

Comparison of New Zealand and Australian regulation of electricity transmission networks

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1. Summary and conclusions

The purpose of this report¹ is to provide a comparison between the New Zealand and Australian arrangements for regulating electricity transmission networks.

The analysis presented in this report indicates that Transpower is exposed to substantially greater stranded asset risk than its peers in Australia. Overall, we regard the arrangements in relation to capital expenditure as being unlikely to encourage efficient and timely investment, contrary to the stated purpose of the regime.

Our comparison also shows that in a number of areas Transpower will face negative cash flow outcomes compared to the Australian arrangements. An important exception to this observation is the Commission's approach to the roll forward of the regulatory asset base, which adopts a historic cost asset valuation methodology. Under this approach, Transpower will obtain a positive cash flow outcome compared to the approach adopted in Australia (which applies an indexed historic cost asset valuation methodology).

Where Transpower is subject to regulatory arrangements that have the effect of deferring cash flows, the regulated WACC must be applied to ensure that Transpower does not incur an economic loss. In this regard, we note that it is unclear whether the Commission intends to include an allowance for financing costs during construction at the regulated WACC when capital projects are rolled into the regulatory asset base (RAB). If a lower financing cost is imposed by the Commission, Transpower will be negatively affected in NPV terms, as well as cash flow terms, compared to the Australian arrangements.

Even if Transpower is kept economically whole under regulatory arrangements that entail cash flow deferral, cash flow issues are very important from a business liquidity and risk perspective, and should be considered carefully by the Commission. In this regard, we note that the Commission's proposed approach to returning the EV accounts to zero balance is asymmetric in the sense that surpluses are required to be returned to balance more quickly than deficits. This will have a negative impact on Transpower's cash flows and it raises broader legitimate concerns regarding Transpower's ability to recover its revenue requirements. The New Zealand approach to EV accounts does not have a parallel in Australia.

We also note that the Commission's approach to including capital expenditure in the RAB on commissioning has the effect of deferring cash flows. The Commission argues that the "as commissioned" approach is consistent with the outcomes of a workably competitive market, where assets only earn a return after they are commissioned. In Australia, however, capital expenditure is included in the RAB when it is incurred.

It should be noted that the "as commissioned" approach may introduce greater forecasting risk where large projects have uncertain commissioning dates, especially towards the end of a regulatory period. In contrast to the Commission's view, workably competitive markets provide examples of "as incurred" and "as

¹ In the course of preparing this report, we have read the Code of Conduct for Expert Witnesses as laid down by the High Court of New Zealand, and we agree to comply with it.



commissioned” payment methods. For example, it would not be unusual for building and construction contracts to provide for staged payments. In light of these observations, in our view the Commission should not rule out adopting an “as incurred” approach to recognising capital expenditure.

Other aspects of the regulatory arrangements in New Zealand and Australia are broadly similar. In particular, the general principles governing the design of service standards and incentive schemes are broadly comparable. We generally regard the New Zealand arrangements in respect of these matters as being consistent with good regulatory practice.

In relation to arrangements for recovering unforeseen cost increases during a regulatory period, we do not consider that the New Zealand arrangements address the risks of unforeseen events appropriately. We consider the Australian arrangements to be better as they provide for the unforeseen costs associated with changes in legislation or taxation, for example, to be addressed without re-opening the entire price-quality path determination. The Australian arrangements also adopt a lower threshold for the recovery of the costs of such change events.

The next section of this report sets out recommendations for addressing the issues we have identified in the course of comparing the Australian and New Zealand regimes.

2. Recommendations

In light of the comparison between the New Zealand and Australian arrangements for regulating electricity transmission network, we recommend that the Commission should adopt the following changes to its intended approach:

- (a) **Reduce stranded asset risk.** Transpower’s actual capital expenditure should be included in the regulatory asset base, even if it exceeds the amount approved by the Commission. Our suggested approach will ensure that Transpower does not suffer a permanent capital loss in the event that the approved amounts will be too low to fully compensate Transpower for the efficient delivery of projects. Under the Commission’s approach, any expenditure incurred in excess of the approved amount will not be recoverable. If our recommendation is not adopted, it is likely that the level and timing of new investment will be sub-optimal, contrary to the objectives of the New Zealand regime.
- (b) **Consider adopting an “as incurred” approach to capital expenditure.** The Commission should reconsider whether an “as incurred” approach” to incorporating capital expenditure into the RAB is preferred. The cash flow and forecasting benefits may outweigh the theoretical purity of an “as commissioned” approach.
- (c) **Ensure the WACC is used to calculate financing costs during construction.** If the Commission maintains its “as commissioned” approach, it should ensure that the regulated WACC is used to remunerate financing costs during construction. The regulated WACC represents the true opportunity cost of financing a project (providing that the regulated WACC accurately reflects the firm’s cost of capital).



- (d) **Adopt the Australian cost pass through arrangements.** This approach would ensure that costs associated with changes in legislation or taxation, for example, could be addressed without re-opening the wider price-quality path. A threshold of 1% of revenue should apply to these cost pass through items. For the avoidance of doubt, we support the Commission's approach of applying zero threshold to the Commission's existing cost pass through items.

3. Summary of comparison

Section 5 of our report compares the approaches applied in Australia and New Zealand by examining 22 issues that relate to the economic regulation of electricity transmission networks. The 22 issues we examined are grouped into five key areas. The table below provides a summary of our comparison of the New Zealand and Australian regimes in relation to each of these five key areas. The summary table focuses on the principal elements of the regulatory regimes in both jurisdictions, and provides a high-level description of the differences exist between the two jurisdictions.



Summary of comparison of New Zealand and Australian electricity transmission regulation

Areas	Our overall assessment of NZ arrangements compared to Australia
Cost allocation and negotiated services	<p>The New Zealand arrangements are likely to deliver outcomes that are not materially different to the Australian arrangements.</p>
Regulatory asset base, stranded asset risk and related issues	<p>The New Zealand arrangements are likely to deliver outcomes that are materially NPV negative compared to the Australian arrangements.</p> <p>In the New Zealand regime, Transpower is exposed to two forms of significant stranded asset risk. Firstly, capital expenditure can only enter the regulatory asset base at the lesser of approved costs or actual costs. The restrictions in New Zealand on capital expenditure substitution between certain expenditure categories further heightens this stranded asset risk. Secondly, Transpower is exposed to risk that assets previously included in the regulatory asset base may be subsequently removed from it.</p> <p>In Australia, the Rules require that actual capital expenditure must be included in the regulatory asset base. In addition, there are no restrictions in relation to capital expenditure substitution. The Rules relating to removal of assets from the regulatory asset base are highly restrictive and do not expose transmission companies to significant risks.</p> <p>The exposure of Transpower to asymmetric asset stranding risk, coupled with the restriction on capital expenditure substitution is likely to diminish the incentives for Transpower to invest efficiently. This is not consistent with the objectives of the regulatory regime.</p> <p>We regard the New Zealand arrangements as being inconsistent with good regulatory practice because:</p> <ul style="list-style-type: none"> • they expose Transpower to an asymmetric risk of loss of capital value (“stranded assets”); and • they damage Transpower’s incentives for efficient investment, and in so doing, the arrangements appear to be inconsistent with the achievement of the purpose of Part 4 of the Act. <p>In addition to the negative NPV impact of asset stranding risk, which we regard as material, the New Zealand arrangements are likely to deliver negative cash flow outcomes compared to Australia because assets enter the regulatory asset base on commissioning. Moreover, under the New Zealand approach it is unclear whether an allowance for financing costs during construction would be calculated using the regulated WACC when capital projects are rolled into the regulatory asset base. If a lower financing cost is used by the Commission, Transpower will be negatively affected in NPV terms compared to the Australian arrangements.</p> <p>Even if Transpower is kept economically whole under regulatory arrangements that entail cash flow deferral, cash flow issues are very important from a business liquidity and risk perspective, and should be considered carefully by the Commission.</p>
Cost of capital and taxation	<p>The New Zealand regime adopts a different WACC formulation to Australia, but a similar approach to taxation. We understand that Transpower has sought a separate expert opinion in relation to the cost of capital, and therefore we have not considered the Commission’s proposed WACC estimate for Transpower.</p>



Areas	Our overall assessment of NZ arrangements compared to Australia
Form of control, incentive mechanisms and cost pass through arrangements	<p>The New Zealand arrangements are likely to deliver outcomes that are NPV negative compared to the Australian arrangements.</p> <p>The New Zealand and Australian regimes largely adopt similar approaches to these issues. The Australian arrangements provide greater clarity on how operating and capital expenditure allowances will be set.</p> <p>A material issue arises in relation to Transpower’s exposure to legislative and regulatory change, in which the Commission applies a higher materiality threshold -compared to the Australian regime.</p>
Transmission pricing and rebalancing arrangements	<p>The New Zealand arrangements deliver outcomes that are cash flow negative.</p> <p>The arrangements should be economically neutral over the long term, provided the NZ arrangements adopt the regulated WACC in the valuation of deferred cash flows, consistent with the Australian arrangements.</p> <p>The principal difference between the regimes is the EV accounts that apply to AC and DC customer groups in New Zealand. The approach to rebalancing these accounts exposes Transpower to substantial negative cash flows, and raises legitimate concerns regarding Transpower’s ability to recover its revenue requirements. Similar issues do not arise in Australia. It may be possible to adopt a simpler method for addressing existing imbalances without maintaining separate EV accounts for AC and DC customer groups.</p>

4. Overview of the objectives of the Australian and New Zealand regulatory regimes

Before examining the detail of the two regulatory regimes, the overarching objectives as set out in the enabling legislation for each jurisdiction are discussed briefly below.

In Australia, the National Electricity Law requires the Australian Energy Regulator (AER) to perform or exercise an economic regulatory function or power in a manner that will or is likely to contribute to the achievement of the national electricity objective, which is defined as follows²:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to—

- (a) price, quality, safety, reliability and security of supply of electricity; and
- (b) the reliability, safety and security of the national electricity system.”

In New Zealand, Section 52A of the Commerce Act sets out the following purpose statement:

“The purpose of this Part is to promote the long-term benefit of consumers in markets referred to in section 52 by promoting outcomes that are consistent with outcomes produced in competitive markets such that suppliers of regulated goods or services—

- (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

² National Electricity Law, sections 16(1)(a) and 7.



- (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
- (d) are limited in their ability to extract excessive profits.”

It is noteworthy that the purpose statement was recently amended by the Commerce Amendment Act 2008. The principal amendments were to place additional requirements on the Commission in relation to:

- promoting outcomes that are consistent with outcomes produced in competitive markets; and
- providing suppliers of regulated goods or services with incentives to innovate and to invest, including in replacement, upgraded, and new assets.

It is noteworthy that the objectives of both the Australian and New Zealand regimes focus on promoting the long term benefit or interests of consumers by encouraging efficient investment. The New Zealand regime is more explicit in making reference to competitive market outcomes and providing service providers with incentives to invest and improve efficiency. Similar concepts, however, are implicit in the Australian regime, as explained in the second reading speech³:

“The national electricity market objective in the new National Electricity Law is to promote efficient investment in, and efficient use of, electricity services for the long term interests of consumers of electricity with respect to price, quality, reliability and security of supply of electricity, and the safety, reliability and security of the national electricity system.

The market objective is an economic concept and should be interpreted as such. For example, investment in and use of electricity services will be efficient when services are supplied in the long run at least cost, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities.

The long term interest of consumers of electricity requires the economic welfare of consumers, over the long term, to be maximised. If the National Electricity Market is efficient in an economic sense the long term economic interests of consumers in respect of price, quality, reliability, safety and security of electricity services will be maximised.”

In our view, the overarching objectives of regulatory regimes in New Zealand and Australia are closely aligned. The similarities in the overarching regulatory objectives allow us to compare the detail of the regulatory arrangements in each jurisdiction and comment on the differences and similarities.

A detailed comparison of the regimes is provided in the next section.

³http://www.ret.gov.au/Documents/mce/_documents/NEL2ndreadingspeechhansard9feb0520050211091852.pdf



5. Detailed comparison of the Draft Decisions in New Zealand with the Australian regulatory arrangements

Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
Cost allocation and negotiated services			
1. Overall approach for cost allocation	<p>Transpower is not required to adjust the total costs associated with supplying its regulated services. Specifically the Commission applies a threshold below which common costs fall within the regulated business. The Commission explains that⁴:</p> <p>“The revenue associated with the unregulated services provided by Transpower (consisting of Energy Market Services Limited, d-cypha Trade and Risk Reinsurance Limited) is approximately 2.2% of Transpower’s total revenue, which is below the 5% threshold in the Commission’s proposed CAMSC process. Any common costs between the unregulated services and regulated services are therefore likely to be of relatively low value.”</p>	<p>Transmission costs must be allocated according to a cost allocation methodology developed in accordance with principles set out in Part G of Chapter 6A of the Rules. The Rules do not provide any specific guidance on the treatment of common costs between non-regulated and regulated activities.</p>	<p>Neutral. The NZ arrangements allow common costs below a threshold amount to fall entirely to the regulated business. It is not clear whether the Australian regulator would approve a similar approach. In any case, the Commission indicates that any benefit to Transpower from its proposed approach is likely to be immaterial.</p>
2. Treatment of costs associated with the system operator service	<p>The Commission’s draft decision is that, where the EC and Transpower have an agreed SOSPA, the Commission should not interpose itself between the EC and Transpower by requiring the revenue associated with the SOSPA to be subject to an individual price-quality path.</p> <p>The revenue associated with the system operator activities undertaken by Transpower is approximately 3.2% of Transpower’s total revenue and therefore, any common costs between the system operator activities and other regulated activities are likely to be relatively small.</p> <p>Given the above, the Commission’s draft decision is that Transpower is not required to adjust the costs of undertaking its regulated activities, other than for the costs of system operator activities. Transpower is required to exclude the costs set out in the SOSPA from any operating or capital expenditure forecasts used to determine Transpower’s individual price-quality path.⁵</p>	<p>In Australia, the system operator role is principally undertaken by the Australian Energy Market Operator, with the exception of Tasmania where Transend has a system operator role. The treatment of system operator activities is therefore not a material issue in Australia.</p>	<p>Neutral. This issue does not arise in Australia. For the reasons outlined in row 1 of this table, we do not regard any benefit that may accrue to Transpower as being material.</p>

⁴ Commerce Commission, Draft Decision Input Methodologies Transpower, June 2010, page 24.

⁵ Commerce Commission, Draft Decision Input Methodologies Transpower, June 2010, paragraphs 3.3.5 to 3.3.7, page 24.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
3. Treatment of New Investment Contracts (NICs)	<p>Services provided by NICs fall under the Part 4 definition of electricity lines services because they involve the conveyance of electricity by line.</p> <p>The Commission will not interpose itself between Transpower and its contract counterparties by requiring the revenue associated with NICs to be subject to an individual price-quality path, provided certain conditions are met.</p> <p>Fixed assets associated with NICs are to be excluded from Transpower's RAB, and any capital expenditure included in NICs are to be excluded from any capital expenditure forecasts used to determine Transpower's individual price-quality path.</p> <p>Transpower should continue to include all operating costs associated with NICs within its total operating costs associated with providing regulated services.⁶</p>	<p>Clauses 6A.9.1 and 6A9.5 of the Rules provide for the transmission company to agree terms and conditions for negotiated transmission services in accordance with a negotiating framework that is approved by the regulator. The purpose of the negotiating framework is to ensure that the transmission company does not exploit its market power in the provision of these services. Practically, the same approach to regulating negotiated transmission services is adopted in Australia and New Zealand. The building block regime in Australia excludes the costs of providing negotiated services.</p>	<p>Neutral. The regulatory arrangements in both countries are similar. In practice, the commercial risks associated with NICs in NZ and negotiated transmission services in Australia may differ. A detailed study would be required in order to identify any potentially material differences between the Australian and NZ arrangements.</p>

⁶ Commerce Commission, Draft Decision Input Methodologies Transpower, June 2010, page ix.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
Regulatory asset base, stranded asset risk and related issues			
<p>4. Overall approach for establishing the initial Regulatory Asset Base (RAB) value</p>	<p>The initial value of the RAB should be the RAB determined under the settlement agreement as at 30 June 2011. The initial value of the RAB should include the remaining value of the HVAC lines pseudo asset, established by the settlement agreement, as at 30 June 2011.</p> <p>The following assets should be excluded from the RAB:</p> <ul style="list-style-type: none"> ▪ any assets not used to provide electricity lines services, as defined in s 54C; ▪ any asset that is part of a works under construction; ▪ working capital; ▪ easement land, that is land acquired for the purpose of creating an easement, and with the intention of subsequently disposing of the land; ▪ assets provided under NICs; and ▪ assets used in the provision of the system operator services. <p>Transpower may include in the RAB value only those intangible assets that meet the GAAP standard NZ IAS 38, using the cost model of recognition, with the exception of goodwill which must be excluded. Transpower may include assets permitted by NZ IAS 17, that is finance leases, in the RAB value.</p> <p>Transpower must allocate asset values using the process set out in the cost allocation input methodology.⁷</p>	<p>The initial regulatory asset base value (in dollars) is prescribed in Schedule 6A2.1(c) of the Rules. In principle, the approach adopted in New Zealand is not inconsistent with the Australian approach, although the debate regarding the initial regulatory asset base in Australia has been settled.</p> <p>Some adjustments to the initial RAB values are provided for in the savings and transitional provisions in Chapter 11 of the Rules to address a number of company-specific issues. For example, in the case of ElectraNet adjustments were allowed in relation to the valuation of easements in the initial RAB value.</p>	<p>Neutral. The difference between the New Zealand and Australian arrangements reflect their relative maturities, rather than differences in approach. In particular, it is noted that the valuation of the initial regulatory asset bases in Australia has been substantially settled.</p> <p>In making this assessment, it is assumed that the Commission's proposed approach to financing costs⁸ is consistent with the Australian arrangements. As discussed in row 8 of this table, the financing costs incurred during the construction of capital projects should be calculated using the WACC.</p>

⁷ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, page 11.

⁸ Commerce Commission, Draft Decision Input Methodologies Transpower, June 2010, paragraph 4.4.61, page 50.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
5. Indexation of the regulatory asset base: DHC or IHC	<p>No indexation is to be applied in rolling forward the RAB. Transpower's RAB must be rolled forward to reflect Commission-approved capital additions at depreciated historic cost.⁹</p> <p>In effect, a nominal rate of return is applied to an unindexed RAB to determine the return on Transpower's capital base.</p>	<p>The RAB is subject to indexation.</p> <p>In effect, a real rate of return is applied to a RAB value that is indexed to increase with inflation to determine the return on the capital base.</p>	<p>The Australian and New Zealand arrangements provide equivalent outcomes in NPV terms over the life cycle of the asset base. However, the New Zealand arrangements provide higher cash flows in the near-term.</p> <p>The New Zealand arrangements can therefore be considered to be "cash flow positive" relative to the Australian arrangements.</p> <p>This feature may be regarded as being more favourable especially during periods of relatively high capital expenditure requirements.</p>

⁹ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, page 12.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
<p>6. Recognition of capital additions</p>	<p>Consistent with the Commission’s view that it should move, over time, to a regime where capital expenditure is approved on an ex-ante basis, the Commission will incorporate all Major capital expenditure projects into Transpower’s MAR if they have received approval prior to the relevant MAR determination. Assets may only be included in the RAB if these receive ex-ante regulatory approval, once commissioned, and at the lesser of approved or actual cost.¹⁰</p> <p>In the event that Transpower’s Minor capital expenditure exceeds its ex-ante approved level, such expenditure must be excluded from Transpower’s RAB unless;</p> <ol style="list-style-type: none"> a. Transpower seeks and receives ex-post approval from the Commission for that capital expenditure; or b. Transpower calculates the revenue impact of that capital expenditure, over the life of those assets, including a reasonable allowance for maintenance, and makes an adjustment to the relevant EV account to fully offset this cost.¹¹ <p>The Commission intends in future, to move to a regime under which Transpower’s revenue allowance is set on an ex-ante basis, with minimal use of wash-ups and ex post reviews. A step in this direction is to not allow ex-post approval of expenditure over and above the Minor capital expenditure allowance, unless exceptional circumstances are presented. The Commission considers it appropriate to limit the use of the ex-post approval to exceptional circumstances only, to ensure the correct discipline and incentives are provided for Transpower to manage project costs and make efficient prioritisation decisions, as well as ensure it provides an accurate forecast of its capital expenditure requirements.¹²</p>	<p>Schedule 6A2.1(f) requires that all capital expenditure incurred is rolled into the RAB regardless of whether it is above or below the approved ex ante allowance. This contrasts sharply with the Commission’s approach where capital expenditure may be permanently excluded from the RAB if it exceeds the ex ante allowance.</p> <p>In the Australian arrangements, the costs of financing any capital expenditure above the ex-ante allowance are borne by the regulated company until the depreciated value of the capital expenditure is rolled into the RAB at the next 5-yearly regulatory review.</p> <p>As noted below, capital expenditure is included in the RAB on an as-incurred basis.</p>	<p>The New Zealand arrangements are likely to provide outcomes that are NPV negative compared to the Australian arrangements.</p> <p>The prospect of capital expenditure of approved projects being permanently excluded from the RAB has the effect of exposing Transpower to greater risks of asset stranding: risks that must be reflected in investment decision-making. In addition, the Commission’s approach creates a very strong incentive for Transpower to spend no more than the ex ante allowance, even when the additional investment may be economically justified in terms of the provision of long-term benefits to consumers. This feature of the NZ arrangements may impede the achievement of the purpose of Part 4 of the Act (namely, the promotion of the long-term benefit of consumers). The Commission’s stance on this issue is also at odds with its aim to promote the long-term interests of consumers by providing incentives to innovate and invest.¹³</p> <p>This is a material point of difference between the Australian and New Zealand regimes. We regard the New Zealand arrangements as being inconsistent with good regulatory practice because:</p> <ul style="list-style-type: none"> • they expose Transpower to an asymmetric risk of loss of capital value (“stranded assets”); and • they damage Transpower’s incentives for efficient investment, and in so doing, the arrangements appear to be inconsistent with the achievement of the purpose of Part 4 of the Act.

¹⁰ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.7.13.

¹¹ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.9.8.

¹² Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.9.4.

¹³ Commerce Commission, Input Methodologies (Electricity Distribution Services), June 2010, Draft Reasons Paper, paragraphs 6.2.32 and 6.12.52.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
<p>7. Substitution of capital projects</p>	<p>Individual approval is required for Major Projects, and approved costs on Major Projects cannot be substituted or applied to other projects.¹⁴</p> <p>The Commission's draft decision is to increase Transpower's flexibility to substitute projects (i.e. the emerging view of preventing substitutions between aggregated programmes, and between aggregated programmes and other Minor capital expenditure sub-categories, has been discarded).¹⁵</p>	<p>There are no issues relating to substitution of expenditure between capital projects or programs. The actual investment decisions of regulated companies are not constrained by the capital expenditure forecasts used in the establishment of the revenue cap. The companies are free to decide the timing, scope and nature of investment once the revenue cap is set. The incentive properties of the revenue cap are designed to encourage efficient execution of the required level of investment, while service incentive mechanisms provide incentives for the companies to undertake the investment that is required to maintain service standards and reliability.</p>	<p>The New Zealand arrangements are likely to provide outcomes that are NPV negative compared to the Australian arrangements.</p> <p>The Commission's approach to substitution has the effect of creating a single expenditure category for Minor projects, and individual expenditure categories for each major projects.</p> <p>As noted in row 6 of this table, the Commission's approach to recognising capital expenditure in the RAB means that exceeding the approved allowance for a capital expenditure category will lead to a permanent economic loss being incurred by Transpower. It follows that the larger the number of expenditure categories, the greater the potential for Transpower to incur a capital loss.</p> <p>We note that the Commission's approach to substitution in its Draft Decision is less restrictive than its earlier 'emerging views'. Nevertheless, compared to the Australian arrangements, the Commission's approach remains restrictive and will expose Transpower to increased risk of capital loss.</p> <p>In our view, it is reasonable for the Commission to monitor actual capital expenditure against the forecast amounts. The difficulty with the New Zealand arrangements is that the consequence of exceeding an approved amount is a permanent capital loss. We regard the regulatory penalty for exceeding an approved allowance as disproportionate, especially given the difficulty in accurately forecasting capital expenditure.</p> <p>In our view, the Commission's approach is unlikely to promote efficient investment or outcomes that are consistent with competitive markets.</p>

¹⁴ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.2.3(c).

¹⁵ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.3.14.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
<p>8. Cost of financing works under construction</p>	<p>In workably competitive markets, assets that have not been commissioned would not normally be expected to earn a return on the capital expended. It was the Commission’s preliminary view, therefore, to allow Transpower to recover financing costs from the time the asset is commissioned.</p> <p>Under GAAP (NZ IAS 23), finance costs are calculated from the ‘commencement date’ to the date at which ‘substantially all the activities necessary to prepare the qualifying asset for use... are complete’. The Commission’s preliminary view for Transpower on the timing of including capital and financing costs in the RAB is consistent with this GAAP treatment.¹⁶</p> <p>The Commission proposes that the cost of finance during the construction of new assets should be capitalised and enter the RAB once new works are commissioned. This will allow Transpower to earn a return on the cash payments made to suppliers when constructing new assets. In effect, Transpower will be compensated for the effects of cash flow shortfalls, if any, experienced during capex programmes which involve periods of intensive cash usage.¹⁷</p>	<p>Financing costs are addressed by recognising capital expenditure in the RAB as it is incurred. The roll forward model adopts a “partially as-incurred method” as its default position¹⁸. This approach calculates the return on capital based on an as-incurred approach and the return of capital (depreciation) is based on an as-commissioned approach. A transmission company can propose a full ‘as incurred’ approach during discussions with the AER prior to lodging its revenue proposal. Previously, the AER applied an “as commissioned” approach to capital expenditure entering the RAB. In this case, the regulated WACC was used to calculate the financing costs during construction and these were included in the RAB. We understand that one of the reasons the AER moved away from the “as commissioned” approach is the practical difficulty associated with forecasting the as-commissioned costs of projects, especially large projects with long lead-times.</p>	<p>The New Zealand arrangements provide outcomes that are cash flow negative compared to the Australian arrangements.</p> <p>The NZ arrangements provide a less favourable outcome in terms of cash flow, as all holding costs prior to the commissioning of new works must be borne by Transpower. This may have negative implications if high capital investment requirements lead to increased short term funding requirements.</p> <p>Furthermore, it is unclear whether the Commission intends to allow financing costs at the regulated WACC. If a lower financing cost is adopted by the Commission, Transpower will be negatively affected in NPV terms compared to the Australian arrangements. This is because an “as incurred” approach remunerates investment at the regulated WACC.</p> <p>The Australian arrangements indicate that an “as incurred” approach is not regarded as inconsistent with good regulatory practice or the range of outcomes that may be expected in a workably competitive market.</p> <p>We note that the Australian arrangements previously applied an “as commissioned” approach, and applied the WACC in calculating the cost of financing during construction. In our view, the calculation of the cost of financing during construction for regulatory purposes should not necessarily be determined by accounting rules.</p>

¹⁶ Commerce Commission, Draft Decision Input Methodologies Transpower, June 2010, paragraph 4.4.35 and 4.4.36.

¹⁷ Commerce Commission, Draft Decision Input Methodologies Transpower, June 2010, paragraph 4.4.61.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
9. Contingent projects	In RCP1 [regulatory control period 1], the Commission has not placed any restriction on Transpower's ability to seek approvals for Major capital expenditure during the RCP. For this reason, as large uncertain projects become more certain, Transpower may seek regulatory approval for that expenditure, and recover its costs via the wash-up process. ¹⁹	Clause 6A8.2 of the Rules provides for a revenue determination to be reopened to provide additional revenue where a trigger event for a contingent project has occurred. A 5-year regulatory allowance is set for the contingent project, thereby providing incentives for the transmission company to deliver the project efficiently. The actual capital expenditure incurred is included in the RAB once the project is complete.	The New Zealand arrangements provide outcomes that are cash flow negative compared to the Australian arrangements The reasoning outlined in relation to row 8 of this table also applies here. In addition, the arrangements in Australia are more conducive to providing an incentive for efficiency savings, as required by the purpose statement. In the medium term, the Commission may wish to develop a contingent project approach similar to the Australian arrangements.

¹⁸ AER, Transmission Network Service Providers, Roll forward model, Final Decision, section 4.2, September 2007, page 4.

¹⁹ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.7.15.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
10. Stranded asset risk	<p>Transpower should be compensated for impaired or stranded assets, when it is caused by factors that are outside of its control, such as changes in user consumption, by allowing accelerated depreciation of those assets, in the year in which assets become stranded. The onus would be on Transpower to provide evidence to the Commission to validate claims that assets will become stranded during a regulatory period, and that they have taken adequate steps to mitigate this risk. Transpower should not earn a return on capital for stranded or impaired assets after this accelerated depreciation is allowed. The assets should instead be written out of the RAB at that time.²⁰</p>	<p>Schedule 6A.2.3 of the Rules only allow assets to be removed from the RAB in circumstances where the transmission company has not made reasonable efforts to manage the risk of asset stranding by discounting the price or entering into an agreement with the customer to manage the risk. The assets must be dedicated to a specific user or small group of users and exceed \$10 million in value. It is noted, therefore, that the circumstances in which asset stranding can occur are quite limited. The Rules also provide for compensation if the risk of stranding is not addressed elsewhere.</p>	<p>The New Zealand arrangements are likely to provide outcomes that are NPV negative compared to the Australian arrangements.</p> <p>The NZ arrangements provide greater prospects of asset stranding. In particular, the NZ arrangements require Transpower to provide evidence that adequate steps have been taken to mitigate stranded asset risk. These arrangements afford some discretion to the Commission in determining both the adequacy of the evidence provided and the adequacy of the measures taken by Transpower. This exposes Transpower to the risk that it may be prevented by the Commission from recovering the costs of stranded assets.</p> <p>This is a material point of difference between the Australian and New Zealand regimes. We regard the New Zealand arrangements as being inconsistent with good regulatory practice because:</p> <ul style="list-style-type: none"> • they expose Transpower to an asymmetric risk of loss of capital value (“stranded assets”); and • they diminish Transpower’s incentives for efficient investment, and in so doing, the arrangements appear to be inconsistent with the achievement of the purpose of Part 4 of the Act.

²⁰

Commerce Commission, Draft Decision Input Methodologies Transpower, June 2010, paragraph 4.4.86.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
<p>11. Wash up process</p>	<p>A wash-up is a year-end process whereby certain forecasts of future expenditure, used in setting Transpower’s MAR, are replaced with actual expenditure. The purpose of this is to recalculate the MAR for that past year, and assess performance of that past year against actual expenditure, rather than forecast expenditure. Transpower’s actual revenues are then assessed against this recalculated MAR, and any resultant ex-post economic gains or losses can then be identified. Transpower is then required take any gain or loss to its EV account.²¹</p> <p>Note that in the event of any over-expenditure relative to the Minor capital allowance, the Commission’s draft decision is that such over-expenditure will not be included in any wash-up. The purpose of ex-post approval is to allow such capital expenditure to be entered into the RAB for recovery in subsequent RCPs (not to provide recovery in the current RCP).²²</p> <p>In contrast to the approach of not allowing wash-ups of additional Minor capital expenditure, the Commission does consider it should allow a full wash-up of additional Major capital expenditure, if Transpower receives ex-ante approval for that expenditure. The reason for the difference in approach is that Major projects are approved individually on an ex-ante basis, and cannot be substituted. With regard to Minor projects, Transpower is provided the flexibility to fully prioritise and substitute its capital expenditure programme between each year of the RCP. As explained in section 5.9.4, the Commission considers Transpower should fully manage within its approved allowance.²³</p> <p>This approach will help ensure that, for the first regulatory period, customers pay for a project only once it is commissioned, and based on actual cost (capped at the approved expenditure level), reducing project risk for both Transpower and its customers.²⁴</p>	<p>In the Australia, ‘wash up’ arrangements are limited to:</p> <ul style="list-style-type: none"> • Pass through events; • Correcting RAB values for any difference between estimated capital expenditure in the final year of a regulatory control period and the actual capital expenditure; and • Contingent projects (although an incentive arrangements applies to these projects, as described in point 9 above). <p>Pass through events are addressed shortly after they occur (the TNSP must submit details to the AER, and the AER then makes a determination regarding costs).</p> <p>The correction to the RAB for differences between estimated and actual capital expenditure in the final year of a control period is not addressed until the subsequent review (i.e. 5 years hence).</p> <p>There is no ‘wash up’ for differences between forecast and actual capital expenditure for transmission companies in the National Electricity Market. However, in Western Australia an investment adjustment mechanism does apply to some categories of capital expenditure to correct for differences between forecast and actual capital expenditure. In this arrangements, which contrasts markedly with the Rules that apply to transmission businesses in the National Electricity Market, the regulator conducts ex post reviews to determine the capital expenditure that should enter the RAB.</p>	<p>The New Zealand arrangements are likely to provide outcomes that are NPV negative compared to the Australian arrangements.</p> <p>The NZ arrangements are summarised as ensuring that “customers pay for a project only once it is commissioned, and based on actual cost (capped at the approved expenditure level), reducing project risk for both Transpower and its customers.” Despite these comments, in reality Transpower is exposed to financial losses if its capital expenditure exceeds the ex ante allowance and no ex post allowance is provided.</p> <p>It is understood from the Draft Decision on the Individual Price-Quality Path that ex post allowances will only be allowed for Minor capital expenditure in “exceptional circumstances”²⁵ and will not be provided with respect to Major capital expenditure²⁶. It follows from these observations that Transpower will be exposed if it exceeds its ex ante capital expenditure allowance, but there is no upside if its expenditure is below the ex ante allowance. It is also noted that “assets may only be included in the RAB if these receive ex-ante regulatory approval, once commissioned, and at the lesser of approved or actual cost.”²⁷</p> <p>It is evident that the New Zealand arrangements expose Transpower to asymmetric risk – the possibility of capital losses, but no possibility of any capital gain. It is difficult to assess the materiality of this exposure. However, compared to Australia, NZ is a less favourable regime, and one that may fail to give effect to the objectives set out in the legislation.</p>

²¹ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.8.5.

²² Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.8.11.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
12. Depreciation	Depreciation should be calculated using straight line depreciation based on the economic life of the underlying asset.	Clause 6A.6.3 of the Rules requires that the depreciation profile reflects the economic life of the assets. In theory, the Rules provide the transmission company with some flexibility in its choice of depreciation schedule. In practice, however, the approach is likely to be consistent with the NZ arrangements.	Neutral.
Cost of capital and taxation			
13. Overall Approach for Treatment of Taxation	Transpower's tax obligations should be estimated using a 'tax payable' approach.	A tax payable approach is also adopted in Australia.	Not examined. We note that New Zealand and Australia adopt the same conceptual approach to taxation and, therefore, appear to be intended to produce materially similar outcomes. However, we have not compared the respective estimations of the regulatory tax allowance. A number of detailed issues would be relevant in any comparison, including the assumed level of gearing and the value attributed to imputation credits.

²³ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.8.13.

²⁴ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.8.14.

²⁵ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.9.4.

²⁶ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.7.5.

²⁷ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 5.7.13.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
<p>14. Overall Approach for the Cost of Capital</p>	<p>The Commission will estimate the cost of equity using the simplified Brennan-Lally version of the Capital Asset Pricing Model.</p> <p>Six parameters are required to estimate the cost of capital:</p> <ul style="list-style-type: none"> ▪ Leverage ▪ Risk-free rate of return ▪ Debt premium and debt issuance costs ▪ Tax-adjusted market risk premium (TAMRP) ▪ Betas ▪ Tax rates <p>The Commission considers that the degree of volatility with regard to the risk-free rate of return and the debt premium is sufficient to update these parameters when calculating suppliers' cost of capital. All other parameters that form part of the cost of capital estimation are assumed to stay constant over time (with the exception of the temporary increase in the TAMRP) and therefore will be fixed in the input methodology determination and will not be updated on a regular basis.</p> <p>Recognising that the cost of capital estimate is subject to some uncertainty (due to uncertainty associated with some of the underlying parameter estimates), the Commission will calculate a cost of capital range.</p>	<p>The Rules provide for WACC parameters to be determined by the AER periodically in a Statement of Regulatory Intent. The AER's first Statement of Regulatory Intent (of May 2009) provides for the application of the same WACC to electricity transmission and distribution activities.</p> <p>The WACC framework mandated by the Rules is the Sharpe CAPM.</p>	<p>Not examined. We understand that Transpower is obtaining a separate expert opinion on the cost of capital.</p>
<p>15. Implementation for Information Disclosure</p>	<p>For information disclosure, the Commission will annually calculate a range for the five-year term of the vanilla and post-tax cost of capital. The Commission considers it appropriate to apply a range between the 25th and 75th percentiles for assessing profitability.</p>	<p>The Australian regime does not have a separate information disclosure regime. However, clause 6A.17.1 of the Rules provides for the provision of certified annual statements.</p>	<p>Likely neutral. The value of a separate disclosure regime is not obvious.</p>



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
Form of control, incentive mechanisms and cost pass through arrangements			
<p>16. Approach for determining operating and capital expenditure allowances</p>	<p>Transpower’s operating expenditure allowance will:</p> <ol style="list-style-type: none"> 1. be determined by the Commission after an ex-ante assessment of operating expenditure forecasts for the RCP submitted by Transpower; 2. reflect what the Commission considers to be a reasonable and efficient level of operating expenditure for Transpower; 3. take into consideration Transpower's performance in the previous regulatory period (or in the Transition Year in the case of the 2012/13-2014/15 allowances); 4. be set in a manner to provide Transpower with incentives to improve efficiency and identify and realise appropriate cost savings; 5. consist of separate allowances set by the Commission for each year of the regulatory period; and 6. exclude pass-through costs and recoverable costs.²⁸ <p>In relation to setting a capital expenditure allowance, the Commission notes that the current wording of the Bill requires the Commission to determine an input methodology for Transpower’s capital expenditure proposals by no later than 1 October 2011.</p>	<p>The Rules provide high-level objectives for operating and capital expenditure allowances. Clause 6A.6.6 requires that the AER must accept the transmission company’s operating expenditure forecast if the AER is satisfied that the total of the forecast operating expenditure for the regulatory control period reasonably reflects:</p> <ol style="list-style-type: none"> (2) the efficient costs of achieving the operating expenditure objectives; (3) the costs that a prudent operator in the circumstances of the relevant Transmission Network Service Provider would require to achieve the operating expenditure objectives; and (4) a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives (“the operating expenditure criteria”). <p>Similar provisions apply in relation to capital expenditure.</p> <p>The Rules also specify 10 factors that the Commission must consider in assessing the forecast expenditure.</p>	<p>The New Zealand arrangements appear more likely to provide outcomes that are NPV negative compared to the Australian arrangements.</p> <p>Compared to the Australian arrangements, the NZ regime appears to provide the Commission with broad discretion to determine Transpower’s operating expenditure allowance. In relation to capital expenditure, the future arrangements in New Zealand have not yet been determined. We regard the extent of regulatory discretion as an important element in the design of a regulatory regime. However, it is difficult to express an opinion on whether the arrangements in New Zealand will have a material impact in terms of the NPV of revenues.</p>

²⁸ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 4.4.1.



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<p>17. Specification of price</p>	<p>Price for Transpower will be specified by a revenue cap. The Input Methodology will include an initial list of Pass-Through Costs and a process for adding new Pass-Through Costs as well as an initial list of Recoverable Costs for Transpower. The initial list of Pass-Through Costs includes local authority rates and regulatory levies.</p> <p>The initial Recoverable Costs for Transpower are instantaneous reserves, the costs of developing and funding transmission alternative services under some conditions, and the net incremental carry-forward amount under the incremental rolling incentive scheme.²⁹</p> <p>The calculated MAR must not include approved pass-through costs or recoverable costs. Transpower will forecast these on an annual basis, these being added to its MAR. Any under or over recovery must be demonstrated in Transpower’s annual compliance statement, and an adjustment to the EV account made equal to the over or under recovery.³⁰</p>	<p>The Australian arrangements mandate a revenue cap for a 5 year period. Pass through events are defined in Chapter 10 of the Rules to include:</p> <ul style="list-style-type: none"> (a) a regulatory change event; (b) a service standard event; (c) a tax change event; (d) a terrorism event; and (e) an insurance event. <p>A network support pass through event is also provided for in Clause 6A.7.2 of the Rules. In addition, a transmission company may propose additional pass-through events as part of its Revenue Proposal.</p> <p>The AER’s principles for defining pass-through events are similar to those set out by the Commission. In Australia, the recovery of costs arising from a pass through event is subject to a materiality threshold, which the AER has defined as 1% of revenue.</p> <p>In the recent Victorian distribution price reviews, the AER has included an L factor to allow the distributors to ‘pass through’ licensing costs. This is not subject to a threshold.</p> <p>In Australia there is no equivalent to the Commission’s “Recoverable Cost” category. It is also noted that instantaneous reserves are not a matter for the transmission networks in Australia, but transmission businesses are required to consider non-network alternatives to delivering transmission services.</p>	<p>Neutral. It is important to understand the definitional differences between the term “pass through” in New Zealand and Australia. In New Zealand, pass through allows Transpower to recover all the associated costs from customers. It includes rates and regulatory levies.</p> <p>In Australia, pass through refers to events that occur during the regulatory period and lead to changes (positive and negative) in the transmission company’s costs. Any claim for a pass through amount is subject to a materiality threshold of 1% of revenue (although there has been some relaxation of this threshold in recent distribution determinations).</p> <p>In terms of comparing the regimes, we note that regulatory levies are ‘passed through’ in Australia, but council rates are generally not passed through. In Australia, increases in council rates would only be recoverable from customers as a pass-through if the increase resulted from a tax change event. On this matter, the New Zealand arrangements better insulate Transpower from differences between forecast and actual council rates.</p> <p>More broadly, however, the New Zealand regime adopts a smaller set of “pass through events” compared to Australia. To provide a comprehensive assessment of the arrangements for recovering unforeseen cost increases, it is important to also consider the arrangements for re-opening a revenue cap, which are addressed in row 18 below.</p>



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<p>18. Reconsideration of Price-Quality Paths</p>	<p>Transpower's IPP may be reconsidered if one of the following events has occurred:</p> <ul style="list-style-type: none"> ▪ a catastrophic event, for which the costs of rectifying the impact of the event is material; or ▪ a material error is discovered in the determination; or ▪ Transpower has provided false or misleading information to the Commission, which the Commission has relied upon in making its determination; or ▪ a change in legislative or regulatory requirements that has a material impact on costs; or ▪ a transaction event where reconsideration is warranted. <p>In this context, material means that the impact of the event over the remainder of the regulatory period is at least 5% of the allowed revenue for the year in which the event occurs.</p> <p>We note that the Commission does not explain whether the re-opening is limited to address the impact of the event, or whether a wider re-opening of the whole IPP determination would be undertaken.</p>	<p>The revocation of a revenue cap is addressed in clause 6A.15 of the Rules and is limited to circumstances where a material error has occurred or the decision was made on the basis of false or misleading information. The materiality threshold for pass through events (which could include changes in legislation or catastrophic events) is 1% of revenue.</p> <p>Clause 6A.7.1 provides for a revenue cap to be re-opened to include additional capital expenditure if an unforeseen event occurs and the additional required capital expenditure exceeds 5% of the RAB. It should be noted that this re-opening is limited to addressing the new capital expenditure requirements, so other aspects of the determination would remain unchanged.</p>	<p>As noted in row 17 of this table, it is important to consider these provisions and the pass-through arrangements together. Our overall assessment is that New Zealand arrangements are likely to provide outcomes that are NPV negative compared to the Australian arrangements.</p> <p>We note that the New Zealand arrangements apply a 5% materiality threshold for reconsidering the price-quality path. This 5% is calculated with reference to the impact of the event over the remainder of the regulatory period. This approach has merit if the reopener is to consider the entire price-quality price path. In particular, we consider that the remaining life of the regulatory period is a relevant consideration if a full scale review is to be brought forward.</p> <p>However, elements in the Commission's re-opener provisions should not, in our view, trigger a re-opening of the entire price-quality path. For example, the costs of a legislative change could be addressed without re-opening other elements of the control. Furthermore, it is more appropriate to consider the impact of these events on an annual basis, which is the approach in Australia.</p> <p>Overall, we do not consider that the New Zealand arrangements address the risks of unforeseen events appropriately. Accordingly, Transpower may be exposed to additional costs as a result.</p>

²⁹ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 2.7.1, page 14.

³⁰ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.5.2, page 21.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
19. Rolling Incentive Scheme under IPPs	<p>The Commission will implement an IRIS for Transpower’s IPP. The efficiency gain or loss for a particular year will be calculated as the difference between actual and forecast controllable operating expenditure for the current year, minus the difference in the preceding year, the result of which provides the incremental gain / loss for that year.</p> <p>While both incremental gains and losses will be carried forward, only positive net balances will be carried forward (i.e. only net rewards will be carried forward).</p> <p>The length of time Transpower is allowed to retain the efficiency gain is five years.</p>	<p>An efficiency benefit sharing scheme applies in Australia. The mechanics of this arrangement appears to be similar to those contemplated by the Commission. One difference is that the New Zealand scheme will not apply negatives for RP1. In Australia, the AER adopts a symmetrical approach to positive and negative carryovers.</p>	Neutral.



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<p>20. Service standards and service incentive mechanisms</p>	<p>The Commission considers an incentive mechanism linking Transpower's quality performance with revenue is an integral part of an individual price-quality path. Any quality incentive mechanism should be symmetrical, such that Transpower can potentially earn rewards as well as incurring penalties.³¹</p> <p>The Commission's draft decision also includes a transition period in which performance is reported but no revenue is at risk. While Transpower has historically reported on most of the proposed measures, or variants of them (refer subsequent sections), it has not set and assessed performance against target levels linked to revenue at risk. Establishing a quality performance regime, but setting the maximum penalty/reward at 0% for the first regulatory period allows the Commission and Transpower to gain experience with setting statistically valid parameters, and better understand the inter-relationships between the various factors, without undue risk.³²</p>	<p>In Australia, transmission companies are subject to a service target performance incentive scheme. The current version of that scheme provides for a revenue exposure of 1%, depending on service relative to targets.</p> <p>It should be noted that the scheme provides for symmetric or asymmetric incentives.</p>	<p>The New Zealand arrangements are likely to provide outcomes that are NPV positive or neutral compared to the Australian arrangements.</p> <p>The NZ arrangements do not (for RCP 1) provide any financial incentives in relation to service performance. The NZ arrangements could be regarded as positive in the sense that they expose Transpower to less service performance related risk compared to arrangements in Australia.</p> <p>However, it has already been noted that the higher asset stranding risks in New Zealand (arising either through the exclusion of capital expenditure from the RAB or through the subsequent removal of redundant assets) diminish Transpower's investment incentives. This may expose customers to the risk of service deterioration over the longer term – an outcome that would be contrary to the objectives set out in the legislation.</p> <p>Based on the arrangements adopted in Australia, we consider that a first-best approach to the provision of adequate investment incentives is to remove Transpower's exposure to stranded asset risk. Once Transpower has adequate certainty regarding the recovery of efficient capital expenditure, the design of an appropriate service incentive scheme could then be considered.</p>

³¹ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 6.4.3.

³² Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 6.4.5.



Issue	Proposed regulation for Transpower	Australian arrangements	Overall assessment of NZ arrangements compared to Australia
Transmission pricing and rebalancing arrangements			
<p>21. Pricing Methodology</p>	<p>The Bill proposes to amend the Act to prevent the Commission from setting pricing methodologies where these are set by an industry-specific regulator (such as the Electricity Authority) and to provide that it is the role of the Electricity Authority to set pricing methodologies for Transpower. Under the Act, pricing methodologies are defined as including methodologies for setting different prices (which are defined as including revenues) for different customer groups.³³</p> <p>The Commission considers that there is some ambiguity in the definition of pricing methodologies in the Act. While it may be argued that the Commission's proposed approach may amount to setting pricing methodologies for Transpower, the Commission considers that, although these rules may have some impact on Transpower's revenue in respect of each customer group, the proposal does not equate to setting revenues for each of those customer groups. For this reason, the Commission considers this approach does not amount to setting pricing methodologies for Transpower. The Commission is of the view that requiring Transpower to separately calculate and disclose its HVAC and HVDC revenue requirements is consistent with, and supports the approach taken under the current transmission pricing methodology.³⁴</p>	<p>Transmission companies are required to develop a transmission pricing methodology that satisfies the requirements of Part J of Chapter 6A of the Rules. Clause 6A.23.2(c) requires that every portion of the revenue requirement must be allocated, and only allocated once. This provides certainty that the allowed revenue will be recovered through transmission prices.</p> <p>The pricing rules provide for connection charges for generation and load and use of system charges for load. The use of system component is 50% location-based and 50% postage stamped. A common service charge is also applied on a postage stamp basis.</p> <p>The transmission pricing methodology must be submitted alongside the transmission company's revenue proposal. In Victoria, there is separation between the asset owner (SP AusNet) and the body responsible for setting prices (AEMO, which has subsumed the roles and responsibility of the Victorian organisation, VENCORP).</p>	<p>Neutral. The Australian arrangements are more settled compared to New Zealand. The existing uncertainty regarding the pricing arrangements in New Zealand does not necessarily render the New Zealand regime 'more risky' than Australia. In our opinion, the key issue is whether the pricing arrangements will enable Transpower to recover its full revenue entitlement. As discussed below, there is some concern regarding this issue, given the Commission's intended approach to the existing imbalances in the EV accounts for AC and DV customers.</p>

³³ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.6.9.

³⁴ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.6.11.



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<p>22. Returning EV accounts to zero balance</p>	<p>The Commission's draft decision is that the balance of the HVAC EV account, which is currently approximately \$109 million in credit (owed to customers), should be returned to customers by the end of the first regulatory control period (30 June 2015).³⁵</p> <p>In respect of the HVDC EV account, the Commission's draft decision is that the balance, which is currently approximately \$103 million in debit (owed by certain generators that are HVDC customers), should be recovered by Transpower from HVDC customers by the end of RCP2³⁶.</p> <p>While the Commission's draft decision is to set rules around cost recovery in respect of the EV balances attributable to the HVAC and HVDC, the Commission does not consider this amounts to setting pricing methodologies for the reasons set out in Sections 3.6.8 to 3.6.11.³⁷</p> <p>We note that the EV accounts in New Zealand imply different building blocks for AC and DV customers.</p>	<p>The Australian arrangements do not provide for EV accounts. There is no systematic under- or over-recovery situation for particular categories of customers. As noted above, the transmission pricing arrangements provide for the recovery of the allowed revenue.</p> <p>It appears that the New Zealand arrangements will provide for a systematic under-recovery for an extended period of time.</p>	<p>The New Zealand arrangements are likely to provide outcomes that are cash flow negative compared to the Australian arrangements.</p> <p>The Commission is proposing that the EV account for AC customers, which is in credit, be returned to customers by 30 June 2015, with 50% returned in the transition year.</p> <p>In contrast, the EV account for DC customers, which is in deficit, is only returned to zero balance by the end of RCP2, which is expected to be 30 June 2020.</p> <p>This means that Transpower will face a growing annual cash outflow throughout RP1, returning to zero balance only in 2020. No such arrangement applies in the Australian regime.</p>

³⁵ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.9.6.
³⁶ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.9.10.
³⁷ Commerce Commission, Draft Decision Individual Price Quality Path Transpower, June 2010, paragraph 3.9.22.