

TRANSPower NEW ZEALAND LIMITED

Submission to the
Commerce Commission on:
Transpower Process and Recommendation Discussion Paper
Input Methodologies Discussion Paper

August 2009



TRANSPower

Table of Contents

Response to Questions posed in the Input Methodologies Discussion Paper

	Page No.
Chapter 3 Sector specific regulatory provisions	1
Chapter 4 Role of regulatory instruments and input methodologies	2
Chapter 5 Cost allocation between business units	6
Chapter 6 The regulatory asset base	10
Chapter 7 Regulatory taxation	17
Chapter 8 The regulatory cost of capital	20
Chapter 12 Transpower	28

Response to Questions posed in the Transpower Process and Recommendation Discussion Paper	41
--------------------------------------------------------------------------------------------------	----

Chapter 3 – Sector-specific regulatory provisions

Question		Transpower comment
Q.1 Page 47	Do you agree with the Commission's preliminary view of the scope of regulated services provided by Transpower? If not, what services do you consider are regulated under Part 4 of the Act? Please provide the reasons for your view.	Transpower notes that the operating and maintenance costs associated with assets that are subject to new investment contracts are allocated to customers using the transmission pricing methodology contained in Schedule F5 of Section IV of Part f of the Electricity Governance Rules 2003. Consequently, these costs should be regulated under Part 4 of the Act. This point does not appear to have been recognised by the Commission's discussion.
Q.2 Page 51	In your view, should gas distribution and gas transmission services be treated as the same type of service or as separate services in determining input methodologies under Part 4? Please provide the reasons for your view.	No comment
Q.3 Page 52	Do you consider that disconnection and reconnection of consumers in distribution systems are included in the scope of regulated gas pipeline services? Please provide the reasons for your view.	No comment
Q.4 Page 52	Do you agree with the Commission's preliminary view that costs associated with operational meters used in the supply of regulated services should be included in regulating gas pipeline services? If not, please provide the reasons for your view.	No comment
Q.5 Page 53	Do you agree with the Commission's preliminary view that the sale and purchase of balancing gas does not form part of the regulated gas pipeline services? If not, please provide the reasons for your view.	No comment
Q.6 Page 53	Do you agree with the Commission's preliminary view that the administrative task of maintaining the line pack in a gas transmission system the regulated gas pipeline services? If not, please provide the reasons for your view.	No comment
Q.7 Page 54	Do you agree with the Commission's preliminary view on the assumption of responsibility for losses of natural gas? If not, please provide the reasons for your view.	No comment

Chapter 4 – Role of regulatory instruments and input methodologies

Question		Transpower comment
Q.8 Page 68	In your view, in what respects can input methodologies promote certainty? Please provide details.	The clear specification of some input methodologies, such as the cost of capital, can obviously help to promote business certainty. However, it will inevitably be the case that some of the input methodologies will be policies or procedures that will be subject to interpretation, and which may be applied to circumstances that the regulator did not envisage, e.g. the allocation of common costs, processes and rules for determining which costs may be classified as “pass through” costs. In these cases, the methodologies need to establish clear principles and processes, but also to provide sufficient flexibility to enable the unexpected issues that inevitably arise in the real world to be dealt with equitably and pragmatically.
Q.9 Page 68	In your view, what matters ought to be covered in a s 52P determination for information disclosure regulation or price-quality regulation, rather than as part of an input methodology determination? Please provide the reasons for your view.	Transpower agrees with the Commission’s analysis in paragraph 4.31. Rates of change and quality standards in default price-quality paths, in particular, should form part of section 52P determinations, as these are likely to be specific to particular suppliers or particular classes of supplier.
Q.10 Page 70	In your view, are revenues, and the effect on investment decisions, appropriate factors in considering the material effects an input methodology might have on a regulated supplier? If not, what factors do you consider would be appropriate? Please provide the reasons for your view.	Yes. The materiality of the effect of a particular input methodology on revenue should be considered, as this may effect the nature and detail of the decision on the particular methodology, e.g. in Transpower’s case common cost allocation generally does not have a material impact on overall revenue, so a straightforward allocation method (e.g. ACAM) could reasonably be applied. The impact of an input methodology decision on investment and operational incentives should also be considered, e.g. a decision not to permit instantaneous reserves availability costs allocated to Transpower as owner of the HVDC link to be treated as “pass through” costs creates an incentive for Transpower to find ways to limit the availability of the HVDC link and also creates incentives to reduce operating expenditure, including maintenance, to levels that may be economically suboptimal.
Q.11 Page 70	In your view, what is an appropriate level of detail for input methodologies? Please provide the reasons for your view.	Where the methodology is a particular number the answer is clear. Where the methodology specifies a set of principles and processes, these should be sufficiently detailed and clear to enable the methodology to be applied with minimal ambiguity, but also incorporate sufficient flexibility to enable the methodology to be applied to future circumstances that may not have been anticipated when the methodology was created.
Q.12 Page 73	Do you agree with the Commission’s proposed application of building blocks analysis to price-quality regulation? If not, what do you consider to be the alternatives? Please provide the reasons for	The Commission’s proposed application of building blocks analysis to price-quality regulation seems reasonable.

	your view.	
Q.13 Page 74	In your view, in what way is building blocks analysis relevant to information disclosure regulation? Please provide details.	The objective of building blocks analysis is to establish efficient regulated returns for regulated entities. The objective of information disclosure regulation is to provide third parties with the information they need to take action if a firm with potential market power misuses its position. Hence, the two forms of regulation are not necessarily relevant to one another. Information disclosure may, however, further assist the achievement of the objectives of regulation which is already being applied using the building blocks method.
Q.14 Page 76	In your view, in what way can each of the matters in s 52T(1)(a) and (b) contribute to promoting objectives (a)-(d) in the s 52A purpose statement? Please provide reasons for your view.	<p>If the cost of capital is set too low, incentives to innovate and invest and provide services that reflect consumer demands can be reduced to economically suboptimal levels.</p> <p>The valuation method used can also critically affect incentives to innovate and invest and provide services that reflect customer demands. An example of this in practice was Transpower's experience of the application of the optimised deprival valuation methodology. Under this approach, Transpower faced a high risk that any investment made would be "optimised down", which meant that Transpower would not be able to recover an economic return on that investment. This produced a strong disincentive to invest. Transpower's current use of depreciated historical cost as its valuation method produces a cash flow profile that helps enable efficient investment and the provision of services at a level that reflects customer preferences.</p> <p>The treatment of taxation can also have an important effect on cash flow profiles, and hence can either encourage or discourage economically efficient investment, innovation and the provision of services that reflect customer preferences.</p> <p>For transmission, the pricing methodology should enable regulated revenues to be recovered in a way that does not distort the consumption decisions of transmission customers. This is particularly important given that most transmission assets are sunk. The methodology may also help to provide locational incentives for load and generation which supplement those provided by nodal pricing and the grid investment test in the Electricity Governance Rules (EGRs). The transmission pricing methodology contained in Scheduled F5 to Section IV of Part F of the EGRs generally achieves these objectives.</p>
Q.15 Page 81	In your view, how might the matters in s 52T(1) apply to information disclosure regulation and default / customised price-quality regulation? Please provide details.	No comment.
Q.16 Page 81	In what way do you consider might default price-quality paths and customised price-quality paths interact? What	No comment.

	<p>implications might this interaction have for how input methodologies are determined? How might efficiency sharing mechanisms between regulatory periods be implemented under default price/quality regulation? Please provide details.</p>	
<p>Q.17 Page 86</p>	<p>Do you consider the criteria listed at paragraph 4.99-4.100 to be appropriate for defining eligible pass-through costs? If not, what criteria do you think are appropriate? Please provide the reasons for your view.</p>	<p>Materiality is another factor that should be considered, and, for this reason the criterion “defined and approved as a pass-through cost by the regulator before the start of the regulatory period, or before information disclosure requirements are set” should be deleted from the list of criteria. An example of why this is appropriate would be the instantaneous reserves availability costs that Transpower is allocated by rule 11.5.1 of Section IV of Part C of the Electricity Governance Rules. These costs are outside Transpower’s control, being driven primarily by generator offer behaviour in the energy and reserves markets. Prior to reaching agreement with the Commerce Commission on an administrative settlement, the terms of which are now incorporated into the Commerce Act (Transpower Thresholds) Notice 2008, these costs were not material relative to Transpower’s overall operating expenditure. However, subsequently they became material because of the confluence of an extraordinary set of circumstances. In circumstances such as this, it would be reasonable for the regulator to have the ability to reconsider the definition and approval of a cost as a “pass through” cost.</p>
<p>Q.18 Page 86</p>	<p>In your view, what percentage of pass-through costs could be allowed to strengthen the incentives to minimise the costs? Do you consider this should vary depending on the extent to which it is within the control of the regulated supplier and are there any costs that should be fully passed-through? Please provide the reasons for your view.</p>	<p>Costs which are entirely outside the control of the regulated entity should be able to be passed through 100 per cent. A 100 per cent pass through of costs should also be permitted if the regulated business could potentially partially control the costs concerned, but only by acting in a way which would be inconsistent with the service preferences of its customers (so creating an incentive to reduce the costs would be inconsistent with the purpose statement in section 52A(1)(c) of the Commerce Act 1986). A 100 per cent pass through should also be permitted if not permitting such a pass through would create an incentive to reduce other costs in a way that would result in an economically suboptimal provision of services to customers (i.e. inconsistent with the purpose statement in section 52A(1)(c) of the Commerce Act 1986).</p>
<p>Q.19 Page 86</p>	<p>Do you agree with the Commission’s preliminary view that pass-through costs should be applied symmetrically? If not, please provide the reasons for your view.</p>	<p>Yes, unexpected windfall gains should also be passed through if they are genuine windfalls due to extraordinary events outside the control of the company and not just cyclical events such as exchange rate movements.</p>
<p>Q.20 Page 87</p>	<p>Do you agree with the Commission’s preliminary view that different pass through costs may be appropriate for default</p>	<p>Yes, for customised and individual price-quality paths businesses should be able to identify costs that are outside their control as part of the building blocks methodology, and have these costs defined as “pass</p>

	price-quality paths, as compared to customised price-quality paths? If not, please provide the reasons for your view.	through” costs. The costs of implementing new regulations that could not reasonably have been anticipated should be able to be defined as “pass through” costs.
Q.21 Page 88	In your view, are there any other approaches than those at paragraph 4.117 that the Commission should consider for defining circumstances under which a price quality path may be re-opened? Please provide details.	No. Transpower believes that the better approach is to define the characteristics that such an event must have in order to qualify as a price-quality path re-opener. The sort of characteristics that could be identified are discussed in the responses to questions 17 and 18 above and in Transpower’s response to the Commission’s questions set out in Chapter 12.
Q.22 Page 88	Do you consider the Commission should define specific events or criteria that such an event must have? Please provide details.	The criteria that such an event should satisfy should be defined. The sort of criteria that could be applied are discussed in the responses to questions 17 and 18 above and in response to the questions set out in Chapter 12.
Q.23 Page 89	What criteria do you consider would be appropriate to define what would warrant re-opening of a price-quality path? Please provide details.	The Commission’s proposed criteria are appropriate. Other criteria that could be included are the materiality of the costs involved relative to the business’s total costs or total operating or capital costs, the possible health and safety implications of not defining particular costs as “pass through” costs (and the incentives that may result from this decision), and the extent to which a decision not to define and approve a cost as a “pass through” cost may result in the incentives being created for the regulated business which are not consistent with the purpose statement in section 52A of the Commerce Act 1986.
Q.24 Page 90	Do you consider a materiality threshold to be important for re-openers? Please provide details.	Yes, a materiality threshold or thresholds should be set for re-openers based on relevant overseas experience. In Transpower’s view, the AER threshold of 1 per cent of annual revenue per event would be a reasonable starting point.
Q.25 Page 90	In your view, how might an appropriate materiality threshold be set? Please provide details.	The threshold for re-openers should initially be based on overseas experience in comparable jurisdictions. In Transpower’s view, the AER threshold of 1 per cent of annual revenue per event would be a reasonable starting point.
Q.26 Page 91	Do you consider that there are any changes in circumstances that would warrant the re-opening of a default price-quality path? If so, please provide reasons the reasons for your view.	Changes in the costs associated with implementing new regulations may justify re-opening a price-quality path as these are clearly outside the control of the regulated business and impossible to foresee.

Chapter 5 – Cost allocation between business units		
Question	Transpower comment	
<p>Q.27 Page 99</p> <p>Do parties agree with the Commission's interpretation of the sharing of efficiency gains as discussed above?</p>	<p>No. Transpower agrees with the view expressed by Vector and Mighty River Power that Parliament intended that only the benefits of efficiency gains in the regulated business should be shared with consumers (section 52A(1)(c) of the Commerce Act refers). Allocating the incremental costs of an unregulated business unit to that business unit ensures that there is no cross subsidisation. In order to maintain comparability between regulated businesses it is important that all costs that are causally related to regulated services be allocated to the regulated business units. Allocating some of these costs to unregulated business units (as the Commission seems to be suggesting) would undermine comparability between regulated businesses, particularly between those that have associated unregulated business units and those that do not, and introduce an unnecessary element of judgment and subjectivity.</p> <p>Transpower does not agree with the Commission's interpretation of section 52T(1)(a)(iii) of the Commerce Act. This section requires the Commission to establish a methodology for evaluating or determining the allocation of common costs, including between activities, businesses, etc. This requirement does not preclude the Commission from establishing an allocation methodology, such as the avoidable cost allocation methodology (ACAM, i.e. SAC/IC), which allocates incremental costs only to incremental business units. Such an allocation methodology is a methodology for allocating common costs between activities, business, etc, and thus meets the requirements of section 52T(1)(a)(iii).</p>	
<p>Q.28 Page 100</p> <p>Do parties agree with the desirable properties of a cost allocation methodology that have been listed by the Commission? Do parties consider that there are any other desirable properties that the cost allocation methodology should have? Are there any properties outlined above that parties think are unnecessary? If so, please explain why?</p>	<p>The objective relating to identifying and preventing cost shifting between regulated and unregulated business units (third bullet point) aims to identify the extent to which costs are allocated between regulated and unregulated business units in a way that does not reflect causality. As this aim appears to be already covered by the first objective ("promote the allocation of costs between regulated and unregulated business units on a causal basis, to the extent practicable") Transpower recommends that the third objective be deleted as redundant.</p> <p>Transpower recommends that a further objective be added, consistent with the Government Policy Statement on Electricity Governance (s.7(c)), viz.:</p> <p>"ensure that the treatment of common costs provides regulated firms with the confidence that their regulated business units will not be disadvantaged if they invest in other services".</p>	
<p>Q.29 Page 126</p> <p>Do parties agree that the application of FDC/FAC/ABC methods for each business unit, which</p>	<p>No, this is not necessarily the case. The Commission acknowledges that the FDC, FAC and ABC allocation methods are somewhat arbitrary and subjective. Because</p>	

	<p>will all form part of the common cost allocation input methodology, will reduce the problem of double counting of common costs across regulated business units? If so why, or why not?</p>	<p>of this, their use can produce a higher risk of double counting than the ACAM (i.e. SAC/IC method), which is generally clearer, provided that SAC are properly accounted for. Of course, this will only be true provided that SAC are only allocated to one business unit.</p>
<p>Q.30 Page 126</p>	<p>Do parties consider there are any alternative approaches to FDC/FAC/ABC that could be used in practice that would limit the level of any double counting of common costs between business units? If so, please provide a detailed account of these methodologies.</p>	<p>The ACAM (i.e. SAC/IC) method should avoid the potential double counting of common costs, provided the SAC are allocated to one business unit only and costs are properly accounted for. If there are more than two business units, there is a risk that some IC may be double counted, but this can also be avoided by ensuring that any particular IC is allocated to only one business unit, or if split between more than one business unit, that the total IC allocated does not exceed the total value of the IC.</p>
<p>Q.31 Page 126</p>	<p>Do parties consider that there might be other instances where common costs might be material, but where sharing such costs would result in corresponding benefits to the consumers of the regulated service?</p>	<p>No.</p>
<p>Q.32 Page 126</p>	<p>What types of common costs do parties consider are likely to be material and immaterial? What types of infrastructure or investments do parties consider are more likely to have material economies of scope associated with its supply?</p>	<p>Infrastructure such as buildings, facilities and IT corporate costs are most likely to have "material" economies of scope associated with supply (in terms of absolute values, rather than necessarily as a proportion of total revenue or RAB).</p> <p>For network companies, such as Transpower, the provision of fibre optic cables could create economies of scope.</p> <p>However, Transpower believes that, for electricity transmission (and probably also distribution) ACAM (i.e. SAC/IC) will always be the preferred allocation method for the reasons set out in response to question 34 below. Consequently, materiality should not be an issue in practice.</p>
<p>Q.33 Page 126</p>	<p>Do parties have any views on the criteria that could be specified in order to assess whether common costs or economies of scope achieved are material or immaterial? For example, in assessing common costs should materiality be based on the absolute or relative amount of the common cost of the firm, and could the level of common costs as a percentage of revenues or direct costs be used?</p>	<p>If materiality thresholds are needed (and Transpower's view is that ACAM should apply to electricity transmission and therefore they are not), such thresholds should be based on the value of the cost or the scope economy relative to the value of the firm's asset base, or the total value of the cost relative to the value of the relevant category of expenses.</p>
<p>Q.34 Page 126</p>	<p>How should the apportionment of common costs associated with the supply of regulated and unregulated services be allocated to the regulated</p>	<p>ACAM (i.e. SAC/IC) should be used to apportion the common costs associated with the supply of regulated and unregulated services, with the full SAC allocated to the regulated business unit. Economies of scope that result from the joint provision of a regulated and an unregulated</p>

	<p>service? Do parties have any views on a maximum or minimum amount that should be apportioned? If so, please provide reasons for your view.</p>	<p>service are not the result of improvements in the efficiency of the provision of the regulated service. If such cost savings were used to justify a reduction in the returns permitted to be recovered from the regulated business unit, relative to what would be permitted if the regulated business unit were operated as a standalone entity, this would be inconsistent with the GPS provision that requires regulatory control to seek to provide regulated firms with the confidence that their business units will not be disadvantaged if they invest in the provision of other services (section 7(c) of the GPS). Such an approach would also be clearly inconsistent with section 52A(1)(c) of the Commerce Act, which requires that one of the purposes of Part 4 of the Act is to share with consumers the benefits of efficiency gains in the supply of the <u>regulated</u> goods or services – i.e. not efficiency gains that have been derived from the joint supply of unregulated goods and services. There is also a risk that such an approach would unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services, which would be directly contrary to section 52T(3) of the Act.</p> <p>The use of ACAM (i.e. SAC/IC) with SAC allocated to the regulated business unit also preserves the ability of the regulator to compare the performance of regulated businesses consistently and monitor business performance over time, because it establishes a “level playing field” between firms that have unregulated business units and those that do not (i.e. where a firm has a regulated business only, clearly the firm must bear the full SAC of that business). The FDC, FAC and ABC necessarily reduce comparability by reducing the allocation of common costs to the regulated business unit below SAC. These methods also reduce comparability because they are somewhat arbitrary and subjective and consequently tend to obfuscate firms’ cost drivers.</p> <p>For electricity transmission and distribution businesses ACAM (i.e. SAC/IC allocation) also has the theoretical advantage of being closely aligned with Ramsey/Boiteux pricing principles. As electricity is generally observed to have a very low price elasticity of demand, allocating a high proportion of common costs to the electricity transmission or distribution business unit should tend to minimise overall distortions to consumption and hence minimise deadweight losses to the economy as a whole.</p>
<p>Q.35 Page 126</p>	<p>What types of materiality thresholds do parties consider are required to implement the cost allocation methodology?</p>	<p>As Transpower believes that the ACAM (i.e. SAC/IC) approach is the best allocation method for electricity transmission (and probably also electricity distribution), no materiality thresholds are needed in practice.</p>
<p>Q.36 Page 126</p>	<p>What magnitude of materiality threshold do parties consider to be appropriate in the current case?</p>	<p>Not applicable – see response to question 35.</p>
<p>Q.37 Page 126</p>	<p>Should the Commission consider other approaches than one based on materiality to exclude</p>	<p>For the reasons set out in response to question 34, Transpower believes that ACAM (i.e. SAC/IC) should be the allocation methodology applied to electricity</p>

	certain business units from a FDC/FAC/ABC approach?	transmission, and probably also electricity distribution.
Q.38 Page 128	When considering the trade-off between the consistent application of the cost allocation input methodology, and the additional compliance costs associated with the imposition of more detailed prescription are there any other key considerations that parties consider the Commission should be taking into account?	<p>The Commission should take into account Transpower's view that the approach it is proposing to adopt is inconsistent with section 7(c) of the GPS, inconsistent with section 52A(1)(c) of the Part 4 purpose statement, possibly inconsistent with section 52T(3) of the Act and inconsistent with the objective of preserving the ability of the regulator to compare the performance of regulated businesses consistently and monitor business performance consistently over time, for the reasons set out in response to question 34 above.</p> <p>The Commission should also take into account Transpower's view that its proposed approach would, with respect to electricity transmission, be inconsistent with Ramsey/Boiteux pricing principles. As electricity is generally observed to have a very low price elasticity of demand, allocating a high proportion of common costs to the electricity transmission business unit as is achieved by the ACAM (i.e. SAC/IC) method should tend to minimise overall distortions to consumption and hence minimise deadweight losses to the economy as a whole. The Commission's proposed approach would not achieve this.</p>
Q.39 Page 129	Do parties agree that the reconciliation of regulatory costs to audited statutory costs is likely to be necessary? Do parties have any views on what rules should apply in order to undertake this reconciliation?	Regulatory costs should be aligned to financial statements whenever possible and GAAP rules should be applied to the extent possible. Transpower believes that if the ACAM (i.e. SAC/IC) allocation method is used to allocate common costs there should be no inconsistency between the allocation method and GAAP.
Q.40 Page 129	Can parties think of any specific instances where the economies of scope between the regulated and unregulated business units are likely to be too small to warrant a move to an FDC/FAC/ABC cost allocation methodology?	In Transpower's view the continued use of the ACAM (i.e. SAC/IC) method for allocating common costs is appropriate for electricity transmission and probably also electricity distribution businesses for the reasons set out in response to question 34 above, so this question does not arise for these businesses.
Q.41 Page 130	Do parties agree with the four main ways that the Commission considered asset costs are shared between unregulated services or activities? If not, what other ways has the Commission overlooked?	Yes.
Q.42 Page 132	Should the Commission develop a cost allocation handbook (or handbooks)? If so, what information should be included in a cost allocation handbook?	This is not relevant to Transpower if it retains the ACAM (i.e. SAC/IC) allocation methodology. The discussion in paragraphs 5.193 to 5.204 clearly sets out the problems associated with the arbitrary and imprecise nature of the FDC, FAC and ABC allocation methods.
Q.43 Page 132	Should this handbook form part of an input methodology determination or information disclosure requirements?	Not for Transpower, assuming Transpower retains the ACAM (i.e. SAC/IC) allocation methodology.

Chapter 6 – The regulatory asset base		
Question		Transpower comment
Q.44 Page 136	Are there any other types of asset that you think that the Commission should consider including in the RAB?	Certain intangibles should be included in the regulated asset base (in particular, easements and software). In Transpower's case, the pseudo assets that have been defined by Transpower's administrative settlement with the Commission, to enable regulatory and financial asset values to be reconciled, should continue to exist until they are fully written down. Capitalisation of operating leases should be permitted. There should also be a more explicit definition of working capital.
Q.45 Page 140	Do you agree that these considerations are relevant to the establishment of an initial RAB value that is consistent with s 52A(1)(a) and (d)? If not, please provide reasons for your view.	Yes. For Transpower, see the response to question 185.
Q.46 Page 141	Do you agree that implementation principles and contextual factors should be taken into account by the Commission in setting the initial RAB value? If not, why not?	Yes. For Transpower's situation, see the response to question 185.
Q.47 Page 141	Are there any additional factors that you consider should be relevant to the Commission's decision around how to determine the initial RAB value? If so, please give a few examples.	Transpower's experience of the optimised deprival valuation method was that assets could often be "optimised down" on questionable grounds, which resulted in a sub-economic return being earned on the RAB, and which in turn created a strong incentive not to invest even when investment was economic, contrary to section 52T(3) of the Commerce Act. Please also refer to Transpower's responses to the relevant chapter 12 questions.
Q.48 Page 143	Do you agree that historical costs and replacement costs place an upper and lower limit on valuations that could be consistent with s 52A(1)(a) and (d)?	Not necessarily, as replacement costs may be higher than historical costs. For Transpower's situation, see the responses to the relevant chapter 12 questions.
Q.49 Page 143	Do you agree that GAAP valuations can provide a cost-effective way of implementing regulation?	Yes, for the reasons described by the Commission.
Q.50 Page 145	Do you agree that base valuations should only be updated for revaluation gains (or losses) to the extent that they have been appropriately reflected in pricing over the period? If not, please explain how an alternative treatment could be consistent with s 52A(1)(d).	No comment.
Q.51 Page 147	In your view, do you think that the Commission should take into account contextual factors when determining whether or not	For Transpower's situation, see the response to question 185.

	to implement an historic cost-based approach? If so, please give some examples of the sorts of considerations that you believe to be relevant.	
Q.52 Page 147	Should the scope of efficiency reviews of expenditure prior to regulation be limited during a period in which the asset base is updated using an historic cost based method? If not, why not?	Yes.
Q.53 Page 149	Are there any additional factors that the Commission should consider in relation to the hypothetical new entrant benchmark?	Transpower's experience of the optimised deprival valuation (ODV) method was that it required a great deal of judgment to be used and the application of that judgment could be problematic. In practice, assets were often "optimised down" on questionable grounds, which resulted in a sub-economic return being earned on the RAB, and which in turn created a strong incentive not to invest even when investment was economic, contrary to section 52T(3) of the Commerce Act. The way in which ODV was applied was one of the factors that contributed to a lengthy period of under-investment in the transmission grid.
Q.54 Page 151	Do you agree that the initial RAB value should be consistent with previous valuations the Commission has accepted?	Yes.
Q.55 Page 152	Do you agree that the outcome of a new replacement cost valuation would be uncertain and may be less appropriate under Part 4 than an updated past valuation that was previously accepted by the Commission? If not, please explain why.	Yes.
Q.56 Page 153	Do you agree that easements should be valued at historic costs? If not, what alternative approach could be implemented in a way that was consistent with limiting suppliers from earning excessive profits in future?	<p>Easements should be valued at the actual cost of establishing the easement, including any injurious affection payments and all other costs of establishing the easement, including administrative and legal costs. This is consistent with the relevant terms in the Transpower's administrative settlement with the Commission relating to the definition of specified services, viz.:</p> <p>"For the avoidance of doubt, any easement established upon such land for the purposes of any specified services, together with any injurious affection payments and all other costs of establishing the easement will, upon establishment of the easement, form part of the specified services."</p> <p>The settlement further provides that:</p> <p>"the capital value of those easements and any injurious affection payments is to be valued by independent valuations".</p>
Q.57 Page 156	In your view, are there other options for the appropriate valuation of non-specialised assets that	No.

	the Commission should consider? If so, please explain how an alternative approach would be appropriate under Part 4.	
Q.58 Page 156	Are there any other non-specialised assets other than land that you consider should be valued using opportunity costs? Please give examples.	No.
Q.59 Page 156	Do you have any additional comment on the Commission's proposed treatment of non-specialised assets?	No.
Q.60 Page 157	Do you have any specific additional comment that you would like to make on any of the Commission's analysis of the way in which the initial RAB value should be established? Please provide it in your response to this question.	No. The response to question 185 sets out how Transpower believes its initial RAB value should be established.
Q.61 Page 158	Are these the key factors that the Commission should consider in determining the way in which the RAB should be rolled forward and, in particular, designing the appropriate incentives that suppliers face? If not, what other factors should the Commission consider?	The Commission should consider the impact that the revaluation of assets has on the incentive to maintain an economic level of investment. Transpower's experience of the optimised deprival value method (ODV) was that the ODV rules could often require assets to be "optimised down" or "optimised out", even though the relevant investments were economically well justified at the time they were made. The net result was that the business earned a sub-economic rate of return. This disincentivised further investment and was one factor that led to the current situation, which features an aged and heavily loaded grid that now requires a substantial "ramp up" of capital expenditure. Hence, experience shows that inappropriate downward asset revaluations can produce an outcome inconsistent with section 52T(3) of the Commerce Act.
Q.62 Page 158	Do you agree that the Commission is required to determine the appropriate treatment of revaluations and depreciation for all suppliers of regulated services? If not, please give reasons for your view.	Yes.
Q.63 Page 163	Do you agree that efficiency reviews play a large part in determining the incentives facing regulated suppliers? If not, please provide reasons for your view.	Yes, they are an important component of the incentives facing regulated suppliers.
Q.64 Page 163	Do you agree with the Commission brief summary of the approaches that can be taken to efficiency reviews? If not, please provide reasons for your view.	Yes.
Q.65 Page 165	Are these the appropriate things for the Commission to consider when determining the roll	Yes.

	forward methodology? If not, please provide alternative factors that could be considered.	
Q.66 Page 166	Do you agree that the efficiency review mechanisms inherent in replacement cost valuation methodologies lead to uncertainty for suppliers that is detrimental to the incentives they have to invest? If not, why not?	Yes, Transpower strongly agrees.
Q.67 Page 168	Do you agree that the periodic replacement cost revaluations should not be implemented under Part 4? If not, please provide reasons for your view.	Yes.
Q.68 Page 169	Do you agree that suppliers subject to default price-quality regulation, and that therefore have their prices indexed to CPI inflation, should revalue their assets on the basis of the CPI? If not, please provide reasons for your view.	No comment. As the Commission notes, the constraints that may be imposed by an instrument involving CPI indexation and productivity analysis are unlikely to apply to Transpower.
Q.69 Page 169	Do you agree that it is desirable for interested parties to be able to assess the profitability of suppliers in real terms (i.e., through the use of an historic cost based approach with CPI-indexation)?	No comment.
Q.70 Page 169	Are there any reasons why an un-indexed approach may be preferable for suppliers subject to information disclosure requirements only?	Transparency and minimisation of compliance costs.
Q.71 Page 169	Are there any other factors that the Commission should consider if determining the treatment of revaluations using an historic cost-based approach?	No comment.
Q.72 Page 170	Do you agree that historic cost-based approaches are more cost-effective and transparent than replacement cost based approaches? If not, please provide reasons for your view. 170	Yes.
Q.73 Page 171	Do you agree that the Commission's proposed approach is the best way to ensure that suppliers do not have a perverse incentive to sell land when its opportunity cost valuation rises above that recognised in the RAB? If not, please explain and give details around how an alternative approach may operate.	The Commission's proposed approach may be appropriate for airports. For Transpower, the most pragmatic approach is to treat any gain from land revaluations or sales as income, and refund these gains to customers.

<p>Q.74 Page 171</p>	<p>Do you believe that an efficiency sharing mechanism would be desirable? If so, please give details of how you envisage such a scheme operating.</p>	<p>See response to question 73 above. An efficiency sharing mechanism will not be necessary for Transpower, as any gains from land revaluations or sales will be returned to customers.</p>
<p>Q.75 Page 171</p>	<p>Do you consider that an approach involving periodic opportunity cost revaluations or an alternative price index would be preferable? If so, please give reasons and propose a land price index for consideration (if appropriate).</p>	<p>No comment.</p>
<p>Q.76 Page 172</p>	<p>Are there any other factors relating to the treatment of revaluations that the Commission should consider?</p>	<p>No.</p>
<p>Q.77 Page 175</p>	<p>Do you agree that straight line depreciation should be used under Part 4? If not, why not and what alternative do you suggest? Please give reasons for your view.</p>	<p>Yes – this approach has low compliance costs, is transparent relative to other methods and consistent with GAAP.</p>
<p>Q.78 Page 175</p>	<p>Are there any other issues the Commission should consider when implementing a depreciation approach, and what are their implications?</p>	<p>The degree to which the method chosen affects the alignment, or lack of it, between the regulatory and financial accounts.</p>
<p>Q.79 Page 176</p>	<p>Do you agree with the Commission's proposed approach to recognise the value of assets that are fully depreciated? If not, please explain why it is not necessary under Part 4.</p>	<p>Not for Transpower. This sort of adjustment is unnecessary for Transpower, as the service measures in the service measures in section VI of Part F of the Electricity Governance Rules and in the Benchmark Agreement in schedule F2 to section II of the Rules mean that there is no incentive for Transpower to take fully depreciated assets out of service.</p>
<p>Q.80 Page 177</p>	<p>Do you agree that suppliers should be provided with an incentive to mitigate the risk of asset stranding? If not, please suggest an alternative and how it would better meet the purpose of Part 4.</p>	<p>In Transpower's case, assets that are genuinely stranded should not be included in the RAB, but a return of the remaining capital value of the assets should be permitted by way of accelerated depreciation. This is reasonable, because Transpower's WACC does not incorporate any allowance for the risk of asset stranding. Transpower's administrative settlement with the Commission currently provides for such treatment, viz.:</p> <p>"Transpower is to adjust cash flows (using accelerated depreciation) to achieve a return of capital as asset stranding or impairment becomes apparent. Asset stranding may be handled through the relevant customer account with recovery achieved through an adjustment to the relevant customer account if stranding is not anticipated at the time the revenue requirement is set. Transpower is not to earn a return on capital for stranded or impaired assets."</p> <p>Where partial or total asset stranding may potentially result from an investment that could be made by one of Transpower's customers, either to bypass existing transmission assets or embed transmission-connected</p>

		existing generation within a distribution network, and such a bypass or embedding would result in a reduction in the customer's transmission charges, the transmission pricing methodology contained in Schedule F5 of Section IV of Part F of the Electricity Governance Rules 2003 permits Transpower to grant a customer which could potentially make such an investment a reduction in its transmission charges, referred to as a "prudent discount", provided that to do so would result in a more economic outcome from the perspective of the nation as a whole than permitting the bypass or embedding to proceed.
Q.81 Page 177	Are there any other ways in which suppliers could be compensated for losses associated with asset stranding, realised or potential? Please give details.	No.
Q.82 Page 177	Do you agree with the Commission's preliminary view in relation to the provision of compensation for asset stranding? If not, what are the additional factors that remain to be taken into account when promoting the long term benefit of consumers through the approach to asset stranding?	Yes. The prudent discount arrangement described in response to question 80 above is a way of promoting the long term benefit of consumers by avoiding investments that would result in uneconomic asset strandings (albeit commercially attractive from the perspective of the customer undertaking the investment that would strand the assets).
Q.83 Page 179	Are there any other situations that you think may merit an alternative depreciation schedule? If so, please give your reasons.	No.
Q.84 Page 179	Do you have any views on the best way in which alternative depreciation schedules could be accommodated within an input methodology? If so, please outline in detail the way that this may operate.	No.
Q.85 Page 179	Do you have any other specific additional comments on the Commission's preliminary views on depreciation?	No.
Q.86 Page 180	Do you agree with the Commission's preliminary view on the treatment of works under construction? If not, please provide the reasons for your view.	The Commission's preliminary view is sensible, but may not be consistent with the detail of investment approvals made by the Electricity Commission. Consequently, this issue will need to be considered further as the detail of Transpower's individual price-quality path regulation is developed.
Q.87 Page 186	Do you have any views on the structure of incentives across the various regulatory instruments?	Transpower discusses these issues in relation to relevant questions in chapter 12.
Q.88 Page 187	Do you consider that a roll forward handbook is required? If not, please give reasons.	Yes. However, it should generally not be needed for Transpower because of the individual price-quality path regulation that will apply to it.
Q.89	Do you agree with the likely content of a replacement	No comment.

Page 189	cost handbook?	
Q.90 Page 193	Do you have any specific additional comment on the likely content of an Historic Cost Handbook?	No.
Q.91 Page 193	Are there any parts of a roll forward handbook that you think could be specified as part of an input methodology? If so, please give reasons for your view.	No.

Chapter 7 – Regulatory taxation		
Question		Transpower comment
Q.92 Page 205	Do you agree with the Commission's preliminary view that a tax expense approach is not consistent with suppliers being limited to an expectation of earning a normal return over time? If not, please provide the reasons for your view.	Yes
Q.93 Page 207	Do you have any specific comment on the Commission's discussion of the deferred tax approach? Please provide details.	No
Q.94 Page 210	Do you agree with the Commission's preliminary view that improvement in the overall efficiency of suppliers is more relevant to the long-term benefit of consumers than improvements in tax efficiency? If not, please provide the reasons for your view.	No comment.
Q.95 Page 210	If you believe tax efficiencies should be incentivised, please provide the reasons for your view and explain how this could be achieved and the way in which the approach will benefit consumers in the long-term.	No comment.
Q.96 Page 211	Do you agree with the Commission's preliminary view that tax costs should be allocated to the regulated part of a business using estimates of other cost components? If not, please provide the reasons for your view, an alternative and why you consider this to be consistent with the purpose of Part 4.	Yes.
Q.97 Page 211	Do you agree with the Commission's preliminary view that the assumption about leverage that is used to estimate tax costs should be consistent with the approach used to calculate the WACC? If not, please provide the reasons for your view, an alternative and why you consider this to be consistent with the purpose of Part 4.	Yes.

<p>Q.98 Page 213</p>	<p>Do you agree with the Commission's preliminary view that the tax position of the wider tax group should generally be ignored for the purposes of estimating tax costs? If not, please provide the reasons for your view, an alternative and why you consider this to be consistent with the purpose of Part 4.</p>	<p>Yes.</p>
<p>Q.99 Page 214</p>	<p>Do you agree with the Commission's preliminary view that a 'levered' tax estimate should correspond to a 'vanilla WACC' as described above? If not, please provide the reasons for your view.</p>	<p>Yes.</p>
<p>Q.100 Page 214</p>	<p>Do you agree with the Commission's preliminary view that presenting tax as a building block in its own right is the most transparent approach to presenting tax costs? If not, please provide the reasons for your view.</p>	<p>Yes.</p>
<p>Q.101 Page 216</p>	<p>Do you agree with the Commission's preliminary view that tax costs should be estimated using an assumed level of leverage? If not, please provide the reasons for your view.</p>	<p>In Transpower's view, tax should be a pass through taking into account the interest tax shield. Consequently, there would be no requirement for a leverage estimate.</p>
<p>Q.102 Page 218</p>	<p>Do you agree with the Commission's preliminary view that suppliers should be compensated for tax depreciation claw-back? If not, please provide the reasons for your view, an alternative, and why you consider this to be consistent with the purpose of Part 4.</p>	<p>Yes.</p>
<p>Q.103 Page 219</p>	<p>Do you agree with the Commission's proposed approach to provide compensation for the effects of tax depreciation clawback? If not, please provide the reasons for your view, an alternative, and why you consider this better meets the purpose of Part 4.</p>	<p>Yes.</p>
<p>Q.104 Page 221</p>	<p>Do you have any views on the appropriate treatment of the effects of tax depreciation claw-back during the regulatory period? If so, please provide details.</p>	<p>No comment.</p>

<p>Q.105 Page 222</p>	<p>Do you agree with the Commission's preliminary view that there should be no tax wash up at the end of a period of price-quality regulation? If not, please provide the reasons for your view.</p>	<p>If an adjustment mechanism is provided to ensure that attributable tax liabilities are passed through during the current regulatory control period then there will be no need for a wash up. If, however, there is an <i>ex ante</i> regulatory allowance for tax, there should be a wash up at the end of the regulatory period to adjust for any differences between the allowance and actual tax liabilities. This is because taxation is largely outside the control of the regulated business. Moreover, a direct incentive to minimise tax may create other perverse or undesirable incentives.</p>
<p>Q.106 Page 222</p>	<p>Do you agree with the Commission's preliminary view that the tax payable approach should be adopted under Part 4? If not, please provide the reasons for your view.</p>	<p>Yes.</p>
<p>Q.107 Page 223</p>	<p>Do you have any other specific additional comment on the Commission's proposed treatment of taxation? If so, please provide details.</p>	<p>No.</p>

Chapter 8 – The regulatory cost of capital		
Question		Transpower comment
Q.108 Page 226	Do you agree with the Commission's preliminary view that the framework set out in the generic Cost of Capital Guidelines should be adopted as the basis for its assessment of the appropriate cost of capital for input methodologies? If not, please provide the reasons for your view.	<p>Transpower agrees that the broad framework set out in the Guidelines, i.e. the use of the CAPM model, is appropriate at a high level. However, Transpower does not believe the Guidelines provide sufficient certainty in all areas and so does not necessarily endorse all of the detail in the June 2009 revised draft Guidelines.</p> <p>These issues are further elaborated in the answers to other specific questions.</p>
Q.109 Page 230	Do you agree with the Commission's preliminary view that a 'vanilla' WACC approach should be adopted in light of tax being included as a separate cost item? If not, please provide the reasons for your view.	Transpower would be comfortable with the move to a "vanilla" WACC.
Q.110 Page 230	Do you consider that it is better to apply a nominal WACC to an indexed RAB and then account for revaluation gains through the cash flows, or to simply apply a real WACC? Please provide reasons for your view, and specific details where applicable.	Transpower notes that, under the Commission's proposals set out Chapter 12, Transpower's RAB would continue to be rolled forward according to DHC and, accordingly, it would not be indexed. Transpower supports the Commission's view that, under such circumstances, it is appropriate to set a nominal cost of capital for Transpower.
Q.111 Page 230	Do you agree with the Commission's preliminary view that an industry-wide cost of capital is appropriate for regulated suppliers in a multi-firm sector? If not, please provide the reasons for your view and details of any alternative approaches that you propose.	<p>The Commission has noted that Transpower is an example of an industry where there is only one firm. This implies that Transpower may have its own particular risk characteristics and capital expenditure profile.</p> <p>Transpower agrees and it would seem more appropriate that a transmission industry specific cost of capital be determined using Transpower's actual leverage and a transmission-specific equity beta.</p>
Q.112 Page 231	Do you agree with the Commission's preliminary view that a single notional leverage assumption should be applied to all regulated suppliers in an industry? If not, please provide the reasons for your view and details of any alternative approaches.	Transpower agrees with the Commission's view, set out in paragraph 8.36, that for a single firm industry (such as electricity transmission) it would be relatively straightforward to adopt the actual leverage of the firm (i.e. the forecast average leverage for the regulatory period), provided it is satisfying reasonable credit rating assumptions.
Q.113 Page 234	Do you agree with the Commission's preliminary view that a parameter estimate for the MRP of 7 per cent is appropriate to apply to regulated suppliers in each of the relevant industries in light of the current market situation? If not, please provide the reasons for your view and details of robust evidence supporting any different estimates.	<p>In view of the asymmetric risk of under investment if the MRP is set too low, the Commission should review further the changed market circumstances on the basis of current investor perceptions to confirm (or revise) its view of the transitory effects of the recent financial market turmoil.</p> <p>Transpower considers that in arriving at a view that a MRP of 7% is appropriate, the Commission has given too much weight to historical data and may not have adequately taken into account the forward looking nature of the CAPM model. The global financial crisis has fundamentally</p>

		<p>changed investors perceptions of risk and reward and indications are that investors are seeking higher returns than in the past.</p> <p>As an example of the approach of other regulators, the AER, in its recent WACC review decision, explicitly added 0.5% to the historical MRP for this reason.</p>
<p>Q.114 Page 193</p>	<p>Do you agree with the Commission's preliminary view that in practice it could adopt the same equity beta assumption for electricity distribution and gas pipeline services which are subject to price-quality regulation? If not, please provide the reasons for your view and evidence supporting why different estimates should be used.</p>	<p>Transpower considers that it is appropriate to set an industry-wide equity beta for regulated suppliers in a multi-firm industry sector if they are subject to the same regulatory framework.</p>
<p>Q.115 Page 236</p>	<p>Given the different asset betas that have been associated with different regulatory regimes, do you consider there is scope for applying different asset betas for the default price-quality path and customised price-quality path, to the extent that the power of the incentive regime differs? Please provide the reasons for your view and evidence supporting why different estimates should or should not be used.</p>	<p>In theory at least, the default price path is a less intrusive form of regulation and thus could be considered to have "high powered" incentives and thus should attract a higher asset beta.</p> <p>However, this is complicated by the availability of two different regulatory options for regulated businesses.</p> <p>As they have a free option to choose between the default and customised price paths, it is likely that only those businesses which perceive they will "lose" under the default price path will chose the customised price path option. It is thus idiosyncratic that those businesses should be further penalised by a lower asset beta and thus lower returns to investors.</p>
<p>Q.116 Page 237</p>	<p>Do you agree with the Commission's preliminary view of adopting an investor tax rate equal to the corporate tax rate of 30%? If not, please provide the reasons for your view and reasons for why a different estimate should be used.</p>	<p>Transpower agrees with the Commission's preliminary view that it should assume that the investor tax rate is equivalent to the corporate tax rate, which is 30%. As the Commission notes, whilst this figure would not reflect the true position for all investors in companies regulated under Part 4, the impact of any difference is likely to be relatively small.</p>
<p>Q.117 Page 238</p>	<p>Do you agree with the Commission's preliminary view that a debt issue cost annual allowance should be specified for inclusion in operating expenditures? If not, please provide the reasons for your view and details of any alternative approach.</p>	<p>Transpower notes that the Commission has recognised debt issuance costs as a legitimate expense that needs to be remunerated. Transpower concurs with this approach and suggests that the Commission base its detailed assessment in this area on a typical bond issue amount (e.g. \$100million) and estimate the components of debt issuance costs based on actual industry data, including:</p> <ul style="list-style-type: none"> • underwriting fees • legal and roadshow costs • company credit ratings • issue credit rating • registry fees • cost of establishing and maintaining standbys (the largest cost of capital market fees excluded from debt margins) for liquidity.

<p>Q.118 Page 240</p>	<p>Do you have any suggestions for how a reserve fund that <i>ex ante</i> accounts for Type I risks could be implemented in practice?</p>	<p>Accounting standards generally prohibit a provision being raised in a firm's accounts where there is no present obligation, no probable outflow of resources and no reliable estimate of the amount of the obligation.</p> <p>Thus, it would be difficult to recognise low probability self insurance events as formal balance sheet reserves unless there were some statutory backing to do so. A funded reserve would be even more problematic.</p> <p>To some extent, self insurance risks are no different to other risks faced by businesses in an incentive based regulatory scheme, i.e. shareholders will face varying returns over a period and they do not explicitly "reserve" profit greater than that allowed by the regulator to offset against lower returns in other periods.</p> <p>If the Commission is concerned about businesses having sufficient funds to meet a low probability, high cost event, a suitable mix would be to allow self insurance premiums as an operating expense up to a specified value of event and allow either a reopener or <i>ex post</i> adjustment for expenditure above this value if it occurs.</p>
<p>Q.119 Page 240</p>	<p>Do you agree that in practice any unsystematic or asymmetric risks could be addressed by selecting a WACC that is above the mid-point range?</p>	<p>Theoretically, such an approach is not valid as it assumes that the WACC mid-point is the mid-point of a normal distribution for which standard errors have been empirically determined. Given that this is not the case for some of the ranges which have been suggested for the various WACC parameters this assumption is not valid.</p> <p>The preferred approach would be to consider unsystematic or asymmetric risks in the determination of both the range and preferred value for each individual WACC component.</p> <p>In practice, the final result may well be an above mid-point WACC, but consideration at the component level will enable the Commission to demonstrate it has considered these risks explicitly and systematically, rather than applying a final judgment on what might be an erroneous statistical basis.</p>
<p>Q.120 Page 255</p>	<p>Do you consider that any of the parameters relevant to the Commission's proposed approach to the cost of capital input methodologies are materially impacted by the global financial crisis? If so, what evidence is available to support changes in parameter estimates, especially relative to past estimates?</p>	<p>The global financial crisis has fundamentally changed investors perceptions of risk and reward and indicates that they are seeking higher returns than in the past.</p> <p>In view of the asymmetric risk of under investment if the WACC is set too low, the Commission should review further the changed circumstances on the basis of current investor perceptions to confirm (or revise) its view of the transitory effects of the recent financial market turmoil.</p> <p>Specifically, debt margins should reflect current trends rather than any historical averages, as network businesses will be refinancing existing debt and new debt at current debt margins.</p> <p>Similarly, the MRP should not reflect historical levels or any reversion to a mean. In its recent WACC review decision the AER explicitly added 0.5% to the historical</p>

		MRP for precisely this reason.
Q.121 Page 258	Do you agree with the Commission's preliminary view that an approach that specifies some parameters within the input methodology, and sets out the Commission's process for updating the WACC each year is appropriate for input methodologies? In particular, would this approach set out the cost of capital in sufficient detail and balance the need to provide certainty to suppliers, while retaining an appropriate level of flexibility to address current market conditions? If not, please set out your proposed alternative approach and include reasons for your view.	Transpower agrees with this approach, but suggests that the Commission should allow some limited flexibility to vary these parameters on a case by case basis where there is "persuasive evidence" to justify variation from the standard parameters to avoid an overly mechanistic approach. Transpower notes that, in the case of an individual price path as described by the Commission, the target rate of return would be "locked in" for the duration of the regulatory period.
Q.122 Page 258	Do you agree with the Commission's preliminary view that the notional industry-wide leverage assumption, the industry-wide equity beta assumption, the market risk premium and the investor tax rate could be specified in the cost of capital input methodology? If not, please provide the reasons for your view and details of any alternative approach.	<p>Transpower agrees that the MRP and investor tax rate parameters should be specified in the cost of capital input methodology along with "transmission" industry specific parameters based on actual leverage and a transmission-specific equity beta.</p> <p>However, the Commission should consider allowing some limited flexibility to vary these parameters on a case by case basis where there is persuasive evidence to justify variation from the standard parameters.</p>
Q.123 Page 258	Do you agree with the Commission's preliminary view that the risk-free rate and the debt premium should be updated on a periodic basis? If not, please provide the reasons for your view and details of any alternative approach.	<p>Transpower agrees that, in the interests of transparency and predictability, these parameters should be updated on a periodic (e.g. annual) basis.</p> <p>However, Transpower has some more fundamental concerns about the Commission's proposed approach to determining a theoretical cost of debt.</p> <p>Period of Risk Free Rate & Cost of Debt</p> <p>Transpower strongly disagrees with the Commission's proposal to align the period of the risk free rate and thus period of debt to the length of the regulatory control period. While this approach may be theoretically correct under the CAPM approach, it is an example of finance theory colliding with market realities.</p> <p>In theory, the CAPM approach, as proposed by the Commission would see that entity refinancing its entire debt portfolio at the time of each regulatory determination for a period equal to the regulatory control period. In this way the entity would minimise any interest rate exposure risk by aligning its cost of debt with the cost of debt allowed by the Commission in its WACC.</p> <p>In practice, treasury managers in businesses with substantial debt and long life assets, such as Transpower, seek to have a debt portfolio with a longer average term</p>

	<p>than the regulatory period (to reflect the lives of the assets being financed) in order to manage refinancing risk, i.e. the risk of Transpower being unable to renew or replace existing shorter dated facilities when they mature. Refinancing risk is a key concern for both shareholders and credit rating agencies and can even threaten the viability of a business with strong underlying fundamentals. The Commission's proposed approach does not consider or make allowance for refinancing risk.</p> <p>A prudent treasury manager will manage refinancing risk by:</p> <ul style="list-style-type: none"> • having longer term debt that reflects the lives of the assets being financed, while balancing the higher cost of longer dated debt; and • having a range of different instruments and maturities to avoid any "cliff edge" maturity issues. <p>As the Commission notes, interest rate risk can be managed separately from the debt duration by the use of interest rate swaps of varying durations as a hedge over the regulatory period. However, the Commission's proposal does not take into account that:</p> <ul style="list-style-type: none"> • the use of interest rate swaps in this manner incurs an additional cost; and • the credit margin for longer dated debt over shorter dated debt cannot be hedged away and is still incurred by the business. <p>The extent of the use of interest rate swaps will vary from business to business depending on individual tolerance for interest rate risk.</p> <p>As an example of a policy to manage refinancing risk, or liquidity risk, Transpower's finance subsidiary Transpower Finance (which manages Transpower's entire debt portfolio) has adopted the following liquidity risk policy:</p> <p style="padding-left: 40px;"><i>"...committed debt facilities maturing in any 12 month period are not to exceed NZ\$500,000,000. No more than 50% of debt facilities can mature within the next three years and at least 30% of debt facilities must mature after five years.¹"</i></p> <p>The AER, in its May 2009 "Review of the weighted average cost of capital (WACC) parameters" recognised this issue and concluded that:</p> <p style="padding-left: 40px;"><i>"Based on the available evidence the AER acknowledges that a term for the risk-free rate which matches the length of the regulatory</i></p>
--	------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

¹ Transpower Finance, "Director Report 2005", page 16

		<p><i>period may result in a significant shortening of debt on issue by the benchmark efficient regulated energy network business. Despite the strong conceptual arguments for a term matching the length of the regulatory period on the equity side (leaving aside the issue of consistency with estimates of the MRP – discussed at section 6.5.3), the AER considers it is reasonable and appropriate to take a cautious approach on this matter so as to ensure that refinancing risk is not increased for the sector.”</i></p> <p>Transpower contends that a prudent regulated business must take appropriate measures and policies to manage the real risk of refinancing and it is thus inconsistent for the Commission to effectively penalise such a prudent business by aligning the term of the risk free rate, and thus the term of debt, to the regulatory control period.</p> <p>Transpower also contends that allowing a longer term than the regulatory control period for debt will not result in any significant over compensation for the business and will thus not void the NPV = 0 principle, as the apparent overcompensation by use of longer dated debt will be paid by a prudent business as the term premium for the longer dated debt that cannot be hedged away, and is necessary to reduce refinancing risk.</p> <p>Debt Premium</p> <p>In addition to the period of the risk free rate and thus the cost of debt, Transpower has concerns about the Commission’s approach to the debt risk premium. The discussion, in both the WACC Guidelines paper and the Input Methodologies paper, does not make it clear that the Commission intends to use market observations solely as the determinant of the debt premium.</p> <p>The WACC Guidelines paper implies that there are other factors included in the margin between the corporate cost of borrowing and the risk free rate (credit risk and maturity are nominated) and that observed margins over the previous two years are the proposed measure of the debt premium.</p> <p>Similarly, the Input Methodologies paper suggests that “there are times when the risk-free rate and spreads exhibit increased levels of volatility when considered in isolation” and suggests “cross-checking its cost of debt allowance against current observable yields”.</p> <p>Neither proposition gives Transpower the necessary degree of confidence that the Commission will establish a debt premium based on observed current market conditions (as the best indicator of a forward looking allowance) for corporate borrowing of a similar maturity to the risk free rate (ten years) and for a firm with at least an investment grade credit rating.</p>
--	--	---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

		<p>Transpower must raise new debt and refinance existing debt in the commercial debt market and not a theoretical market construct. The Commission's statement in the Input Methodologies paper "that firms with sufficient flexibility in their finances may chose not to go to the market during periods of enhanced volatility" does not reflect the environment in which firms actually operate. To begin with, having "sufficient flexibility" in their finances will come at a considerable cost to a firm (raising debt early, having standby facilities, deferring major capital works etc); a cost not recognised or allowed by the Commission's proposed approach. Second, it leaves the firms that do not have "sufficient flexibility" in the untenable position of raising debt in the real market and being only partially compensated by an inadequate allowance for debt from the Commission based on its views of some theoretical market.</p> <p>Transpower's view is that the debt premium should be based on observed corporate lending data over a short period leading up to the determination for businesses with comparable credit ratings and for relevant maturities.</p> <p>By contrast, the Commission's proposed approach does not provide the necessary certainty and predictability of the debt premium and exposes regulated businesses to risks they cannot manage, to the extent that the Commission deviates from an observed market-based approach and exercises "regulatory judgment" as to the allowed debt premium.</p>
<p>Q.124 Page 261</p>	<p>Do you agree with the Commission's preliminary view that an appropriate balance of flexibility and certainty is retained when estimating the cost of capital in each year, by specifying a point on the range for each industry in advance of any suppliers proposing a customised price-quality path? If not, please set out your proposed alternative approach and include reasons for your view.</p>	<p>Transpower considers that setting a point on the range (i.e. a WACC value) for each industry in advance of a customised / individual price path proposal is superior to the alternative proposed of setting a specific percentile.</p> <p>However, Transpower has concerns that, as individual WACC parameters (those that are not econometrically determined) do not have valid standard errors, the final WACC range would be statistically meaningless.</p>
<p>Q.125 Page 262</p>	<p>Do you agree with the Commission's preliminary view on applying the cost of capital input methodology in practice under the various regulatory instruments? If not, please provide the reasons for your view and details of any alternative approach.</p>	<p>An observation on the Commission's approach to establishing the reasonable rate of return for a regulated entity is that, in general, there is an over reliance on the CAPM as an all encompassing methodology.</p> <p>There is limited empirical data to fully support the CAPM model. Observations from the financial markets should be used to sense check CAPM, particularly in circumstances where financial markets diverge from model predictions. Regulated businesses must operate within the parameters set by real world financial markets.</p> <p>CAPM also has specific deficiencies, such as its non-recognition of refinancing risk, as previously discussed, and these deficiencies should be allowed for and</p>

		<p>compensated by the Commission.</p> <p>In capital markets, businesses may have debt covenants that place specific restrictions on the financial and operating parameters of the firm. In addition, rating agencies may also impose specific requirements, such as a maximum leverage ratio, in order for a business to gain or retain specific credit ratings or risk being put on credit watch or be downgraded. The CAPM theory does not recognise these real world issues.</p> <p>Any application of CAPM must also ensure consistency between the parameters because of their interrelationships, i.e. once a term has been adopted for one parameter, that same term should be adopted for other parameters.</p> <p>For the rate of return to be a forward looking rate of return that is aligned with current conditions in the market for funds, and appropriately recognises the risks faced by regulated businesses, it cannot mechanically apply the CAPM parameters and must be based on current observed market conditions in order to provide both the right degree of certainty and predictability for businesses and minimise their exposure to financing risks that they cannot manage.</p>
--	--	---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

Chapter 12 – Transpower		
Question		Transpower comment
Q.183 Page 357	What other matters do you consider are relevant to the determination of Transpower's individual price-quality path using a building blocks approach? Please provide details.	<p>Transpower acknowledges that the Commission is at an early stage in the process needed to define the future regulatory arrangements for Transpower and has put in place a formal procedure to engage further to define the detail which will build on its preliminary views. It is important that any codification of "rules" in the input methodologies be drafted in a precise way in order to actually deliver what is intended at the level of principle. In addition to the issues raised by Transpower in its submission response, Transpower considers that further thought should be given to the following.</p> <ul style="list-style-type: none"> • the inter-relationship between revenue setting and service performance, including the overlap and working arrangements between the jurisdictions of the Commission and EC; • the process and timing for implementing the proposed transitional arrangement for Transpower, including an agreed process for updating the operating expenditure allowance and the target rate of return on capital for the rollover period, as required; and • the scope and timing of the <i>ex ante</i> and <i>ex post</i> reviews, including information requirements that will need to be provided by Transpower.
Q.184 Page 357	What matters, other than those listed in s 51T(1)(a), do you consider should also be determined within input methodologies? What matters should be determined as part of a s 52P determination? Please provide details.	See question 183 above.
Q.185 Page 364	Do you agree with the Commission's preliminary view of the methodology for valuing Transpower assets for the purposes of determining the initial RAB? If not, what valuation method should be adopted? Please provide the reasons for your view.	<p>Yes. Transpower believes that the continued use of non indexed depreciated historical cost is appropriate for the following reasons:</p> <ul style="list-style-type: none"> • DHC allows Transpower to invest with certainty and facilitates the monitoring of financial and economic performance; • DHC is administratively simple and transparent; • DHC best matches cash flows to the need to fund Transpower's major investments; • DHC reduces Transpower's exposure to the risk of regulatory change over the life of cycle of its assets. <p>For the reasons set out by the Commission in paragraph 12.48, Transpower agrees that the initial value of the RAB under Part 4 of the Act should be based on Transpower's 2006 ODV valuation, along with the inclusion of the five pseudo assets, rolled forward for approved capital additions and depreciation under the settlement agreement.</p>

<p>Q.186 Page 366</p>	<p>In your view, should Transpower be compensated for stranded assets, when the stranding is caused by factors that are outside its control? Please provide the reasons for your view.</p>	<p>Yes. Transpower should be compensated for impaired or stranded assets, when it is caused by factors that are outside of its control, as the Commission's proposed regulated rate of return (WACC) does not compensate for such risk. As the Commission notes, the onus should be on Transpower to provide evidence to the Commission to validate claims that assets are likely to become stranded during a regulatory period, and that the company has taken adequate steps to mitigate this risk.</p> <p>The Commission notes, in paragraphs 12.204 and 12.205, that only projects submitted for and receiving approval from either the Electricity Commission under Part F, or from the Commission, may be entered into the regulatory asset base under the settlement agreement. To clarify, Transpower's current Thresholds Notice states that:</p> <p><i>A fixed asset acquired since 30 June 2006 cannot be included in the regulatory asset base unless the asset is used to provide specified services; and</i></p> <ul style="list-style-type: none"> <i>(a) has been approved by the Electricity Commission under the procedures in Part F; or</i> <i>(b) is within a class of assets to which the transmission (non-Part F capex) threshold applies and does not result in the transmission (non-Part F capex) threshold being exceeded; or</i> <i>(c) it is an asset resulting from capital expenditure incurred between 1 July 2006 and 30 June 2008, and is an asset of the kind described in clause 1(2) of Schedule 2; or</i> <i>(d) results from non-Part F capital expenditure incurred as a direct result of a force majeure event or a security of supply event confirmed by the Commerce Commission in accordance with clause 9(2) of this Notice; or</i> <i>(e) results from non-Part F capital expenditure which the Commerce Commission has otherwise determined to be justified notwithstanding that the expenditure incurred exceeded the transmission (non-Part F capex) threshold in the relevant assessment period; or</i> <i>(f) relates to business support assets; or</i> <i>(g) results from Part F capital expenditure which has not been approved under the Part F approval processes, but in respect of which the Electricity Commission has formally advised the Commerce Commission that it considers the expenditure to be prudent; or</i> <i>(h) results from non-Part F expenditure which is the result of an insurance event and has been recovered by insurance income, or is reasonably anticipated by Transpower to be so recovered.</i>
-----------------------------------------	---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------

<p>Q.187 Page 366</p>	<p>In your view, which approach is the most appropriate to compensate Transpower for assets that have or will become stranded? Please provide details.</p>	<p>Consistent with the current settlement agreement, Transpower should be compensated for impaired or stranded assets, when stranding is caused by factors that are outside of its control, such as a change in user consumption, by allowing accelerated depreciation of those assets, in accordance with the Commission's proposed Historical Cost Handbook, in the year in which assets become stranded. Transpower should not earn a return on capital for stranded or impaired assets.</p>
<p>Q.188 Page 366</p>	<p>In your view, what information should Transpower provide to support any claims that assets will become stranded? Please provide details.</p>	<p>Transpower believes that an appropriate approach would be it to seek an external independent review to support any claims that assets will become stranded. The independent reviewer could be pre-approved by the Commission.</p>
<p>Q.189 Page 388</p>	<p>In your view, what is the appropriate treatment of capital expenditure currently defined as non-Part F and Part F? Please provide details.</p>	<p>Transpower notes that the Commission has based its consideration of the appropriate treatment of capital expenditure, under individual price-quality regulation, on the existing regulatory structure, including the existing role of the Electricity Commission. Transpower's broader position is that the economic regulation of transmission services should be consolidated in a single economic regulator and that this single regulator should review the reasonableness of Transpower's proposed expenditure plans in aggregate as part of an ex ante revenue setting framework.</p> <p>However, in the context of the Commission's position as set out in the consultation document, Transpower concurs with the Commission's proposed treatment of capital expenditure currently defined as non Part F and Part F.</p>
<p>Q.190 Page 388</p>	<p>In your view, what information should be provided to the Commission at the start of a regulatory control period to support Part F projects that fall during the regulatory period? Please provide details.</p>	<p>Transpower suggests that this aspect of regulatory reporting under the Part 4 framework be discussed further by the Commission, Transpower and the Electricity Commission as the Part 4 development work progresses.</p>
<p>Q.191 Page 389</p>	<p>In your view, what criteria should the Commission use when undertaking ex ante reviews of non-Part F capital expenditure? Please provide details.</p>	<p>Refer to the response to question 189.</p> <p>Based on the Commission's proposed capex approval arrangements, a similar approach to that currently adopted by the Commission (Strata) to assess annual non Part F expenditure should be used to assess non-Part F capital expenditure under the proposed Part 4 framework. This focuses on reviewing Transpower's policies, processes and practices with respect to capital expenditure on asset replacement, refurbishment and enhancement and Information Services and Technology and considers their appropriateness and effectiveness in achieving a least "whole of life" cost objective. The aim of any review should be to provide the Commission with a "reasonable" assurance that planned work is effectively co-ordinated across the organisation and is based on sound principles that are in accordance with capex strategies, policies and procedures which reflect good</p>

		<p>industry practices.</p> <p>In paragraph 12.203 the Commission draws a comparison between its proposed approach to setting an annual expenditure allowance (for non-Part F capex) and the assessment of base capital expenditures by the UK and Australian regulators. It is noted that, in both the UK and Australia, a company's approved forecast of annual capex expenditure forms a component of the forecast RAB for the period, and therefore, indirectly, the capex is rolled up into the total revenue allowance – the latter forming the cap (the revenue cap being the sum of the annual revenue requirements for the regulatory period). The Commission is proposing to effectively apply an <u>annual expenditure cap</u> to Transpower's capex (similar to the current thresholds) which is not the same.</p>
<p>Q.192 Page 389</p>	<p>In your view, what criteria should the Commission use when undertaking ex post reviews of non-Part F capital expenditure? Please provide details.</p>	<p>As Transpower has noted in its previous submissions, an ex post review (with potential retrospective adjustments applied to Transpower's capex-derived revenue to "claw-back" material variances against forecasts) should only be considered as a transitional arrangement pending the Commission gaining an increased confidence in Transpower's capex forecasts. As a matter of principle, ex post reviews (with retrospective adjustments) increase regulatory risk. In Transpower's view, it is appropriate for the regulator to inform its forward looking revenue determination by looking back at the previous period's performance but not to claw-back and adjust for variances against the forecasts which were deemed to be reasonable at the start of the previous regulatory period.</p> <p>If the Commission considers that an ex post review is required, it should focus on reviewing actual performance against forecasts made at the commencement of the period, with a view to understanding the reasons for any material variations. As the Commission notes in Paragraph 12.211, any ex post review should apply only to non part F capex and focus on under / over spend that may have resulted from forecasting error. Also, any ex post review and adjustment of future expenditure would need to be consistent with any capex incentive scheme implemented for Transpower.</p>
<p>Q.193 Page 389</p>	<p>In your view, does the current approach for approving or declining capital projects under Part F of the EGRs preclude Transpower from obtaining ex ante approval of all Part F projects that would occur during a regulatory period? Please provide details.</p>	<p>Transpower considers that, from a practical / timing perspective, the current Part F arrangements which, <i>inter alia</i>, require individual projects to be processed through a Grid Upgrade Plan and considered and approved separately on a case by case basis by the Electricity Commission, would make it difficult for Transpower to obtain ex ante approval for the majority of Part F projects that would occur during a regulatory period.</p> <p>As the Commission notes in Paragraph 12.210, the GPS on Electricity Governance (May 2009) requires the EC to consult on and change the approach it applies to the review and approval of Transpower's capital expenditure by introducing a streamlined approvals process for minor transmission works. The development of Part F to include such a streamlined approvals process would, in theory, enable Transpower to review and consult on several</p>

		<p>project proposals at one time and would therefore facilitate more projects being able to be approved prior to the start of a regulatory period.</p> <p>At the start of regulatory period there will always be some projects which either:</p> <ul style="list-style-type: none"> a) have not been fully developed or processed through the approvals processes under Part F; b) are uncertain; and / or c) are not yet planned or foreseeable. <p>As the Commission notes in Paragraph 12.205, Transpower could, to the extent that it is possible, identify “contingent” projects that have yet to be considered by the Electricity Commission, but are likely to fall within the regulatory period, as well as the specific project triggers that could result in the project being required.</p>
<p>Q.194 Page 390</p>	<p>In your view, how should Transpower’s works under construction be treated? Please provide details.</p>	<p>Under Transpower’s administrative settlement agreement, Part F and non-Part F capital expenditure is held in a works under construction account until the assets are commissioned. Interest on this expenditure is accrued at Transpower’s cost of debt and capitalized in accordance with GAAP and included in the asset base used to determine the AC and HVDC revenue requirement once the assets have been commissioned. Transpower considers that this approach is acceptable.</p> <p>However, as Transpower has canvassed in previous submissions, because of the impact on cash-flows, especially at a time of significant capital investment, Transpower’s preferred approach would be to record the timing of capital expenditure on an “as incurred” basis – which reflects the time at which Transpower pays for a particular project – noting that both approaches should be NPV neutral.</p>
<p>Q.195 Page 390</p>	<p>In your view, how should Transpower’s ‘transmission corridor investments’ and ‘land and easement investments’ and any associated resource consents or designations works be treated? Please provide details.</p>	<p>Transpower concurs with the Commission’s view that it should have flexibility around the timing of transmission corridor and land and easement investments. Allowing charging for “transmission corridor investments” and “land and easement investments” before an active line utilises them, provided their purchase has been approved by a regulator on an efficient net benefit basis, is appropriate, as it provides an incentive to invest at the most economic time and therefore promotes the long term benefit of consumers.</p>
<p>Q.196 Page 392</p>	<p>In your view, should a margin allowing Transpower to retain part of any savings or bear some of the forecasting risk associated with non-Part F capital expenditure be included in the regime? Please provide the reasons for your view.</p>	<p>The Commission’s preliminary view is that an incentive mechanism should be provided for Transpower to meet or beat its non-Part F capital expenditure allowance. In arriving at this view, the Commission refers to similar productivity incentive mechanisms used overseas (notably the UK and Australia). Transpower notes that, in the jurisdictions referred to, the productivity incentives (or efficiency sharing mechanisms) apply only to operating expenditure. Incentives around capital expenditure are ensured by:</p> <ul style="list-style-type: none"> a) the <i>ex ante</i> review by the regulator ensuring that a

		<p>company's capex forecast are reasonable for the period;</p> <p>b) capping the maximum amount of revenue that a company can recover based on these <i>ex ante</i> forecasts; and</p> <p>c) ensuring (<i>ex post</i> at the next reset) that appropriate policies and processes have been applied by the company in relation to project expenditure actually incurred.</p> <p>The regulator allows for an adjustment of the RAB at the start of the next period based on actual capex incurred (above or below the forecast expenditure). The regulator applies no claw-back of revenue (depreciation and return on capital) associated with capex variances and as such accepts the risk that a company might have under-spent against the "reasonable" forecasts and, as a result, all things being equal, earned a revenue windfall during the period. Equally the company bears the revenue risk associated with getting its forecasts wrong and as a result overspending its allowance. The key point to note is that these risks are only borne for the duration of the regulatory period.</p> <p>The approach described above does, however, require a reasonable amount of confidence in the initial forecasts of capital expenditure and Transpower has previously acknowledged that, as an interim measure (e.g. for the initial regulatory period), some form of <i>ex post</i> review / adjustment to account for significant forecast variance relating to non-Part F expenditure may be appropriate, before moving fully to the framework applied overseas.</p> <p>Transpower considers that a pragmatic and simple to apply approach would be to adopt a cap and collar mechanism, based on a percentage of aggregate under or overspend (over or above a defined margin from the forecast position) during the regulatory period.</p> <p>For example, above or below a percentage variance margin, Transpower would retain a percentage of benefit (in revenue terms) associated with under spend and bear a similar percentage of the revenue costs associated with overspend. The margins and maximum incentive amounts should be capped symmetrically.</p>
<p>Q.197 Page 392</p>	<p>What factors do you consider are appropriate for the Commission to consider when determining an appropriate incentive mechanism? Please provide details.</p>	<p>Refer above. It is important to consider the nature of any incentive arrangements in the context of the wider regulatory framework, particularly in relation to how overall risks are allocated. In relation to non Part F capital expenditure, the extent to which reopening provisions and uncertainties are managed will be particularly relevant. The possible need to apply adjustments to take into account factors reasonably outside the company's control should be considered by the Commission.</p>
<p>Q.198 Page 392</p>	<p>In your view, what would be an appropriate margin to apply to non-Part F capital expenditure? Please provide details.</p>	<p>It is too early in the development of this mechanism to identify an appropriate margin. This will need to be considered carefully as the form of the arrangement is further progressed.</p>

<p>Q.199 Page 392</p>	<p>What changes do you consider would be required to the EV account to accommodate the proposed Commission approach? Please provide details.</p>	<p>Transpower's current EV mechanism could be modified to allow recovery of a certain margin or proportion of a permitted absolute amount above or below WACC in order to support the application of any incentive arrangements. The precise nature of any changes would need to be carefully considered as the detail of the regulatory arrangements is progressed. Transpower agrees with the Commission's proposal that customer EV balances at the end of the settlement period should be included in the calculation of Transpower's revenue requirements for the first regulatory period. This would reconcile past revenue discrepancies which have arisen under the previous regime and allow for a clean and equitable starting point for the new arrangements.</p>
<p>Q.200 Page 393</p>	<p>In your view, how should new investment contracts be treated under individual price-quality regulation? Please provide details.</p>	<p>The Commission is not correct when it suggests that there is no actual or implicit third party oversight of investments made pursuant to new investment contracts. The terms of the Benchmark Agreement in Schedule F2 to Section II of the Electricity Governance Rules, and transmission agreements based on it, require that investments in connection assets must satisfy the Grid Reliability Standards, whether or not they are made pursuant to new investment contracts. In most cases, connection asset investments will not be core grid assets, so demonstrating compliance with the Grid Reliability Standards will mean satisfying an economic test to show that the value of the unserved energy avoided by the investment will exceed the cost of the investment. The justification for this approach is the existence of a principal/ agent problem, insofar as distribution companies may not always fairly represent the preferences of the final consumers of electricity.</p> <p>Transpower agrees that revenue associated with electricity lines services provided in accordance with new investment contracts should be excluded from any individual revenue-quality path, but it believes that, given the need to satisfy the Grid Reliability Standards (and hence to perform a cost/benefit analysis), there is no need for the other party to agree that the terms and conditions reflect workable or effective competition for the provision of the goods and services. The other party could still confirm that the terms and conditions are reasonable.</p>
<p>Q.201 Page 393</p>	<p>What do you consider the Commission's role should be with respect to new investment contracts? Please provide the reasons for your view.</p>	<p>The Commission does not need to play a role with respect to new investment contracts, given the Benchmark Agreement requirement that investments must comply with the Grid Reliability Standards.</p>
<p>Q.202 Page 393</p>	<p>In your view, should the Commission review and approve Transpower's negotiating framework for new investment contracts? Please provide the reasons for your view.</p>	<p>No, Transpower considers that the terms of the Benchmark Agreement in Schedule F2 to Section II of the Electricity Governance Rules, and transmission agreements based on it, provide adequate protection for contracting parties.</p>

<p>Q.203 Page 395</p>	<p>In your view, how should the system operator services be treated under individual price-quality regulation? Please provide details.</p>	<p>As the Commission notes in Paragraph 12.243, the revenue for the System Operator business is currently determined through a fixed price contract with the Electricity Commission called the system operator service provider agreement (SOSPA). Transpower agrees with the Commission that, where the Electricity Commission and Transpower have an agreed SOSPA, there is no need for the revenue associated with the SOSPA to be subject to an individual price-quality path. This is appropriate under the current arrangement, but Transpower envisages that revenue for the System Operator business might ultimately be recovered within the overall revenue-quality path framework. This is something that could be further considered by the Commission as the new arrangements develop and evolve.</p>
<p>Q.204 Page 395</p>	<p>What do you consider the Commission's role with respect to the system operator services should be? Please provide the reasons for your view.</p>	<p>Refer to the response to question 203 above.</p>
<p>Q.205 Page 397</p>	<p>What costs do you consider should be included or excluded from the base Transpower operating expenditure allowance? Please provide the reasons for your view. 397</p>	<p>Transpower agrees with the Commission's preliminary view that the definition of operating expenditure included within the allowance should be based upon the definition included in the existing settlement agreement but, as noted in response to question 219, considers that there is a case for the Commission to define instantaneous reserves availability costs allocated to Transpower as owner of the HVDC link as pass through costs.</p>
<p>Q.206 Page 397</p>	<p>In your view, how should the efficiency incentive for Transpower operating expenditure be calculated? Please provide the reasons for your view.</p>	<p>Transpower considers that any operating expenditure efficiency incentive scheme should:</p> <ul style="list-style-type: none"> a) be simple to understand and apply, b) be predictable; c) require minimal adjustments; d) should focus on controllable costs and, e) should not threaten Transpower's financial viability. <p>As the Commission notes the regulatory regime applying to transmission service providers (TNSPs) in Australia incorporates a continuous operating efficiency incentive mechanism by allowing the TNSP to retain, for a fixed period only, the difference (negative or positive) between its actual and forecast operating expenditure. Any such difference arising in any year of a regulatory period is retained by the TNSP and carried forward for a duration aligning with the length of the regulatory period (5 years in the case of Australia) following the year in which the efficiency gain or loss is incurred. In this way, the scheme encourages the regulated firms to remain efficient throughout the regulatory period rather than to concentrate efficiency gains during the early part of the period. Adjustments are made to forecast and actual operational expenditure arising from changes in statutory</p>

		<p>responsibilities, pass-through events, costs associated with reopening trigger events and to reflect any changes in capitalisation policy, prior to calculating any carryover amounts.</p> <p>Applying such a framework under an individual price path for Transpower, with the efficiency carryover applying for a three year period (consistent with the duration of the first regulatory period) would result in a benefit sharing ratio in the order of 20% Transpower and 80% customer (based on estimates by the Australian regulator – AER).</p> <p>The Commission could adopt the Australian approach or alternatively consider an approach more simple to apply such as a cap and collar incentive mechanism, based on a percentage of aggregate under or overspend against the controllable element of operating expenditure (over or above a defined margin from the forecast opex position).</p>
<p>Q.207 Page 397</p>	<p>In your view, should a margin allowing Transpower to retain part of any savings or bear some of the forecasting risk associated with operating expenditure be included in the regime? Please provide the reasons for your view.</p>	<p>In relation to triggers for re-opening the operating allowance within a regulatory period, Transpower notes that in Paragraph 12.623 the Commission seems to have misquoted from Transpower’s submission on the Provisions Paper (February 2009). Whilst Transpower did state support for an ex post review of operating expenditure in order to establish the appropriate efficiency “carryover” amount Transpower’s submission did not explicitly support limited or no opening provisions being put in place (refer to question 221 below).</p>
<p>Q.208 Page 397</p>	<p>What margin do you consider would be appropriate to apply to the Transpower operating expenditure? Please provide the reasons for your view.</p>	<p>Refer to the response to question 206 above.</p>
<p>Q.209 Page 397</p>	<p>In your view, should the retention of any benefits or losses from under- or overspend be limited to the regulatory control period or should a carry forward mechanism, similar to that used in Australia, be used to provide incentives independent of the set control period? Please provide the reasons for your view.</p>	<p>Refer to the response to question 206 above.</p>
<p>Q.210 Page 398</p>	<p>Do you agree with the Commission’s preliminary view of the approach for the treatment of taxation? If not, what should the treatment of taxation be? Please provide the reasons for your view.</p>	<p>Transpower agrees with the Commission’s preliminary view of the approach for the treatment of taxation.</p>
<p>Q.211 Page 399</p>	<p>Do you consider that pricing methodologies for Transpower are an applicable input methodology for the Commission to determine given the role of the</p>	<p>Given that the Electricity Commission is responsible for Transpower’s pricing methodology, pursuant to the Electricity Governance Rules 2003 (“the Rules”), the Commission’s input methodology should refer only to the pricing principles contained in rules 2 and 3 of Section IV</p>

	Electricity Commission? Please provide the reasons for your view.	of Part F of the Rules.
Q.212 Page 399	In your view, should the Commission develop other pricing methodologies for Transpower given the Electricity Commission's role and ongoing consultation with respect to Transpower pricing methodology? Please provide details.	No, provided that Transpower's pricing methodology as determined by the Electricity Commission pursuant to the Rules continues to meet the purpose of the Commerce Act 1986.
Q.213 Page 400	In your view, should the Commission refer to the Electricity Commission's pricing methodology and if so what part(s) do you consider it should refer to?	No. The Commission should refer to the pricing principles in the Rules only.
Q.214 Page 401	Do you agree with the Commission's preliminary view of the approach for the cost of capital? If not, please provide the reasons for your view of what approach you consider should be taken for the cost of capital.	The Commission has noted that Transpower is an example of an industry where there is only one firm. As this implies that Transpower may have its own particular risk characteristics and capital expenditure profile, it would seem appropriate to use Transpower's actual leverage and a transmission-specific equity beta.
Q.215 Page 402	In your view, how should the Commission give effect, under individual price-quality regulation, to the quality standards set by the Electricity Commission? Please provide the reasons for your view.	As an interim measure, Transpower believes that the Commission should give effect to the quality standards set by the Electricity Commission simply by acknowledging these standards and the potential penalties for breaching them contained in the Electricity Governance Regulations 2003. This would avoid a potential double jeopardy situation from arising, whereby Transpower could be exposed to penalties arising from the enforcement provisions of the Commerce Act 2003 as well as those contained in the Electricity Governance Regulations 2003. Ultimately, as noted by the Commission, further work could be undertaken to determine a single set of quality obligations and the regulatory agency to be responsible for them. The current suite of quality performance indicators could be reviewed to better reflect aggregate performance at a network level and allow for ongoing trend monitoring.
Q.216 Page 404	In your view, what form of control should apply to Transpower under individual price-quality regulation? Please provide details.	Transpower supports the Commission's preliminary view that incentive based regulation in the form of a total revenue cap would be appropriate for Transpower under individual price-quality regulation.
Q.217 Page 404	In your view, what should the regulatory control period length be for the first regulatory period under individual price-quality regulation? Please provide the reasons for your view.	Four years (including the one year transition). The first regulatory control period will necessarily involve a degree of learning for Transpower and the regulator, and for this reason should be the shortest period permitted by the legislation, which is four years.
Q.218 Page 404	Do you consider that there are any constraints or limitations from the Commission's proposed approach for setting Transpower prices? Please provide the reasons for	No.

	your view.	
Q.219 Page 404	In your view, what Transpower costs would meet the criteria for pass through costs defined in Chapter 4? Please provide details.	<p>Transpower concurs with the Commission's preliminary view that for a cost to be eligible for inclusion as a pass-through cost it should be:</p> <ul style="list-style-type: none"> • outside the control of a regulated business; • unforeseen (i.e., amount unable to be accurately forecast); and • defined and approved as a pass-through cost at the start of the regulatory period by the regulator. <p>Within Transpower's administrative settlement pass-through costs are defined as the rates on system fixed assets paid or payable by Transpower to a territorial local authority under the Rating Powers Act 1988 or the Local Government (Rating) Act 2002 and Electricity Commission levies. Transpower agrees that these costs should continue to be treated at pass through costs.</p> <p>Transpower also considers that there is a case for the Commission to define instantaneous reserves availability costs allocated to Transpower as owner of the HVDC link as pass through costs.</p> <p>As Transpower has noted in previous submissions the reserve costs are outside Transpower's control and therefore meet the criteria for classification as pass through costs. Transpower does not control the direction or magnitude of power flows, the prices of reserves or the offer behaviour of generators which determines which particular generators are dispatched. These are the factors that determine the allocated availability costs of instantaneous reserves.</p>
Q.220 Page 405	How do you consider the percentage of pass-through costs to be allowed should be determined? Please provide details.	<p>By definition pass through costs are outside the control of a regulated business and unforeseen (i.e., amount unable to be accurately forecast) at the start of a regulatory period. As such the full amount of any pass through cost item should be recoverable.</p>
Q.221 Page 406	In your view, what event characteristics should be considered for re-opening Transpower's individual price-quality path? Please provide the reasons for your view.	<p>The Commission has set out two possible approaches for identifying the circumstances in which a re-opening of a price-quality path may be considered. The two approaches are defining a specific event that could result in a re-opener or defining the characteristics that such an event must have in order to qualify for a reopener. The Commission's preliminary view is that defining the characteristics of an event that would be considered for re-opening the price-quality path is the more appropriate approach for input methodologies. Transpower agrees the Commission's position.</p> <p>The actual expenditure outcomes in the regulatory period incurred by Transpower are likely to differ from the revenue allowance made by the Commission. These cost differences can be endogenous, that is, due to circumstances within Transpower's control (for which the proposed incentive mechanisms would apply), and exogenous, that is, due to the occurrence of events</p>

		<p>predominantly outside of Transpower's control. The Commission acknowledges that some exogenous events (and associated costs) are foreseeable but beyond the control of a company and these would be defined as pass through items.</p> <p>When the costs of exogenous events are unpredictable and are so large that Transpower would suffer a material financial penalty in responding to the event, a reopening adjustment mechanism should apply to realign revenue with efficient costs after the exogenous event.</p> <p>Transpower considers that re-opening of a revenue cap should be conditional upon:</p> <ul style="list-style-type: none"> • Transpower being materially adversely affected by the event • the event being beyond Transpower's control • the event not having been contemplated at the time the revenue control decision was made. <p>Transpower considers that it would be appropriate to adopt a materiality threshold based on a percentage of the average maximum allowed revenue for a financial year, estimated at the time of the revenue cap determination. Transpower would be required to demonstrate that the cost impacts of the exogenous event exceed this level. If this test is met, Transpower would be entitled to recover the full efficient cost impact of the exogenous event.</p> <p>Reopening triggers should include such events as:</p> <ul style="list-style-type: none"> • a change in taxes event • an insurance event • a service standards event • a terrorism event • an adverse weather event • changes to legislative or regulatory obligations • a force majeure event • other events (subject to the approval of the Commission before a revenue cap began)
<p>Q.222 Page 409</p>	<p>In your view, what do you consider to be the appropriate level of detail that would be required to set input methodologies for Transpower in order to promote certainty for suppliers and consumers as to how the input methodology will be applied in the regulation of the services (s 52R and s 52T(2)(b)). Please provide the reasons for your view.</p>	<p>Refer to Transpower's response to Questions 8 to 11</p>
<p>Q.223 Page 409</p>	<p>In your view, what do you consider to be the appropriate level of detail that would be required to set input methodologies for Transpower in order to allow it to estimate the material effect of the input</p>	<p>Refer to Transpower's response to Questions 8 to 11</p>

	methodology in its business (s52T(2)(a)). Please provide the reasons for your view.	
--	--------------------------------------------------------------------------------------------	--

Transpower Process and Recommendation Discussion Paper		
	Question	Transpower Comment
Q.1 Page 8	Do you consider that the Commission should hold a session at the input methodologies conference to discuss this Discussion Paper in September 2009?	It is difficult to see what purpose would be served by including a session, on the Transpower Process and Recommendation Paper as part of the input methodologies conference in September. The development of Transpower's individual price-quality path regulation will be at too early a stage for interested parties to comment on meaningfully and all the points that the Commission needs to consider at this juncture should have been included in the submissions and cross submissions. Transpower recommends that the Commission consider a conference at a later stage in the process.
Q.2 Page 14	Do you agree that all input methodologies applicable to the regulation of Transpower should be determined prior to the Commission making its recommendation to the Minister? If not, which input methodologies do you consider should be determined before the Commission makes its recommendation, and why?	Transpower agrees with the Commission's analysis. The Commission should determine the input methodologies applicable to the type of price-quality regulation recommended for Transpower under s.52U of the Commerce Act before making its recommendation to the Minister of Commerce. This approach will promote certainty in relation to the rules, requirements and processes applying to the proposed regulation.
Q.3 Page 14	Do you agree that the Commission is not required to determine input methodologies for a customised price-quality path at the time of making its recommendation, if the Commission recommends that individual price-quality regulation should apply to Transpower?	Yes.
Q.4 Page 17	What other matters should the Commission consider when developing the process for the regulation of Transpower under Part 4 of the Act?	Transpower acknowledges that the Commission is at an early stage in the process to define the future regulatory arrangements for Transpower but the overall process as proposed appears sound. Transpower notes that, despite the transitional arrangement, the timetable permits very little room for slippage with several key milestones occurring in Q2/Q3 of 2011. Nevertheless Transpower considers that the timetable is achievable.
Q.5 Page 20	Do you agree with the Commission's proposed process for making the recommendation to the Minister and making the s 52P determination? If not, what changes do you consider should be made, and why?	The Commission's final decision on expenditure needs to be made by the end of Q3 2011 to enable Transpower to calculate and publish its prices for 2012/13 by the end of November 2011. As noted above the timetable is compressed in Q2 /Q3 2011. There might be merit in Transpower submitting a "draft" expenditure plan at an earlier stage in the process, say Q1 2011.

Q.6 Page 34	Do you agree with the Commission's preliminary view that a full building blocks type analysis, including expenditure review is required to recognize Transpower's revenue requirement? If not what type of analysis should be undertaken to set Transpower's price-quality path, and why?	Yes. Transpower agrees with the Commission's reasoning as set out in Section 4.3.
Q.7 Page 34	Do you agree with the Commission's preliminary view that individual price-quality regulation would be more suitable for Transpower than default/customised price-quality regulation? If not, why should default/customised price-quality regulation apply?	Yes. Transpower agrees with the Commission's reasoning as set out in Section 4.3.