Part 4 Determinations: Request for Clarification and/or Amendment

Please complete the table below and email to:

regulation.branch@comcom.govt.nz – Attn: Dane Gunnell

<table>
<tr><td>Transpower reference</td><td colspan="3">IM_09 (CPI/FX for major capex)</td></tr>
<tr><td>Date of request</td><td colspan="3">14 June 2013</td></tr>
<tr><td>Party requesting clarification or amendment</td><td colspan="3">Transpower</td></tr>
<tr><td>Relevant determination (Decision number)</td><td colspan="3">Capex IM – NZCC 2</td></tr>
<tr><td>Clause reference</td><td colspan="3">B4(4)</td></tr>
<tr><td rowspan="7">Description of clarification or amendment sought. If an amendment is proposed, provide the suggested wording of the determination.</td><td colspan="3">Amend clause B4(4) as proposed below to remove the CPI adjustment from the Major Capex Overspend Adjustment equation.</td></tr>
<tr><td colspan="3">adjusted major capex allowance $o + \cancel{p +} q + r$</td></tr>
<tr><td>o</td><td>major capex allowance</td><td>approval in accordance with Part 3 Subpart 3</td></tr>
<tr><td>~~p~~</td><td>~~adjustment correcting for disparity between forecast CPI and actual CPI in respect of o~~</td><td>~~major capex annual information required by an ID determination or a s53ZD notice~~</td></tr>
<tr><td>q</td><td>adjustment correcting for disparity between forecast FX rates and actual FX rates for each relevant foreign currency in respect of o</td><td>major capex annual information required by an ID determination or a s53ZD notice</td></tr>
<tr><td>r</td><td>amount of major capex to which the major capex overspend adjustment does, or does not, apply as the case may be (and therefore being a positive or negative amount).</td><td>major capex annual information required by an ID determination or a s53ZD notice</td></tr>
<tr><td colspan="3">In addition, make the following consequential amendments:

adjusted major capex allowance means major capex allowance adjusted to take account of
(a) any disparity between-
~~(i) forecast CPI and actual CPI; and~~
(ii) forecast FX rates and actual FX rates; and
(b) other amounts which do not apply in respect of the calculation of the major capex overspend adjustment, and its quantum is calculated in accordance with clause B4(4);</td></tr>
<tr><td>Reason why clarification or amendment is required</td><td colspan="3">We consider that the ex post CPI adjustment to major capex allowances should be removed.

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

"…to ensure that Transpower does not bear</td></tr>
</table>

	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."[1] 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[2]. 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[3]. In combination, the adjustment is 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 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[4], we concluded that, unlike the CPI adjustment, it is sufficiently robust and serves the intended purpose. We do not therefore propose any change to the FX adjustment.
Reasons Paper reference (if applicable)	Capex IM reasons paper 4.4.10
Date amendment is required to be made by and why (if applicable)	As soon as practicable.

[1] Capex IM reasons paper, paragraph 4.4.10.

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

[3] 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.

[4] 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.