the quality required by consumers at an efficient price. Some of the elements of the 2006 GPS have now been reflected in the changes to the Act introduced through the CAA.
- 4.7 The Commission has regard to the 2006 GPS in forming its preliminary view on the type of price-quality regulation to apply to Transpower.

#### GPS on electricity governance

- 4.8 On 29 October 2004, the Government issued a GPS in relation to electricity governance. Further revisions to the GPS have been made in October 2006, May 2008 and May 2009 (2009 GPS).<sup>11</sup> The 2009 GPS was transmitted by the Minister of Commerce to the Commission pursuant to s 26 of the Act.
- 4.9 The 2009 GPS states the Government's key priority in maintaining the security of electricity supply, which is vital to achieving its objective of sustainable economic development. Under the Electricity Act 1992, s 172O, the Electricity Commission is to use reasonable endeavours to ensure security of supply, without assuming any demand reduction from emergency conservation campaigns. The Electricity Commission should also develop and set security standards for adequacy of capacity to meet peak demand.
- 4.10 The Commission notes that the 2009 GPS includes a subsection entitled 'Investment in Minor Transmission Works', which seeks to put in place a more streamlined process for the approval by the Electricity Commission of grid upgrades by Transpower, where the expected total cost of the project is less than \$20m.
- 4.11 The Commission has regard to the 2009 GPS in forming its preliminary view on the type of price-quality regulation to apply to Transpower.

#### **Default/customised price-quality regulation**

- 4.12 As stated above, the Commission may recommend that default/customised price-quality regulation be applied to Transpower after its administrative settlement expires on 30 June 2011. Section 53K sets out the purpose of default/customised price-quality regulation as:

to provide a relatively low-cost way of setting price-quality paths for suppliers of regulated services, while allowing the opportunity for individual regulated suppliers to have alternative price-quality paths that better meet their particular circumstances.

- 4.13 The main features of default/customised price-quality regulation are:

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<sup>11</sup> Ministry of Economic Development: Government Policy Statement on Electricity Governance, May 2009.

- a default set of regulatory provisions (e.g. starting prices, rates of change and quality standards) that apply for the regulatory period and are set in a “relatively low cost way” using readily available information;
  - the ability for individual suppliers to make proposals to the Commission for a customised price-quality path, seeking alternative price-quality paths that better meet their particular circumstances; and
  - penalty provisions for a breach of default/customised price-quality regulation provisions.
- 4.14 The default price-quality path automatically applies to suppliers subject to default/customised price-quality regulation, unless they have proposed a customised price-quality path and the Commission has made a customised price-quality path determination.
- 4.15 Section 53M specifies the required content and timing of default/customised price-quality paths, including s 53M(4) to (6) which specifies that the regulatory period for a default price-quality path is 5 years, unless the Commission considers that a shorter period, of not less than 4 years, would better meet the purposes of Part 4. The regulatory period may be different for suppliers subject to a customised price-quality path, which is set in accordance with s 53W (maximum of 5 years and minimum of 3 years).

#### Requirements for default price-quality path

- 4.16 Sections 53O and 53P of the Act set out the parameters for setting and resetting a default price-quality path. These parameters relate mainly to how the Commission sets starting prices, rates of change in prices, and quality standards.
- 4.17 A general limitation on the Commission is that it may not use comparative benchmarking on efficiency in setting starting prices, rates of change, quality standards or incentives to improve quality of supply (s 53P(10)).

#### *Starting prices*

- 4.18 Section 53P(3) requires starting prices must be either:
- the prices that applied at the end of the preceding regulatory period; or
  - prices, determined by the Commission, based on the current and projected profitability of each supplier.
- 4.19 Under s 53P(4), these starting prices must not seek to recover excessive profits made during any earlier period.

#### *Rates of change*

- 4.20 Under s 53P(5), the Commission must usually set only one rate of change in prices (X factor) per type of regulated goods or services (subject to s 53P(8)). Section 53P(6) requires the X factor to be based on the long-run average productivity improvement rate achieved by either or both of suppliers in New Zealand and/or other comparable countries, using appropriate productivity measures. The Commission may take into account the effects of inflation on supplier inputs in setting the X factor (s 53P(7)).
- 4.21 An alternative rate of change may be set under s 53P(8) for a particular supplier, as an alternative (in whole or in part) to the starting prices if, in the

Commission's opinion, this is “necessary or desirable to minimise any undue financial hardship to the supplier or to minimise price shock to consumers”, or as an incentive to improve quality of supply. Section 53P(9) allows these alternative rates to include step changes.

### *Quality standards*

- 4.22 Under s 53M(3), quality standards may be prescribed in any way the Commission considers appropriate, such as targets, bands, or formulae. However, with respect to Transpower quality standards, s 54M(6) provides that the only quality standard requirements that may be included in a s 52P determination are requirements that give effect to quality standards set by the Electricity Commission.

### Customised price-quality path applications and determinations

- 4.23 Section 53Q(1) provides that:

At any time after a default price-quality path is set by the Commission, a supplier that is (or is likely to be) subject to the default price-quality path may make a proposal to the Commission for a customised price-quality path to apply to that supplier.

- 4.24 Subpart 6 of Part 4 of the Act specifies the decision-making process and statutory timeframes for the Commission to assess and make customised price-quality path determinations.
- 4.25 Suppliers must submit customised price-quality path proposals within the period, or by the annual date, specified in the default price-quality path determination (s 53Q(2)(b)). The Commission then has 40 working days to assess proposals and to determine their compliance with relevant input methodologies (s 53S). If a proposal has any deficiencies, the Commission may ask the supplier to remedy the deficiencies within 40 working days or it may discontinue its consideration of the proposal. If a supplier is requested but fails to remedy the deficiencies and to provide additional information, the Commission may discontinue its consideration of the proposal.
- 4.26 Subject to any prioritisation in relation to any other customised price-quality path applications and any extensions granted, the Commission must make a determination within 150 working days of receiving a complete customised price-quality path proposal (s 53T).
- 4.27 Section 53Q establishes other limitations around making customised price-quality path applications. These include that every customised price-quality path proposal must comply with the relevant input methodologies, a supplier may make only one proposal during a regulatory period and may not make a proposal in the 12 months preceding a reset of the default price-quality path. A supplier cannot withdraw a proposal, once submitted to the Commission.
- 4.28 The Commission may determine any customised price-quality path it considers appropriate (s 53V) and a supplier is bound by any customised price-quality path that the Commission sets for the duration of the regulatory period to which it applies (s 53R).
- 4.29 Under s 53W, a customised price-quality path applies for 5 years, or a minimum of 3 if the Commission considers this would better meet the purpose of Part 4 of the Act.

- 4.30 When a customised price-quality path expires, the supplier automatically moves to the relevant default price-quality path unless it has proposed and received approval for a new customised path.<sup>12</sup>

### **Individual price-quality regulation**

- 4.31 The provisions for individual price-quality regulation, set out in subpart 7 of Part 4 of the Act, are less prescribed than the default/customised provisions. The provisions give the Commission the discretion to set individual price-quality paths as it sees appropriate (s 53ZC(1)):

the Commission may set the price-quality path for that supplier using any process, and in any way, it thinks fit, but must use the input methodologies that apply to the supply of those goods or services.

- 4.32 No specific purpose statement applies to subpart 7 beyond the overall purpose statement for Part 4 of the Act.
- 4.33 No suppliers are currently subject to this type of price-quality regulation. The Commission may recommend to the Minister that particular goods or services be subject to individual price-quality regulation as part of an inquiry under s 52I. As stated above, the Commission may recommend that individual price-quality regulation be applied to Transpower when its administrative settlement expires on 30 June 2011.

## **4.2 Application of price-quality regulation**

### **Submission from interested parties**

- 4.34 In its submission to the Commission on the Provisions Paper, Transpower stated its preference that the Commission recommend to the Minister that individual price-quality path regulation apply to Transpower. Transpower's submission included the following points.
- It believes that the regulatory constraints should be tailored to its particular circumstances and therefore proposes that the Commission recommend to the Minister that individual revenue-quality path regulation apply to Transpower from 1 July 2011.
  - Although default/customised price-quality regulation might be less intrusive than individual price-quality regulation in some circumstances, such an approach is most appropriate when a business is in a "steady state", with relatively certain revenue requirements. This type of price-quality regulation is most reliably implemented when the New Zealand industry comprises a number of comparable businesses, which can be used to determine the long-run average productivity improvement on which the set rate of change in prices is based. Transpower is not in a "steady state" position and has no domestic comparators.

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<sup>12</sup> Greater detail on the provisions for customised price-quality paths are set out in Chapter 14 and 15 of the Input Methodologies Discussion Paper.

- It considers that individual price-quality regulation could better provide for its particular circumstances, which include “lumpy” investment, major investment cycles with large amplitudes, and other particular circumstances such as the fact that Transpower has no domestic comparators against which to benchmark performance.
- 4.35 Transpower went on to state that under individual price-quality regulation, it would prefer a multi-year revenue path (which may be 3 years initially and 5 years ultimately), set at the start of the regulatory period using an ex-ante building blocks approach. The revenue path would be based on Transpower's multi-year forecast of operating and capital expenditure, cost of capital, depreciation and taxation, using, where appropriate, the transmission input methodologies developed by the Commission.
- 4.36 In response to the Commission's question within its Provisions Paper<sup>13</sup> on whether individual price-quality regulation should be the preferred form of price quality regulation for single supplier sectors, Eastland Networks stated ‘individual price-quality regulation might be best suitable to meet business-specific needs and provide for businesses ability to meet their asset management plans in a sustainable fashion’.<sup>14</sup> In its submission prepared on behalf of Unison, CRA stated that, ‘individual price-quality regulation should be the preferred form of price-quality regulation for single supplier sectors’.<sup>15</sup>

### **Commission's analysis**

- 4.37 The Commission has examined the suitability of default/customised and individual price-quality regulation for Transpower.

#### Default/customised price-quality regulation

##### *Default price-quality path*

- 4.38 The Commission considers that a default price-quality path is unlikely to be suitable for Transpower.
- 4.39 The default set of regulatory provisions are to be set in a relatively low-cost way using readily available information. This will necessarily impact on the overall form of the default price-quality path, the manner in which it is set and potentially, the information that may be requested from businesses, given the compliance costs associated with regulation.
- 4.40 In addition, there are statutory constraints on the analytical approach that the Commission is able to use to set rates of change in prices (X-factors) for default price-quality paths (s 53P). These constraints require the X-factors to be based on the long-run average productivity improvement rate achieved by

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<sup>13</sup> Regulatory Provisions of the Commerce Act 1986: Discussion Paper, paragraph 152, p. 45.

<sup>14</sup> Eastland Network Limited, *Submission on the discussion paper Regulatory Provisions of the Commerce Act 1986*, 16 February 2009, paragraph 3.3.5, p. 35.

<sup>15</sup> CRA International, *Final Report Prepared For Unison Networks Ltd on Regulatory Provisions of the Commerce Act*, 16 February 2009, p. 32.

suppliers in New Zealand and/or other comparable countries, using appropriate productivity measures.

- 4.41 To address aging transmission assets and insufficient investment in the transmission grid over an extended period of time, Transpower is planning to undertake capital expenditure totalling more than \$3 billion over the next 5 years. Transpower is currently undertaking major upgrade projects, in various stages of development or construction, costing around \$2 billion. This investment includes large projects that are uncertain with respect to project costs and timing and are currently subject to review and approval by the Electricity Commission under Part F<sup>16</sup> of the Electricity Governance Rules.
- 4.42 One of the key issues associated with allowing for Transpower's forecast investment programme within any price-quality path is Transpower being able to provide robust forecast expenditure information for a regulatory period. This issue was identified by Transpower in its submission on the Provisions Paper, where Transpower stated that, for the first regulatory period, it would be developing its forecasting systems and this may result in some uncertainty with respect to its efficient capital expenditure profile (and possibly operating expenditure).
- 4.43 Any determination of a price-quality path would need to review Transpower's forecast expenditure and set a level of revenue that adequately reflects an approved expenditure amount, including providing a mechanism that incorporates the large and uncertain projects currently approved by the Electricity Commission.
- 4.44 If the Commission was required to set a default price-quality path for Transpower, the need to provide a relatively low-cost price-quality path and the constraints on the analytical approach that the Commission is able to use to set rates of change in prices (X-factors) would likely result in the Commission using a combination of industry-wide and firm-specific data to derive a default price-quality path for Transpower. This could include using key components of the input methodologies to establish the starting prices and an indexing approach to set the X-factor. This type of approach is sometimes referred to as a "partial" building blocks approach and traditionally does not include a detailed review of forecast capital expenditure.
- 4.45 The Commission considers that it is unlikely, however, that a low-cost partial building blocks type approach would be able to take into account Transpower's specific forecast expenditure requirements, including

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<sup>16</sup> The Electricity Commission is responsible under Part F of the Electricity Governance Rules for approving or declining reliability and economic investments contained in grid upgrade plans submitted by Transpower. Reliability investments are defined as investments by Transpower in the grid, or alternative arrangements by Transpower, the primary effect of which is, or would be, to reduce expected unserved energy. Economic investments are defined as investments in the grid that can be justified on the basis of the grid investment test (GIT) and are not reliability investments, where the GIT is a cost-benefit test.

providing a mechanism that addressed the large Transpower projects that are uncertain with respect to timing and cost. If the price-quality path did not adequately reflect Transpower's forecast revenue requirement this may adversely affect Transpower's incentives to invest in regulated services, including replacing and upgrading assets.

- 4.46 Given the level of uncertainty with Transpower's forecasts the Commission considers that an ex-post review would be required at the end of the regulatory period to address any forecasting errors. The Commission is proposing to use the results of the ex-post review within the calculation to set the price-quality path for the next regulatory period. However, under a default price-quality path s 53P(4) states that starting prices must not seek to recover any excessive profits made during any earlier period. This appears to preclude the Commission using the results of an ex-post review together with Transpower's existing economic value account to address any over recovery during the regulatory period as a result of forecasting errors.
- 4.47 In contrast, customised or individual price-quality paths can be designed to take account of capital expenditure projects as they are approved (see paragraph 4.57 below) and the Commission is able to consider the results of ex-post reviews when setting the price-quality path for subsequent regulatory periods.
- 4.48 Given the magnitude of Transpower's forecast expenditure, historic information is likely to be of limited use in understanding the level of forecast expenditure and therefore the level of forecast revenue required. In addition, there are few Transpower comparators within New Zealand and overseas, which, together with the level of Transpower's forecast capital expenditure, makes it unlikely that a long-run average productivity improvement rate based on comparators would be suitable for Transpower.
- 4.49 Indeed, Transpower's administrative settlement was accepted partly because the thresholds set between 2003 and 2007 were based on historic information and therefore, could not accommodate fully the level of capital investment required by Transpower during that period. Transpower's investment programme was recognised in the administrative settlement and will need to be appropriately recognised under any future regulatory instrument.

#### *Customised price-quality path*

- 4.50 If the Commission set a default price-quality path to apply to Transpower, which Transpower considered did not meet its particular circumstances, Transpower could propose a customised price-quality path.
- 4.51 The Commission's determination on any customised price-quality path proposal is likely to combine input methodologies in a similar fashion to a full building blocks analysis. In this determination, however, the Commission would be constrained by the timeframes set out in the Act, which include 40 working days to assess the proposal and to determine its compliance with the relevant input methodologies and 150 working days to make a determination following receipt of a complete proposal.
- 4.52 Given the size and uncertainty associated with Transpower's expenditure, the time limitations that apply to the consideration of customised price-quality paths could impact on the Commission's ability to adequately assess



Transpower's proposal and make a suitable customised price-quality path determination. Not adequately considering and reflecting Transpower's forecast revenue requirement in its price-quality path could impact on Transpower's incentives to invest, including replacing and upgrading assets.

- 4.53 Setting a customised price-quality path would be a 3 step process. Following the Commission's determination of a default price-quality path, Transpower would make a customised price-quality proposal to the Commission, which the Commission would then consider and make a determination. Default/customised price-quality regulation would require the Commission to set the requirements and evaluation criteria for customised price-quality proposals in advance as part of the input methodologies.
- 4.54 The Commission considers that if Transpower was subject to default/customised price-quality regulation it is likely that Transpower would propose a customised price-quality path. The Commission considers that designing a default price-quality path, Transpower making a customised price-quality path proposal and the Commission assessing the Transpower proposal and making a customised price-quality path determination for a single regulated supplier is not the most efficient use of Commission resources and could impose additional regulatory costs on Transpower.

#### Individual price-quality regulation

- 4.55 The provisions for individual price-quality regulation are the least prescriptive of all the new regulatory instruments, allowing the Commission to set the price-quality path using any process, and in any way, it thinks fit, using the relevant input methodologies.
- 4.56 The Commission considers that individual price-quality regulation may be appropriate where the goods or services are supplied by only one supplier, as is the case for electricity transmission services supplied by Transpower. Transpower is also distinct from other lines businesses due to the level of capital investment it is proposing to undertake over the next 5 years. In their submissions on the Provisions Paper, Eastland Networks and CRA stated that individual price-quality regulation should be the preferred form of price-quality regulation for single supplier sectors. No submissions on the Provisions Paper opposed the use of individual price-quality regulation for Transpower.
- 4.57 The Commission considers that the Transpower input methodologies are likely to combine to underpin the determination of individual price-quality paths using a full building blocks type approach. This full building blocks type approach would need to incorporate a review of Transpower's forecast expenditure, including taking account of projects as they are approved by the Electricity Commission or any other regulatory body including the

Commission. A possible approach would be to set a maximum allowable revenue using the following components:<sup>17</sup>

- a multi-year forecast of operating expenditure set at the start of a set regulatory period;
- a multi-year forecast of the base capital expenditure (such as replacement and refurbishment, minor development and enhancements and operational network information and technology services)<sup>18</sup> set at the start of a set regulatory period;
- projects approved by the Electricity Commission or another regulatory body being used to update the revenue requirement for the remainder of the regulatory period as they are approved; and
- an ex post review at the end of the regulatory period so that future revenue can be adjusted to take account of over or under recovery that may result from forecasting error, including a margin for the retention of some savings or Transpower taking some of the forecasting risk.

4.58 As the Commission may set an individual price-quality path using any process, and in any way it thinks fit, the Commission's preliminary view is that under individual price-quality regulation it can use the results of any ex-post review within the calculation to set the price-quality path for the next regulatory period.

4.59 With respect to any breaches of a price-quality path, the Commission anticipates that there will be several steps to determine the appropriate action. The Commission may investigate breaches using its powers under sections 53N and 53ZD, in addition to section 98 of the Act. The Commission will develop "Enforcement Guidelines" to give suppliers greater certainty about the steps proposed for compliance and enforcement matters arising from Part 4 of the Act. It is envisaged that the Guidelines will outline these steps - including informal processes to ensure regular engagement with industry on enforcement matters; formal processes involved in gathering information prior to any enforcement action; through to factors the Commission will consider before taking Court action.

4.60 The Commission notes that paragraphs 87-88 of the Government Policy Statement on Electricity Governance dated May 2009 (2009 GPS) relates to 'Investment in Minor Transmission Works'.<sup>19</sup> The 2009 GPS requires the Electricity Commission to consult on and change the approach it applies to the review and approval of Transpower's capital expenditure. Any changes to the Electricity Commission capital expenditure approval process would require the Commission to consider whether the level of regulatory oversight

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<sup>17</sup> See chapter 12 of the Commission's Draft Input Methodologies Paper for a full discussion on the proposed treatment of Transpower's capital expenditure under individual price-quality regulation.

<sup>18</sup> This type of capital expenditure is approved under the non-Part F process within the existing settlement agreement.

<sup>19</sup> Government Policy Statement on Electricity Governance, May 2009.

applied to Transpower's capital expenditure continues to meet the Commission's obligations under Part 4 of the Act. This in turn may necessitate the Commission consulting on the treatment of Transpower's capital expenditure that has been considered by the Electricity Commission.

- 4.61 In addition to addressing capital expenditure uncertainty, an individual price-quality path is likely to be more cost-effective to design and implement than a customised price-quality path.
- 4.62 The process for setting an individual price-quality path would involve fewer steps as the Commission would not have to set a default price-quality path and it would not require matters relating to customised price-quality path proposals (s 52T(1)(d)) to be set in advance as part of the input methodologies. Nevertheless, the process would still be set out in sufficient detail to promote certainty.
- 4.63 The Commission notes that in Transpower's submission on the Provisions Paper it preferred a multi-year revenue path, which may be 3 years initially and 5 years ultimately. Section 53M(4) to (6) of the Act specifies that the regulatory period for an individual price-quality path is 5 years, unless the Commission considers that a shorter period, of not less than 4 years, would better meet the purposes of Part 4.
- 4.64 However, under individual price-quality regulation the Commission considers that it can set different price-quality paths for a regulatory period.
- 4.65 As discussed in paragraphs 3.8 to 3.12, the settlement agreement will expire on 30 June 2011, which is during Transpower's 2011/12 pricing year (1 April 2011 to 30 March 2012). The Commission proposes that under individual price-quality regulation the s 52P determination would include a transition period between the expiry of the existing administrative settlement on 30 June 2011 and the end of the 2011/12 pricing year (30 March 2012), which would allow the prices set for the 2011/12 pricing year to remain until the end of the 2011/12 pricing year, and allow for a individual price-quality path from 30 March 2012 though to the end of the regulatory period.
- 4.66 Under individual price-quality regulation the Commission would use this transition period to undertake a review of Transpower's expenditure (operating and capital) in order to set an expenditure allowance for the remainder of the regulatory period.

### **4.3 Commission's preliminary view**

- 4.67 From the preceding analysis, the Commission concludes that to set a price-quality path that adequately reflects Transpower's forecast expenditure would necessitate a full building blocks type analysis, including expenditure review, supplemented by approval of projects by the Electricity Commission

or other regulatory body, including the Commission, during the regulatory period.<sup>20</sup>

- 4.68 A full building blocks type analysis is unlikely to be consistent with setting default regulatory provisions (e.g. starting prices, rates of change and quality standards) in a relatively low-cost way. In addition, there are statutory constraints on the analytical approach that the Commission is able to use to set rates of change in prices (X-factors) for default price-quality paths (s 53P). These constraints require the X-factors to be based on the long-run average productivity improvement rate achieved by suppliers in New Zealand and/or other comparable countries, using appropriate productivity measures. A default price-quality path is unlikely to be able to accommodate the approval of large projects by the Electricity Commission, or other regulatory body, during the regulatory period.
- 4.69 A full building blocks type analysis could be undertaken as part of setting either a customised or individual price-quality path for Transpower. However, setting an individual price-quality path is likely to be more effective as it:
- could allow for review and approval of large one off projects that are uncertain with respect to timing and cost at the beginning of a regulatory period, including the involvement of another regulatory agency, such as the Electricity Commission, in reviewing Transpower's investment proposals;
  - could include an ex-post review that would take account of any under- or over-recovery resulting from forecasting error;
  - could include targeted incentive mechanisms on operating expenditure or parts of Transpower's capital expenditure;
  - would not be subject to the customised price-quality path time constraints for reviewing Transpower's forecast expenditure;
  - could include a transition period to allow capital expenditure forecasts to be prepared by Transpower and reviewed by the Commission; and
  - would not require the Commission to develop a default price-quality path prior moving to a full building blocks type analysis.
- 4.70 Ensuring that Transpower's forecast revenue requirement is reflected in the price-quality path, including for projects that are uncertain with respect to timing and cost, is an appropriate way of providing the appropriate incentives for Transpower to continue to invest in the transmission assets, which is consistent with the s 52A purpose statement and the 2006 GPS.
- 4.71 Similarly, providing appropriate incentive mechanisms in areas that Transpower can target, such as operating expenditure and the base capital

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<sup>20</sup> The Commission's proposed approach for the treatment of Transpower capital expenditure under individual price-quality regulation is set out in chapter 12 of the Commission's Input Methodologies Draft Guidelines Discussion Paper.

expenditure allowance, should provide the appropriate incentives for Transpower to improve efficiency and share efficiency gains with consumers over time.

- 4.72 The inclusion of an ex-post review would limit Transpower's ability to extract excess profits during a regulatory period.
- 4.73 Based on the above conclusions, the Commission's preliminary view is that individual price-quality regulation would provide a more appropriate way of promoting the s 52A purpose statement than default/customised price-quality regulation. The Commission's preliminary view is consistent with Transpower's submission to the Commission on the Provisions Paper.
- 4.74 The Commission's preliminary view is that it recommend to the Minister that Transpower be subject to individual price-quality regulation following the expiry of the administrative settlement on 30 June 2011 and that the Commission recommendation include:
- that individual price-quality regulation should apply;
  - what input methodologies apply; and
  - the material provisions that apply under individual price-quality regulation.

- (6) Do you agree with the Commission's preliminary view that a full building blocks type analysis, including expenditure review is required to recognise Transpower's revenue requirement? If not what type of analysis should be undertaken to set Transpower's price-quality path, and why?
- (7) Do you agree with the Commission's preliminary view that individual price-quality regulation would be more suitable for Transpower than default/customised price-quality regulation? If not, why should default/customised price-quality regulation apply?

#### **4.4 Parameters under individual price-quality regulation**

- 4.75 Following consultation on this paper, and any conference, the Commission will provide a draft recommendation for consultation. If the Commission confirms its preliminary view that it will recommend individual price-quality regulation, the draft recommendation will set out the material provisions to apply. If the Commission decides that default/customised price-quality regulation is more appropriate, the draft recommendation will contain the default price-path and quality standards. If the Minister accepts the Commission's recommendation and an Order in Council is made accordingly, these provisions or path will inform the making of the s 52P determination applying the relevant regulation to Transpower.
- 4.76 The Commission is proposing to determine input methodologies relating to individual price-quality regulation by 30 June 2010. If, following consultation, the Commission decides to recommend default/customised price-quality regulation, the Commission would consult on and determine input methodologies relating to default/customised price-quality regulation including the matters in s 52T(1)(d). The consultative process for

determining input methodologies is set out in the Input Methodologies Discussion Paper.

### **Building blocks approach**

4.77 Under individual price-quality regulation the Commission considers that the input methodologies applying to Transpower would combine to underpin the determination of individual price-quality paths using a full building blocks type approach.

4.78 The building blocks approach involves determining allowable regulated revenues that are expected to recover the following ‘building block’ cost components faced by the regulated business, namely:

- payments to capital, comprising:
  - a ‘return on’ efficiently invested capital (i.e., RAB)—updated each year for depreciation and efficient capital expenditure—multiplied by the cost of capital, which is typically the Weighted Average Cost of Capital, or WACC); and
  - a ‘return of’ efficiently invested capital (i.e., depreciation of the RAB); and
- non-capital costs (e.g., operating expenditure and tax).

4.79 A general expression for the annual building blocks allowed revenue for a regulated supplier can be represented as follows:

$$\begin{aligned}
 & \textit{Regulatory Asset Base} \times \textit{Cost of Capital} \\
 & + \textit{Depreciation} \\
 & + \textit{Operating Expenditure} \\
 & + \textit{Tax} \\
 & - \textit{Revaluation Gains (or + Revaluation Losses)} \\
 & - \textit{Other income} \\
 & \hline
 & = \textit{Building Blocks Allowable Revenue}
 \end{aligned}$$

4.80 Each building block cost component is generally intended to reflect realistically achievable efficiencies for the particular component in question during the period of analysis (e.g., operating expenditure). Nevertheless, a more important consideration is to ensure that appropriate incentives for efficiency are provided by application of the building blocks methodology as a whole, as opposed to any individual block.

### **Input methodologies and matters specified in a s 52P determination**

4.81 Chapter 12 of the Commission’s Input Methodologies Discussion Paper sets out the Commission’s preliminary views on the input methodologies that are relevant to Transpower and the other matters that are relevant to determining Transpower’s price-quality path using a full building blocks approach under individual price-quality regulation.

4.82 As stated in the Input Methodologies Discussion Paper, the Commission’s preliminary view is that all the input methodologies listed in s52T(1)(a), except for matters relating to proposals for a customised price-quality path are relevant to Transpower. The Commission considers that all other matters

relevant to determining Transpower's price-quality path under individual price-quality regulation could be set out in the s52P determination. This would include the treatment of operating expenditure and the treatment of additions and deletions with respect to rolling forward the asset base.

- 4.83 However, for completeness the input methodologies set out within s52T(1)(a) and the other key matters relevant to the determination of Transpower's individual price-quality path using a building blocks type approach are discussed within Chapter 12 of the Input Methodologies Discussion Paper.
- 4.84 A summary of the Commission's preliminary views on the input methodologies and the other matters that are relevant to determining Transpower's price-quality path under individual price-quality regulation are set out in the table below. Please refer to Chapter 12 of the Input Methodologies Discussion Paper for further details.

Topic	Parameters under Individual Price Quality Regulation
<b>Relevant input methodologies and other matters</b>	<p>The Commission's preliminary view is that the items listed below are relevant to individual price/quality regulation.</p> <ul style="list-style-type: none"> <li>▪ allocation of common costs;</li> <li>▪ establishing the initial regulatory asset base;</li> <li>▪ the capital expenditure review, approval and inclusion in the regulatory asset base;</li> <li>▪ treatment of operating expenditure;</li> <li>▪ treatment of taxation;</li> <li>▪ pricing methodologies;</li> <li>▪ cost of capital; and</li> <li>▪ processes and rules.</li> </ul>
<b>Cost allocation methodology</b>	<p>Given that the materiality of the common costs between the System Operator (SOSPA) and other activities are likely to be relatively small, the Commission's preliminary view is that the same approach to cost allocation as taken in the settlement agreement will continue to be appropriate.</p>
<b>Initial RAB</b>	<p>The Commission's preliminary view is that Transpower's initial RAB should be consistent with the RAB values arising from the implementation of the administrative settlement. Therefore, the initial RAB under Part 4 of the Act would be based on Transpower's 2006 ODV valuation, along with the inclusion of the five pseudo assets, rolled forward for Commission approved capital additions and depreciation. No indexation would be applied.</p>
<b>Depreciation and Stranded Assets</b>	<p>The Commission continues to consider that it is appropriate that Transpower receives a return of capital through a depreciation charge. The depreciation charge and any asset write-off calculated would need to be consistent with the Commission's historic cost handbook.</p>

<b>Topic</b>	<b>Parameters under Individual Price Quality Regulation</b>
	<p>The Commission's preliminary view is that Transpower should be compensated for impaired or stranded assets, when it is caused by factors that are outside of its control by allowing accelerated depreciation of those assets, in accordance with the Commission's proposed historic cost handbook, in the year in which assets become stranded. The onus would be on Transpower to provide evidence to the Commission to validate claims that assets will become stranded during a regulatory period, and that they have taken adequate steps to mitigate this risk. Transpower should not earn a return on capital for stranded or impaired assets after this accelerated depreciation is allowed.</p> <p>Any capital expenditure associated with a new investment contract will not be entered into the asset base. In the event of stranding or impairment of these assets the capital expenditure will be treated as specified in the contract for those assets.</p>
<p><b>Treatment of Transpower Capital Expenditure Under Individual Price-Quality Regulation</b></p>	<p>Given the potential level of uncertainty with Transpower's forecasts the Commission's preliminary view is that both ex-ante and ex-post reviews of Transpower's capital expenditure forecasts would be required, for at least the first regulatory period.</p> <p>With respect to ex-ante reviews the Commission's preliminary view is that the capital expenditure currently defined under the settlement agreement as non-Part F and Part F would be treated differently.<sup>21</sup> This approach is based on the different types of the investments contained with Part F and non-Part F investments.</p> <p>The Commission considers that the Transpower non-Part F capital expenditure forecasts would be subject to an ex-ante review and approval process prior to the regulatory period that set the annual allowance for a multi-year period (such as four years).</p> <p>The Transpower Part F projects would continue to be approved by the Electricity Commission on a project by project basis under the current EGRs. Any Part F projects that have been approved by the Electricity Commission prior to the regulatory period would be included in a Part F capital expenditure allowance set for the regulatory period. The Transpower Part F projects that are planned to occur within a regulatory period, but have yet to be considered by</p>

<sup>21</sup> The Commission recognises that the term 'non-Part F' does not mean that this grid-related expenditure cannot be submitted to the Electricity Commission in accordance with the current Part F rules. The terms non-Part F and Part F within the Commission's Preliminary Views on the Treatment of Transpower Capital Expenditure is used to define the type of capital expenditure and the treatment of that type of capital expenditure.



<b>Topic</b>	<b>Parameters under Individual Price Quality Regulation</b>
	<p>the Electricity Commission, would continue to be approved by the Electricity Commission on a project by project basis under the current EGRs, during a regulatory period. The Commission proposes the Part F capital expenditure projects approved by the Electricity Commission during a regulatory period would be used to update the revenue requirement for the remainder of the regulatory period as the projects are approved. Prior to the regulatory period Transpower would be required to identify specific projects (including indicative timing and costs) that have yet to be considered by the Electricity Commission but are likely to fall within the regulatory period and specific project triggers that would result in the project occurring.</p> <p>With respect to ex-post reviews, the Commission's preliminary view is that an ex-post review is undertaken at the end of the regulatory period on actual capital expenditure currently defined as non-Part F capital expenditure only. The review would focus on the reasons for any under spend or the prudence of any overspend that may have resulted from forecasting error. Any ex-post review and adjustment of future revenue would need to be consistent with any incentive scheme implemented for Transpower.</p>
<p><b>Treatment of New Investment Contracts under Part 4</b></p>	<p>The Commission's preliminary view is that the services provided by new investment contracts fall under the Part 4 definition of electricity lines services because they involve the conveyance of electricity by line.</p> <p>With respect to the treatment of new investment contracts under Part 4, the Commission's preliminary view is that the revenue associated with electricity lines services provided by Transpower through new investment contracts should be excluded from any individual price-quality path but, in the case of new investment contracts entered into after 5 June 2003, only if the other party agrees in writing that the terms and conditions are reasonable or reflect workable or effective competition for the provision of the goods and services.</p>
<p><b>Treatment of the System Operator Service under Part 4</b></p>	<p>Ensuring that electricity is conveyed across the transmission network in accordance with required quality standards requires centralised co-ordination. This is provided by Transpower through the system operator activities, in accordance with the EGRs.</p> <p>The Commission considers that activities which relate to quality and reliability of electricity transmission are integral to the conveyance of electricity. Therefore, the Commission's preliminary view is that the system operator activities provided by Transpower form part of the conveyance of electricity by line and are regulated services under the Act.</p> <p>The Commission's preliminary view is that where the Electricity Commission and Transpower have an agreed SOSPA the revenue</p>

<b>Topic</b>	<b>Parameters under Individual Price Quality Regulation</b>
	associated with the SOSPA should be excluded from any individual price-quality path.
<b>Operating Expenditure</b>	<p>The Commission preliminary view is that, under individual price-quality regulation, Transpower's operating expenditure forecasts would be subject to an ex-ante review and approval process prior to the regulatory period that set an annual operating expenditure allowance for a multi-year period.</p> <p>The approved operating expenditure forecasts would be a component of the building blocks analysis used to determine the individual price-quality path.</p> <p>The definition of operating expenditure included within the allowance would be based upon the definition included in the existing settlement agreement.</p>
<b>Incentive mechanism</b>	<p>The Commission's preliminary view is that incentive mechanisms should be provided for Transpower to meet or beat its non-Part F capital expenditure allowance and its operating expenditure allowance by allowing Transpower to retain part of any savings or bear some of the forecasting risk with respect to non-Part F capital expenditure and operating expenditure. The incentive could be achieved through a margin applying to the ex-post review adjustment.</p> <p>The Commission also considers that the regulatory asset base should be adjusted at the end of the regulatory period to reflect actual costs as opposed to approved forecast costs. The calculation of future revenues would include the result of the ex-post review and the incentive margin allowing Transpower to retain or bear part of any under- or over-spend.</p>
<b>Transpower's treatment of taxation</b>	<p>The Commission's preliminary view is that a 'tax payable' approach should be used by Transpower in its treatment of taxation, by undertaking a 'tax payable' calculation in each year in order to reflect the tax liability associated with the provision of regulated services in that year.</p> <p>This approach is consistent with the existing settlement agreement.</p>
<b>Commission's pricing methodology</b>	<p>Given the Electricity Commission's responsibility for Transpower's pricing methodology the Commission's preliminary view is that it refer to all or part (such as principles only) of the Electricity Commission's pricing methodology in the Transpower pricing methodology input methodology.</p> <p>Given the Transpower pricing methodology is currently subject to consultation it may be preferable to refer to the Electricity Commission's pricing methodology (or part of it) rather than replicate some, or all, of the Electricity Commission's pricing</p>

<b>Topic</b>	<b>Parameters under Individual Price Quality Regulation</b>
	methodology in the input methodology determination.
<b>Transpower's cost of capital</b>	<p>The Commission's preliminary view is that Transpower's cost of capital be estimated in accordance with the Commission's draft generic guidelines using the simplified Brennan-Lally version of the CAPM. It is proposed that the Commission would provide a point estimate of WACC for Transpower for a set regulatory period under individual price-quality regulation, with the relevant parameters determined as follows:</p> <ul style="list-style-type: none"> <li>▪ The risk-free rate – set by the Commission at the time of a s 52P determination for individual price-quality regulation for Transpower following a procedure specified in the input methodology;</li> <li>▪ The debt premium – set by the Commission at the time of a s 52P determination for individual price-quality regulation for Transpower following a procedure specified in the input methodology;</li> <li>▪ The industry-wide leverage assumption – specified within the input methodology as discussed in paragraph;</li> <li>▪ The market risk premium – specified within the input methodology as discussed in paragraphs;</li> <li>▪ The industry-wide equity beta assumption – specified within the input methodology pursuant to a five step process as outlined in paragraph; and</li> <li>▪ The investor tax rate on interest income – specified within the input methodology as an amount equivalent to the prevailing corporate tax rate (currently 30%).</li> </ul>
<b>Form of Control</b>	The Commission's preliminary view is that incentive based regulation in the form of a total revenue cap would be appropriate for Transpower under individual price-quality regulation.
<b>Regulatory Period</b>	The Commission's preliminary view is that a period of 4 years, for at the least the first regulatory period, is preferred given the uncertainty associated with Transpower's forecast capital and operating expenditure. This 4 year regulatory period would include the transitional period as set out in the proposed process for the regulation of Transpower under Part 4.
<b>Pass-through costs</b>	The Commission's preliminary view is to allow rates on system fixed assets and Electricity Commission levies to be pass-through costs under individual price-quality regulation.
<b>Re-openers</b>	The Commission's preliminary view is that re-openers, are relevant to Transpower under individual price-quality regulation and that defining the characteristics of an event that would be considered for re-opening an individual price-quality path is an appropriate approach.

## APPENDIX A: INDEX OF QUESTIONS

<b>Questions</b>	
1	Do you consider that the Commission should hold a session at the input methodologies conference to discuss this Discussion Paper in September 2009?
2	Do you agree that all input methodologies applicable to the regulation of Transpower should be determined prior to the Commission making its recommendation to the Minister? If not, which input methodologies do you consider should be determined before the Commission makes its recommendation, and why?
3	Do you agree that the Commission is not required to determine input methodologies for a customised price-quality path at the time of making its recommendation, if the Commission recommends that individual price-quality regulation should apply to Transpower?
4	What other matters should the Commission consider when developing the process for the regulation of Transpower under Part 4 of the Act?
5	Do you agree with the Commission's proposed process for making the recommendation to the Minister and making the s 52P determination? If not, what changes do you consider should be made, and why?
6	Do you agree with the Commission's preliminary view that a full building blocks type analysis, including expenditure review is required to recognise Transpower's revenue requirement? If not what type of analysis should be undertaken to set Transpower's price-quality path, and why?
7	Do you agree with the Commission's preliminary view that individual price-quality regulation would be more suitable for Transpower than default/customised price-quality regulation? If not, why should default/customised price-quality regulation apply?