

TRANSPower NEW ZEALAND LIMITED

Submission to the
Commerce Commission on:
Commerce Act (Transpower Input Methodologies)
Determination 2010

Part 3 – Drafting comments

August 2010



TRANSPower

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T R A N S P O W E R

Introduction

1. This is Part 3 of Transpower’s submission on the Part 4 consultation material comprising the Commission’s draft decisions on Input Methodologies and the Individual Price-Quality Path for Transpower, and the accompanying draft determination (“the draft decisions”).
2. Our submission on the draft decisions is in three parts:
 - Part 1: on all non-cost of capital issues (submitted on 9 August);
 - Part 2: on cost of capital issues (submitted on 16 August); and
 - Part 3: (submitted on 16 August).
3. This document (Part 3) comments on the wording of the draft determination and consists of:
 - A legal opinion on the Draft Determination from Ian Millard QC; and
 - An amended version of the Draft Determination with preliminary suggested drafting changes.
4. It is noted that Transpower has a number of fundamental disagreements with some of the draft decisions reached by the Commerce Commission. These have been summarised in our Parts 1 and 2 submissions. Whilst we have provided some preliminary comments on the Draft Determination it follows that if there is any inconsistency between the substantive submissions of Transpower and the amended version of the Draft Determination then nothing in the draft attached should be taken as undermining the substantive submissions of Transpower.
5. We suggest that final drafting should await the final decisions from the Commerce Commission and that a further opportunity to comment is extended to interested parties.

16 August 2010

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COMMERCE COMMISSION – TRANSPOWER – DRAFT DETERMINATION –
LEGAL DRAFTING

A. PRELIMINARY COMMENTS

1 Paragraph 1.4.11 of the Commerce Commission's Input Reasons Paper in relation to Transpower states:

1.4.11 Where submitters disagree with the Draft Determination as currently drafted the Commission asks that they provide alternative wording. A Microsoft Word version of the Draft Determination will be posted on the Commission's website for the purpose of providing drafting suggestions.

2 I attach to this letter a version of the Draft Determination with **preliminary** suggested drafting changes.

3 I emphasise the word "preliminary" for a number of reasons:

- (a) Transpower has a number of fundamental disagreements with the draft decisions reached by the Commerce Commission, for example in relation to the allowed rate of return. There are several ways of addressing those concerns. Final drafting should await the final decisions from the Commerce Commission;
- (b) As outlined in part D of my opinion of 9 August 2010, I consider that the Commerce Commission has not properly complied with s52T and, in particular, subsection (2). I will comment more on the practical aspects of this in part B below;

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- (c) As also outlined in part D of my prior opinion, I am of the view that the Commission's information disclosure regime is fundamentally wrong. That creates major difficulties in trying to provide comprehensive drafting of the Determination given that the disclosure regime is at the front of the Draft Determination despite the most relevant part being Part 3. That part 3 then incorporates, by reference, parts from the disclosure regime. Some of the practical issues are dealt with in part C below;
- (d) There are then the time constraints which, of necessity, are imposed by the Commerce Commission given the tight timetable it is working to. However, I understand that once final decisions are made there will be a further opportunity to comment on the draft final Determination.

4 It follows from this that if there is any inconsistency between the substantive submissions of Transpower and the draft attached then nothing in the draft attached is to be taken as undermining the substantive submissions from Transpower.

B. COMPLIANCE WITH SECTION 52T

5 Section 52T(1) requires the Commerce Commission to specify the input methodologies for the various listed items (including the regulatory processes and rules for a specification and definition of prices). It then proceeds:

“2. *Every input methodology must, as far as is reasonably practicable,—*

(a) *set out the matters listed in subsection (1) in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier; and”*

6 Relevantly the final Determination needs to be gazetted under s52W. The purpose of that must be so that an interested party can, by reading what has been officially published, understand how the price (revenue) control regime applies to Transpower, at least in terms of methodologies, what assets it can obtain a return on and when etc.

7 Against that background I was anticipating when I came to read the Draft Determination that I would see a clear statement that Transpower was restricted to a total revenue cap with a statement of the relevant inputs that went into that revenue cap, even if the rules and processes for some of the aspects were then in the Individual Price – Quality path. In any event it should be reasonably clear from the input methodology how those rules would apply so that Transpower could reasonably estimate the material effects of the methodology.

8 Unfortunately the Draft Determination does not do that. The nearest is clause 3.1.2, but that does not describe how the total revenue cap is fixed.

9 Some further information is then found in the Input Reasons Paper but, even then, major questions were left unanswered. Some additional information is contained in the Transpower IPP Reasons Paper but still there were major gaps.

10 By way of example, the Regulatory Asset Base is dealt with in clause 2.2.4 of the Draft Determination which is then bought down into the input calculation in clause

3.3.1. Although that describes the opening RAB and the closing RAB it does not describe what is to happen to assets commissioned part way through a “disclosure year” (incidentally an inapt description for what is, essentially, a pricing model as opposed to a disclosure model). The Input Reasons Paper does say that a return on assets should be earned once commissioned but it is unclear whether that means the exact date of commissioning or the year of commissioning.

- 11 I understand from discussions with Transpower staff that they are anticipating that what happens under the Administrative Settlement will continue to apply. That is, where assets are scheduled to be commissioned in any pricing year they are deemed to be commissioned exactly halfway through the pricing year (effectively 1 January) with any differences as to which assets were commissioned then being dealt with through wash-ups. This is nowhere to be seen. I looked for that in vain in the draft decisions of the Commerce Commission yet it is extremely important to Transpower, especially given that it is committed to about \$3 billion of capital works. That large budget also emphasises the desirability of annual wash-ups.
- 12 In similar vein a second example relates to clause 2.2.5 dealing with depreciation. Under this no depreciation is allowed on an asset commissioned part way through a disclosure year. This is not then addressed in either the Input Reasons Paper or the Transpower IPP Reasons Paper. I assume that the same approach as applies to the commissioning of assets under the Administrative Settlement will apply here but that should be spelt out.
- 13 A third example relates to the existing, very substantial, EV account balances. In terms of s52T, in the case of the HVDC this is an asset and, in the case of the HVAC, a “negative asset” of Transpower’s (that description being apt given that the balance is an outcome of the existing regulatory regime). There is nothing about the EV accounts in either the Draft Determination or Input Reasons Paper.
- 14 These are clearly matters that should be dealt with in the input methodology in light of s52T(1)(a)(i) and (ii).
- 15 The best way to comply with s52T in this regard would be to have an upfront statement that Transpower’s maximum annual revenue is to be made up of the following elements which are then listed.
- 16 That approach would also be helpful in relation to the Incremental Rolling Incentive Scheme which, as currently drafted, is very opaque unless one has read the Input Reasons Paper.

C. DISCLOSURE ACCOUNTS

- 17 As set out in part 11 of my opinion of 9 August 2010, these should follow the requirements of the input methodology so that it can be seen whether or not Transpower is complying with that, rather than putting Transpower to the considerable expense of preparing separate accounts. Likewise these input methodology accounts should, as far as possible, mirror GAAP, being the basis on which Transpower reports financially.
- 18 In any event I find it surprising that, based on the order in which they are dealt with in the Draft Determination, it would appear that the Commerce Commission

considers the pricing Input Methodology less important than the disclosure requirements.

19 On this basis it would be appropriate to bring part 3 of the Draft Determination up as part 2. However to do that in a tracked change form would be unduly cumbersome. It would mean that the actual changes would get lost as a result of the change of order.

20 One advantage of this is that it helps to ensure that decisions on Input Methodology issues are not overlooked where (despite the illogicality of it) the Commission adopts a different approach to pricing than it does for disclosure.

D. DRAFTING ISSUES

21 Many of the drafting issues will be self explanatory and, where not, I have tried to comment in square brackets in the relevant sections.

22 However, one problem about drafting changes is that in many areas Transpower has, of course, submitted that what is proposed should not be adopted. I have **not** accordingly looked closely at some of those clauses that Transpower says should not apply. As noted earlier there needs to be a further opportunity to review drafting once all final decisions have been made.

23 I should however, in this letter, make some comment on some of the changes that I have made.

Easements

24 The Commerce Commission in the Input Reasons Paper para 4.4.69 decided (emphasis added):

Draft decision

4.4.69 The Commission's draft decision is Transpower should be able to include capex relating to 'transmission corridor investments' and 'land and easement investments', in its RAB before an active line uses them, provided their purchase has been approved by the EC or the Commission on a cost benefit basis. This approach would not apply to Transpower purchasing land to gain an easement with the intention of on-selling some or all of the land. In this case the costs that are included in the regulatory asset base are the costs associated with establishing the easement as determined by an independent valuer.

25 This is not reflected in the Draft Determination. That does not contain any reference to "transmission corridor investments" or "land and easement investments".

26 Transpower, of course, contends that the same treatment should apply to easement lands and some other lands. That is consistent with the 2009 GPS – see Part 6 on my earlier opinion. But even if that submission is not accepted the Draft Determination needs amending to reflect the existing draft decisions of the Commission.

- 27 In particular, in the Draft Determination easements are referred to but are only dealt with in the definitions section and then in Part 2 as to information disclosure with such references occurring in clause 2.2.6 (dealing with the value of commissioned asset) and in clause 2.2.5 (to exclude easements from a depreciation charge unless the easement is a fixed life easement). But because clause 3.3.1 in Part 3 (dealing with price regulation) brings down the provisions in Part 2 dealing with asset values (i.e. all of clause 2.2 including 2.2.5 and 2.2.6), the same rules apply there.
- 28 Of concern is that there is no express reference to easements in clause 2.2.4 dealing with the Regulatory Asset Base. They, therefore, can only become part of the Regulatory Asset Base if they are an asset that is “commissioned” (defined in clause 1.1.3 to mean when first used by Transpower to provide electricity lines services). In that event they are brought in at their “value of commissioned asset” which term is defined in clause 2.2.6 and which value is to be fixed by a registered valuer. They should of course be brought in at cost, not market value, and they should have been brought in as and when the expense was incurred.

Depreciation

- 29 In addition to the comments made at para 12, the Draft Determination looks first at disclosure and then it incorporates the same approach into the pricing methodology (at least in relation to asset valuation). Subpart 3 of part 3 overlooks the decision in the Input Reasons Paper at para 4.4.94. This is that all system fixed assets in the asset base at the beginning of the regulatory asset period shall be deemed to have a minimum of five years life and, so can be depreciated even if a nil value.
- 30 There needs also to be an allowance for the write off of an asset that does **not** reach its standard life. By definition, half of the assets will be in this category.

Regulatory Asset Exchanges

- 31 If Transpower buys an asset that was part of the vendor’s own regulatory asset base, for input methodology purposes that purchase is deemed to be at the existing regulatory carrying value.
- 32 This removes the incentive to trade at all. There may be situations where an asset could be used more efficiently by another regulated supplier. Accordingly, that purchaser may be prepared to pay above the (artificial) Regulatory Asset Base value. This happens all the time in competitive markets. The discouragement to do that is then threefold:
- (a) It cannot recover the extra purchase price;
 - (b) It does not get a return on the extra purchase price; and
 - (c) It has to share the efficiency gains with consumers after 5 years.
- 33 Such outcomes are inconsistent with the general requirement that the outcomes of price regulation should mimic competitive markets **and** the requirement in s52A(1)(b) that a regulated supplier should have the incentive to improve efficiency.

- 34 Transpower should be permitted to bring the asset in at cost unless the Commission considers the cost excessive.

Pass-Through Costs

- 35 Clause 3.1.3 of the Draft Determination does not adequately draw a distinction between the initial pass-through costs that have been accepted and the process that needs to be gone through to add new items. I have tried to correct that.
- 36 The relevant clause also uses the expression “*territorial local authority*”. The Local Government (Rating) Act 2002 refers to territorial authorities, regional councils and local authorities with the latter expression covering both territorial authorities and regional councils. I have amended the description to try to remove any confusion.

Re-Opening Events

- 37 I dealt at length with the issue of when a reconsideration of a price path should occur in Part 9 of my prior opinion. I have redrafted subpart 8 in line with my prior comments.
- 38 However one further aspect has arisen in the course of that process. Transpower’s pricing year runs 1 April each year with prices having to be fixed at least 3 months in advance. The Commission is proposing that it will fix Transpower’s maximum allowable revenue by 30 November although Transpower has submitted this should be brought forward to the end of the third week in November in order for it to have time to implement the decision. That MAR is then the base rolling forward into future years.
- 39 If a major event occurred in, say, December of the last year of one regulatory control period then, as currently drafted, its impact would only be measured over a period of about 3 months. Yet the methodology and relevant individual inputs would have been fixed for 5 years 3 months. Consistent with the underlying philosophy of re-opening, the impact should be measured over the total period for which the individual price path has been fixed.

Tax Year

- 40 Although I have generally left the WACC calculations alone there is one point I should mention.
- 41 The Commerce Commission uses tax rates in its WACC formula. It also adopts a “*tax payable*” approach when calculating the tax cost that should be allowed when fixing the revenue cap that is appropriate.
- 42 Inconsistently with that, when estimating the cost of capital, the Commerce Commission applies the 28% corporate tax rate from 1 April 2011. Although that tax rate applies in the income tax period commencing on 1 April 2011, Transpower cannot take advantage of that tax rate until 1 July 2011. This is because its financial year ends on 30 June 2011 and, under the tax laws, it must return income to 30 June 2011 as though it was income to 31 March 2011 for income tax rate purposes.

Asset Definitions Relating to “*Electricity Lines Services*”

43 In various places throughout the Draft Determination various terms include, within their definition, the further term “electricity lines services” – see for example, the definition of “commissioned” in clause 1.1.3.

44 The term “electricity lines services” is then defined (in clause 1.1.3) by reference to the meaning given to that term in s54C of the Commerce Act. There (subject to some exclusions in s54(2) that are not presently relevant) it is defined as meaning:

the conveyance of electricity by line in New Zealand.

45 Some of Transpower’s assets that would be considered to be within the regulatory asset base do not actually convey electricity by line. These would include monitoring equipment and business support assets.

46 That was recognised in the prior Administrative Settlement. That document, instead of using the term “electricity line services”, used the expression “specified services”. To the extent relevant that defines the goods or services as those provided by Transpower:

that are electricity transmission goods or services or are directly related to the provision of electricity transmission.

47 The contrast with what went before could be seen as pointing to a narrow interpretation of some of the terms to exclude ancillary assets. This could be overcome by inserting, wherever required, after the initial reference to “electricity lines services”, some appropriate variant that uses the term “directly related to electricity lines services”, e.g. “**Commissioned**” would now be defined to read:

*“**Commissioned** means first used by **Transpower** to provide **electricity lines services** or services directly related to **electricity lines services**”.*

48 That concept would flow through into the definition of “lost asset” in clause 2.2.1, “found asset” in clause 2.2.8(3).

Instantaneous Reserve Charges

49 Transpower, of course, is submitting on this that the exclusion to the definition of pass-through costs in relation to instantaneous reserves should be eliminated. That aside, clause 3.1.4(2)(b) is too widely drafted and could capture an asset taken out of service by way of decommissioning. If the existing definition remains I suggest that there be a new subclause (4) added in:

(4) *For the purpose of subclause (2)(b) an asset must not be treated as remaining out of service if it is decommissioned and replaced by an asset of at least an equivalent capacity and standard.*

Refurbished Assets

- 50 Not all assets being refurbished will necessarily be taken out of service. The example used by the Commerce Commission of tower painting is one such case. There needs to be a mechanism to bring the refurbishment costs into the asset base.

Definitions

- 51 I found the frequent sets of definitions confusing. When looking to see what the term meant it was often necessary to search in more than one place. At least in relation to the definitions in the existing clause 2.2.1 they should all be in Part 1.

Formatting

- 52 One final comment should be made. When making the drafting changes I have, of course, been working from the Microsoft Word version of the Draft Determination as downloaded from the Commission's website. The changes are red-lined.
- 53 However the version that has been downloaded restricts the formatting options available. I cannot, for instance, put defined definitions in bold and headings and numbering are problematic.



Ian Millard QC