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Proposed further amendments to input methodologies for Transpower New Zealand Limited

Draft decisions and reasons paper

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1. Introduction

Purpose of paper

1.1 This paper outlines our draft decisions on, and invites submissions on, how we propose to amend the *Transpower Input Methodologies Determination 2010* (**Transpower IM determination**)[1] to:

1.1.1 explicitly allow an economic value account (**EV account**) balance to be carried forward from one regulatory period to the next; and

1.1.2 introduce new price-quality path reconsideration provisions (**reopeners**) for Enhancement and Development (**E&D**) base capital expenditure (**base capex**).

1.2 Our proposed amendments to the Transpower IM determination are relevant to the individual price-quality path (**IPP**) for Transpower New Zealand Limited (**Transpower**) applying from 1 April 2020 (**RCP3**).

1.3 Our proposed amendments to the Transpower IM determination are in addition to the proposed amendments to the Transpower IM determination we published on 29 May 2019.[2]

1.4 This chapter sets out:

1.4.1 the structure of this paper;

1.4.2 the decision-making framework we have applied in reaching our draft decisions;

1.4.3 when the proposed input methodologies (**IM**) amendments are intended to take effect; and

1.4.4 how you can provide your views.

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1 *Transpower Input Methodologies Determination 2010* [2012] NZCC 17, as amended and consolidated as at 10 June 2019, available on our website at: https://comcom.govt.nz/regulated-industries/input-methodologies/transpower-ims.

2 Commerce Commission "Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited: Reasons paper" (29 May 2019); and *[DRAFT] Transpower Input Methodologies Amendments Determination 2019* [2019] NZCC [XX], available on our website at: https://comcom.govt.nz/regulated-industries/input-methodologies/projects/amendments-necessary-to-implement-transpowers-2020-individual-price-quality-path-and-future-price-quality-paths.

Structure of paper

1.5 Chapter 2 of this paper describes our proposed changes to the specification of price provisions of the Transpower IM determination for RCP3 and subsequent regulatory periods, to allow an EV account balance to be carried forward between regulatory periods.

1.6 Chapter 3 of this paper describes our proposed changes to the Transpower IM determination to introduce two new reopeners to amend the price-quality path during the regulatory period to allow for additional allowance for E&D base capex that:

1.6.1 is not included in the expenditure forecasts used to set the IPP;

1.6.2 could not have been reasonably foreseen at the time of setting the price-quality path; or

1.6.3 was foreseen, but the costs and/or timing of the expenditure were uncertain at the time of setting the price-quality path.

1.7 In each chapter we set out:

1.7.1 the current IM requirements;

1.7.2 our proposed IM amendments and why we are proposing these changes; and

1.7.3 how our proposed IM amendments meet our 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 (**the Act**).

1.9 In accordance with sections 52V(1) and 52X of the Act, we published a notice of intention on the proposed Transpower IM amendments set out in this paper on 16 May 2019.[3]

[3] Notice of Intention: Proposal to Consider Amending Input Methodologies for Electricity Distribution Services and Transpower New Zealand Limited (16 May 2019), available on our website at: https://comcom.govt.nz/regulated-industries/input-methodologies/projects/amendments-necessary-to-implement-transpowers-2020-individual-price-quality-path-and-future-price-quality-paths. We also published a Notice of Intention: Proposal to Consider Amending Input Methodologies for Electricity Distribution Services and Transpower New Zealand Limited on 29 May 2019 in relation to the base capex allowance adjustment mechanism. But we are not relying on that Notice of Intention for the purposes of the proposed Transpower IM amendments in this paper.

2015-16 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 it helps provide consistency and transparency in our decisions.

1.11 Consistent with the decision-making framework adopted in our 2015-16 IM Review and in our 2017-18 review of the Transpower Capital Expenditure Input Methodology Determination (**Capex IM**),[4] we have considered each proposed IM amendment by asking the questions:[5]

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).[6]

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 Transpower IM determination is published in the New Zealand *Gazette* in accordance with s 52W of the Act. We are proposing that we would determine these IM amendments together with the proposed Transpower IM amendments that we published on 29 May 2019.[7]

1.14 We propose that the amendments would apply for Transpower's IPP for RCP3.

1.15 In practical terms, the amended IMs will need to be applied in our setting of the RCP3 Transpower IPP determination in November 2019.

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4 *Transpower Capital Expenditure Input Methodology Determination 2012* [2012] NZCC 2, as amended and consolidated as at 1 June 2018, available on our website at: https://comcom.govt.nz/regulated-industries/input-methodologies/transpower-ims.

5 Commerce Commission "Input methodologies review decisions: Framework for the IM review" (20 December 2016), at [66] to [67], available on our website at: https://comcom.govt.nz/regulated-industries/input-methodologies/projects/201516-im-review/final-decisions.

6 Above n 5, at [59].

7 Above n 2.

How you can provide your views

Submissions on this paper

1.16 We welcome your views on the matters raised in this paper and how we are proposing to give effect to our draft decisions by **5pm on Thursday, 1 August 2019**.

Address for submissions

1.17 Responses should be addressed to:

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

1.18 Please include "Proposed Transpower IM amendments No.2" 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

1.19 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.[8] We offer the following guidance:

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

1.19.2 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.

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

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8 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. The request 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.

1.19.4 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.

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

Separate consultation processes for draft decision relating to Transpower's IPP for RCP3

1.21 There is a separate consultation process, with a different timeframe for receiving submissions, in respect of our decision relating to Transpower's IPP for RCP3. The dates for our further draft decisions and our final RCP3 IPP decisions on expenditure, grid output measures and quality standards are set out in Table 1 below.

Table 1 – IPP and IM decisions and consultation timeframes

Publication date	Consultation on draft decisions and on determination of final decisions	Submissions on draft decisions	Cross-submissions on draft decisions
29 May 2019	Draft decisions on Transpower's IPP	Submissions closed 27 June 2019	Cross-submissions closed 11 July 2019
29 May 2019	Draft decisions on Transpower IMs and Capex IM amendments	Submissions closed 5 July 2019	Cross-submissions due 19 July 2019
14 June 2019	Draft IPP determination	Submissions closed 11 July 2019	N/A
12 July 2019	Draft decision on IRIS baseline adjustment term	Submissions due 22 August 2019	Cross-submissions due 5 September 2019
18 July 2019	Draft decisions on further Transpower IM amendments- new reopeners and EV account balance carry forward	Submissions due 1 August 2019	N/A
28 August 2019	Final decisions on Transpower IMs and Capex IM amendments	N/A	N/A
29 August 2019	Final decisions on operating expenditure, capital expenditure, grid output measures and quality standards for RCP3	N/A	N/A

2. Proposal to allow an EV account balance to be carried forward between regulatory periods

Purpose of this chapter

2.1 This chapter describes our proposed changes to the Transpower IM determination to explicitly allow for a balance in the Transpower EV account to be carried forward from one regulatory period to the next.

2.2 Our proposed changes are to Part 3 Subpart 1 (Specification of price) and supporting definitions of the Transpower IM determination.

2.3 This chapter explains:

2.3.1 the current requirements;

2.3.2 our proposed amendments; and

2.3.3 how our proposed amendments are likely to promote the IM amendments framework outcomes set out in paragraph 1.11 above.

Summary of proposed amendments

2.4 We propose amending the Transpower IM determination to explicitly allow an EV account balance to be carried forward from one regulatory period to the next, and for that carried forward balance to be applied in the setting of Transpower's maximum allowable revenue for that next regulatory period.

Current requirements for EV account balances

2.5 Under the Transpower IPP determination for the regulatory period from 1 April 2015 to 31 March 2020 (**RCP2**), the Transpower EV account is a memorandum account maintained by Transpower on an after-tax basis to record each EV account entry not yet returned to or recovered from Transpower's customers through Transpower's allowable revenue.[9]

9 *Transpower Individual Price-Quality Path Determination 2015*, as amended and consolidated as at 28 February 2017, at [7] (definition of 'EV account'), available on our website at: https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-transmission/transpowers-price-quality-path/20152020-transpower-individual-price-quality-path.

2.6 An EV account entry is defined in the Transpower IPP determination for RCP2.[10] The EV account entries that are relevant for RCP3 and future regulatory periods will include:

2.6.1 ex-post economic gains and losses arising from annual price path wash-up of building block revenue calculations, as specified in the Transpower IPP determination applying to each regulatory period;[11, 12]

2.6.2 after-tax economic gains or losses arising from annual incentive calculations under the Capex IM;[13]

2.6.3 an after-tax economic gain or loss arising from a major capex sunk costs adjustment;[14]

2.6.4 after-tax gains or losses on capital expenditure commitments;[15] and

2.6.5 an after-tax economic gain or loss in respect of an instrument that ceases to be an effective hedge, or on a commodity instrument that is not an effective hedge.[16]

2.7 The EV account for RCP2 also records interest calculated on the rolling balance of the account for each disclosure year using the post-tax estimate of interest corresponding to the WACC rate.

2.8 Because EV account entries are recorded in the EV account on an ex-post basis, there is a delay in Transpower being able to recover or return the amount to customers through its price-setting under the transmission pricing methodology (**TPM**).

2.9 In the Transpower IPP determination for RCP2, we refer to the application of the EV account balance in the price path for a later year as an 'EV adjustment'.[17]

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10 Above n 9, at [7] (definition of 'EV account entry').

11 Above n 9, at [7] (definition of 'ex-post economic gain or loss').

12 In RCP3 and later regulatory periods, the price path wash-up calculations will also include wash-ups between forecast operating expenditure incentive amounts and the actual operating expenditure incentive values confirmed during the regulatory period. Those differences will be entered to the EV account during the regulatory period and will be recovered from/returned to customers in setting the revenue for the next regulatory period.

13 The incentive calculations for the base capex expenditure adjustment, the grid output adjustment and the major capex expenditure and output adjustment are specified in the Capex IM (above n 4, at [B1] to [B3]).

14 Major capex sunk costs adjustments are specified in the Capex IM (above n 4, at [3.3.7].

15 Above n 9, at [7] (definition of 'gain or loss on capital expenditure commitments').

16 Above n 9, at [23.1.3(b)] to [23.1.3(c)].

17 Above n 9, at [7] (definition of 'EV adjustment').

2.10 In the first two regulatory periods (RCP1 and RCP2), the price path was updated annually and the EV account balance was progressively cleared by EV adjustments. The procedures for this have been set out in the Transpower IPP determinations for RCP1 and RCP2.

2.11 EV account entries that arose in a following regulatory period, but which related to calculations for the preceding period, have also been specified in the RCP1 and RCP2 Transpower IPP determinations.

2.12 As a result, because combined rolling balances for multiple years of the regulatory periods were not being carried forward into a subsequent regulatory period, and because the Transpower IPP determinations set out the process requirements within each regulatory period for the updating of the price path, we did not consider it necessary to also set out in the Transpower IM determination how the EV account recording and clearing process was to take place.

Our proposed amendments

2.13 We propose amending the Transpower IM determination to explicitly allow an EV account balance to be carried forward from one regulatory period to the next, and for that carried forward balance to be applied in the setting of Transpower's maximum allowable revenue for that next regulatory period.

2.14 In our draft decisions on expenditure and the price-quality path that we published on 29 May 2019, we proposed that EV account entries would not be cleared from the EV account through annual updating of the maximum allowable revenue in the RCP3 price path as soon as possible after the entries arise.[18] This was also set out in our draft Transpower IPP determination for RCP3, which we published on 14 June 2019.[19]

2.15 In those RCP3 IPP draft decisions, we proposed that annual calculations of wash-up gains and losses and of incentive amounts would continue to be calculated annually and would be entries into the EV account during the regulatory period, but the combined balance comprising these entries would be rolled forward from that regulatory period until we next reset the price-quality path. Based on our draft decisions for RCP3, this would be in 2024 for the price-quality path commencing 1 April 2025. The EV account balance at that time would be applied in setting the next price-quality path.

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18 Commerce Commission "Transpower's individual price-quality path from 1 April 2020: Draft decisions and reasons paper" (29 May 2019), at Table 3.1, [69] and Attachment J, available on our website at: https://comcom.govt.nz/__data/assets/pdf_file/0032/149837/Transpowers-individual-price-quality-path-from-1-April-2020-Draft-decisions-and-reasons-paper-29-May-2019.pdf.

19 *[DRAFT] Transpower Individual Price-Quality Path Determination 2020*, at [17.1.10], [27] and Schedule B, available on our website at: https://comcom.govt.nz/__data/assets/pdf_file/0029/153866/DRAFT-Transpower-Individual-Price-Quality-Path-Determination-2020-14-June-2019.PDF.

2.16 The issue raised by this approach is that a balance comprising multiple entries in the EV account would be rolled forward for recovery from or returned to customers in the subsequent regulatory period, but an IM does not currently exist specifying how this balance would be rolled forward in subsequent regulatory periods.

Proposed amendments to the Transpower IM determination

2.17 We propose to amend clause 3.1.1 of the specification of price IMs as follows:

3.1.1 Price

~~For the purpose of s 53M(1)(a) of the Act, the maximum revenues that may be recovered by Transpower will be specified in a s 52P determination as a total revenue cap, net of~~

~~(a) the sum of pass-through costs; and~~

~~(b) the sum of recoverable costs.~~

(1) For the purpose of s 53M(1)(a) of the **Act**, the maximum revenues that may be recovered by **Transpower** for **electricity transmission services** will be specified in an **IPP determination** as a revenue cap, whereby the forecast revenue that **Transpower** uses for setting transmission charges under the **TPM** for each **pricing year** must not, in aggregate, exceed the **forecast SMAR** for that **pricing year** of the **regulatory period**.

(2) For the purpose of setting the 'forecast SMAR' under subclause (1), the **Commission** must specify in the **IPP determination** for each **pricing year** of the **regulatory period**:

(a) the **forecast MAR**; and
(b) the **IPP revenue growth rate**.

(3) For the purpose of setting the 'forecast SMAR' under subclause (1)-

(a) the present value of the aggregated **forecast SMAR** values for a **regulatory period** must equal the present value of the aggregated **forecast MAR** values for that **regulatory period**;
(b) the **IPP revenue growth rate** must be applied when calculating the **forecast SMAR** for each **pricing year** of the **regulatory period** after the first **pricing year**; and
(c) the respective present values in (a) must be calculated using the **WACC**.

(4) For the purpose of subclause (2)(a), the **forecast MAR** for each **pricing year** in a **regulatory period** is as determined by the **Commission** in accordance with the method set out in the **IPP determination** for that **regulatory period** and must include, but is not limited to, application of:

(a) the **WACC**;

(b) **forecast EV adjustments**;

(c) forecast **pass-through costs**; and

(d) forecast **recoverable costs**.

2.18 To support the above proposed amended clause 3.1.1, we are proposing a definition of 'forecast SMAR' which is different to the definition proposed as part of our draft RCP3 Transpower IPP determination.[20] The maximum allowable revenue determined under a smoothed price path would instead be set in accordance with proposed clauses 3.1.1(2) to 3.1.1(4):[21]

forecast SMAR	means, for each **pricing year** in the **regulatory period**, the maximum allowable revenue determined by the **Commission** for that **pricing year**, as set out in an **IPP determination** in accordance with clauses 3.1.1(2) to 3.1.1(4);

2.19 To support this proposed definition of 'forecast SMAR', we are also proposing the following definition of 'forecast MAR' for the purposes of the Transpower IM determination, which again differs from the definition proposed as part of our draft RCP3 Transpower IPP determination:[22]

forecast MAR	means, for each **pricing year** in the **regulatory period**, the forecast maximum allowable revenue building blocks as determined by the **Commission** in accordance with the method set out in an **IPP determination**;

2.20 To support the above proposed calculation of the 'forecast SMAR' for each pricing year under the present value calculation method, we are proposing the following definition of 'IPP revenue growth rate':

IPP revenue growth rate	means the maximum allowable annual percentage growth in **forecast SMAR** for each **pricing year** of the **regulatory period** after the first **pricing year** of the **regulatory period,** as specified in the **IPP determination**;

20 Above n 19, at [7] (definition of 'forecast SMAR').

21 This definition of 'forecast SMAR' for the purposes of the Transpower IM determination links with the application of the definition of 'forecast SMAR' in the draft IPP determination for RCP3 which we published for consultation on 14 June 2019 on our web site: *[DRAFT] Transpower Individual Price-Quality Path Determination 2020.*

22 This definition of 'forecast MAR' for the purposes of the Transpower IM determination links with the application of the definition of 'forecast MAR' in the draft IPP determination for RCP3 which we published for consultation on 14 June 2019 on our web site: *[DRAFT] Transpower Individual Price-Quality Path Determination 2020.*

2.21 To support the above proposed amended clause 3.1.1(4)(b), we propose the following definition of 'forecast EV adjustment':

forecast EV adjustment	means an input to the **forecast MAR** calculation specified in the **IPP determination**, for the purpose of returning to or recovering from **customers** the balance of the **EV account** applying to those **customers** which is available to draw down, where this input to the **forecast MAR** is calculated in accordance with the formula- $\frac{x}{y}$ where- x is the forecast closing post-tax **EV account** balance for the final **disclosure year** of RCP_{t-1} converted to a pre-tax revenue value by the addition of a tax gross-up amount, as specified in the **IPP determination**[23] y is the number of years in RCP_t RCP_{t-1} is the **regulatory period** immediately before the **regulatory period** for which the **forecast MAR** is being calculated RCP_t is the **regulatory period** for which the **forecast MAR** is being calculated[24]

2.22 We also propose bringing various supporting definitions across from the Transpower IPP determination. We consider these defined terms would be more appropriately included for the purposes of all Transpower determinations in the Transpower IM determination. These include the definitions of:

2.22.1 'code':

"has the same meaning as defined in section 5 of the Electricity Industry Act 2010;"

2.22.2 'consumer':

"has the same meaning as defined in section 52C of the **Act**;"

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23 On 29 May 2019, we proposed defining 'EV account' in our Transpower IM determination as 'means a memorandum account maintained by **Transpower** on an after-tax basis to record each **EV account entry** not yet returned to or recovered from **Transpower's customers**, and to record interest calculated on the balance of that account for each **disclosure year** using the post-tax estimate corresponding to **WACC**;'. We propose using this definition for the purposes of the amendments proposed in this paper.

24 In the current instance, RCP_{t-1} is RCP2 and RCP_t is RCP3.

2.22.3 'customer':

"means any generator, distribution business, **consumer**, or other entity in New Zealand that is connected, or applies to be connected, to the **grid**;"

2.22.4 'electricity transmission services':

"has the same meaning as defined in the **Capex IM**;"

2.22.5 'grid':

"has the same meaning as defined in the **Capex IM**;"

2.22.6 'TPM':

"means the transmission pricing methodology applicable to a **pricing year** in a **regulatory period**, as specified in the **code** as amended from time to time;"[25]

2.23 The proposed changes include changing all references to 'Electricity Industry Participation Code' in the Transpower IM determination to the proposed above defined term 'code' and amending clause 3.1.3(4) to:

"(4) In this clause 'Act' and 'Regulations' have the same meaning as defined in s 29 of the Interpretation Act 1999."

How the proposed amendments are likely to promote the IM amendments framework outcomes

2.24 We consider that the proposal to amend the Transpower IM determination to explicitly allow an EV account balance to be carried forward from one regulatory period to the next, and for that carried forward balance to be applied in the setting of Transpower's maximum allowable revenue for that next regulatory period (ie, RCP_t), will promote the Part 4 purpose in s 52A of the Act more effectively than the current specification of price IM and is consistent with s 52R of the Act.

2.25 In particular, our proposed IM changes aim for Transpower to share with consumers the benefits of efficiency gains in the supply of electricity transmission services, including through lower prices over regulatory periods.[26]

2.26 We are proposing for Transpower's future regulatory periods to:

2.26.1 set Transpower's annual revenue cap over the next regulatory period (ie, RCP_t) using a smoothed building blocks approach; and

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25 Above n 9, at [7] (definition of 'TPM').

26 Section 52A(1)(c) of the Act.

2.26.2 smooth Transpower's annual revenue by:

2.26.2.1 forecasting costs, including pass-through costs, recoverable costs, and the closing EV account balance for the current regulatory period (ie, RCP_{t-1}), and building these into the forecast MAR;

2.26.2.2 smoothing the resulting forecast MAR over the next regulatory period (ie, RCP_t) to produce annual forecast smoothed maximum allowable revenue amounts (ie, the forecast SMAR); and

2.26.2.3 washing up any variation, between the forecast SMAR and the actual revenue, and any incentive amounts, into the EV account and accumulating this over the next regulatory period (ie, RCP_t), with the balance to be spread over the subsequent regulatory period (ie, RCP_{t+1}).

2.27 As we expect some variation between the revenue Transpower forecasts and the revenue it actually earns, we have proposed as part of our draft Transpower IPP determination for RCP3 that the difference is calculated annually and is then included in the EV account. We have proposed that other amounts, such as incentive amounts that have not yet been recovered from, or returned to, Transpower's customers are also included within the EV account.[27]

2.28 In the current regulatory period (ie, RCP2), the forecast MAR was updated annually for these revenue wash-up and incentive amounts, and the EV account balance was carried forward (being adjusted at the WACC rate) until the next available pricing year. For future regulatory periods, we are proposing a different approach.

2.29 The building blocks approach to setting Transpower's forecast MAR can produce volatility from year to year, and when transitioning between regulatory periods. This volatility is reflected in the prices Transpower charges its customers.

2.30 Volatility in annual prices can potentially lead to increased difficulty of budgeting for transmission lines charges. Transpower's customers have supported price path smoothing to avoid a large, temporary, change in revenue.[28]

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27 EV account entries that are relevant for RCP3 and future regulatory periods will include those listed at paragraph 2.6 above.

28 Above at n 18, at Attachment J.

2.31 We are proposing that in future regulatory periods we would set Transpower's building blocks-based forecast MAR values and smooth those values into forecast SMAR maximum allowable revenue values. We propose to allocate the resulting annual revenue between pricing years to produce a constant rate of change over the next regulatory period (ie, the resulting annual revenue will be smoothed to give 'forecast SMAR' amounts).

2.32 Differences between the forecast SMAR and the revenue Transpower actually earns would then be washed up annually and included in the EV account.

2.33 Consistent with the smoothing of the forecast MAR, in future regulatory periods we also propose to smooth Transpower's recovery of pass-through costs and recoverable costs by first including forecast values of the pass-through costs and recoverable costs with the forecast MAR building blocks calculation and then also smoothing them across the regulatory period.

2.34 Consistent with the approach of setting an ex-ante expectation of earning WACC, and of providing incentives for meeting quality measures (and penalties for failure to do so) Transpower should be able to recover wash-up and incentive amounts (or required to repay, where it has over-recovered or incurred penalties). However, annual recovery of these amounts would reintroduce volatility to a smoothed price path.

2.35 We therefore propose for recovery (or repayment) of wash-up and incentive amounts to be deferred until the regulatory period after 'RCP_t' (ie, RCP_{t+1}) when the net balance would be recovered. These amounts would be calculated annually during the next regulatory period (ie, RCP_t) and accumulate within Transpower's EV account for later recovery from, or return to, customers in that subsequent regulatory period (ie, RCP_{t+1}).

2.36 As part of our draft Transpower IPP determination for RCP3, we have proposed that the annual value of the EV account would be disclosed so that interested persons could form a view on the likely impact on RCP4 revenues. This would be supplemented by an independent assurance requirement by an auditor to provide interested persons with assurance on those calculations.

2.37 We are currently consulting on a proposed new reopener under the Transpower IMs ('Reconsideration of an individual price-quality path' provisions) to enable Transpower's price-quality path to be reopened in the event that any unexpected material 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 between regulatory periods (ie, from RCP_t to RCP_{t+1}).[29] The effect of the reopener would be that the balance of the EV account is spread over the remaining years of the then-current regulatory period (ie, RCP_t).[30]

2.38 Consistent with our proposed approach of carrying EV account balances to a later regulatory period, we have proposed including the balance in Transpower's EV account at the end of the current regulatory period in the forecast SMAR calculations for the next regulatory period and spreading it over that period, via an estimate of the closing EV account balance for the current regulatory period. We propose that the difference would be washed up and rolled forward within the EV account for later recovery or return.

2.39 Wash-up and incentive amounts are a source of price-quality path volatility, similar to pass-through and recoverable amounts. Recovery of these wash-up and incentive amounts during the next regulatory period would reintroduce a layer of volatility into Transpower's price-quality path.

2.40 However, unlike most pass-through and recoverable amounts, these cannot be forecast in advance and their expected value is neither positive nor negative. However, some fluctuations in annual amounts are expected.

2.41 So long as the balance does not become materially large, we consider that accumulation over the next regulatory period (ie, RCP_t) and recovery of the net balance over the subsequent regulatory period (ie, RCP_{t+1}) is preferable to the potential additional volatility in annual revenue from recovery during the next regulatory period (ie, RCP_t).

2.42 As the EV account would effectively be locked for the next regulatory period, subject only to some of the balance potentially being released under the new contingency price path EV account reopener discussed at paragraph 2.37 above, consideration should be given to any balance remaining at the end of the current regulatory period.

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29 Commerce Commission "Proposed amendments to input methodologies for electricity distributors and Transpower New Zealand Limited: Reasons paper" (29 May 2019), at [3.17].

30 Above n 29, at [3.17] to [3.24].

2.43 There does not appear to be justification for deferring recovery of that EV account balance until the subsequent regulatory period (ie, RCP_{t+1}), for spreading over that regulatory period. This could potentially result in some of the current amount not being recovered until over ten years later.

2.44 As the next price path (RCP3) will be set on or before 30 November 2019, this means it will be set before the actual closing balance of the EV account at the end of the final RCP2 disclosure year (on 30 June 2020) is known to Transpower or us.[31] Under our proposed approach of applying a forecast balance in the setting of the forecast SMAR, Transpower will need to estimate the closing balance for the current regulatory period so we can set the price path for RCP3. Any difference between this forecast and the actual balance will be washed up and rolled forward to the next reset (eg, RCP4) in the EV account.

31 As a practical matter, when applying s 53M(7) and s 53ZC(2)(a) of the Act, in order for the next IPP to apply from 1 April 2020, the next IPP must be reset at least four months before the end of the current IPP regulatory period on 31 March 2020 (ie, it must be reset on or before 30 November 2019).

3. Proposed new reopeners for E&D base capex

Purpose of this chapter

3.1 This chapter describes our draft decision to amend the Transpower IM determination to introduce new reopeners for E&D base capex.

3.2 Our proposed changes are to Part 3 Subpart 7 (Reconsideration of an individual price-quality path) and supporting definitions of the Transpower IM determination.

3.3 This chapter explains:

3.3.1 the current requirements for reconsideration of Transpower's IPP;

3.3.2 our proposed amendments; and

3.3.3 how our proposed amendments are likely to promote the IM amendments framework outcomes set out in paragraph 1.11 above.

Summary of proposed amendments

3.4 We propose amending the Transpower IM determination to introduce new reopeners for Transpower to use to seek additional funding when projects arise in the E&D base capex portfolio that were either:

3.4.1 not reasonably foreseeable at the time of setting the price-quality path; or

3.4.2 foreseeable but the costs and/or timing were uncertain at the time of setting the price-quality path.

Current requirements for reconsideration of Transpower's IPP

3.5 Currently Transpower is able to seek a reconsideration of an IPP within a regulatory period for a range of external factors that are reasonably outside of its control, such as catastrophic events, change events and error events.[32]

3.6 In the 2017-18 Capex IM review, we introduced a base capex allowance adjustment mechanism (**BCAM**) that was intended to account for the inherent uncertainty in the E&D base capex portfolio.

32 Above n 1, at [3.7.3] to [3.7.5].

3.7 However, in its RCP3 IPP proposal Issues Paper submission, Transpower stated that it was unable to satisfy the requirements of the BCAM because it could not find any projects that the BCAM applied to. Transpower noted that:[33]

> We did not find it possible to identify E&D projects with sufficient certainty to a level of detail that would allow the base capex allowance adjustment mechanism to be used.
>
> For near-term projects (2-3 years out), we have sufficient certainty on costs and the triggers have either already been met or we are confident they will be met. This removes the need for the base capex allowance adjustment mechanism.

3.8 We indicated in our draft decision for the IPP for RCP3 that the BCAM "likely needs amending to appropriately balance the risks to consumers and Transpower that the ultimately approved E&D amount is too high or too low".[34] We noted that we intended to publish an amendment to the Capex IM with our proposed amendments to the BCAM.[35]

3.9 However, after further consideration, rather than further modifying the BCAM as a means to address uncertainty in the E&D base capex portfolio, we propose addressing this in a similar way to other events that are outside of Transpower's reasonable control.

Our proposed amendments

3.10 We intend to address the inherent uncertainty of projects in the E&D base capex portfolio to allow funding for those projects:

3.10.1 that had not been approved at the time the IPP is reset; and

3.10.2 that are unforeseeable when the IPP is reset, or that are foreseeable but are unknown in their cost and/or timing.

3.11 Notwithstanding the cost and timing uncertainties, Transpower's RCP3 proposal material has highlighted that most E&D projects are driven by external factors that could reasonably be considered outside of Transpower's control, such as:

3.11.1 new connections that result in significant demand step changes (or possibly demand reductions);

3.11.2 new generation connections (or decommissioning of generation); and

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33 Transpower "Transpower's individual price-quality path for the next regulatory control period: issues paper" (28 February 2019), at 18-19.

34 Above n 18, at [C5].

35 Above n 18, at [C6].

3.11.3 any other existing or potential connected party developments that require interconnected grid transmission network enhancement or development.[36]

3.12 In our RCP3 draft decisions on E&D expenditure, we have proposed to approve a funding amount only for those projects in the E&D portfolio that Transpower is confident are reasonably certain to proceed (**initial E&D approval amount**).[37]

3.13 We propose that after the end of the second disclosure year (ie, second reporting year ended June 30) of a regulatory period, Transpower would have a single opportunity to propose and seek additional funding approval (**additional E&D approval amount**).

3.14 This timing has been chosen because:

3.14.1 it is a defined statutory process date that Transpower can use as a submission reference;

3.14.2 it gives Transpower time to ascertain if the **initial E&D approval amount** is likely to be sufficient over a regulatory control period;

3.14.3 it gives us sufficient time to consider the proposed additional amount and, if approved;

3.14.4 allow this amount to be reflected in Transpower's prices in the penultimate and final years of a regulatory control period once approved.

3.15 Transpower could seek this additional funding in the E&D capex portfolio when:

3.15.1 it is reasonably confident that it will exceed the **initial E&D approval amount** in the final two years of the regulatory control period; and

3.15.2 it can demonstrate that the projects that comprise the **additional E&D approval amount**:

3.15.2.1 are E&D projects (but excluding those E&D projects that are to be funded by the initial E&D approval amount);

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36 Interconnection assets on the transmission grid are defined in the Electricity Industry Participation Code 2010 (EIPC 2010), at Part 12, Subpart 6 and Schedule 12.4, available at: https://www.ea.govt.nz/code-and-compliance/the-code/.

37 Above n 18, at 235-241.

3.15.2.2 are projects that are reasonably outside of Transpower's control such as demand step changes, generation developments (or decommissioning) and any other existing or potential grid connected party development that requires a transmission network enhancement or development;

3.15.2.3 were either unforeseeable when the IPP was reset, or were foreseeable but were unknown in their cost and/or timing; and

3.15.2.4 are comprised of two or more E&D projects that exceed a total project cost threshold of $20 million. The two or more projects may be either or both[38] 'unforeseeable' or 'foreseeable' E&D projects (see paragraph 3.17 below).

3.16 Our proposed amendments for Transpower are similar to those proposed for the Electricity Distribution Businesses (**EDBs**) to account for unforeseeable and foreseeable major connection projects on distribution networks.[39]

3.17 We propose not making any changes to the current BCAM provisions in the Capex IM – as they can continue to provide for an automatic mechanism to allow for additional expenditure allowance where E&D projects or programmes can be specified at the time of the reset (ie, where there is less uncertainty).

Proposed amendments to the Transpower IM determination

3.18 We propose the following clause additions to Part 3 Subpart 7 of the Transpower IM determination:

3.18.1 the insertion of a new clause 3.7.3B as follows:

3.7.3B Enhancement and Development Projects

(1) 'Enhancement and Development Project' means either an **Unforeseeable Enhancement and Development Project** as specified in subsection (2) or a **Foreseeable Enhancement and Development Project** as specified in subsection (3).

(2) 'Unforeseeable Enhancement and Development Project' means a Transpower project that requires a transmission network enhancement or development in the present or future interconnected grid as defined by the **code**, and has a **primary driver** of either:

(a) a step change in demand; or

(b) a generation connection or generation decommissioning; or

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38 For example, the projects that comprise the 'additional E&D approval amount' may be one 'foreseeable' E&D project and two 'unforeseeable' E&D projects, which when taken together exceed a total project cost threshold of $20 million.

39 Above n 29, at [2.35] to [2.62].

(c) any other existing or potential connected party development that requires a transmission network enhancement or development,

where:

(d) expenditure on the project had not been reasonably forecast for the current IPP regulatory period;

(e) it would have been reasonably unforeseeable for Transpower to forecast expenditure on the project for the current IPP regulatory period; and

(f) Transpower can demonstrate that the project is reasonably likely to proceed in the penultimate and final years of the regulatory period.

(3) 'Foreseeable Enhancement and Development Project' means a Transpower project that requires a transmission network enhancement or development in the present or future interconnected grid as defined by the **code**, and has a **primary driver** of either:

(a) a step change in demand; or

(b) a generation connection or generation decommissioning; or

(c) any other existing or potential connected party development that requires a transmission network enhancement or development,

where:

(d) expenditure cost estimates on the project could not have been accurately forecast for the current IPP regulatory period by a prudent transmission operator;

(e) it would have been unreasonable for Transpower to forecast project timing for the current IPP regulatory period; and

(f) Transpower can demonstrate that the project is reasonably likely to proceed in the penultimate and final years of the regulatory period.

3.18.2 the insertion of new sub-clauses (1)(a)(vi) to clause 3.7.4 of the Transpower IM determination as follows:

3.7.4 When price-quality paths may be reconsidered

(1) **Transpower's IPP** may be reconsidered by the **Commission** if-

(a) the **Commission** considers, or **Transpower** applies to the **Commission** and satisfies the **Commission**, that-

(vi) subject to sub-clauses (7) and (8), two or more **Enhancement and Development Projects** are required.

3.18.3 the insertion of new sub-clauses (2)(b)(vi) to clause 3.7.5 of the Transpower IM determination as follows:

3.7.5 Amending price-quality path after reconsideration

(2) The **Commission** must not amend the-

(b) **grid output targets**, **caps**, **collars** and **grid output incentive rates** associated with **revenue-linked grid output measures** to mitigate the effect of-

(vi) the approval of **Enhancement and Development Projects** by the Commission in clause 3.7.4,

as the case may be.

3.18.4 The insertion of a new sub-clauses (7) and (8) to clause 3.7.4 of the Transpower IM determination as follows:

(7) For the purpose of clause 3.7.4(1)(vi), Transpower may only apply once during a **regulatory period** for reconsideration of the **IPP** in respect of **Enhancement and Development Projects**, and that application must be received by the **Commission** no later than the end of the **disclosure year** of the second year of that **regulatory period**.

(8) For the purpose of clause 3.7.4(1)(vi), the total of the **Enhancement and Development Projects** must in aggregate amount to at least $20 million. For the avoidance of doubt, the two or more **Enhancement and Development Projects** may comprise of either or both **'**Unforeseeable Enhancement and Development Projects' in accordance with clause 3.7.3B(2) or 'Foreseeable Enhancement and Development Projects**'** in accordance with clause 3.7.3B(3)**.**

3.19 We propose inserting the following additional definitions to clause 1.1.4(2) of the Transpower IM determination:

Connection asset	has the same meaning as "connection asset" as set out in the transmission pricing methodology which is set out in subpart 4 of Part 12 of the **code**[40];
Enhancement and Development Projects	has the meaning set out in clause 3.7.3B;
Primary driver	means the primary reason for a decision to incur a cost in the year the cost was incurred or forecast to be incurred;

How our proposed amendments are likely to promote the IM amendments framework outcomes

3.20 We consider that the proposed amendments promote the IM amendments framework outcomes because there is considerable uncertainty surrounding E&D expenditure required later in the regulatory control period at the time a proposal is submitted. By allowing Transpower the opportunity to seek additional funding later in the regulatory period:

3.20.1 it reduces the risk to consumers that the E&D expenditure proposal amount is too high, and because base capex is essentially a fungible pool of allowable expenditure, this may lead to inefficiencies across the base capex programme; and

40 As provided at paragraph 2.22.1 above, we are proposing to introduce 'code' as a defined term in the Transpower IM determination.

3.20.2 it reduces the risk to Transpower that the E&D expenditure proposal amount is too low, and because base capex is essentially a fungible pool of allowable expenditure, this may lead to base capex from other projects and programmes being used instead to fund E&D. This will impact on other project and programme deliverability and may increase asset failure risk overall.

3.21 If we were to include a forecast allowance for the unforeseeable E&D projects at the point where we consider an IPP proposal, Transpower may earn excessive profits where these projects do not eventuate. The proposed amendments provide Transpower with an incentive to invest, consistent with the Part 4 purpose.

3.22 The proposed amendments may create additional compliance costs for Transpower and for the Commission, but we consider that these costs are more than offset by the Part 4 benefits. Further the proposed amendments limit when Transpower can make an application for reconsideration to only once and within a set time period (by the end of the disclosure year of the second year of a regulatory period).

3.23 The proposed minimum threshold of $20 million for the new reopeners is consistent with our intention to apply proportionate scrutiny principles.[41] We consider that proportionate scrutiny should guide our evaluation of Transpower's expenditure proposals as well as the setting of IPPs more generally.

41 In broad terms, 'proportionate scrutiny' means that we will apply the level of scrutiny that is commensurate with potential price and quality impacts of forecast expenditures on Transpower's customers and where we consider the benefits of such scrutiny to customers outweigh the associated costs over time. We consider that a $20m minimum threshold for the **additional E&D approval amount** aligns with the Capex IM framework where more focussed and detailed reviews would be carried out for Major Capex Proposals and Listed Projects, including their more extensive consultation requirements.