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Dear Dane

Re: Amendments to Transpower Input Methodologies for RCP2

This letter follows recent discussions on potential amendments to the Transpower Input Methodologies (IMs). These potential amendments represent a fine tuning of the IM framework which we consider to be operating effectively on the whole.

I begin by recapping on the process to date, then refresh the list of Transpower IM amendment requests and conclude with thoughts on timing and next steps. In addition there are two appendices:

Appendix A: contains our response to recent queries from Commission staff

Appendix B: contains four new IM amendment requests, and updated earlier requests

Process to date

Following introduction of the Transpower IMs and IPP in December 2010 a dialogue between Transpower and the Commission sought to clarify certain clauses, address a small number of errors and address several requests from Transpower to resolve issues we had identified with the determinations.

That dialogue culminated in the Commission's 20 July 2011 letter which outlined how it intended to address the various errors, clarifications and amendment requests. The Commission subsequently:

- made a number of changes to the determinations to correct drafting errors
- made a number of clarifications to Transpower, including through the "Necessary Modifications" document
- posted "request for clarification and/or amendment" documents on its website, including several requests that the Commission determined it could not address within the current regulatory control period (RCP1)

Over the last few months we have reinitiated the discussion of these outstanding requests and introduced other, more recently identified issues. We also discussed the process by which these requests could be considered and how best to align that with the Commission's work programme and the RCP2 process.

Refresh of Transpower IM amendment requests

Of the seven documents on the Commission website, amendment requests IM_01 and 02 remain, IM_03 has been partially addressed (i.e. two of three issues addressed), we wish to withdraw IM_04 and IM_05, 06 and 07 have been addressed. In addition we request four new amendments, IM_08, 09, 10 and 11, all of which we have discussed.

A brief summary of the substance of each remaining request is provided below, and the new or updated amendment request templates are included in Appendix B.

<u>IM_01 - no depreciation in year of commissioning</u>
We remain in favour of amending the IM to align depreciation with GAAP.

In developing the Transpower IMs, there was an objective of aligning with GAAP. This has benefits in terms of the costs and complexity of achieving and verifying compliance, and also reflects that our IMs are for a single supplier and build on an earlier administrative settlement. Unlike EDB IMs, there was not a requirement to create consistency across suppliers that had different starting points (in terms of systems and approaches).

The Transpower IM reasons paper records the Commission's decision to adopt a straight-line depreciation approach for Transpower. There is no discussion of omitting first year depreciation, and no indication that this was a deliberate policy choice. Rather, omission of first year depreciation arises as a consequence of the drafting in the IM[1]. By omitting first year depreciation, the IMs produce a non-GAAP depreciation profile over the full life of all transmission assets (not just in the first year).

For our 2010/11 MAR wash-up, we adopted a manual spreadsheet-based, asset level approach to assess the depreciation wash-up. A similarly manual approach was required for the initial RCP1 MAR forecasting exercise. Together, these exercises required more than 10 FTE days of internal resource plus commensurate external auditing resource. Each year, the manual wash-up process would have to be repeated and, each control period, the manual forecasting process repeated.

In addition to these resourcing concerns, a manual process is inherently more error-prone, less robust and less flexible than a systems approach we could use if the depreciation rules were aligned with GAAP.

<u>IM-02 - treatment of fully depreciated assets within an RCP</u>
We remain in favour of amending the IM to align depreciation with GAAP.

The IM currently requires depreciation to be spread evenly over each year of the control period during which the asset is fully depreciated. Unlike the omission of first year depreciation, this is an explicit and clearly intentional feature of the Transpower IMs[2]. There is limited discussion in the reasons paper of the rationale for spreading. The basis appears to be to prevent Transpower having an incentive to bring asset retirement forward into the early years of a control period. At the time the IMs were in development, Transpower supported this approach.

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[1] In section 2.2.4(2) of the IMs, depreciation is calculated using the formula "*[1 ÷* ***remaining asset life****] ×* ***opening RAB value***" and in section 2.2.3(3)(a), opening RAB value is defined as an asset's "…*closing RAB value in the preceding disclosure year*". This results in zero depreciation in the first year an asset enters the RAB.
[2] See clause 2.2.6(2) of the IMs.

On reflection, we believe there is no such incentive and, accordingly, no reason for the spreading rule. This is because, unlike in Australia, we have an annual wash-up for capital, depreciation and tax building blocks. As such, there is no depreciation-linked incentive to bring forward or defer retirement of an asset.

Depreciation spreading creates similar resource demands and other practical challenges to the non-GAAP treatment of first year depreciation.

IM_03 - recovery of costs associated with write-offs, [dismantling and pseudo asset depreciation]
Recovery of costs associated with dismantling and pseudo asset depreciation: *addressed in the 20/7/2011 Commission letter to Transpower (refer Table A)*

Write-offs: there is an outstanding issue regarding recovery of costs associated with base capex projects that are written off prior to commissioning. The Capex IM includes a 'sunk cost' recovery mechanism for major projects that are written off, but does not deal directly with the base capex equivalent.

Any business will face occasions where it becomes more rational to write off a partially completed project than to commit further expenditure. For example, we could commit expenditure to build a new transmission pricing system, to meet anticipated regulatory timing requirements, only for the investment to become obsolete prior to completion due to subsequent regulatory changes or decisions. It is not clear that the IMs permit recovery of costs without first commissioning the relevant project. This could create a perverse incentive for Transpower to continue investment, inefficiently, in order to commission a project (and then write off the assets) rather than cease the project and write-off the expenditure prior to completion.

We propose that project write-offs should be disclosed in the Annual Regulatory Report, that the costs should be able to be recovered against the base capex allowance. Consistent with the framework for base capex, project write-offs should not be subject to individual approval.

IM_04 - treatment of costs recovered through insurance
Withdrawn - resolved to the satisfaction of Transpower. Appendix A contains a description of Transpower's current practice (as requested). We will work through our insurance approach for RCP2 as part of the RCP2 proposal process.

IM_05, 06 and 07: *Addressed in the 20/7/2011 Commission letter to Transpower (refer Table A)*

Additional Transpower IM amendment requests

We propose four new amendment requests (IM_08 to IM_11). The populated amendment request templates are included at Appendix B, and summaries are provided below.

IM_08 - reclassification and addition of pass-through or recoverable costs
We propose to classify certain categories of costs as pass-through or recoverable costs. Those cost categories are:

1. There is a likelihood that the scope and cost of blackstart and over frequency arming, currently classified as opex, will change. Transpower is unable to accurately forecast (or control) the scope change or consequential cost changes, and requests that these items be reclassified as pass-through costs.

2. It is likely that Transpower will face costs associated with the introduction of a new retailer indemnity provision in the Consumer Guarantees Act 1993. The proposed legislation would impose uncertain, uncontrollable and potentially material costs. As such, Transpower requests that retailer indemnity payments under the revised Consumer Guarantees Act are treated as recoverable costs.

   This recoverable provision would need to be structured in such a way as to be consistent with the relevant policy objectives.

IM_09 – CPI/FX for major capex projects

We consider that the *ex post* CPI adjustment to major capex allowances should be removed.

The CPI and FX adjustments were included at Transpower's request:

> "…to ensure that Transpower does not bear costs related to cost elements that are largely outside its control. Taken together, the Commission considers that the CPI and foreign exchange adjustments will reduce the incentives that might otherwise arise for Transpower to price the risk of difference (for foreign exchange and inflation forecasts) into its Major capex proposal, or to over-forecast these variables to reduce exposure risk."[3]

In other words, the adjustments were added so that major project allowances would 'automatically' increase if CPI was higher than forecast, or the NZD was weaker than forecast. In theory, this avoids the need to use the amendment process in such circumstances and mitigates any incentive to adopt unduly conservative CPI and FX rate forecasts[4].

In practice, experience has shown that there is no robust and reliable way of calculating CPI adjustments that properly reflect the influence of CPI movements on major projects. The key problem is that it is our suppliers' CPI expectations at a point in time that influence project costs, rather than actual CPI changes over the course of the project. In addition, the methodology cannot properly account for difference between forecast and actual spend profile[5]. Combined, these make adjustment close to arbitrary in practice.

We also note that the Capex IM prescribes the CPI forecasting method we must use for major capex projects in any event. This effectively eliminates the risk of us adopting conservative CPI assumptions. Taken together, these points mean that there is no obvious benefit to retaining the CPI adjustment.

In contrast to the difficulties devising a valid CPI adjustment methodology, we have been able to work with the Commission to develop a workable FX adjustment methodology. We carefully considered whether there was a strong case for removing the "automatic" ex post FX adjustment. While we did identify arguments for and against the FX adjustment, including that the methodology is not perfect[6], we concluded that, unlike the CPI adjustment, it is

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[3] Capex IM reasons paper, paragraph 4.4.10.

[4] Paragraph 4.4.8 of the reasons paper describes the adjustment as only applying if a project exceeds its original (unadjusted) allowance.

[5] We note that both of these problems are likely to be less acute for base capex, which has a less 'lumpy' spend and contracting profile.

[6] For example, the methodology cannot perfectly isolate FX rate movements from other scope changes, and cannot perfectly deal with re-weighting between forecast and actual currencies.

sufficiently robust and serves the intended purpose. We do not therefore propose any change to the FX adjustment at this time.

We do not propose to change the CPI and FX adjustment for base capex. That is because the spend and contracting profile of base capex is less 'lumpy', so we expect that the methodological issues described above will be less material. In addition, there is no alternative process for amending base capex due to FX or CPI rate movements.

IM_10 - IDC capped at 75th percentile WACC

We consider that the 75th percentile WACC cap on IDC should be removed.

Transpower calculates interest during construction (IDC) based on our average cost of debt. The IM only permits this GAAP-compliant approach if the average cost of debt does not exceed our 75th percentile estimate of WACC. This raises a substantive issue that we believe should be addressed, and a procedural issue that will persist if the substantive issue is not addressed.

The substantive issue is that the asymmetric treatment of IDC in the IMs results in Transpower under-recovering its interest costs. This is because, when our average cost of debt falls this automatically flows through to IDC, but when our interest costs rise the IDC rate is capped. This asymmetry cannot be completely eliminated by interest rate hedging.

Procedurally, we have followed an approach to date, in consultation with the Commission, of flowing through a macro-level (not asset by asset) depreciation adjustment to deal with the mismatch between GAAP and IM IDC. We propose to continue this approach.

IM_11 – spend based allowance for base capex (for discussion)

We propose that the Commission sets a base capex allowance relating to forecast expenditure for each year, rather than forecast value of assets to be commissioned each year, i.e. an *expenditure* allowance rather than a *commissioned value* allowance.
We would still prepare forecast MAR figures based on commissioning (i.e. forecast RAB values) and calculate annual MAR wash-ups based on the timing and value of the assets we have commissioned. However the base capex incentive would be based on spend rather than commissioned value (i.e. actual expenditure vs. adjusted expenditure allowance) and the CPI and FX adjustment to the allowance (used above) would be assessed and applied on an expenditure basis.

Like any business, it makes sense for our financial controls and management processes to predominantly operate at an expenditure level rather than a commissioned value level. While we have put in place systems and processes to deal with operating to a commissioned-value allowance for RCP1, these do not replace processes that operate at an expenditure level, because expenditure is still the most important control point. We cannot see any problem with operating the base capex incentive on an expenditure basis.

For base capex projects, expenditure generally flows through to commissioned values over a relatively short time period, so the timing of any incentive for expenditure savings will more or less be matched by the timing of a MAR reduction (and vice versa). We understand that customers should pay for commissioned assets rather than expenditure, and that the MAR should be forecast and washed-up accordingly. The above proposal preserves this approach.

Other matters

When we met to discuss potential IM amendments on 12 March I mentioned potential amendments relating to EV adjustments (to smooth large one off adjustments) and third party contributions. On reflection, we have decided not to propose IM amendments at this stage.

Commission staff have also asked for a description of how Transpower deals with insurance costs and proceeds and contributions from third parties. Appendix A addresses these points.

We would also like to discuss options for managing the contingent cost risk associated with implementation of the Electricity Authority's proposed revision of the transmission pricing methodology. PwC have estimated implementation costs of up to $20m, which would include capex and opex.

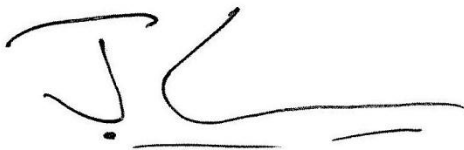
Next steps

I understand that the Commission's intention is to consult on IM amendments early in 2014 and to issue draft and final decisions on a parallel timetable to draft and final RCP2 determinations (May and August 2014 respectively).

I note that this timetable will mean that we will not able to reflect the outcome of the IM change process into our RCP2 proposal. This is not relevant for all of the amendments we have requested, but where an IM change does materially alter assumptions that underpin our proposal we would expect to have the opportunity to address this through the RCP2 proposal.

I will be in touch to discuss the process for consideration of these amendment requests but please contact me if you have immediate queries or comments.

Yours sincerely



Jeremy Cain

APPENDIX A: DESCRIPTION OF CURRENT ACCOUNTING PRACTICES

When we met on 13 March 2013 Commission staff asked Transpower to describe current accounting policy for treatment of (1) insurance costs and proceeds and (2) third party contributions.

1. Treatment of insurance costs and proceeds

Insurance premium costs form part of the opex cap set by the commission.

Where there is an insurance event then there are generally operating costs and/or capital costs associated with repairs or replacements. These *insurance event costs* are absorbed in the opex or base capex allowance (as applicable) with any excess costs funded by the shareholder. *Insurance proceeds* from the event subsequently accrues to the shareholder. This approach makes the insurance event economically neutral for Transpower.

2. Treatment of third party contribution

Transpower can enter into third party contracts (called CICs) with customers where the customer is seeking an enhancement or development to a connection asset. CICs are executed under the benchmark agreement framework provided in Part 12 of the Electricity Industry Participation Code. This provides flexibility in how contracts are structured, but they generally reflect the same revenue outcome as if the asset was being replaced under the IMs. For example, the regulatory WACC is used, tax depreciation benefits are passed to the customer, etc.

On occasion, Transpower undertakes a line deviation agreement (LDA) on behalf of a third party such as a Council, land developer or the NZ Transport Agency. Both the capital costs and any related revenues are excluded from the regulated business.

Contract terms for LDAs are similar to CICs.

IDC

You noted that, if we wished to proceed with our request to change the current IDC rules, then the Commission would want to satisfy itself that Transpower's accounting practices ensured a fair outcome for consumers.

We have briefly described the approach Transpower takes to calculating IDC costs in the amendment request (Appendix B). We would be happy to elaborate if necessary.

APPENDIX B: POPULATED IM AMENDMENT REQEST TEMPLATES

[Separate documents]