

TRANSPower NEW ZEALAND LIMITED

## KEY POINTS SUMMARY

Part 1 – Submission to the  
Commerce Commission on:

Input Methodologies Transpower  
(excluding Chapter 6 – Cost of Capital)

and

Individual Price-Quality Path Transpower

Draft Reasons Papers

*August 2010*



**TRANSPower**

## Overview

### Context

Transpower has come through a prolonged period of under-investment. Compared to other transmission grids internationally, our national grid is older and more heavily loaded. This has: led to deteriorating reliability of supply for consumers; affected the development and operation of the energy market; and created uncertainty for regional economic development. Furthermore, we are in an age of technological change with respect to supply, demand and transmission of electricity that, if it is to benefit consumers, will require timely adoption and integration of new technology. Providing strong incentives for investment is, therefore, paramount when setting the regulatory framework for transmission. We submit that the proposed regulatory arrangements fail to achieve this overriding objective and require significant changes as a result.

### Policy intent

The clear intention of policy makers is to provide strong incentives to remedy past under-investment so that the transmission system provides a reliable core infrastructure and a secure platform for economic and energy market development. The Part 4 Purpose Statement, in section 52A of the Commerce Act, has been deliberately revised to give pre-eminence to the need for regulated firms to “*have incentives to innovate and to invest, including in replacement, upgraded and new assets*”. Similarly, Government Policy Statements have been amended to emphasise the importance of streamlined regulatory processes which encourage investment to maintain and develop the national grid over the long-term. The reality underlying these policies is the strong asymmetry between the relatively smaller welfare losses from early or over-investment and the much larger losses that result from late or under-investment in transmission. However, the draft decisions reflect a propensity to control each and every risk of early or over-investment, resulting in an outcome that sends very strong signals to under-invest.

### Concerns with the Commission’s response

While we do not doubt the Commission embarked with the intent to deliver on the policy objectives in the Commerce Act and the Government Policy Statements, much of the detail in its proposals will achieve the reverse. The draft decisions contain a lot of well meaning detail, but in aggregate this detail combines into a framework that manifestly does not achieve what the Commission set out to do.

We believe the Commission has attempted to move toward the mature form of regulatory regime found, for example, in Australia. However, a simple comparison against the Australian regime is telling: the investment risks faced by Transpower under the proposed regulations are higher than those faced by our Australian counterparts (refer to Harding Katz’s expert opinion), while the proposed rate of return on investment is below the Australian benchmark (as will be discussed further in part 2 of our submission due on 16 August 2010). These risks include uncertainty created by the extent of discretion that the Commission proposes to assume, compared to that of the Australian regulator.

### Conclusion

Collectively, the draft decisions discourage investment by not striking an appropriate balance between risk and return. They favour low risk, incremental investment and discourage major, innovative and long term investments. This is exactly what not to do to encourage the efficient development of long-life infrastructure.

### Remedy

Transpower’s submission (of which this is Part 1 of 3), provides constructive solutions to these problems, which we recommend to the Commission.

## Introduction

1. This is the first part of Transpower's submission on the Part 4 consultation material, comprising the Commission's draft decisions on Input Methodologies and Individual Price-Quality Path for Transpower, and the accompanying draft determination ("the draft decisions").
2. Our submission on the draft decisions will be made in three parts:
  - Part 1: on all non-cost of capital issues (this document);
  - Part 2: on cost of capital issues (to be submitted by 16 August); and
  - Part 3: comments on the wording of the draft determination (to be submitted by 16 August).
3. Part 1 consists of: an Overview; this Key Point Summary; detailed submissions on the draft decisions (in tabular form); a comparison between the regime contemplated by the draft decisions and the regime applied in Australia by the Australian Energy Regulator (AER) (prepared by Harding Katz); and an opinion from Ian Millard QC on various legal issues raised by the draft decisions.
4. We note at the outset of our submissions that Section 52T(2)<sup>1</sup> requires that the matters to be addressed under Section 52T(1) are to be dealt with in the Input Methodology determination in sufficient detail for Transpower to be able to reasonably estimate the material effects on it of the methodologies. When working through the proposed Input Methodologies, we have found that we can only estimate these impacts by also considering many of the proposed decisions in the Individual Price-quality draft reasons paper. This dependency is discussed further in Mr Millard's opinion.
5. Further we note that the Commerce Commission ("the Commission") has failed to give adequate weight to the changes in the Part 4 Purpose Statement (section 52A) and to the Government Policy Statements transmitted to it under Section 26 of the Act. As a consequence, the draft decisions fail to provide adequate incentives for investment and innovation or to deliver outcomes consistent with those found in (workably) competitive markets.
6. We believe that the intention of the Commission was to set out a path toward less intrusive, incentive-based regulation of transmission, and we acknowledge some progress on this path: for example, the increased flexibility for substitution of Minor capital projects and the planned move to five-yearly revenue resets.
7. This creates some similarities with the regime developed in more mature regulatory jurisdictions such as the regime in Australia, developed more recently under the auspices of the AER. However, sharp differences between the two regimes remain: for example the greater exposure to the risks of unrecovered costs under the Commission's regime<sup>2</sup>.

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<sup>1</sup> Legislative references are to Part 4 of the Commerce Act 1986 unless otherwise stated.

<sup>2</sup> Further details are provided in the comparison of the two regimes prepared by Harding Katz.

8. As a result, the regulatory framework envisaged by the draft decisions compares unfavourably with the regime in Australia, exposing Transpower to risks for which there is no compensation. Overall, the Commission's putative regime is NPV and cash flow negative compared to that in Australia. We are disappointed that the Commission has not paid greater attention to the Australian experience to draw lessons from what is now a relatively mature regulatory regime.
9. We are most concerned that the rate of return on investment projected from the draft decisions (based on the Commission's methodology for estimating Transpower's cost of capital) will be insufficient to encourage efficient investment and thus fails to meet the requirements of the section 52A purpose statement.
10. In part, this conclusion reflects the asymmetric and uncompensated risks, referred to above, to which Transpower would be exposed. The proposed treatment of historical customer EV balances, the risk of unrecoverable capital expenditure and the deferred recovery of approved capital expenditure are examples. These proposals would have material adverse cash flow impacts which further compound the cash flow impacts of a low rate of return. These risks should be removed in the final decisions.
11. We will address cost of capital issues specifically in Part 2 of our submission and assess the impact on our future financial flexibility measured in terms of, for example, balance sheet gearing or capacity for dividend payments to the Crown. Below, we summarise the most significant of our concerns with the remainder of the draft decisions, beginning with the draft decisions in respect of capital expenditure approval and recovery.

### **Major capital expenditure approval and cost recovery**

12. The Commission has defined Major capital expenditure as upgrade projects in excess of \$5m (\$1.5m for the Transition Year). As discussed, below this threshold is set too low.
13. Under the draft decision for "Major" capital investment, Transpower recovers the lesser of the approved project budget or actual project spend. There is no ability to offset or substitute expenditure between projects to mitigate the risk of project cost overruns. The Commission is also opposed to ex post review of project approvals. These draft decisions create risks of unrecovered capital expenditure for which there is no alternative compensation. As a result, Transpower is all but guaranteed a return below its estimated cost of capital.
14. This outcome represents a disincentive to investment and risks creating perverse incentives to address investment needs through a number of smaller, potentially less efficient projects rather than a "major" upgrade.
15. This asymmetric treatment of project cost risk without alternative compensation must be addressed. In the first instance, there should be a clearly defined process for "re-approval" of project cost forecasts when it becomes apparent that the original project budget is likely to be exceeded. The re-approval process must be streamlined to ensure that the delivery of ongoing projects is not delayed. This mirrors the approach that has developed under the Electricity Commission and is consistent with the 2009 Government Policy Statement. An application for re-approval should be possible at any stage of a project which will,

in most cases, be once a project is already well advanced. Additionally, the basis for re-approval should allow for any unforeseen circumstances (for example a change in scope in response to customer load requirements or equipment performance specifications) and not be limited to exogenous factors such as exchange rate movements. A clear process for re-approval reduces the requirement otherwise that approval for Major projects be based on extreme cost estimates (e.g. P(99) cost)<sup>3</sup>.

16. Where a project exceeds its ex ante approved budget (and for which no subsequent increase in costs has been approved), the project should be included at cost in the RAB from the beginning of the next Regulatory Control Period (RCP). In other words, for projects exceeding their final approved cost, Transpower should be at risk of not recovering its full costs only for the remainder of the current RCP.<sup>4</sup>
17. We disagree strongly with the draft decision not to re-open the determination of maximum allowable revenue (MAR) during the Remainder Period of RCP1 to allow timely recovery of costs for Major projects that are approved (and commissioned) after the initial setting of MAR. This draft decision is in contrast to the annual revenue reset process operating under the Administrative Settlement and exposes Transpower to the risk of additional cash flow deferral.
18. We propose that the re-setting of MAR be an annual process for RCP1 for the purpose of accommodating approved Major capital projects. An annual reset is, in our view, consistent with the current (transitional) regime in which project by project assessments and approvals of Major capital projects are likely to occur on an “ongoing” basis throughout the first RCP.
19. We should emphasise that, in principle, we support the concept of a largely fixed MAR for the duration of an RCP, once a regime is adopted in which the MAR is set based on a forecast of all capital expenditure for the entire RCP, in common with the AER regime<sup>5</sup>. We are hopeful that the Commission will adopt such an approach from RCP2.

### **Threshold for “Major” capital expenditure approval**

20. As noted above, the \$5m threshold for Major grid upgrades is too low<sup>6</sup>. To put the threshold into context, \$5m represents the cost of purchasing and installing an upgraded supply transformer. As such, a low threshold creates a strong incentive for Transpower to avoid the time, bureaucracy and risk of project specific approval, to favour “like for like” asset replacement rather than planning and investing for the future in the most efficient and innovative way possible.

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<sup>3</sup> P(99) means a probability of being exceeded of 1%.

<sup>4</sup> This mirrors the capex incentive arrangements under the AER regime in Australia

<sup>5</sup> In common with the AER regime, the only exception would then be for true “contingent” projects triggered by pre-specified events. These projects would be exceptional and the MAR would be re-opened in the event that such a contingent project was “triggered”.

<sup>6</sup> Transpower’s concerns about the level of the proposed Major capital expenditure threshold were presented to the Commission at the Transpower Workshop in March 2010.

21. We propose that the threshold be increased to \$20m. A \$20m threshold is consistent with the 2009 Government Policy Statement (GPS), to which the Commission must have regard<sup>7</sup>. We note that the GPS was written expressly as a signal to the regulator of Part F, followed extensive industry discussion and debate and reflected experience of operating under the current arrangements with the Electricity Commission.
22. As well as being consistent with a directly relevant statement of government policy, this change would have other practical benefits. There would be a reduced workload for the Commission in reviewing fewer individual projects, which would enable greater focus on larger, more complex investments. This would help constrain some of the increase in regulatory costs that the MED has signalled will occur as a result of the transition from Electricity Commission oversight<sup>8</sup>, as well as facilitating more timely investment.
23. Importantly, an increase of the threshold would not reduce the requirements for justification and review of the investments that would now be below the threshold. These projects would be subject to the Commission's alternate processes for approval of Minor capital expenditure. Similarly, the application of Transpower's minor grid investment process could be applied to ensure appropriate consultation with stakeholders on, for example, alternative investment options.

## Minor capital expenditure

24. Raising the threshold for Major capital expenditure increases the "pool" of Minor capital expenditure projects. This would increase Transpower's operating flexibility in a way that would benefit consumers. A higher threshold would reduce the incentive to favour "like for like" (Minor) replacement or refurbishment of existing assets in preference to (Major) investment in innovative or forward looking alternatives. Similarly, a higher threshold would increase Transpower's flexibility to reprioritise across its investment portfolio and to evolve investment programmes over time in response to changing circumstances and requirements.
25. We agree with the proposal to set MAR to reflect forecast annual Minor capital commissioning, with a wash-up mechanism to account for annual variances. However, we are concerned about the Commission's proposal that any review of commissioning at the end of the RCP would allow only "emergency" investment in excess of the forecast to be included in the RAB going forward. In our view, the ex post review should be extended to include consideration of projects that have been commissioned earlier than forecast, i.e. that were begun during the RCP and unexpectedly completed during the RCP. To exclude these projects from ex

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<sup>7</sup> Government Policy Statement on Electricity Governance – May 2009. *...The [Electricity] Commission should not be required to assess and evaluate the merits (whether technical, economic or otherwise) of small investment plans with an expected cost of less than \$20 million.* While the GPS pre-dates the transfer of jurisdiction from the EC to the CC proposed by the Electricity Industry Bill, we believe the principle set out in the GPS is clear and transcends the subsequent changes to institutional arrangements.

<sup>8</sup> Costs for implementing new Electricity Industry Governance Arrangements – Impacts on Electricity Levies, MED 7 July 2010 *...During the transition phase, while the Commerce Commission implements this function, it is estimated there will be an increase in costs (relative to the proposed reduction in electricity governance costs from transfer of this function)*.

post review would create perverse incentives to “slow down” projects toward the end of the RCP rather than deliver them most efficiently (i.e. early).

26. We strongly disagree with the proposal that no contingency be allowed on IST projects in setting the Minor capital forecast (in common with zero contingency for replacement and refurbishment projects). The “logic” for having “zero contingency” is that all projects are forecast at their P(50)<sup>9</sup> cost and that the distribution of estimation errors will be evenly distributed around the P(50) estimates. In practice, to account for unforeseen circumstances and events, a P(50) project cost estimate will include an allowance for “unspecified” costs. Forecasting uncertainty is heightened for IST projects especially in relation to applying new technologies. We propose that the contingency of 7.5% allowed under the Administrative Settlement for IST projects be retained. Moreover, the Commission must recognise that a true P(50) cost estimate for any project will necessarily incorporate some allowance for unforeseen costs.

### **Capital recovery on an as incurred basis**

27. The Commission’s overarching approach to capital recovery is that this should occur on an “as commissioned” basis, rather than an “as incurred” – the latter is the approach adopted by the Australian regulator. The “as commissioned” approach was a non-negotiable condition adopted by the Commission at the outset of negotiations on the Administrative Settlement.
28. The key impact of the “as commissioned” approach is the cash flow deferral that results compared to “as incurred”<sup>10</sup>. In addition, it requires regulation based on forecasts of project commissioning dates rather than forecasts of capital expenditure, which is harder to apply in practice. Accordingly, it contributes to the overall package of measures that act as a disincentive to investment.
29. We submit that the Commission should re-examine this key difference with the AER regime, and adopt capital recovery on an “as incurred” rather than an “as commissioned” basis.

### **Acquiring property rights**

30. Following on from the discussion of Minor capital expenditure, we propose an additional Minor Capex category for “Transmission corridor, land and easements<sup>11</sup>”. The draft decisions require that such capex must be approved ex ante by the Electricity Commission or the Commission. Often such property purchases need to happen quickly and opportunistically. Requiring prior regulator approval hinders efficient purchases and either eliminates the opportunity or drives up the cost.

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<sup>9</sup> P(50) means a probability of being exceeded of 50%.

<sup>10</sup> Correctly applied, the two approaches should be equivalent in NPV terms.

<sup>11</sup> Examples of transmission corridor investments (i.e. not linked to a particular project) are: (i) purchase of land or easement to mitigate the risks of further development under our lines, without which our future ability to do maintenance and upgrade works is impeded; or (ii) acquiring land adjacent to an existing substation that is likely to be required in the future (e.g. for expansion, entry of a new line) but which might otherwise be sold for alternative use preventing the future development of the site.

31. Therefore, we submit that an explicit provision be made in the Minor Capex categories for an asset classification “Transmission corridor, land and easements”. This would enable us to secure revenue in the MAR for a forecast annual cost of obtaining strategic property rights. A property rights strategy would support the capex forecast, consistent with the asset strategies developed for other classes of Minor capital expenditure.
32. We propose a fundamental change to the basis for the recovery of costs associated with the purchase and re-sale of land, compared with the terms of the Administrative Settlement. The reasons for this change are summarised below.
33. Our experience of the purchase of freehold titles to facilitate easement acquisition is that, while a necessary approach in some circumstances to ensure efficient project delivery, it raises complex commercial and regulatory issues that were not well understood at the time of the settlement.
34. The settlement assumed that, in those cases where the acquisition of an easement is facilitated by also purchasing the underlying freehold title, a clear distinction could be made between the costs of acquiring the easement and related expenses on the one hand and all other costs on the other. In practice this is not the case. Moreover, the cost of acquiring easements by negotiation with third-parties has differed markedly from the independent valuation of easements placed on Transpower owned land.
35. Going forward we propose as follows:
  - The gains and losses associated with the purchase and resale of freehold property acquired for the purposes of establishing an easement should be included as a project cost.
  - The final decisions should allow flexibility in the nature of the costs that are recoverable in respect of acquiring property rights. In future, costs might include: the full costs of freehold purchase and re-sale; negotiated easement costs; or other forms of commercial agreement acceptable to landowners that secures the property rights necessary to complete the project most efficiently.
  - The appropriate time for regulatory consideration of the costs of acquiring the required property rights is when the “grid investment test” is applied i.e. when the total project costs are weighed against the net benefits to consumers. This assessment would include valuing the risks of securing property rights in a more or less timely and/or costly manner to support efficient project delivery.

## **Elimination of historical customer EV account balances**

36. We support the Commission’s proposal to change the current EV account balance adjustment mechanisms to eliminate the historical imbalances in the HVAC and HVDC customer accounts. The respective imbalances are roughly equal in dollar terms but opposite in terms of “ownership”. However, we strongly disagree with the Commission’s suggestion that the proposed solution is symmetric: this characterisation stemming from the fact that the draft decisions may, to some extent, mimic what would occur under the status quo.
37. In our view, a change that is symmetric is one that delivers a broadly cash flow neutral outcome. In practical terms, this means eliminating the imbalances over similar time periods. Given the scale of the balances, and the fact that the sum owed to Transpower is allocated amongst relatively few HVDC customers

(compared to the allocation of amounts owed amongst many HVAC customers), we propose that the elimination of both customer accounts occur over the first two regulatory periods.

38. A wash-up mechanism to adjust for economic over/under-recovery is an essential part of the regulatory regime and it should be designed to avoid allowing imbalances to develop of the scale that has occurred under the previous regulatory arrangements. We, therefore, support the Commission's proposal to redress future imbalances that arise in each subsequent regulatory period.

## **Treatment of HVDC Instantaneous Reserves Costs**

39. We welcome the Commission's recognition that Transpower should not be the party which bears the costs of instantaneous reserves for the HVDC link. We disagreed with the Commission's reasoning for denying relief to recover these costs in full during the Administrative Settlement. That decision represents a present cost to Transpower's Shareholder of ca. \$48m over the first four years of the settlement.
40. This cost is sunk. However, its occurrence should not be overlooked. This episode, and the attendant signals it sends about the balance of regulatory risk, is now factored into rating agencies' assessment of Transpower's economic outlook and, in the real world, is built into our cost of capital.
41. It also illustrates, in general, the unforeseen "downside" losses to which Transpower (and most other regulated entities) are exposed. Any countervailing opportunity for "upside" gains is, at best, very limited (e.g. by holding operating expenditure below the regulatory allowance). In fact, the distribution of such unforeseen losses and gains is highly asymmetric and must be factored into an assessment of an appropriate regulated rate of return.
42. The draft decision to allow the future recovery of HVDC instantaneous reserves costs is satisfactory in principle, but unacceptable in practice.
43. First, the proposal to disallow the recovery of costs associated with outages in excess of 14 days should be removed. This exclusion is arbitrary and totally undermines the intent of the underlying decision.
44. Second, the treatment of Event Charges should be revised. The Commission proposes that Transpower continue to be exposed to the risk of Event Charges, which are only partly controllable by Transpower. However, under-frequency events can also arise from the actions of a third party but Transpower still determined to be the "causer" of the event. The recent changes to the Electricity Governance Rules regarding event charge causer determination make this outcome more likely in the future<sup>12</sup>.

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<sup>12</sup> Electricity Governance (Event Causer Determination) Amendment Rules 2010 (*Gazette* Notice 5 August 2010)

45. To address this and to reflect the future outlook for Event Charges based on the current and future operation of the HVDC link, we propose as follows:
- that there be an additional provision included in base operating expenditure for the Transition Year<sup>13</sup> (of \$0.8m) for Event Charges; and
  - where Event Charges exceed this allowance, as a result of charges for events outside our control, any over expenditure should be fully recoverable.

### **Operating cost allowance for 2011/12**

46. Transpower notes that the Commission's draft decision allows for an increased operating expenditure allowance for additional maintenance expenditure but submits that the operating expenditure allowance for the Transition Year (2011/12) should be \$234.02 million, compared with the Commission's draft decision of \$231.67 million.
47. The calculation of the transition year operating allowance in the draft decision incorrectly double counts the adjustment for instantaneous reserve availability charges. In addition, as noted above, we propose that a provision of \$0.8m be included to reflect Transpower's ongoing and increased exposure to Event Charges.

### **Departure from using GAAP as the default**

48. A key feature of the current Administrative Settlement is its reliance, where possible, on Generally Accepted Accounting Principles (GAAP) for determining the appropriate regulatory accounting treatment. The reliance on GAAP imports into the settlement framework a set of sound and well tested governing principles, the application of which is subject to the external financial audit conducted under the oversight of the Office of the Auditor General (OAG). The reliance on GAAP simplifies codification of the regulatory arrangements and allows, as far as possible, consistent treatment of costs and asset values for both financial and regulatory accounting purposes.
49. The draft decisions seek, in several places, to overturn this approach in favour of setting prescriptive rules for regulatory accounting. As a consequence, the draft decisions make it inevitable that Transpower would need to prepare a set of (non GAAP) regulatory accounts. In some instances, the proposals are impracticable and beyond the capability of our existing financial systems.
50. The allowance for tax costs is a notable example. The Commission has proposed a simplified methodology for estimating a regulatory tax allowance that approximates to Transpower's actual tax payments but ignores real-world effects. We propose that, in common with the Administrative Settlement, the regulatory tax allowance be Transpower's actual tax paid.
51. As a result of the proposed departures from GAAP, the application of the draft decisions would incur inefficient costs. We agree with the Commission's previous

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<sup>13</sup> An allowance will also need to be provided for the Remainder Period. This will be included in our operating expenditure proposals to be submitted in due course.

view that “... consumers would benefit from both the greater transparency and lower administrative costs arising from Transpower having one set of accounting records for regulatory and financial accounting purposes...”<sup>14</sup> Accordingly, we urge the Commission to revert to the underlying principle of the Administrative Settlement and, where possible, defer to GAAP to set the framework for regulatory accounting.

52. Any increased operating costs resulting from these and other additional compliance requirements signalled by the Draft Decisions, would need to be reflected in future regulatory operating cost allowances.

## Quality performance framework

53. Transpower is generally in agreement with the proposed quality performance framework. However, we disagree with the inclusion of the unserved energy (or total impact) of interruptions measured in system minutes. As we have argued consistently, this is an unsatisfactory measure of the effectiveness of actions taken by Transpower to improve quality performance. For example:
- the figure will vary markedly from year to year sometimes because of factors beyond Transpower’s control; and will not readily reflect the actions undertaken by Transpower to improve reliability;
  - a single high impact, low probability event can markedly skew the result;
  - actions by transmission customers may contribute to system minute events, and actions which could reduce such events most effectively may be within the control of transmission customers rather than Transpower.
54. We note that the use of the system minutes measure has been discontinued in Australia, following a review which found that the measure was statistically unsound.
55. The Commission comments that it will need to work with the Electricity Commission (and subsequently the Electricity Authority) in respect of the Electricity Commission’s unconditional service guarantee (USG) concept. We refer the Commission to our submission on the EC’s consultation paper “Transmission Pricing Review: High-Level Options” for a summary of our major, fundamental concerns with the USG concept. We strongly recommend that the USG concept be abandoned and that the performance incentive scheme developed by the Commission be the sole quality performance framework.

## Re-opening provisions

56. We submit that the thresholds for reopening the price path are set too high. In particular, the requirement that an adverse event needs to have a net cost impact of at least 5 per cent of annual RCP revenue is at a level of materiality that exceeds what is normally considered acceptable and its application would give rise to outcomes inconsistent with those found in competitive markets. We propose that the materiality threshold be set at 1 per cent of annual RCP

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<sup>14</sup> Refer “Input Methodologies (Transpower) Draft Reasons Paper”, 4.3.12 (page 35).

- revenue. This is a relatively high threshold, which will only be triggered in exceptional circumstances.
57. The substantial increases that occurred in the cost of instantaneous reserves allocated to the HVDC provides an example of an unforeseen event. The extent to which the regime fails to recognise the possibility of, and allow for, future unforeseen event, lets a further source of asymmetric risk persist which again will have an impact on our real cost of capital (an impact which, we note, has not been reflected in the Commission's draft decisions).
58. In part, for similar reasons to those put forward in respect of other re-opening provisions, the cost impacts of regulatory or legislative changes should be adjusted in the MAR in full on an annual basis, without the restriction of any materiality threshold.

### **Approach to information disclosure**

59. The continuation of Information Disclosure requirements that are different from the information required under the individual price-quality path is both confusing and costly for consumers<sup>15</sup>.
60. We acknowledge that Transpower is subject to an information disclosure regime under Section 54F, as well as an individual price-quality path. However, the draft decisions impose two separate accounting regimes for these purposes, for example, in relation to anything that involves the application of WACC. We can see no justification for this separate disclosure requirement. We submit that sufficient information will be available to interested persons to assess whether the purpose of Part 4 of the Commerce Act is being met under the individual price-quality path and that the associated compliance statements satisfy the requirements of Section 54F without the need for separate (and inconsistent) information disclosures.

### **Incentives for efficient foreign exchange hedging**

61. Although not contemplated by the draft decisions directly, we have included submissions on the need to ensure that there are appropriate incentives on Transpower to undertake hedging of foreign exchange and commodity price risks efficiently and in the best interests of consumers. This is an issue that we have highlighted to Commission staff informally already and is relevant to the final decisions. In our view, it is at best uncertain whether the present or proposed capital approval regimes provide the right incentives. There are two aspects to this issue.
62. First, where the Commission approves project capital expenditure in NZ\$, the decision should be clear as to the assumptions made for foreign exchange rates and commodity prices, with the understanding that the final approved amount may be adjusted to reflect any material movements in these costs. This is

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<sup>15</sup> We note also that there is considerable scope to streamline other compliance requirements by removing those requirements that add little value to either the Commission or to Transpower's customers – the annual price / quality consultation and reporting process being such an example.

particularly important for individual project approvals where there is little or no scope to substitute or re-prioritise work or to offset cost variations with other projects.

63. Second, the project value established in accordance with IFRS<sup>16</sup> will depend upon whether or not any foreign exchange hedging undertaken meets the effectiveness test necessary to qualify for hedge accounting<sup>17</sup>. Unless, the test for hedge accounting is met, the economic costs of a project will be represented by two separate accounting entries: the project capital value calculated at the spot exchange rate and a Profit and Loss statement adjustment for the cost difference due to the variance between the spot and hedged exchange rates. Irrespective of the accounting outcome, the full costs of the project including the outcomes of any hedging should be borne by customers<sup>18</sup>.

## Process timings

64. We are concerned with several of the proposed timings for implementation of the new arrangements.
65. The proposed deadline for calculating the MAR for the Remainder Period and subsequent RCPs is impracticable, as it does not provide adequately for all the processes that must be completed. We recommend that the draft decision be amended such that Transpower will be required to provide its calculated MAR for each year of the RCP by 31 October.
66. The proposed date of 30 November by which the Commission will make its decision on the MAR is too late for Transpower to finalise calculation and notification of transmission prices to its customers. Transpower is legally required to notify its prices before the end of the calendar year, which makes Christmas Eve the latest practicable date. To achieve this deadline, the final MAR must be approved by the Commission by mid November. If the approved MAR varies from that originally calculated by Transpower (and used to calculate transmission prices) this timeframe would give Transpower sufficient time to recalculate the prices, have this change audited and approved by the Transpower Board, and then to communicate prices appropriately to our customers before Christmas. Any later decision on the final MAR would make this impossible.

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<sup>16</sup> International Financial Reporting Standards

<sup>17</sup> If a foreign exchange hedge contract can be “hedge accounted”, the project value will reflect the hedged foreign exchange rate. If not, the project value will reflect the spot rate on the day that the goods or service is received. In the former case, the economic outcome of the foreign exchange contract is represented by the single accounting entry (i.e. the capitalised value of the project on the balance sheet calculated at the hedged rate). In the latter case, the economic outcome of the foreign exchange contract is represented by two accounting entries (i.e. the capitalised value of the project on the balance sheet calculated at the spot rate and an entry in the profit and loss account for the difference (gain or loss) in project value based on the spot rate and the hedged rate).

<sup>18</sup> In practice, we note that for reasons of both efficiency and accounting, foreign exchange and commodity price risks will typically not be hedged at the time of project approval but only subsequently when contracts are let.

67. We disagree with the proposed requirement that Transpower publish a written statement that confirms compliance, or otherwise with the individual price-quality path by the second Friday of each August. It is impractical to meet this date and submit that the earliest achievable date is 30 September, consistent with the current administrative settlement. We note that both the Listing Rules for the New Zealand Stock Exchange and the State-owned Enterprises Act allow three months for the year end audited accounts.

### **Concluding remarks**

68. As noted above, Parts 2 and 3 of Transpower's submission are still in preparation for submission by 16 August 2010, in accordance with the Commission's revised submission timetable. We have, to the extent practical, sought to separate and conclude our submissions on non cost of capital issues in Part 1 of the submission. We note, however, that this division of issues is artificial and there are inevitably matters raised in each Part of the submission that ultimately will need to be read in conjunction with the other Parts.
69. We note also that the subsequent submission on draft determination issues may identify contradictions or inconsistencies between the reasons papers and the effect of the draft determinations. We will endeavour to highlight any such contradictions, and their impacts on our position, in Part 3 of our submission.