# INDIVIDUAL PRICE-QUALITY PATH (TRANSPOWER) CONSULTATION UPDATE PAPER

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COMMERCE COMMISSION

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# Table of Contents

**CHAPTER 1: INTRODUCTION .......... 1**
1.1 Overview .......... 1
1.2 Purpose and Scope .......... 1
1.3 Next Steps .......... 2
1.4 Submissions .......... 2
1.5 Confidentiality .......... 3

**CHAPTER 2: UPDATES TO DRAFT DECISIONS .......... 4**
2.1 Introduction .......... 4
2.2 Form of control .......... 5
2.3 Operating Expenditure .......... 9
2.4 Capital Expenditure .......... 14
2.5 Quality Standards .......... 16

References .......... 19

# CHAPTER 1: INTRODUCTION

## 1.1 Overview

1.1.1 This paper provides updates to the Commerce Commission (Commission) draft decisions on the development of the individual price-quality path (IPP) to apply to Transpower New Zealand Limited (Transpower) under Part 4 of the Commerce Act 1986 (the Act).

1.1.2 The Commission's draft decisions and draft reasons for the IPP for Transpower, as well as the input methodologies that will apply to Transpower, are set out in the following papers:

- *Individual Price-Quality Path (Transpower) Draft Reasons Paper (*Draft Reasons Paper*)* published 28 June 2010;
- *Input Methodologies (Transpower) Draft Reasons Paper* published 25 June 2010; and
- *Draft Commerce Act (Transpower Input Methodologies) Determination* published 2 July 2010.

1.1.3 The Commission expects to publish on 12 November 2010, the following papers:

- Input Methodologies (Transpower) Consultation Update Paper; and
- Draft Commerce Act (Transpower Input Methodologies) Determination 2010

1.1.4 The Commission expects to publish in December 2010 its final decisions papers and determinations setting out both the IPP for Transpower and the Input methodologies that apply. Following this, Transpower will be subject to the IPP from its pricing year commencing 1 April 2011.

## 1.2 Purpose and Scope

1.2.1 The Individual Price-Quality Path (Transpower) Draft Determination is based on the Commission's Draft Decisions, with updates the Commission has made as a result of previous consultation, further consideration and deliberations of the Commission, and further analysis, as well as efforts to improve the clarity of the drafting.

1.2.2 The purpose of this technical consultation is to ensure that the Draft Determination gives effect to the draft decisions[1] already published, subject to the updates in this paper[2] and other drafting refinements that have been made. The Commission, therefore, seeks submissions from interested parties on whether the Draft Determination achieves this purpose. Where the updated draft decisions have not been accurately reflected in the Draft Determination, the Commission requests that

[1] Commerce Commission, *Individual Price-Quality Path (Transpower) Draft Reasons Paper*, 25 June 2010 (Draft Reasons Paper).

[2] Unless otherwise stated in this paper, draft decisions remain unchanged at the time of release of this paper.

submissions include any drafting amendments that are deemed necessary.[3] A Microsoft Word version of the Draft Determination is being published for this purpose.

1.2.3 Further information on the timing for release of the Final IPP Determination and Final Decisions Paper is discussed below in the Next Steps section.

## 1.3 Next Steps

1.3.1 The next step is for the Commission to consider submissions on this paper and the technical drafting of the IPP Determination in November 2010. This is consistent with the Revised Process Paper setting out keys steps and dates for the IPP for Transpower that the Commission published on 26 August 2010.[4]

1.3.2 Following this, the Commission will publish its final reasons paper and determination, which will apply individual price-quality regulation to Transpower from 1 April 2011, consistent with paragraph 1.1.3. A summary of the determination will be published in the *New Zealand Gazette* in late December 2010.

## 1.4 Submissions

1.4.1 The Commission invites submissions on the updated draft decisions set out in this paper. Submissions should be received by the Commission no later than 26 November 2010. In order to meet the timeframes 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 if received after the due date.

1.4.2 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). The Commission also requires that these electronic copies be provided in an accessible form (i.e., they are ‘unlocked’ and text can be easily transferred). If the submission contains confidential information or if the submitter wishes that the published version be ‘locked’, an additional document labeled ‘public version’ should be provided.

3 Unless otherwise stated, terms used in this paper have the same meaning as specified in the Draft Reasons Paper and Draft Determination.

4 Commerce Commission, *Individual Price-Quality Regulation of Transpower Revised Process Paper*, 26 August 2010.

1.4.3 Submissions should be sent to:

regulation.branch@comcom.govt.nz;

or

Alex Sim
Chief Adviser
Regulation Branch
Commerce Commission
P.O. Box 2351
Wellington

## 1.5 Confidentiality

1.5.1 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.

1.5.2 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.

1.5.3 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. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions. 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.

# CHAPTER 2: UPDATES TO DRAFT DECISIONS

## 2.1 Introduction

2.1.1 This chapter sets out the updates to the Commission's draft decisions that were previously set out in the Commission's Draft Reasons Paper. In updating its draft decisions, the Commission has considered both submissions and cross-submissions on the Draft Reasons Paper. Unless otherwise stated in this paper, the draft decisions set out in the Draft Reasons Paper remain unchanged.

2.1.2 Updates are provided in the tables below. It should also be noted that, in a number of cases, the tables below also contain a number of clarifications to the Commission's draft decision, even if no change is being proposed.

## 2.2 Form of control

| Topic and Submitters' Views | Commission's Response |
|---|---|
| **MAR Updates**<br>Transpower submitted that annual forecast MARs should be set at the start of each RCP, but should be adjusted each year to account for Major capex approved and commissioned during the RCP.[1]<br><br>Transpower also submitted that, in RCP2, there should be more frequent updates than the proposed two updates of the forecast MARs. It proposed annual updates, unless the Commission adopts the Australian "mini revenue cap" approach to setting the forecast MAR[2] | The Commission has concluded that there is benefit in allowing the forecast MAR to be updated on an annual basis, including during RCP1, because the impact of not allowing annual updates to forecast MARs would be to defer cashflows. The Commission has consciously sought to avoid the deferral of cashflows in the case of Transpower, due to the current intensive investment period (for example, by applying depreciated historic cost instead of indexed historic cost).<br><br>Annual updates to the forecast MAR will therefore reflect Major capex approvals that have not previously been reflected in the forecast MAR. Each update will include the incremental impacts of Major capex additions on the capital charge, depreciation and taxation for the remaining years of the RCP, but will not include any adjustment to the Minor capex allowances or the opex allowances.<br><br>The annual update of the forecast MAR will also include EV adjustments that will zero out the value of the earlier MAR wash-ups. The objective of this is to clear the EV account balances that accrue from a previous year at the first available MAR update. In this manner, the EV balances should never accumulate to more than the value of one year's MAR wash-up.<br><br>With regard to the opening EV account balance rolled over from the settlement in 2011, the aim is to spread these so they would be zeroed out by the end of the second RCP, i.e. over a period of 9 years.<br><br>The Commission will require Transpower to calculate updates of forecast MARs by October each year, with any updated forecast MAR to be applied in the pricing year commencing in the following April.<br><br>For example, in RCP1 the first update of a forecast MAR will be in respect of any Major Capex approvals that occur in the Transition Year (2011/12), but after the Remainder Period forecast MARs have been set in November 2011. That update will be applied to the Year 3 forecast MAR, being the forecast MAR for the second year of the Remainder Period, i.e. the pricing year commencing on 1 April 2013. There will therefore potentially be two updates of forecasts for RCP1 (being applied to Years 3 and 4 of RCP1).<br><br>On the basis that RCP2 is a five year period following RCP1, there may be up to four updates of the forecast MAR in RCP2, being updates that would cover Years 2 through 5 of RCP2, and that reflect any Major Capex approvals after the forecast MARs for RCP2 are set in November 2014. |

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| | As updates of forecast MARs must be calculated on a consistent basis with the original forecast calculations, and as they are not a full recalculation of the forecast, Transpower must present the updates as incremental forecast revenue adjustments. The Commission considers that this will enable it to assess the proposed updates in an efficient manner. The Commission will not require an independent assurance opinion on the updates of forecast MARs. |
| **Wash-ups**<br>Transpower submitted that it should use its current method for calculating the annual wash-ups which does so separately from the forecast MAR calculation in the revenue model.[3] | The Commission considers that Transpower's existing method for calculating the annual wash-ups of the actual revenue against the MAR and for determining the adjustments to the EV accounts using its annual EV Statements has worked satisfactorily in the past and is acceptable going forward. The MAR wash-up calculations under this method will be required to apply the same approved building blocks as applied in determining the forecast MAR for the purposes of revenue-setting, but replacing the building block values with actual expenditure, where appropriate. Transpower must disclose sufficient information to enable interested parties to compare the forecast MAR calculation and the actual revenues for the year with the MAR wash-up as part of its annual compliance statement. |
| **Approach for setting the forecast MAR: Remainder Period of RCP1**<br>▪ Transpower submitted that its forecast MAR calculations for the Remainder Period of RCP1 could not be provided earlier than 31 October 2011.[4]<br>▪ Transpower submitted that in order for it to meet its pricing notification requirements, it needed the Commission to set each forecast MAR by the end of the third week of November.[5] | The Commission's timing objective, subject to satisfactory certification of the draft forecast MAR calculations by the Auditor and by Transpower's Directors and subject to resolution by Transpower of any outstanding queries raised by the Commission in respect of the draft forecast MAR calculations, is to set the Remainder Period forecast MARs by not later than 25 November 2011.<br>To provide the Commission with sufficient time to evaluate the draft forecast MARs and to set the forecast MARs within the timetable provided by Transpower for its price-setting, Transpower must provide the Commission with its draft forecast MARs for the Remainder Period of RCP1 by not later than 21 October 2011. |
| **Approach for setting the forecast MAR: RCP2**<br>▪ Transpower submitted that the draft forecast MAR calculations for RCP2 and subsequent RCPs could not be provided by the second Friday of September. It submitted that the deadline should be the end of October.[6]<br>▪ Transpower submitted that in order for it to meet its pricing notification requirements, it needed the Commission to set each forecast MAR by the end of the third week of November.[7] | The Commission's timing objective, subject to satisfactory certification of the draft forecast MAR calculations by the Auditor and by Transpower's Directors, and subject to resolution by Transpower of any outstanding queries raised by the Commission in respect of the draft forecast MAR calculations, is to set the forecast MARs for RCP2 by not later than 21 November 2014.<br>To provide the Commission with sufficient time to evaluate the draft forecast MARs and set the forecast MARs within the timetable provided by Transpower for its price-setting, Transpower must provide the Commission with its draft forecast MAR calculations for RCP2 by not later than 24 October 2014. |

| Topic and Submitters' Views | Commission's Response |
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| **Economic Value framework**<br>▪ Transpower disagreed with the proposal to adjust the HVAC EV account by 50% in the Transition Year (with the remainder of the balance being spread over RCP1), and submitted that the balance should be spread over RCP1 and RCP2.[8] | Due to the setting of Transpower's MAR for the Transition Year being required in advance of the Commission's final determination on this matter, the Commission decided to roll over the requirements of the settlement in respect of the approach for setting the Transition Year EV adjustment. |
| ▪ There were differing views regarding the period that should be adopted for reducing the existing EV balances to zero:<br>- Transpower proposed two regulatory periods;[9]<br>- Meridian considered that, at a minimum, two regulatory periods would be reasonable;[10]<br>- Genesis supported the Commission's proposal of two regulatory periods;[11]<br>- MEUG considered that two regulatory periods was too long, and suggested that a 2 year period would be more appropriate.[12] | While the Commission, in general, prefers the symmetrical approach offered by the formula in its draft reasons paper, the Commission is concerned to ensure the cash flow implications of this decision are not working against other determinations made by the Commission in this regard. For this reason, the Commission's updated view is to balance the timeframes for zeroing the opening customer EV account balances, thereby eliminating the negative cashflow effects the alternative approach would have. This approach is more consistent with the Commission's decision, for example, to continue to use depreciated historic cost in RCP1, primarily to front-load the depreciation of capital to assist Transpower in its period of high capital growth. The Commission considers this timeframe is workable for both HVDC customers and HVAC customers alike. |
| ▪ Transpower submitted that any spreading of the EV account balances needed to take into account that the EV accounts are 'net of tax' balances, and that any spreading must also be adjusted to reflect a tax gross-up.[13] | The Commission agrees that the spreading of the EV account balances should also take into account the tax effects, which results in the EV account adjustments taken to each forecast MAR being grossed-up for the applicable rate of tax. |
| ▪ Genesis has submitted that new entrants should not be exposed to liability for historic EV account costs.[14] | The Commission considers that this is a matter best dealt with via the transmission pricing methodology. The Act specially precludes the Commission from setting pricing methodologies that apply to Transpower, and the Commission considers it appropriate that once it has set revenues to apply to Transpower, the transmission pricing methodology should be the mechanism to implement the apportionment of those revenues. |

| Topic and Submitters’ Views | Commission’s Response |
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| **Compliance framework**<br>▪ **Clarification**: Compliance with the individual price path | Compliance with the individual price path will be demonstrated by Transpower evidencing that the revenue assumption used to determine prices under the transmission pricing methodology was no higher than the forecast MAR set by the Commission for each relevant pricing year. This evidence will be required to be provided to the Commission each year at the time Transpower announces its prices.<br>Each draft of a forecast MAR is to be calculated by Transpower in accordance with the building blocks approach for the Commission’s approval. In the interests of transparency, the Commission will include a description of the building blocks formula by way of a schedule to the s 52P IPP determination, which will provide an additional link between the input methodologies in the IM determination and the calculations underpinning the forecast MAR that the Commission ultimately determines.<br>For the avoidance of doubt, it should be noted that failure to correctly implement mechanisms such as MAR wash-ups, EV adjustments, revenue adjustments due to quality performance, and so forth, will not result in a breach of the price path for that year. Such non-adherence to process would inevitably cause a price path breach in a subsequent year when Transpower is required to demonstrate that the revenue assumption used to determine prices under the transmission pricing methodology is no higher than the forecast MAR set by the Commission. |
| ▪ **Clarification**: Compliance with the quality standards | Compliance with the individual quality standards will be achieved by Transpower reporting the following information in the annual compliance statement:<br>- actual annual performance for each of the quality measures set by the Commission;<br>- reasons for any failure to meet the quality targets set by the Commission;<br>- for all interruptions over 1 system minute, a report that sets out:<br>o the reason or reasons for the interruption;<br>o Transpower's response to the interruption;<br>o any change to Transpower's policies as a result of the interruption; and<br>o the impact of the interruption in system minutes.<br>In addition, during the year Transpower is required to provide a report to the Commission, for any outage in excess of 1.0 system minutes that explains the reason or reasons for the interruption, Transpower's initial response to the interruption and an estimate of the impact of the interruption in system minutes. This report is to be provided to the Commission within 5 working days of services being restored. |

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| ▪ The draft decisions required Transpower to publish its annual compliance statement by the second Friday in August each year.<br>▪ Transpower submitted that, to align with the annual timetable for its Annual Report signoff, the 30 September is the earliest achievable date for providing is compliance statement.[15] | The Commission considers that Transpower's proposed timeframe is reasonable. This revised timeframe allows Transpower to prepare and audit its statutory accounts, including the calculation of its annual ex-post economic gain or loss, and have these audited. This aligns with Transpower's Annual Report timetable.<br>Accordingly, the Commission considers it should set the date for publication of the annual compliance statement at 30 September each year. This will also enable the verified data in the annual compliance statement to be used for the setting of forecast MARs (or updates of forecast MARs) in November each year. |

## 2.3 Operating Expenditure

| Topic and Submitters' Views | Commission's Response |
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| **Instantaneous Reserves**<br>▪ The Commission's draft decision was that an operating expenditure allowance of $231.67 million would apply to the Transition Year (excluding pass- through costs and recoverable costs).<br>▪ Transpower submitted that the Commission's initial allowance double-counted the exclusion of instantaneous reserve charges.[16] | Transpower is correct that the Commission inadvertently double-counted the impact of instantaneous reserve charges (removing the base amount under the settlement allowance of $1.4 million twice). Accordingly, the $1.4 million, indexed from the start of the settlement, results in an indexed amount of $1.55 million that must be added back to the opex allowance for the Transition Year. |
| ▪ Transpower submitted that the operating expenditure definition, as used under the administrative settlement and as proposed for the IPP, be amended to include instantaneous reserve event charges.[17]<br>▪ Contact stated on its cross submission that it supports the Commission's draft decision not to allow event charges to be passed on.[18]<br>▪ Meridian argued in its cross submission that Transpower does have some control over reserve charges, and as Transpower is best placed to manage event risk, the most economically efficient outcome is for Transpower to bear the costs of event charges.[19] | The Commission has updated its view and now considers an allowance for event charges should continue to be included in operating expenditure. This recognises that a number of outages will occur, for which Transpower should not be penalised, but including this as a component of opex ensures that appropriate incentives exist to minimise the number of events it causes.<br><br>The opex definition will be clarified to explicitly include event charges as operating expenditure. The result of this is that a forecast for event charges will be included in the opex allowance for each forecast MAR and MAR wash-up. |

| Topic and Submitters' Views | Commission's Response |
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| ▪ Transpower submitted that the operating expenditure allowance for the Transition Year should include an allowance for instantaneous reserve event changes. Transpower proposed the provision be set at $800,000 for the Transition Year.[20] | The Commission has reviewed Transpower's estimate of event charges for the Transition Year and has concluded that an allowance of $800,000 for instantaneous reserve event charges should be included in the opex allowance. This is based upon Transpower's 2009/10 costs of approximately $893,750, which were recovered under the previous Electricity Governance Rules. Transpower has indicated that under the new rules in the current EGRs it faces an increased potential exposure to event charges by making it more likely that Transpower as grid owner will be determined to be the causer of any event.[21] Costs in excess of $800,000, if Transpower exceeds its opex allowance, would be borne by Transpower.<br>For the avoidance of doubt, the Commission considers that rebates paid for under-frequency events, in accordance with clause 8.65 of the Electricity Industry Participation Code, must be netted off against availability charges (not event charges). |
| **Operating lease payments**<br>▪ Transpower submitted that the Commission should clarify that operating leases can be included in the RAB.[22] | The Commission considers it appropriate for operating leases to be treated in accordance with GAAP for the purposes of the IPP. This aligns with Transpower's treatment for financial accounting purposes and is more consistent across sectors. It means that, for regulatory purposes, operating lease payments will be treated as operating expenditure and the annual cost must be estimated for setting each opex allowance.<br>This decision affects the Commission's draft determination on the Transition Year opex allowance. As the Commission's s53ZD forecast MAR notice did not include any provision for operating lease payments in the opex allowance, a provision for this will be added to Transpower's opex allowance when undertaking the Transition Year MAR wash-up. Transpower will be required to treat such costs in accordance with the Commission's final determinations in the Transition Year MAR wash-up.<br>Accordingly, the final opex allowance for the purposes of the MAR wash-up will now include an additional sum of $14.5 million for operating leases. The Minor capex allowance, however, will be reduced by $17 million, being the forecast capitalised lease amount (taking into account a WACC return and depreciation) that Transpower provided to the Commission when setting the Minor capex allowance for the Transition Year.<br>The initial RAB, as specified under input methodologies, will need to be adjusted by Transpower to remove the depreciated balance of capitalised lease values as at 30 June 2011 to set the opening RAB under the IPP. |

| **Topic and Submitters' Views** | **Commission's Response** |
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| ▪ Clarification: Opex for Transition Year MAR | The Commission needed to specify a level of opex to apply to Transpower's forecast MAR calculation well in advance of the Commission's final determinations being ready. At the time, using the best information available to it, the Commission specified that Transpower must calculate its forecast MAR using a level of opex of $234.02 million. |
| ▪ Clarification: Opex for Transition Year MAR wash-up | Subsequent to setting the level of opex to be used when calculating Transpower's Transition Year MAR, and consistent with the updated Asset Valuation input methodology, the Commission has clarified its updated draft decision that operating leases should be included in the opex allowance (see *Operating lease payments* above). As such, the year-end wash-up will be made on the basis of an opex allowance of $248.5 million.<br>An offsetting reduction of $17 million to the Minor capex allowance for lease payments which had been capitalised will also be made at the year-end MAR wash-up (this was originally included in the Minor capex allowance for the purposes of the forecast MAR for the Transition Year).<br>The opex allowance for the Transition Year for the purposes of the MAR wash-up therefore takes into account:<br>▪ Instantaneous reserve event charges (+$800,000); and<br>▪ operating lease payments (+$14.5 million);<br>▪ reversal of the double-counted adjustment for instantaneous reserves (-$1.55 million) |
| ▪ Transpower submits that it should be made clear, for the avoidance of doubt, that operating costs include event insurance premiums, black start costs and the cost of over-frequency arming.[23] | The Commission intends to update the definition, as previously set out in the Draft Reasons Paper, as follows:<br>The Commission's decision is that operating expenditure means expenditure incurred by Transpower in the provision of electricity lines services that is not capital expenditure. For the avoidance of doubt, operating expenditure:<br>▪ includes departmental costs, investigations, communications and control, IT&T operations, transmission and substation maintenance, operating lease costs, insurance premiums, black start costs and the cost of over-frequency arming, and instantaneous reserve event charges; but<br>▪ excludes depreciation; tax; revaluations; pass-through costs; recoverable costs; any operating costs associated with transmission alternative services that have been approved by the Electricity Authority (or any other regulatory body); operating |

| Topic and Submitters' Views | Commission's Response |
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| | expenditure that is the result of an insurance event and has been recovered by insurance income (or is expected to be recovered); and costs associated with unregulated businesses and expenses related to the system operator function. |
| **Foreign exchange gains or losses**<br>▪ Transpower's submission states that at present, gains or losses on hedge contracts relating to capex are borne by Transpower's shareholder when hedge accounting is not able to be used under GAAP. Transpower proposed that in such instances the hedge gain or loss should be credited or debited to the customer account, through the MAR wash-up process, as these gains and losses are legitimate components of the underlying economics of the transaction and a true cost of the project. The maximum approved amount for a project in such a situation should be compared to the total project cost +/- any hedged amounts not already included in the project.[24] | The Commission's draft decision in the asset valuation input methodology is that capex projects are to be valued in accordance with GAAP. This will result in gains and losses from foreign exchange and commodity transactions that are intended by Transpower to serve as hedges in respect of capex projects also being accounted for in accordance with GAAP. Where transactions qualify as effective hedges under GAAP (i.e. meet conditions that qualify them as hedges), the gains and losses will be capitalised into asset values, whereas gains and losses on transactions that are intended to be hedges (i.e. transactions that qualify for hedge accounting at the date of the transaction), but subsequently cease to meet the tests for effective hedges will be taken to Transpower's profit and loss for financial accounting purposes and will be included in the calculation of Transpower's EV account. The Commission notes that this will generally be more favourable to Transpower than the administrative settlement.<br>Transpower has a policy of comprehensive hedging of capex projects. The Commission expects that consistent with its policy, Transpower will hedge its foreign exchange and commodity pricing exposures in an efficient and comprehensive way, such that transactions are undertaken that qualify as effective hedges in respect of capex projects and thus qualify for hedge accounting under the applicable accounting standard (currently NZ IAS 39). This will generally mean that hedging gains or losses will be capitalised to the RAB.<br>Major capex approval values will therefore implicitly reflect the quality of Transpower's hedging. Thus capex levels will be approved by the Commission based on values that Transpower has advised, and the Commission's advisor has verified, that use actual or estimated forward rates for valuing each project in accordance with Transpower's application of its hedging policy at the stage of planning capex. Documentation provided in support of capex approvals will be expected to include confirmation regarding this point.<br>Variations of the assumed hedging rates once the project is commissioned may give rise to a significant change in value of the project relative to the approved project cap. A change in value of a project will be subject to application and approval by the Commission only as part of any variation in value of the overall project that requires Transpower to seek a change in the approval, i.e. in practice, where the approved value would be exceeded.<br>Minor capex allowances will be based on Transpower's estimate of the forward rates |

| Topic and Submitters' Views | Commission's Response |
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| | applicable to those projects in accordance with Transpower's hedging policy, as applied at the capex planning stage. The Commission will review these forward rates when setting the allowances. There will be no wash-ups of the Minor capex allowances in respect of these hedging estimates. |
| | Where a transaction that qualified for hedge accounting in respect of capex when transacted ceases to qualify for hedge accounting in the course of a year, the resulting gain or loss will be taken to the EV accounts in the year-end MAR wash-up, which will have the effect of passing the hedging costs and benefits to customers. This variation in approach from the administrative settlement potentially benefits Transpower, but is consistent with having a comprehensive policy of capex hedging applying to capex projects.<br>The Commission considers these hedging gains and losses should be allowed for separately from the opex allowance and pass-through or recoverable costs. It therefore prefers the use of the EV accounts to pass to customers any hedging gains or losses that are not capitalised to the RAB.<br>The Commission's updated draft decision is aimed at encouraging Transpower to achieve a high level of effective hedging in accordance with its hedging policy (and thereby minimising the EV account adjustments).<br>To enable the Commission to monitor the effectiveness of applying Transpower's hedging policy, Transpower must include in its annual compliance statement details of any changes to its policy with regard to capex hedging.<br>Transpower will be required to provide the Commission with details of any transaction that ceases to qualify as an effective hedge. |

## 2.4 Capital Expenditure

| Topic and Submitters’ Views | Commission’s Response |
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| **Remainder Period Minor Capex Allowance**<br>▪ Transpower submitted that the cost of an independent review would be large and could take up to two months. Transpower maintains that such a review would not add much value and hence is not justified. If required to obtain an independent review Transpower has asked that the cost of the review be recovered through future OPEX.[25] | While customised price-quality proposals are likely to be required to be supported with a report by an independent verifier, in the case of Transpower specifically, the Commission intends to undertake its own extensive review of Transpower’s opex and capex proposal. It will be engaging its own expert advisors in this regard, and, for this reason, considers the amount of duplication of review that would exist warrants removal of this requirement. |
| **Remainder Period Minor Capex Allowance**<br>▪ Transpower is concerned that there is a lack of clarity concerning the recovery of minor capital expenditure in excess of the approved MAR. Such expenditure could occur if projects are commissioned ahead of their planned commissioning dates. Transpower argues that not being able to recover such expenditure would discourage completing projects ahead of plan.[26]<br>▪ Transpower also submitted that such costs should be recoverable by way of ex post review. | As set out in paragraph 3.10.4 of the Commission’s draft reasons paper, if Transpower's final annual compliance statement for a given RCP identifies that Transpower has undertaken and commissioned Minor capital expenditure in excess of the combined level approved ex-ante, such expenditure must be excluded from Transpower's RAB unless:<br>- Transpower seeks and receives ex-post approval from the Commission for that capital expenditure; or<br>- Transpower calculates the revenue impact of that capital expenditure, over the life of those assets, including a reasonable allowance for maintenance, and makes an adjustment to the relevant EV account to fully offset this cost, and includes in its compliance statement an independent opinion that verifies Transpower’s estimates are reasonable and calculations are correct.<br>To add further clarification on this matter, the Commission will not consider any application for capex in excess of the pre-approved level for any individual year of an RCP. If Transpower wishes to apply for additional capex on an ex-post basis, then it may only include this application in the annual compliance statement that relates to the final year of that RCP. This is because Transpower has been provided the flexibility to move capex freely between years, thereby having the ability to take into account timing and other such changes. As Transpower has been provided the flexibility to operate a dynamic capex programme within the approved limits, the Commission considers that timing issues are unlikely to meet the ex-post approval criteria of ‘exceptional’ (paragraph 5.9.1 of the draft reasons).<br>It should also be noted that the Commission has also increased Transpower’ flexibility in this regard by allowing substitution between the Transition Year and |

| Topic and Submitters' Views | Commission's Response |
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| | Remainder Period.<br>Where capex submitted in the final annual compliance statement does meet the ex-post approval criteria and is approved by the Commission, such capex will be then enterered into the RAB. This will then automatically factor in to the next wash-up, and then factor into prices via the next update of the forecast MAR. |
| **Remainder Period Minor Capex Allowance**<br>▪ Transpower sought clarification of clause 5.6.3. Transpower's interpretation was that all future Minor capex is to have completed its internal processes prior to being commissioned and included in the RAB.[27] | Transpower's interpretation of clause 5.6.3 is correct. The following footnote will be added:<br>"It is recognised that some projects included in the Minor capital expenditure proposal submitted to the Commission prior to the start of the RCP may be at various stages of Transpower's approval process. These projects will be included in the RAB after their internal approval processes are completed and the projects commissioned, if within the overall expenditure limit". |
| **Major Capital Expenditure Projects**<br>▪ Transpower submitted that that projects approved and commissioned during the RCP, including uplifts of expenditure approved prior to the commissioning of a project, should be able to have a return of and on their capital values included in the MAR and recovered via the prices calculated for the pricing year following commissioning.[28] | The Commission considers that this principle is appropriate. Projects approved prior to the relevant forecast MAR determination will be included in the forecast MAR based upon forecast commissioning dates. Projects not approved prior to the relevant forecast MAR determination will be excluded from the forecast MAR for that pricing year. Projects approved and commissioned during the RCP, including uplifts of expenditure approved prior to the commissioning of a project, will be included in the updates of forecast MARs following the date of commissioning of the project. As noted above (see *MAR updates*), updates of forecast MARs will occur annually. |
| **Major Capital Expenditure Projects**<br>▪ Transpower sought clarification on the term 'ex-ante regulatory approval' used in this clause.[29] | The following footnote will be added:<br>For the avoidance of doubt 'ex-ante regulatory approval' means approval of the expenditure in advance of undertaking the work. |
| **Substitution of Approved Capital Expenditure**<br>▪ Transpower requests that the Commission consider allowing some substitution of Minor capital expenditure between the Transition Year and Remainder Period in its final decisions.[30] | The Commission's updated view is that because the Transition Year and Remainder Period are now essentially being assessed on the same basis, there is no difficulty in allowing substitution across these periods. Accordingly, its updated view is that Transpower should be provided the flexibility to fully substitute and reprioritise Minor capital expenditure within RCP1. Compliance at the end of RCP1 will consider performance against the aggregate amount of approved capex for all four years of RCP1. |

## 2.5 Quality Standards

| Topic and Submitters' Views | Commission's Response |
|---|---|
| **Setting targets, caps and collars**<br>▪ Transpower's interpretation of the draft decision is that Transpower will propose targets, caps and collars to apply to each of the quality measures, supported by sufficient evidence.[31] | Transpower's interpretation of the draft decision is correct. Transpower will be required to propose targets, caps, collars, supporting evidence and justification for each quality measure. This information will be provided at the same time as Transpower submits its operating and capital expenditure forecasts for the upcoming control period. |
| **Total Duration of Interruptions**<br>▪ Transpower submitted that it was uncertain whether it had to disclose duration of interruptions in minutes or impact of interruptions in system minutes under the information disclosure regime. Currently, under the Electricity information Disclosure Requirements Transpower is required to report electricity customer interruptions in system minutes (total, planned and unplanned).[32] | Transpower will be required to report total duration of interruptions (planned and unplanned), duration of planned interruptions and duration of unplanned interruptions within the information disclosure requirements using the same definitions as those used in the performance incentive regime. That is, the definition used to define the total duration of interruptions in the performance incentive regime would also be used to define the total duration of interruptions within ID. |
| **Loss of supply event frequency**<br>▪ Transpower proposes that the sub measures under loss of supply event frequency be entitled:<br>- number of loss of supply events over 0.05 system minutes;<br>- number of loss of supply events over 1.00 system minutes.[33]<br>▪ Transpower considers that this terminology better reflects the loss of supply event measures.<br>▪ Transpower also submitted that this measure does not include interruptions caused by a connected customers and is based on all assets operated as part of the grid.[34] | The Commission considers the terminology and definition provided by Transpower in its submission on the draft decision to be acceptable. |

<table>
<tr><th>Topic and Submitters' Views</th><th>Commission's Response</th></tr>
<tr><td>Availability<br>▪ Transpower submitted that:[35]<br>- HVDC bi-pole availability due to unplanned outages be renamed 'HVDC bi-pole unavailability (unplanned); and<br>- that any period in excess of seven days be excluded, in order to avoid very long duration outages skewing the results.<br>▪ This is consistent with the treatment of HVAC circuit unavailability (unplanned).</td><td>The Commission considers that the HVDC bi-pole unavailability should be renamed HVDC bi-pole unavailability (unplanned) to better reflect the information collected by the measure.<br>With respect to placing a cap on the duration of outages for the HVDC bi-pole unavailability, the Commission considers that the decision be made following the collection of the first set of data during RCP1, in conjunction with setting the targets for HVDC bi-pole unavailability targets for RCP2.</td></tr>
<tr><td>Setting targets for the first year of RCP1<br>▪ Transpower states that the Total System Minute figures set out in Table 6.1 need to be stated to two decimal places. The target, collar and cap figures should be 16.69, 4.31, 29.07 respectively.[36]</td><td>The Commission considers that the accuracy of two decimal places is desirable and will amend its final determination accordingly.</td></tr>
<tr><td>▪ Transpower submitted that: [37]<br>- as a general rule, the five year historical period should be applied to all the measures and that alternative methods of addressing the skewing of data caused by a small number of very long events.<br>- Transpower considers that the most robust method of dealing with small numbers of events that skew the outcome is to cap these at a pre-agreed level.<br>- For example, this approach has been used for HVAC circuit unavailability (unplanned). Capping individual interruptions events at 10 system minutes, while basing the target on 5 years of historical data and the cap and collar at two standard deviations, would result in:<br>- Target of 16.26 system minutes:<br>- Cap of 3.74 system minutes; and<br>- Collar of 28.79 system minutes.</td><td>The Commission will consider using either method when setting targets, caps and collars (using caps with 5 years or 7 years of data or using raw data for 5 years or 7 years) going forward. For the Transition Year of RCP1, however, the target for HVAC circuit unavailability (unplanned) will be set using the raw 7 years data as set out in the draft report.<br><br>The Commission considers that using uncapped data would retain consistency with quality information collected and reported under the administrative assessment and that capping events would result in the measure not reflecting the impact interruptions actually have on consumers.<br><br>The Commission intends to reassess the suitability of the approach in conjunction with setting targets for the Remainder Period of RCP1 and RCP2.</td></tr>
</table>

| Topic and Submitters' Views | Commission's Response |
|---|---|
| **Reporting Large Events**<br>▪ New subject - not discussed in draft reasons paper | The Commission's updated draft decision is that Transpower should be required to provide the Commission with background information on events (including the reason for event and response to event) that result in interruptions over 1.0 system minutes.<br><br>This will keep the Commission informed about large events that occur and Transpower's response to those events. |
| **Quality Standards**<br>New subject – clarification of quality standards for RCP1 | In RCP1 the quality standards require Transpower to disclose the quality information set out in clause 4.3 of the IPP determination to the Commission.<br>In RCP2 the quality standards will require Transpower to disclose quality information to the Commission and adjust its forecast MAR during RCP2 to reflect the annual revenue adjustment from the quality incentive regime. |

# References

[1] Transpower, *Part 1 - Submission to the Commerce Commission on: Input methodologies Transpower and Individual price-quality path Transpower Draft Reasons Paper*, August 2010, p.43.
[2] ibid, p.44.
[3] ibid, p.42.
[4] ibid, p.41.
[5] ibid, p.42.
[6] ibid, p.42.
[7] ibid, p.42.
[8] ibid, p.43.
[9] ibid, p.8.
[10] Meridian Energy, *Submission on Transpower's input methodologies determination and draft reasons paper*, 9 August 2010, p.3, paragraph 21.
[11] Genesis submission, p.3.
[12] MEUG, *Submission on Transpower Individual Price-Quality Path Draft Reasons Paper*, Appendix p.1.
[13] Transpower, *Part 1 - Submission to the Commerce Commission on: Input methodologies Transpower and Individual price-quality path Transpower Draft Reasons Paper*, August 2010, p.47.
[14] Genesis, *Submission on Input Methodology and Individual Price-Quality Path for Transpower*, 6 August 2010, p.3.
[15] Transpower, *Part 1 - Submission to the Commerce Commission on: Input methodologies Transpower and Individual price-quality path Transpower Draft Reasons Paper*, August 2010, p.13.
[16] ibid, p.10, paragraph 47.
[17] ibid,p.51.
[18] Contact Energy, *Cross submission on draft determination and input methodologies for Part 4 regulation of Transpower*, August 2010, p.11.
[19] Meridian Energy, *Cross submission on Transpower input methodologies determination and draft reasons paper*, August 2010, p.11.
[20] Transpower, *Part 1 - Submission to the Commerce Commission on: Input methodologies Transpower and Individual price-quality path Transpower Draft Reasons Paper*, August 2010, p.52.
[21] ibid, p.52.
[22] ibid, p.21.
[23] ibid, p.51.
[24] ibid, p.69-70.
[25] ibid, p.62.
[26] ibid, p.63.
[27] ibid, p.63.
[28] ibid, p.67.
[29] ibid, p.67.
[30] ibid, p.68.
[31] ibid, p.72.
[32] ibid, p.74.
[33] ibid, p.75.
[34] ibid, p.75.
[35] ibid, p.76.
[36] ibid, p.78.
[37] ibid, p.78.