

Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited

Reasons paper

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Associated documents

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1. Introduction

Purpose of paper

- 1.1 This paper outlines our draft decisions, and invites submissions on, how we propose to amend the input methodologies (**IMs**):
- 1.1.1 for Electricity Distribution Services contained in the *Electricity Distribution Services Input Methodologies Determination 2012 (EDB IM determination)*;¹
 - 1.1.2 for Transpower New Zealand limited (**Transpower**) contained in the *Transpower Input Methodologies Determination 2010 (Transpower IM determination)*;² and
 - 1.1.3 for Transpower contained in the *Transpower Capital Expenditure Input Methodology Determination 2012 (Transpower Capex IM determination)*.³
- 1.2 The amendments primarily relate to:
- 1.2.1 changes to the EDB IM determination relevant to the default price-quality path for electricity distribution businesses from 1 April 2020 (**EDB DPP3**);
 - 1.2.2 changes to the Transpower IM determination and Transpower Capex IM determination relevant to the individual price-quality path for Transpower from 1 April 2020 (**Transpower RCP3**); and
 - 1.2.3 correcting certain errors in the EDB IM determination and the Transpower IM determination.

¹ Prior to the amendments outlined in this paper, the principal determination was most recently amended in 8 November 2018 by *Electricity Distribution Services Input Methodologies (Accelerated Depreciation) Amendments Determination [2017] NZCC 30*. A consolidation of the principal determination and all subsequent amendments was published by us on 31 January 2019.

² Prior to the amendments outlined in this paper, the principal determination was most recently amended in 20 December 2016 by *Transpower Input Methodologies Amendments Determination [2016] NZCC 27*. A consolidation of the principal determination and all subsequent amendments was published by us on 28 February 2017.

³ Prior to the amendments outlined in this paper, the principal determination was most recently amended in 25 May 2018 by *Transpower Capital Expenditure Input Methodology Amendments Determination [2018] NZCC 8*. A consolidation of the principal determination and all subsequent amendments was published by us on 1 June 2018.

1.3 This Chapter sets out:

- 1.3.1 the structure of this paper;
- 1.3.2 the decision-making framework we have applied to reach our draft decisions;
- 1.3.3 when the proposed IM amendments are intended to take effect;
- 1.3.4 what materials have been released alongside this paper; and
- 1.3.5 how you can provide your views.

Structure of paper

- 1.4 Chapter 2 of this paper describes our proposed changes to the EDB IM determination.
- 1.5 Chapter 3 of this paper describes our proposed changes to the Transpower IM determination.
- 1.6 Chapter 4 of this paper describes our proposed changes to the Transpower Capex IM determination.
- 1.7 In each of Chapters 2, 3 and 4 we set out:
 - 1.7.1 the current IM requirements;
 - 1.7.2 the proposed IM amendments and why we are proposing these changes; and
 - 1.7.3 how the proposed IM amendments meet the decision-making framework.

Decision-making framework we have applied

Statutory compliance

- 1.8 The IM amendments proposed in this paper are in accordance with s 52X of the Commerce Act 1986 (**Act**).
- 1.9 In accordance with sections 52V(1) and 52X of the Act, we published notices of intention relevant to the proposed IM amendments set out in this paper on 15 November 2018⁴ and 16 May 2019.⁵

⁴ Notice of Intention: Proposal to Amend Input Methodologies for Electricity Distribution Services (15 November 2018).

2016 IM Review decision making framework

- 1.10 We are using a decision-making framework that we have developed over time to support our decision making under Part 4. This has been consulted on and used as part of prior processes, and helps provide consistency and transparency in our decisions.
- 1.11 Consistent with the decision-making framework adopted in our 2016 IM Review⁶ and in the 2018 Transpower Capex IM review, we have considered each proposed IM amendment by asking the questions:
- 1.11.1 does it promote the Part 4 purpose in s 52A of the Act more effectively than the current IM;
 - 1.11.2 does it promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose); or
 - 1.11.3 does it significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).⁷
- 1.12 We refer to the outcomes specified in paragraph 1.11 as the **‘IM amendments framework outcomes’** in this paper.

Effective dates for proposed amendments

- 1.13 The proposed amendments will come into force on the day after the date on which notice of the final amended EDB IM determination, Transpower IM determination and Transpower Capex IM determination is given in the New Zealand Gazette in accordance with s 52W of the Act.
- 1.14 We propose that the amendments apply:
- 1.14.1 under ID for EDBs, immediately upon the amendments coming into force;
 - 1.14.2 for EDBs subject to DPPs, from 1 April 2020;

⁵ Notice of Intention: Proposal to Consider Amending to Input Methodologies for Electricity Distribution Services and Transpower New Zealand Limited (16 May 2019).

⁶ Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016), paragraphs 66-67.

⁷ Commerce Commission “Input methodologies review decisions: Framework for the IM review” (20 December 2016), paragraph 59.

- 1.14.3 for future EDB CPP proposals, immediately upon the amendments coming into force;
 - 1.14.4 under ID for Transpower, immediately upon the amendments coming into force; and
 - 1.14.5 for Transpower's price-quality path, from 1 April 2020.
- 1.15 In practical terms, the amended IMs will need to be applied in our setting of the EDB DPP3 determination in November 2019 and in our setting of the Transpower RCP3 determination in November 2019.

Materials released alongside this paper

- 1.16 Alongside this paper, we have published a:
- 1.16.1 draft Electricity Distribution Services Input Methodologies Amendments Determination (**draft EDB IM amendments determination**),⁸
 - 1.16.2 draft Transpower Input Methodologies Amendments Determination (**draft Transpower IM amendments determination**);⁹ and
 - 1.16.3 draft Transpower Capital Expenditure Input Methodology Amendments Determination (**draft Transpower Capex IM amendments determination**).¹⁰

How you can provide your views

Submissions on this paper

- 1.17 We welcome your views on the matters raised in this paper and how we are proposing to give effect to our decisions within our draft EDB IM amendments determination, draft Transpower IM amendments determination and draft Transpower Capex IM amendments determination, within the timeframes below:
- 1.17.1 submissions by 5pm on **Friday, 5 July 2019**; and
 - 1.17.2 cross-submissions by 5pm on **Friday, 19 July 2019**.

⁸ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019* (29 May 2019).

⁹ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019* (29 May 2019).

¹⁰ [DRAFT] *Transpower Capital Expenditure Input Methodology Amendments Determination 2019* (29 May 2019).

Address for submissions

1.18 Responses should be addressed to:

Dane Gunnell (Manager, Price-Quality Regulation)
c/o regulation.branch@comcom.govt.nz

1.19 Please include “EDB and Transpower IM amendments” in the subject line of your email. We prefer submissions in both a format suitable for word processing (such as a Microsoft Word document), as well as a ‘locked’ format (such as a PDF) for publication on our website.

Confidential submissions

1.20 While we discourage requests for non-disclosure of submissions so that all information can be tested in an open and transparent manner, we recognise that there may be cases where parties that make submissions wish to provide information in confidence.¹¹ We offer the following guidance:

1.20.1 If it is necessary to include confidential material in a submission, the information should be clearly marked, with reasons why that information is confidential.

1.20.2 Where commercial sensitivity is asserted, submitters must explain why publication of the information would be likely to unreasonably prejudice their commercial position or that of another person who is the subject of the information.

1.20.3 Both confidential and public versions of the submission should be provided.

1.20.4 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.

1.21 We request that you provide multiple versions of your submission if it contains confidential information or if you wish for the published electronic copies to be ‘locked’. This is because we intend to publish all submissions on our website. Where

¹¹ Parties can also request that we make orders under section 100 of the Act in respect of information that should not be made public. Any request for a section 100 order must be made when the relevant information is supplied to us, and must identify the reasons why the relevant information should not be made public. We will provide further information on section 100 orders if requested by parties. 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 section 100 order will apply for a limited time only as specified in the order. Once an order expires, we will follow our usual process in response to any request for information under the Official Information Act 1982.

relevant, please provide both an 'unlocked' electronic copy of your submission, and a clearly labelled 'public version'.

Separate consultation process for draft decisions on EDB DPP3 and Transpower RCP3

- 1.22 There are separate consultation processes, with different timeframes for receiving submissions, in relation to our draft decisions on EDB DPP3 and Transpower RCP3.
- 1.23 We intend to publish our final IM amendments determinations in November 2019 before our final determinations for EDB DPP3 and Transpower RCP3.
- 1.24 We note that any changes to our EDB DPP3 and Transpower RCP3 following submissions on our draft decisions may impact on our final IM amendments determinations.

2. Proposed amendments to the EDB IM determination

Purpose of this chapter

- 2.1 This chapter describes our proposed changes to the EDB IM determination.
- 2.2 For each of these proposed changes, we explain:
 - 2.2.1 our current requirement;
 - 2.2.2 our proposed amendment; and
 - 2.2.3 how the proposed amendment is likely to promote an IM amendments framework outcome.¹²

Summary of proposed amendments

- 2.3 We propose amending the EDB IM determination as follows:

Specification of prices

- 2.3.1 the ability for us to specify in a default price-quality path (**DPP**) or customised price-quality path (**CPP**) for electricity distribution businesses (**EDBs**) a limit or limits on the annual maximum percentage increase in “forecast revenue from prices”;
- 2.3.2 the introduction of a new recoverable cost for expenditure on innovation projects for EDBs subject to a DPP or CPP;
- 2.3.3 the introduction of a new recoverable cost for Fire Emergency New Zealand (**FENZ**) levies for EDBs subject to a DPP or CPP;
- 2.3.4 a correction that the existing pass-through cost available to EDBs subject to a DPP or CPP for levies payable by all members of the Electricity and Gas Complaints Commissioner Scheme are now levies payable by all members of the Energy Complaints Scheme operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010;

Circumstances when DPPs can be reconsidered

- 2.3.5 in respect of the circumstances in which DPPs may be reconsidered within a regulatory period, new reopeners for EDBs subject to a DPP to respond to:
 - 2.3.5.1 major unforeseeable consumer connection expenditure; and
 - 2.3.5.2 major foreseeable consumer connection expenditure;

¹² As defined in Chapter 1, paragraphs 1.11-1.12.

Implementation changes

- 2.3.6 a clarification to the EDB IM determination in respect of the definition of ‘operating costs’, specifically that court or statutory imposed fines or penalties cannot be treated as ‘operating costs’;
 - 2.3.7 correcting implementation errors in the incremental rolling incentive scheme (**IRIS**) drafting applying to EDBs subject to DPPs and CPPs; and
 - 2.3.8 correcting typographical errors in matters relating to proposals by a regulated supplier for a CPP.
- 2.4 We expand on each of these proposed IM amendments below.

Limit or limits on the annual maximum percentage increase in “forecast revenue from prices”

Current requirement

- 2.5 There is no current IM requirement to limit the annual maximum percentage increase in “forecast revenue from prices”.¹³
- 2.6 There is a provision that we may specify an annual maximum percentage increase in “forecast revenue from prices as a function of demand”.¹⁴ This mechanism was introduced to address the concern that there is the potential for large downward demand shocks that result in large price increases to consumers.¹⁵ We have not been able to develop a workable mechanism for this limit for EDB DPP3 in the event of a distributor carrying out certain types of price restructure.¹⁶

Proposed amendment

- 2.7 We propose introducing a limit on the percentage annual increase in forecast revenue from prices.¹⁷ We propose this limit to respond to one of the causes of potential price volatility during a regulatory period; increases in the gross revenue EDBs can earn. The proposed amendment would mitigate price shocks to consumers

¹³ *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clause 3.1.1(3).

¹⁴ *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clause 3.1.1(2).

¹⁵ Commerce Commission “Input methodologies review decisions – Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (20 December 2016), paragraph 135.

¹⁶ The implementation issues are discussed in the Commerce Commission “Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision – reasons paper” (29 May 2019), paragraphs H41 to H45.

¹⁷ *[DRAFT] Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 3.1.1(2A).

that could otherwise arise from a significant increase in the forecast revenue from prices. We propose this because some new drivers of price volatility that will affect forecast revenue from prices are expected to apply in future regulatory periods that do not apply in the current regulatory period.¹⁸

- 2.8 If an EDB was to consider setting its prices such that the limit would be exceeded, this would be apparent to the EDB during the price setting process. The EDB would then set prices at a lower level to not breach the limit.
- 2.9 The wash-up mechanism for over and under-recovery of revenue would allow an EDB that has limited its prices to recover any lost revenue in subsequent years. This recovery would take into account the time-value-of-money arising from the delay in the cash flow. This mechanism would be present value neutral for an EDB in the long term.

How the proposed amendment is likely to promote an IM amendments framework outcome

- 2.10 We consider that the proposed amendment promotes the IM amendments framework outcome of the Part 4 purpose in s 52A of the Act. The proposed amendment is linked to the s 52A outcome of promoting outcomes consistent with outcomes produced in competitive markets such that suppliers have incentives to innovate and invest (s 52A(1)(a)), as discussed below.
- 2.11 One of the IM amendments from the 2016 IM review was to change the form of control for EDBs from a weighted average price cap to a revenue cap with wash-up. We noted in Topic paper 1 of the 2016 IM Review that this change in form of control would remove “the quantity forecasting risk, and therefore the potentially detrimental effect of that risk on EDBs’ incentives to incur expenditure efficiently (consistent with s52A(1)(a) and (b))”.¹⁹
- 2.12 As noted in paragraph 2.6 above, the IM implementation of the revenue cap with wash-up included the annual maximum percentage increase in “forecast revenue from prices as a function of demand”. This maximum increase was to reduce the risk of price shocks, but as noted above we have not found a workable mechanism for it.

¹⁸ Examples of new drivers of volatility include recoverable costs relating to the incremental rolling incentive scheme and the Transpower transmission charge recoverable cost. For further discussion in relation to the EDB DPP3 regulatory period, refer the Commerce Commission “Default price-quality paths for electricity distribution businesses from 1 April 2020 - Draft Reasons paper” (29 May 2019), Attachment H.

¹⁹ Commerce Commission “Input methodologies review decisions – Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower” (20 December 2016), paragraph 59.

- 2.13 We propose to mitigate the risk of price shocks that might otherwise arise from us not implementing an annual maximum percentage increase in forecast revenue from prices as a function of demand by instead applying the proposed limit on the annual maximum percentage increase in forecast revenue from prices.
- 2.14 The proposed limit promotes the s 52A(1)(a) outcome as it allows for the revenue cap with wash-up to continue to be used, despite the “annual maximum percentage increase in forecast revenue from prices as a function of demand” not being able to be implemented. This is because some of the potentially adverse effects of price shocks is mitigated by the proposed IM amendment.

New recoverable cost in respect of expenditure on innovation projects

Current requirement

- 2.15 There is currently no recoverable cost for EDBs in respect of expenditure on innovation projects. EDBs currently treat any expenditure of this type as capital expenditure (**capex**) or operating expenditure (**opex**).

Proposed amendment

- 2.16 We are proposing to introduce an ‘innovation project allowance’,²⁰ which is a new capped recoverable cost term for expenditure by EDBs on innovation projects.
- 2.17 We consider innovation to be the practice of EDBs putting technologies, processes, or approaches, which have not been used in similar circumstances in New Zealand by EDBs before, into practice for the benefit of the electricity distribution service.
- 2.18 We propose that the criteria for the new recoverable cost term be specified in each s 52P price-quality path determination (i.e. in a DPP or CPP determination) that must specify the following:
- 2.18.1 the level of the cap;
 - 2.18.2 the level of contribution that must be made by the EDB (ie, expenditure on the innovation project treated as regulated capex or opex); and
 - 2.18.3 the requirements for approval by the Commission.
- 2.19 We are proposing that this new recoverable cost term be defined in the EDB IMs²¹ because all recoverable cost terms are defined under the specification of price in the IMs, which supports long-term certainty of the regulatory regime.

²⁰ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 3.1.3(1)(x).

- 2.20 We are proposing that the specific criteria and cap be defined in the s 52P determinations (eg in DPPs or CPPs) so that the cap can be increased or decreased in future DPP or CPP resets depending on the required strength of the incentive at the time and the success of the incentive during EDB DPP3. If the limit is changed, then the approval criteria should also be reconsidered to maintain an approach that is proportionate to the size of the cap. The criteria may also need to be revised to account for changing needs in the electricity sector.
- 2.21 We are not proposing to include a minimum materiality threshold for innovation projects to be able to be eligible because this would be a barrier to some projects, particularly from smaller EDBs. We consider that this would have some benefits by reducing the overall regulatory costs of the DPPs/CPPs.

How the proposed amendment is likely to promote an IM amendments framework outcome

- 2.22 We consider that the introduction of an ‘innovation project allowance’ recoverable cost term is likely to promote the Part 4 purpose more effectively than the current set of IMs because it will allow us to set better incentives for innovation in DPPs and CPPs. The Part 4 purpose includes promoting outcomes such that regulated EDBs have incentives to innovate and invest,²² among other areas of distributor performance.
- 2.23 We consider that increasing the incentives for innovation would be in the long-term benefit of consumers. In addition, the increased incentive will help reduce potential barriers to innovation of projects where the benefits of these projects are unclear and may not be realised until future regulatory periods.
- 2.24 We consider that having some of the cost of a potential innovative practice covered by a recoverable cost will provide options for encouraging greater innovation by EDBs.
- 2.25 There is some risk that the innovation recoverable cost may cover expenditure that would have happened without its introduction, resulting in a higher cost for consumers and without any additional long-term benefit.
- 2.26 Further, if in the DPPs or CPPs we make the cap proportionate to revenue, it may mean that the available funding is too small to be useful for the smallest EDBs and for these businesses the compliance costs of the recoverable cost may be too high.

²¹ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 1.4.1(2), definition of **innovation project allowance**.

²² Commerce Act 1986, s 52A(1)(a).

- 2.27 We consider that the risks of the recoverable cost to consumers can generally be addressed within the specific criteria set in the relevant DPPs or CPPs, to ensure that the Part 4 purpose is met. We expect that the level to which the risks are addressed would be proportionate to the cap put in place for that DPP or CPP.

New recoverable cost in respect of FENZ levies

Current requirement

- 2.28 The FENZ levy paid by EDBs is currently borne by their opex allowances. The FENZ levy is charged on certain contracts of insurance, and it funds Fire and Emergency New Zealand.

Proposed amendment

- 2.29 The levy payable by an EDB is largely outside of its control. Therefore, for EDB DPP3 which takes effect from 1 April 2020, we are proposing to include FENZ levy amounts as a recoverable cost,²³ instead of including a forecast within each EDB's opex allowance. As the quantum of these levies are largely outside of the control of EDBs, we consider the nature of these costs are more akin to being recoverable costs than operating costs. We consider that the proposed amendment will also address forecasting risk arising from the uncertainty in future levy rates, as well as any changes in amounts charged to the EDBs as a result of the Government's signalled review of the levy-based funding model.

How the proposed amendment is likely to promote an IM amendments framework outcome

- 2.30 Retaining the current treatment could result in consumers over-paying (if the Government was to discontinue the levy-based funding model following the review, or if the forecast liability was over-forecast), or could result in us setting an insufficient expenditure allowance for an EDB (if the actual liability was higher than forecast).
- 2.31 We are proposing that this new recoverable cost term be defined in the EDB IMs because all recoverable cost terms are defined under the specification of price in the IMs, which supports long-term certainty of the regulatory regime.

²³ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 3.1.3(1)(w).

Amendment that the pass-through cost in respect of levies payable by members of the Electricity and Gas Complaints Commissioner Scheme are now levies payable by members of the Energy Complaints Scheme operated by Utilities Disputes Limited

Current requirement

2.32 Our EDB IM determination currently allows for levies payable ‘by all members of the Electricity and Gas Complaints Commissioner Scheme by virtue of their membership’ to be treated as a ‘pass-through cost’.²⁴

Proposed amendment

2.33 We now propose amending our EDB IMs to no longer reference levies payable ‘by all members of the Electricity and Gas Complaints Commissioner Scheme by virtue of their membership’, and to instead reference levies payable ‘by all members of the Energy Complaints Scheme operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010’.²⁵

2.34 We propose this amendment as the reference to ‘Electricity and Gas Complaints Commissioner Scheme’ is now redundant due to ‘The Office of the Electricity and Gas Complaints Commissioner’ being rebranded as ‘the Energy Complaints Scheme operated by Utilities Disputes Limited’ in 2016.²⁶

New reopeners for major unforeseen consumer connection expenditure for EDBs subject to a DPP

Current requirement

2.35 Currently, under clause 4.5.6 of the EDB IMs, major unforeseen consumer connections are not grounds for reconsidering a DPP.

2.36 Significant, externally driven, and unforeseeable events are generally covered by the existing reopeners within our DPP framework. However, while single large consumer-connections may also be significant, externally driven, and unforeseeable, none of the reopeners allows for them.

²⁴ *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clause 3.1.2(2)(b)(iii). Our reasons for introducing this levy are explained in Commerce Commission “Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper” (December 2010), paragraph 8.3.31.

²⁵ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 3.1.2(2)(b)(iii).

²⁶ For more information about this rebranding, see: https://www.utilitiesdisputes.co.nz/UD/About_us/History_of_Utilities_Disputes/UD/AboutUs/History_of_Utilities_Disputes.aspx.

Proposed amendment

- 2.37 We propose introducing two new DPP reopeners in the EDB IMs that will apply to new major connection projects, to address uncertainty in the existence, timing, or scope of such connection projects.²⁷
- 2.38 The reopeners are intended to cover some projects within three scenarios:
- 2.38.1 where the major connection project was not foreseen;
 - 2.38.2 where the major connection project was foreseen, but was not expected until a future regulatory period; and
 - 2.38.3 where the major connection project was foreseen, but during the regulatory period the expectation changes so that the connection project is expected to be much larger.
- 2.39 We are proposing to structure the reopeners as two separate reopeners. The first covers some projects that were not foreseeable. The second covers some projects that were foreseeable, but are unforeseeably brought forward, or unforeseeably increase in size.
- 2.40 The proposed new reopeners will only apply to major connection projects that:
- 2.40.1 could not have reasonably been foreseen at the time of setting expenditure forecasts which the Commission could have considered when determining the DPP, or were foreseen but reasonably expected to not be required until a future regulatory period or were foreseen but expected to be much larger than forecasted;
 - 2.40.2 are not included in the EDB's expenditure forecasts considered when setting our capex forecasts for the DPP;
 - 2.40.3 are not covered through the EDB's capital contributions policy and there is reasonable justification for it not being covered;
 - 2.40.4 require additional expenditure (net of the capital contributions) by the EDB in that disclosure year of more than 5% of the forecast net allowable revenue for that year for the connection and related network reinforcement;
 - 2.40.5 have sufficient commitment from the connecting party; and

²⁷ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 4.5.5A and 4.5.5B.

- 2.40.6 will appropriately apportion proposed additional revenue sought through the EDB's pricing methodology.
- 2.41 We consider that there would be some benefits of requiring that the expenditure or additional expenditure must have not been included in our DPP forecasts of the EDB's capex. In particular, this would prevent the EDB being compensated for the expenditure twice.
- 2.42 We are proposing to link the reopeners to the EDB's last forecast before the DPP. We consider that this would generally prevent double compensation.
- 2.43 We do not intend the reopeners to apply to situations where the EDB had already forecast the expenditure and we then decided to exclude the expenditure from our DPP allowances because we do not intend for the reopeners to respond to situations which were forecast and the expenditure was foreseeable.

How the proposed amendments are likely to promote an IM amendments framework outcome

- 2.44 We consider that these proposed amendments are likely to better promote the Part 4 purpose because:
- 2.44.1 under the current EDB IMs, if an EDB was to face an unforeseen major connection, it would face disincentives to invest, as any additional commissioned assets would lead to a penalty under the capex IRIS mechanism, with no offsetting incentive to improve efficiency, as the demand for new connections is substantially beyond the distributor's control; and
- 2.44.2 if we were to include a forecast allowance for potential major capex projects when setting a DPP, an EDB may earn excessive profits where the demand does not eventuate.
- 2.45 Because of this, we consider additional reopeners the appropriate mechanism.
- 2.46 The aim of the proposed re-openers is to ensure, where possible, that distributors can connect and manage significant new demand, particularly where it arises from demand for low carbon technologies if New Zealand increases its focus on decarbonisation, and while maintaining network reliability and meeting the long-term interests of consumers. This is consistent with the Part 4 purpose, specifically in providing an incentive for distributors to invest.²⁸

²⁸ [Commerce Act 1986](#), s 52A(1)(a).

- 2.47 The change does create additional compliance costs for an EDB and the Commission. However, we consider this disadvantage in terms of the IM amendments framework outcomes is more than offset by the Part 4 benefits discussed above.
- 2.48 We also note that the proposed new reopeners may also reduce any current incentive of EDBs to encourage new connections to be arranged directly with Transpower, despite connection to the EDBs possibly being a more efficient option.

Clarification that court or other statutory imposed penalties cannot be treated as ‘operating costs’

Current requirement

- 2.49 Currently, clause 1.1.4(2) of the EDB IMs defines ‘operating costs’ as:

a cost incurred by the EDB in question relating to the supply of-

- (a) regulated services alone; or
- (b) regulated services and one or more unregulated service,

- 2.50 The definition also contains exclusions for matters such as the cost of assets recognised as such under GAAP, pass-through costs and recoverable costs. However, these exclusions are not relevant for the purposes of this proposed IM amendment.

Proposed amendment

- 2.51 The current definition of operating costs (which is used in the EDB IMs for determining opex IRIS incentives, and under our current approach to setting DPPs on the basis of current and projected profitability) does not provide sufficient certainty about the treatment of pecuniary penalties.
- 2.52 For clarity, we propose an additional exclusion in the definition of “operating costs” for “**pecuniary penalties**”,²⁹ and a new defined term ‘pecuniary penalties’,³⁰ defined as:

finances or penalties imposed-

- (a) by a court; or
- (b) by any other body with a statutory power to impose such fines or penalties

²⁹ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 1.1.4(2), definition of **operating cost**.

³⁰ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 1.1.4(2), definition of **pecuniary penalties**.

How the proposed amendment is likely to promote an IM amendments framework outcome

- 2.53 While we consider the current definition does not allow such costs to be passed through to consumers (via a DPP or CPP reset and via the IRIS), the exclusion is implicit, and so making this explicit through a proposed IM amendment better promotes the IM purpose in s 52R of the Act.
- 2.54 Given recent breaches of quality standards, some distributors have been subject to court-imposed penalties for breaching quality standards.³¹ As distributors' regulatory opex disclosed under information disclosure (**ID**) informs both the opex forecasts we set,³² and the opex IRIS recoverable costs, we consider that it is important for consumers and suppliers to have certainty as to how these penalties should be treated.

Correction to implementation errors in the IRIS drafting

Current requirement

- 2.55 Our EDB IM determination includes 'opex incentive amounts' for the purposes of the 'IRIS incentive adjustment'.³³
- 2.56 As a result of the 2016 IM review, we amended the 'opex incentive amount' calculation to "fit the purpose of the 'adjustment to the opex incentive' by using a modified version of the 'capex incentive adjustment' calculation".³⁴ We did this to remedy the risk of fluctuations in allowable revenue (and therefore prices to consumers) resulting from adjustments to the opex incentive in the second year of a regulatory period.³⁵
- 2.57 As part of drafting the amendments resulting from the 2016 IM review, we made implementation errors in the 'opex incentive amount' calculation:
- 2.57.1 in the time value of money adjustment; and
- 2.57.2 by referencing the 'DPP regulatory period', rather than the 'regulatory period'.

³¹ [Commerce Act 1986](#), s 87.

³² *Electricity Distribution Information Disclosure Determination 2012*, as amended, Schedule 6a.

³³ *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clause 3.3.2.

³⁴ Commerce Commission "Input Methodologies review decisions: Report on the IM review" (20 December 2016), page 112-115.

³⁵ Commerce Commission "Input Methodologies review decisions: Report on the IM review" (20 December 2016), paragraph 369-372.

Proposed amendment

2.58 We propose amending the calculation for the ‘opex incentive amount’ for EDBs to correct these implementation errors made as a result of the 2016 IM review and therefore, accurately give effect to our 2016 IM review decision.³⁶

How the proposed amendment is likely to promote an IM amendments framework outcome

2.59 We are proposing these implementation changes to give effect to the policy intent of the opex IRIS mechanism. We consider that correcting these implementation errors will promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it will reduce potential confusion for interested persons on how to accurately calculate the ‘opex incentive amount’ component of the ‘IRIS incentive adjustment’.

Correction to typographical errors in matters relating to proposals by a regulated supplier for a CPP*Current requirement*

2.60 Under the EDB IMs, an EDB’s CPP proposal must be verified by a verifier, where this verifier must be engaged in accordance with Schedule F of the EDB IMs.³⁷ Within Schedule F, there are typographic errors.³⁸

Proposed amendment

2.61 We propose amending these typographical errors as set out in the draft EDB IM Amendments determination to correct incorrect cross-references within Schedule F of the EDB IMs.³⁹

How the proposed amendment is likely to promote an IM amendments framework outcome

2.62 We consider that correcting these typographical errors will promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it will reduce potential confusion for interested persons on how EDB’s must engage verifiers for the purpose of a CPP proposal.

³⁶ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause 3.3.2.

³⁷ *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clause 5.5.2(1)-(2).

³⁸ *Electricity Distribution Services Input Methodologies Determination 2012*, as amended, clause F6(2)(d)(ii) and clause F6(3)(i).

³⁹ [DRAFT] *Electricity Distribution Services Input Methodologies Amendments Determination 2019*, clause F6(2)(d)(ii) and clause F6(3)(i).

3. Proposed amendments to the Transpower IM determination

Purpose of this chapter

- 3.1 This chapter describes our proposed changes to the Transpower IM determination.
- 3.2 For each of these proposed changes, we explain:
 - 3.2.1 our current requirement;
 - 3.2.2 our proposed amendment; and
 - 3.2.3 how the proposed amendment is likely to promote an IM amendments framework outcome.

Summary of proposed amendments

- 3.3 We propose amending the Transpower IM determination as follows:

Specification of prices

- 3.3.1 the introduction of a new recoverable cost for FENZ levies payable by Transpower;
- 3.3.2 the introduction of a new pass-through cost for Transpower for levies payable by all members of the Energy Complaints Scheme operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010;

Circumstances when individual price-quality path may be reconsidered

- 3.3.3 an amendment to the circumstances in which an individual price-quality paths (**IPP**) may be reconsidered each year within a regulatory period to recover/return incentive and wash-up amounts through 'EV adjustments';

Implementation changes

- 3.3.4 a clarification to the Transpower IM determination in respect of the definition of 'operating costs', specifically that court or statutory imposed fines or penalties cannot be treated as 'operating costs'; and
 - 3.3.5 correcting implementation errors in the IRIS drafting applying to Transpower.
- 3.4 We expand on each of these proposed IM amendments below.

New recoverable cost in respect of FENZ levies

Current requirement

- 3.5 The FENZ levies paid by Transpower are currently borne by its opex allowance. The FENZ levies are charged on certain contracts of insurance, and they fund Fire and Emergency New Zealand.

Proposed amendment

- 3.6 The levies payable by Transpower are largely outside of its control. Therefore, for Transpower RCP3 which takes effect from 1 April 2020, we are proposing to include FENZ levy amounts as a recoverable cost,⁴⁰ instead of including a forecast within Transpower's opex allowance. As the quantum of these levies are largely outside of the control of Transpower, we consider the nature of these costs are more akin to being recoverable costs than operating costs.

How the proposed amendment is likely to promote an IM amendments framework outcome

- 3.7 Retaining the current treatment could result in consumers over-paying (if the Government was to discontinue the levy-based funding model following the review, or if the forecast liability was over-forecast), or could result in us setting an insufficient expenditure allowance for Transpower (if the actual liability was higher than forecast).
- 3.8 We are proposing that this new recoverable cost term be defined in the Transpower IMs because all recoverable cost terms are defined under the specification of price in the IMs, which supports long-term certainty of the regulatory regime.

New pass-through cost in respect of levies payable by members of the Energy Complaints Scheme operated by Utilities Disputes Limited

Current requirement

- 3.9 Levies paid to participate in the Energy Complaints Scheme under the Electricity Industry Act 2010 and operated by Utilities Disputes Limited, being the approved scheme under Schedule 4 of the Electricity Industry Act 2010, are not currently included in the Transpower IMs. Forecast amounts for the levies form part of Transpower's opex allowance.
- 3.10 The current treatment for levies charged to Transpower differs from the treatment under the EDB IM determination, where the levies are treated as pass-through costs.

⁴⁰ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 3.1.3(1)(f).

Proposed amendment

- 3.11 Under the proposed amendment, Energy Complaints Scheme levies charged to Transpower would be included in Clause 3.1.2 of the Transpower IMs as a pass-through cost for Transpower.⁴¹

How the proposed amendment is likely to promote an IM amendments framework outcome

- 3.12 As the actual amount of levy paid is outside of Transpower's control, including a forecast for the liability within opex results in any difference between the forecast and actual amounts of the levy being retained or borne by Transpower. Treatment as a pass-through cost will remove the risk of consumers paying more than necessary, or Transpower's expenditure allowance being insufficient.
- 3.13 This will be consistent with the treatment of the Energy Complaints Scheme levies under the EDB DPP.

Annual reconsideration of the 'forecast MAR' no longer including an 'EV adjustment'*Current requirement*

- 3.14 Under the current Transpower IM, we will reconsider the IPP in each disclosure year of a regulatory period (other than the last disclosure year) to take account of the following on 'forecast MAR':⁴²
- 3.14.1 the revenue impact of major capex approved by us;
 - 3.14.2 the revenue impact of base capex approved by us for a listed project; and
 - 3.14.3 an EV adjustment.
- 3.15 The building blocks approach we use to set Transpower's forecast MAR can produce revenue volatility for Transpower from year to year, and when transitioning between regulatory periods. This volatility is generally reflected in the prices Transpower charges its customers. The effect is potentially amplified by the reopening of the price path during the regulatory period for the three factors noted for reconsideration in paragraph 3.14.
- 3.16 Volatility in revenues (and therefore prices to customers and end-use consumers) can potentially lead to increased difficulty of budgeting for transmission lines

⁴¹ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 3.1.2(2)(b).

⁴² *Transpower Input Methodologies Determination 2010*, as amended, clause 3.7.4(4).

charges. Transpower's customers have previously supported smoothing of the price path to avoid a large, temporary, change in revenue.⁴³

Proposed amendment

- 3.17 We propose amending the Transpower IMs to remove EV adjustments from the reconsideration provision to limit one cause of price path volatility. We are proposing to amend the Transpower IM determination to no longer reopen the IPP each year to recover/return incentive and wash-up amounts through 'EV adjustments', except in limited circumstances where the build-up in the balance of the 'EV account' during a regulatory period is forecast to give rise to a price shock effect in the step change to the next regulatory period.
- 3.18 In those cases, we propose that the price-quality path may be reopened to spread the EV account balance over the remaining years of the regulatory period and the next regulatory period.⁴⁴
- 3.19 Under our proposed revenue smoothing approach, the balance in the EV account at the end of a regulatory period would be smoothed across the allowable revenues for the next regulatory period (ie, over up to five years).
- 3.20 We are therefore proposing that the price-quality path could be reopened on the basis of a large build-up in the EV account balance where:
- 3.20.1 we or Transpower forecast that the EV account balance as of the last day of an IPP would be, when divided by the number of years in the regulatory period, greater than 10% of the forecast smoothed allowable revenue for the final pricing year of the regulatory period; and
- 3.20.2 that forecast is made prior to 31 March of the third or fourth year of a regulatory period (or made prior to 31 March of the fifth year of a regulatory period where the regulatory period is more than 4 years).
- 3.21 We are proposing that Transpower may only apply for a reconsideration of the IPP to take account of a forecast of a large build-up in the EV account balance within 80 working days after 30 June of the first or second year commencing in a regulatory period (or within 80 working days after 30 June of the third year of a regulatory period where the regulatory period is more than 4 years).

⁴³ For example, in the December 2017 update of the RCP2 forecast MAR, there would have been an initial large reduction in the forecast MAR, followed by a bounce back up in the forecast MAR for the following years. Transpower's customers supported smoothing the forecast MAR for the remaining years.

⁴⁴ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 3.7.3A, clause 3.7.4(1)(a)(v), clause 3.7.4(4)-(6), and clause 3.7.5(2)(b)(v).

- 3.22 Our draft decision is that smoothing of annual revenues is appropriate. However, in contrast to smoothing over a regulatory period, we consider there are significant difficulties with attempting to partially close the step changes when transitioning between regulatory periods, due to the different underlying causes (in particular, the forecast change in WACC between resets of price paths). Hence the need to consider whether a reconsideration provision is still required for possible EV adjustments during a regulatory period.

How the proposed amendment is likely to promote an IM amendments framework outcome

- 3.23 We consider that the policy change to defer the recovery of the balance in the EV account through annual EV adjustments to the smoothed maximum allowable revenue to the extent this can be done without causing a price shock for consumers in the next regulatory period will promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose), by giving consumers greater certainty about how our rules (ie, in the IMs and IPP) will apply to forecast transmission prices for transmission services to be provided by Transpower.
- 3.24 We consider that this change will result in more predictable transmission pricing for consumers from year to year, reduce compliance costs for Transpower, and reduce the effects of complexity for consumers (without detrimentally affecting the promotion of the s 52A purpose).

Clarification that court or other statutory imposed penalties cannot be treated as ‘operating costs’

Current requirement

- 3.25 Currently, clause 1.1.4(2) of the Transpower IMs defines ‘operating costs’ as:

a cost incurred by Transpower relating to the supply of electricity transmission services

- 3.26 The definition also contains exclusions for matters such as the cost of assets recognised as such under GAAP, pass-through costs and recoverable costs. However, these exclusions are not relevant for the purposes of this proposed IM amendment.

Proposed amendment

- 3.27 The current definition of operating costs (which is used in the Transpower IMs for determining opex IRIS incentives) does not provide sufficient certainty about the treatment of pecuniary penalties.

- 3.28 For clarity, we propose an additional exclusion in the definition of “operating costs” for “payment of any **pecuniary penalties**”,⁴⁵ and a new defined term ‘pecuniary penalties’,⁴⁶ defined as:

finances or penalties imposed:

- (c) by a court; or
- (d) by any other body with a statutory power to impose such fines or penalties

How the proposed amendment is likely to promote an IM amendments framework outcome

- 3.29 While we consider the current definition does not allow such costs to be passed through to consumers (via an IPP reset and via the IRIS), the exclusion is implicit, and so this proposed IM amendment better promotes the IM purpose in s 52R of the Act.
- 3.30 As Transpower’s opex disclosed under ID informs both the opex forecasts we set,⁴⁷ and the opex IRIS recoverable costs, we want to provide certainty as to how these fines and penalties should be treated.

Correction to implementation errors in the IRIS drafting

Current requirement

- 3.31 Our Transpower IM determination includes ‘opex incentive amounts’ for the purposes of the ‘IRIS incentive adjustment’.⁴⁸
- 3.32 As a result of the 2016 IM review, we amended the ‘opex incentive amount’ calculation to “fit the purpose of the ‘adjustment to the opex incentive’ by using a modified version of the ‘capex incentive adjustment’ calculation”.⁴⁹
- 3.33 As part of drafting the amendments resulting from the 2016 IM review, we made implementation errors in the ‘opex incentive amount’ calculation in the time value of money adjustment.

Proposed amendment

⁴⁵ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 1.1.4(2), definition of ‘operating cost’.

⁴⁶ [DRAFT] *Transpower Input Methodologies Amendments Determination 2019*, clause 1.1.4(2), definition of ‘pecuniary penalties’.

⁴⁷ *Transpower Information Disclosure Determination*, as amended, Schedule F2.

⁴⁸ *Transpower Input Methodologies Determination 2010*, as amended, clause 3.6.2.

⁴⁹ Commerce Commission “Input Methodologies review decisions: Report on the IM review” (20 December 2016), page 114-115.

- 3.34 We propose amending the calculation for the 'opex incentive amount' for Transpower to correct these implementation errors made as a result of the 2016 IM review.⁵⁰

How the proposed amendment is likely to promote an IM amendments framework outcome

- 3.35 We are proposing these implementation changes to give effect to the policy intent of the opex IRIS mechanism. We consider that correcting these implementation errors will promote the IM purpose in s 52R of the Act more effectively (without detrimentally affecting the promotion of the s 52A purpose) as it will reduce potential confusion for interested persons on how to accurately calculate the 'opex incentive amount' component of the 'IRIS incentive adjustment'.

⁵⁰ [DRAFT] Transpower Input Methodologies Amendments Determination 2019, clause 3.6.2.

4. Proposed amendment to the Transpower Capex IM determination

Purpose of this chapter

- 4.1 This chapter describes our proposed change to the Transpower Capex IM determination in respect of the 'base capex standard incentive rate'.
- 4.2 For this proposed change, we explain:
 - 4.2.1 our current requirement;
 - 4.2.2 our proposed amendment; and
 - 4.2.3 how the proposed amendment is likely to promote an IM amendments framework outcome.

Base capex standard incentive rate

Current requirement

- 4.3 Under the current Transpower Capex IM determination, we set specific incentives that are intended to encourage Transpower to invest and operate efficiently. We set an allowance that is fixed at the beginning of a regulatory period with the intention of allowing Transpower to cover its costs. Transpower can earn increased profits by delivering services more efficiently than assumed when the allowance was set.
- 4.4 The fixed allowance feeds into a revenue path. Once a path is set, Transpower has incentives to outperform that path and over time the incentives lead to lower actual costs. The reduced costs are then reflected in future decisions about the opex and capex needs of Transpower and consumers gain from the subsequent lower revenue allowances provided for Transpower (leading to lower prices for consumers).
- 4.5 We can adjust the strength of the incentives for cost efficiency by adjusting the share of the benefits retained by Transpower versus that passed on to consumers (the 'incentive rate').
- 4.6 There are separate incentive rates for capex and opex and the difference between these incentive rates can affect the relative incentive for Transpower to favour opex over capex or vice versa, when there is the potential for substitution. We can also ensure the incentives for efficiency are constant throughout the period using mechanisms such as IRIS.
- 4.7 Although this incentive provides Transpower with incentives for cost efficiency once a revenue path (or allowance) is set, it also provides Transpower with incentives to

overstate the opex and capex allowance it needs to recover at the time we set the IPP or a major capex allowance.

- 4.8 We made changes to the Transpower Capex IM in 2018 to recognise these different trade-offs and in particular the trade-off described above between promoting incentives to improve efficiency, innovate and invest, and limiting Transpower's ability to earn excessive profits.
- 4.9 In the 2018 review of the Transpower Capex IM we decided to modify the base capex incentive rates and apply two incentive rates for base capex projects, specifically:⁵¹
- 4.9.1 a standard rate of 33% for base capex projects; and
- 4.9.2 a lower rate of 15% for large base capex projects that meet specified criteria (namely that project costs are likely to exceed \$20m).
- 4.10 The changes made in 2018 were not considered to be a change in intent of the incentives regime rather they were considered refinements to improve incentive effectiveness.

Proposed amendment

- 4.11 Our regime intends to provide incentives for Transpower to improve opex and capex efficiencies, with savings intended to be shared between Transpower and consumers, and the incentive rates are set in both opex and capex for this purpose. The IPP opex and base capex incentive rates are presently different; the opex incentive rate, as presently calculated in accordance with the Transpower IM and IPP draft decision is 26%, while the 'standard incentive rate for base capex' is 33%.
- 4.12 We are proposing that the 'base capex standard incentive rate' in the Transpower Capex IM is amended from 33% to 26% to align with the opex IRIS incentive rate.⁵²
- 4.13 The opex and base capex incentive rates are currently different because the opex IRIS incentive rate is determined in the Transpower IM based on the length of the period and weighted average cost of capital (**WACC**) value for the period. Therefore, in Transpower RCP3, without a change to the base capex incentive rate, the opex IRIS incentive rate would be different to the base capex incentive rate.
- 4.14 Providing consistent incentive rates across opex and base capex ensures that Transpower will have equal incentives to find efficiencies regardless of whether

⁵¹ Commerce Commission "Transpower capex input methodology review - Decisions and reasons" (29 March 2018), paragraphs 39-72.

⁵² [DRAFT] *Transpower Capital Expenditure Input Methodology Amendments Determination 2019*, clause 4.

these are through opex or base capex solutions (as we consider opex and base capex to be generally substitutable).

How the proposed amendment is likely to promote an IM amendments framework outcome

- 4.15 We consider that equalising the opex and capex incentive rates will provide Transpower with equal incentives to find efficiencies regardless of whether these are through opex or capex solutions. We consider that this change promotes the Part 4 purpose in s 52A of the Act more effectively than the current IM because it intends to provide equal efficiency incentives between opex and capex.