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COMMERCE COMMISSION DRAFT DETERMINATION INPUT METHODOLOGIES - TRANSPOWER

Index:

A.	*INTRODUCTION*	*1*
	1 Overview	*1*
B.	*LEGAL APPROACH TO SUBSTANTIVE ISSUES*	*4*
	2 Purpose of Price Regulation	*4*
	3 Government Policy Statements	*13*
C.	*PRACTICAL CONSEQUENCES*	*15*
	4 Incentives for Transpower to Invest	*15*
	5 WACC	*19*
	6 Easements	*20*
	7 "Minor Capex"	*24*
	8 Event Charges	*26*
	9 Reconsideration of the Price Path	*28*
D.	*PROCEDURAL LEGAL ISSUES*	*36*
	10 Inadequate Detail in Input Methodology	*36*
	11 Information Disclosure	*37*

A. INTRODUCTION

1 Overview

1.1 I have been asked by Transpower New Zealand Limited ("**Transpower**") to advise on the legal issues that arise in relation to the Input Methodology Draft

Determination and the Draft Reasons Paper issued by the Commerce Commission in June 2010 (respectively the "**Draft Input Determination**" and "**Input Reasons Paper**"). To the extent that the Input Reasons Paper draws on the more general paper Input Methodologies (Electricity Distribution Services) Draft Reasons ("**the EDS Input Methodologies Reasons Paper**") I have also considered that. In other parts the Input Reasons Paper has to be read with the draft Reasons Paper – "Individual Price-Quality Path Transpower" ("**Transpower IPP Reasons Paper**").

1.2 In my view, the Commerce Commission's general legal approach to the substantive issues is flawed in two respects:

(a) The Commerce Commission has failed to give adequate weight to the changes in the purpose of the Price Regulation Part of the Commerce Act as implemented in 2008 (with effect for the electricity industry from 1 April 2009). In particular it has:

(i) In a number of areas not given effect to the words "*consistent with outcomes produced in competitive markets*"; and

(ii) Given inadequate weight to the introduction of the new para (a) in the statutory purpose statement that provides that the supplier of regulated services should have incentives to innovate and invest;

(b) Although the Commerce Commission has referred to the policy statements transmitted to it under s26 of the Commerce Act 1986 in 2006 and in 2009 it has nowhere in the Transpower specific documents referred to the terms of the statements let alone given any overt sign that it has had proper regard to them (as it is required to do under s26). Both refer to the desirability of efficient investment in infrastructure with the 2009 one giving some specific directions in relation to easements.

1.3 Turning to the more specific practical issues the following points arise:

(a) The overall outcome is likely to be **inconsistent** with the incentive to invest, given the cumulative effect of all the downsides (profit, cash flow, risk) Transpower faces and the lack of upside;

(b) One of the tools used by the Commerce Commission, the simplified Brennan-Lally CAPM, does **not** produce outcomes that are seen in competitive markets. It indicates that the cheapest cost of capital gearing ratio is nil when most commercial entities of any size operating in competitive markets have significant gearing. To overcome this, the Commerce Commission has made an arbitrary notional gearing decision applicable to all regulated industries without addressing whether the Brennan-Lally model should be retained given the non-competitive market results that it produces;

(c) The treatment of land acquired for easements is inconsistent with the 2009 GPS;

(d) So too is the threshold for minor investments and the importance of Transpower having the incentive to invest efficiently;

(e) It disallows the recovery of event charges which are often likely to be imposed when Transpower is not at fault and which are, in fact, an allocation mechanism for the costs of instantaneous reserves;

(f) The requirement that each adverse event needs to have a net cost impact over the Regulatory Control Period of at least a 5% of the allowed revenue imposes a materiality test far beyond the normally accepted and would give outcomes inconsistent with competitive markets. It is also inappropriate in relation to regulatory changes and is a fetter on the Commerce Commission's discretion under ss52Q, 52K and s54V(3). In any event, it is highly unreasonable in relation to industry or Transpower specific regulations.

1.4 There are two separate issues where the Commerce Commission overlooked the scheme of the Act:

(a) The Input Methodology decisions do not meet the requirements of s52T(2) as too many decisions required to enable Transpower to reasonably estimate the material effects of the input methodology are in the Transpower IPP Reasons Paper;

(b) The requirement that Transpower be put to the expense of preparing separate disclosure accounts using different inputs to those used for calculating the revenue cap (especially the WACC) imposes an unnecessarily high compliance cost which is inconsistent with the scheme of Part 4 of the Act.

1.5 I propose expanding on these comments in turn.

B. LEGAL APPROACH TO SUBSTANTIVE ISSUES

2 Purpose of Price Regulation

The Change

2.1 The statutory regime under which the Commerce Commission is currently operating when imposing a revenue cap on Transpower is found in Part 4 of the Commerce Act 1986. That Part was rewritten in the Commerce Amendment Act 2008 with the subpart applicable to Transpower coming into force on 1 April 2009. That is, the regime now applicable is different from that prevailing when the 2008 Administrative Settlement was entered into. The specifics of that prior regime may no longer always be appropriate going forward.

2.2 For present purposes the particular significance of the changes in the new regime lies in the changes to the statutory statement as to the purpose of the new Part 4 (s52A) when compared with the statutory statement as to the purpose of the old Part 4A which used to apply to the electricity industry (s57E).

2.3 The contrast is best seen by comparing the two provisions side by side with the principal changes emphasised:

52A Purpose of Part [*Current Provision*]

(1) 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

(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.

(2) In this Part, the purpose set out in subsection (1) applies in places of the purpose set out in section 1A.

57E Purpose [*Old Provision*]

The purpose of this subpart is to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers

(a) [see below]

(b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and

(c) share benefits of efficiency gains with consumers, including through lower prices.

(a) are limited in their ability to extract excessive profits; and

Outcomes Produced by Competitive Markets

2.4 The first significant change is the introduction into the main text of the words "*by promoting outcomes that are consistent with outcomes produced in competitive markets*". This is in place of "*efficient operation*".

2.5 The change must have been for some purpose. In my view the legislature is not trying to confine the regulated industries to some artificial environment but, given that price control only applies where there is little or no competition (see s52), is trying to come up with outcomes that mimic what would or could happen if there is workable competition. The Commerce Commission in the EDS Input Methodologies Reasons Paper also refers to this "*mimicking*" concept at paras 2.7.19 to 2.7.21. However, the Commission often does not appear to have put the concept into practice. I say this despite the assertion to the contrary in the Input Reasons Paper in the Executive Summary at para X14, first bullet point, and in paras 2.5.2, 2.5.4.

2.6 Obviously paragraphs (a) to (d) of s52A(1) create an internal tension. For instance, the providing of incentives to invest as required by paragraph (a) has to be balanced against the requirement in paragraph (d) to limit the ability to extract excessive profits. How then is that tension to be resolved in any particular case? In my view, the answer lies in the opening words of s52A(1) when read with the underlying philosophy of the Commerce Act that the long term interests of consumers are served by promoting workable competition. In the context of price regulated markets such workable competition is not available. Price regulation is intended to protect consumers from excessive profit taking but is not intended to penalise those who operate in such industries, especially not by discouraging investment (through inadequate rewards). Nor does under investment protect the long term interests of consumers.

2.7 But this still leaves the problem of how to strike a balance. In my view, it is by trying to see what happens where competition occurs. In applying paragraph (a)

the Commission should look to see when firms in a competitive market invest. If, for instance, they do **not** invest if the maximum they can expect is their WACC, then to come up with a methodology that only gives a maximum return of WACC with the real potential to not earn WACC, is not only inconsistent with paragraph (a), it is also not consistent with the overriding balancing test contained in the opening words of s52A.

2.8 Those words "*consistent with outcomes products in competitive markets*" should also govern the various input methodologies. That is, if any methodologies or inputs to methodologies are methodologies or factors that would **not** normally be used by enterprises in a competitive market then it is likely that the outcome will **not** mimic outcomes produced by competitive markets. Other methodologies or input factors should be sought.

2.9 Here I endorse what the Commerce Commission stated at para 2.5.20 of the EDS Input Methodologies Reasons Paper:

> *2.5.20 There are, in many cases, practical constraints on the Commission's ability to design IMs that, when applied to a particular instrument, will necessarily promote outcomes consistent with workably competitive market outcomes. Therefore, in weighing up the various options for setting IMs, the Commission has considered the extent to which each option is most likely to move outcomes closer towards, rather than further away from, outcomes consistent with workably competitive markets over time.*

2.10 Unfortunately, I do **not** consider the Commerce Commission did actually apply that correct approach in a number of practical occasions (although, in other areas, it did – see e.g., para 4.4.63 of the Input Reasons Paper dealing with financial leases).

2.11 The Commerce Commission returned more specifically to the whole theme of "*Workably Competitive Market Outcomes and Part 4*" in section 2.7 of the EDS

Input Methodologies Paper. At para 2.7.4 it considered that, as Part 4 of the Commerce Act only applies where there is not workable competition, not all workably competitive market outcomes are meaningful or relevant to regulated markets. While that is something of a truism it does not undermine the point I have made at para 2.8 above.

2.12 The Commerce Commission goes on to say (at para 2.7.6) that long-term contracting can provide some useful insights when weighing up various options for setting Input Methodologies. As developed in Part 9 below I consider the Commission then lost sight of that when considering when Transpower's Individual Price-Quality Path should be re-opened.

2.13 Having considered that information disclosure would assist in mimicking competitive market outcomes the Commission turned to the issues of innovation and investment at paras 2.7.31ff of the EDS Input Methodologies Reasons Paper. In paras 2.7.35 and 2.7.36 the Commerce Commission states:

> *2.7.35 The Commission considers that what matters most for dynamic efficiency is expectations around how new investment and innovations will be treated. It is normal in workably competitive markets for firms to expect to be able to earn a profit that is sufficient to reward them for investment, consistent with s 52A(1)(d). The prospect of earning above-normal profits for a period provides incentives for innovation (and efficiency more generally). In most markets, competitive forces also put pressure on firms to undertake investments at the socially optimal time.*
>
> *2.7.36 If a regulated firm does not expect to make at least a normal return on its efficient incremental investments going forward, it would be unable to maintain the quality of its services and would have no incentive to invest further in order to meet the growth in consumer demand."*

2.14 That is, the Commerce Commission appears to recognise that in competitive markets investments are made in the expectation of earning **above** normal profits

for an initial period. See also para 2.7.34. But the Commerce Commission does not reflect that in how it deals with regulated suppliers who do not have any upside despite the Commission's reference to participants in competitive markets expecting "**at least**" a normal return on their investments.

2.15 The Commerce Commission then returns to this theme at paras 2.7.43ff of the EDS Input Methodologies Reasons Paper where it states (emphasis added):

> *"Profits*
>
> *2.7.43 As listed above, a key performance criterion associated with the outcomes produced in workably competitive markets is that profits are just sufficient to reward investment, innovation and efficiency. The Commission has previously noted that this equates to saying that, over the lifetime of its assets, an efficient firm in a workably competitive market could expect to earn at least a normal rate of return (i.e. its cost of capital)."*

Incentives to Invest

2.16 As will have been noted (see para 2.3 above) the 2008 amendment to the statutory purposes introduced a completely new factor, namely the requirement that regulated firms "*have incentives to innovate and to invest, including in replacement, upgraded and new assets*". At the same time the outcome of limiting excessive profits was downgraded from factor (a) to factor (d). Those changes must also have been for some reason.

2.17 Surprisingly, I can find no analysis by the Commerce Commission of this change and in its importance in either the Transpower Input Reasons Paper or the EDS Input Methodology Reasons Paper.

2.18 Indeed, there is little consideration of s52A(1)(a) on its own. Looking at the Transpower Input Reasons Paper there is:

(a) a general reference to it in para 2.6.5 in the context of providing certainty;

(b) a reference in para 4.3.20 in the context of using the roll forward methodology for the valuation of the Regulatory Asset Base, again in the context of providing certainty to Transpower;

(c) a reference in para 5.4.16 in relation to the value at which acquired assets are brought in. In particular, the Commerce Commission rejected Transpower's submissions that an NPV – adjustment to the Regulatory Asset Base value be undertaken on the basis that this may not promote efficiency enhancing trades consistent with s52A(1)(a).

2.19 In the companion Transpower IPP Reasons Paper the Commerce Commission at para 3.5.5 asserts:

> *"As Transpower will receive an appropriate return on its investment, s52A(a) (sic) is also promoted … "*

2.20 However, nowhere does the Commerce Commission actually assess the rate of return against that particular criterion.

2.21 No doubt the Commerce Commission would respond to those criticisms by saying that this topic had been considered in more detail in the general paper EDS Input Methodology Reasons Paper. There are certainly considerably more references to s52A(1)(a) (as an individual factor) in that paper.[1]

[1] See paras 2.7.32, 2.7.34, 2.7.38, 2.7.45, 2.7.53, 2.7.59, 3.2.3, 4.2.3, 4.2.26, 4.2.40, 4.3.11, 4.3.16, 4.3.17, 4.3.45, 4.3.47, 4.3.57, 4.3.100, 4.3.169, 5.3.5, 5.3.15, 5.4.10, 6.13, 6.2.25, 6.2.26, 6.2.27, 6.12.48, 7.3.17.

2.22 In particular, the Commerce Commission uses s52A(1)(a) to justify why it is appropriate to take a consistent attitude to various factors relevant to the Regulatory Asset Base. If a regulated entity has concerns about future regulatory treatment then, as the Commerce Commission correctly identifies, this will be a disincentive to invest. Likewise, if there is too rigorous a treatment of stranded assets. I have no problem with that as far as it goes but it does not go far enough.

2.23 In section 2.7 of that EDS Input Methodologies Reasons Paper the Commerce Commission discusses "*Financial Capital Maintenance*" and comes to the conclusion that this is maintained by providing a return consistent with WACC and allowing recovery over time of the value assigned to the individual assets in the Regulatory Asset Base.

2.24 This begs two questions:

(a) If all a firm in a competitive environment could look forward to when it was considering an investment was up to a maximum of WACC plus recovery of the historic cost of the asset, with substantial downside risks, would they invest? This is a factual issue. I simple note that it appears from Appendix B to the Input Reasons Paper, p110, column 1 that other submitters were of the view that only allowing a maximum of WACC with potential downsides does not create an incentive to invest;

(b) Is the rate fixed for Transpower sufficient to maintain its Financial Capital?

2.25 Interrelated with the introduction of the new paragraph (a) is the demotion and wording of the old paragraph (a), now (d). The demotion must have some significance. And, relevantly, the wording is not to prohibit **excess** profits but to limit the ability to extract **excessive** profits. The word "*excessive*" means "*too much or too great*". It has a connotation of significantly more than a simple economic profit. If there is a risk that an entity will invest but may earn a profit

that is slightly more than an economic profit compared with a lower return but no investment then the balance should be in favour of the former.

3 Government Policy Statements

Introduction

3.1 The foregoing analysis of s52A(1) is reinforced by the Government Policy Statements to which the Commerce Commission must have regard – see s26(1).[2]

3.2 I accept that the Commerce Commission is only required to "*have regard to*" the Statements (rather than implementing them unquestionably). Nevertheless, where such Statements are directly applicable I would expect the Commerce Commission to refer to the applicable part and explain why it is not implementing the relevant Government policy (in terms of why the Statement is inconsistent with the statutory scheme and objectives this requires the Commission to work to achieve).

3.3 In any event, I see nothing in the relevant Policy Statements that are inconsistent with the approach the Commerce Commission is required to take as mandated by Part 4 of the Commerce Act.

3.4 Here there are two relevant Policy Statements:

(a) The electricity industry specific May 2009 Government Policy Statement on Electricity Governance ("**the 2009 GPS**"). This was transmitted not just to the Electricity Commission but also to the Commerce Commission; and

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[2] *"**26 Commission to have regard to economic policies of Government***

(1) In the exercise of its power under this Act, the Commission shall have regard to the economic policies of the Government as transmitted in writing from time to time to the Commission by the Minister."

(b) A more general policy statement dated 7 August 2006 "*Incentives of Regulated Businesses to Invest in Infrastructure*" ("**the 2006 Policy Statement**") transmitted only to the Commerce Commission.

The 2009 GPS

3.5 The Commerce Commission asserts it has had regard to the 2009 GPS – see paras 2.6.1(a), 2.6.3 and especially 2.6.5 and see also 4.3.20 of the Input Reasons Paper. But there is little in the way of specific analysis. At para 2.6.3 the emphasis is on energy efficiency. At paras 2.6.5 and 4.3.20 the Commission draws the linkage between incentives to invest and the promotion of investor confidence on the one hand, and regulatory certainty on the other. Beyond that there is no reference to the 2009 GPS.

3.6 The 2009 GPS and its immediate predecessor were issued against a background of long term underinvestment in the National Grid. Against that background the 2009 GPS emphasises the need for grid reliability (with consequential need for investment in replacements and upgrades) – e.g., paras 10, 11 (5th bullet point), 14 and the first 3 bullet points of para 71.

3.7 A specific objective for Transpower in para 71 is that its "*services are priced in a manner that … fully reflects their costs including risk…*". That includes capital costs.

3.8 Then para 86 provides:

> "*86. Where the Commission approves a grid upgrade plan, the full costs associated with implementing the grid upgrade plan should be recoverable by Transpower in accordance with the pricing methodology determined by the Commission.*"

3.9 Together these various directions are a signal that the Commerce Commission should err in favour of promoting investment and limiting excessive profits when resolving conflicting objectives.

3.10 The 2009 GPS also has statements about planning ahead, including early acquisition of land interests (paras 89, 90) and about minor transmission works (paras 87 and 88) to which I will return later.

2006 Policy Statement

3.11 The 2006 Policy Statement is much more general but still shows a strong desire by the Government to encourage infrastructure investment which is efficient.

3.12 This 2006 Policy Statement is referred to in the Input Reasons Paper at paras 2.6.1, 2.6.2, 2.6.4 and 2.6.5 but mainly in the context of promoting regulatory certainty rather than any more specific encouragement of investment generally.

C. PRACTICAL CONSEQUENCES

4 Incentives for Transpower to Invest

4.1 I turn now from general comments to specific issues that arise in light of those general comments. The most significant item relates to the incentive Transpower has to invest, that is did the Commerce Commission give proper effect to:

- s52A(1)(a);
- the 2009 GPS para 71; and
- para 7 of the 2006 Policy Statement.

4.2 Typically the assets that Transpower is called on to invest in are very long life assets that, once in place, are largely sunk costs. Schedule A of the Draft Determination attributes a standard asset life of between 45 and 55 years for substations, transformers etc.

4.3 These asset lives are way beyond the usual length of long term debt financing. At the time when Transpower is constructing the new assets and needs to finance the construction costs it will not be able to obtain debt financing for anything like the expected life of the asset.[3] Although it ought to be able to rollover some of its debt financing that always comes at a cost. If, in the meantime, the regulatory regime has undermined the profitability of Transpower or its cash flows, the rolled over finance is likely to be more expensive for Transpower.

4.4 For Transpower to have the incentive to invest in such long term assets it needs confidence that:

(a) It will receive the appropriate return on the capital investment in the asset;

(b) Such return will be available on the full price of the asset and that price should be fully recoverable;

(c) Such return will be available throughout the period when the cost of the asset is being recovered;

(d) These conditions are not likely to be disrupted by changes contemplated by the regulatory regime and, in particular, a force majeure event;

(e) Its future cash flows will be sufficient to more than meet, year by year, the repayments of debt (both interest and capital) and the reasonable dividend expectations of its shareholders.

4.5 Except to the extent I make comments in Part 5, the adequacy or otherwise of the return on capital is essentially a factual issue as to how appropriate is the WACC derived by the Commission's methodology.

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[3] As at 30 June 2009 Transpower owed about $1,160m in non current debt. The longest term debt (comprising about 28% of the total non-current debt) falls due in 11 to 12 years from 30 June 2009 with the next longest term debt (3% of the total) falling due in 7-8 years.

4.6 In relation to the other factors that go into the equation, the Commission does not appear to have properly given weight to the need to have incentives to invest. In particular:

(a) The WACC is fixed by reference to the 75th percentile. That is, there is a one in four chance of getting it wrong;

(b) Transpower bears the risk of cost overruns if such overruns exceed the contingency sum built into the project as approved by the Electricity Commission or, in the future, Commerce Commission but does not benefit from any cost savings;

(c) Transpower bears the risk if there are construction delays;

(d) Transpower will not receive a return on capital if the asset is subsequently stranded;

(e) Transpower cannot recover the cost of the stranded asset unless the Commission accepts that the asset is stranded and that Transpower has taken adequate steps to mitigate the risk of stranding (i.e., there are regulatory risks);

(f) In the commissioning stage there will inevitably be teething problems. If these give rise to an event charge or to instantaneous reserve costs beyond a 14 day grace period then these charges are to be borne by Transpower;

(g) There are delays in the entry of the asset into the Regulatory Asset Base if not approved before the commencement of the relevant regulatory control period – note para 7.6.20 of the Input Reasons Paper. Again this will affect cash flows and could well lead to higher financing costs;

(h) Transpower bears the risk of events that do not pass the very high threshold currently proposed for the reopening of the Individual Price-

quality Path for Transpower. Not only does that potentially directly jeopardise the rate of return for Transpower, it could affect its cost of future borrowing;

(i) Transpower's investment decision making ability is more curtailed by its regulatory environment than is the case for firms in a competitive market. Although some of that restriction arises from the regulatory regime under the Electricity Act rather than under Part 4 of the Commerce Act, the low threshold for minor capex expenditure as set by the Commerce Commission increases that lack of flexibility;

(j) Because the upside of innovation is limited, this discourages risk-taking investments even if, in a competitive market, an industry participant would be willing to take the risk because of the greater returns.

4.7 Although firms in the competitive market will bear some of those risks the normal manner to compensate for that is for the threshold internal rate of return for a new project required by management to be above WACC with a real prospect that the new asset will earn a return above the cost of capital at least for an initial period. Also, such firms will benefit from capital projects coming in under budget or early (unlike Transpower).

4.8 I recognise that a price regulator inevitably has the concern that if too high a return is allowed on new investments then this can lead to inefficient investment. That would be contrary to the thrust of s52A(1). However, at least in the case of investments accepted by the Electricity Commission as passing the Grid Investment Test or future investments approved by the Commerce Commission, that should not be a concern. Such a new transmission investment by Transpower is subject to detailed scrutiny by an outside regulator against statutory criteria with the future benefits discounted back such that the higher the WACC is for Transpower the less likely it is approval will be given. That is, an approved investment is, per se, an efficient investment.

4.9 A transmission investment has also to be consistent with the Statement of Opportunities (i.e., the demand forecasts) prepared and published by, currently, the Electricity Commission or, if the Electricity Industry Bill is passed, then the Ministry of Economic Development. Having passed that hurdle a full return should be available (without risk of it being later classed as a stranded or impaired asset). Since Transpower has to rely on the predictions of a regulator it should not bear the risk that these are wrong.

4.10 The Commerce Commission should also avoid changes to the regulatory environment which are adverse to Transpower unless clearly justifiable. Otherwise such changes will cause concern to Transpower's financiers thereby increasing its cost of borrowing in a way unlikely to be reflected in the allowable WACC. Examples in the proposed decisions (when compared with the Administrative Settlement) include:

(a) The different way tax is to be calculated;

(b) The much higher test before Transpower's price path is re-opened;

(c) The treatment of the HVAC EV account balance (i.e., 50% to be returned in year 1).

5 WACC

5.1 In calculating a suitable WACC for Transpower, the Commerce Commission has applied the simplified Brennan-Lally CAPM using a notional 40% gearing model.

5.2 The analysis supporting this is in section 6 of the EDS Input Methodologies Reasons Paper. After an analysis of alternative approaches (including recording that many submitters highlighted CAPM's poor performance in that it underestimated the cost of capital for low beta firms) the Commerce Commission decided to adopt the simplified Brennan-Lally CAPM.

5.3 However, as the Commerce Commission expressly recognises, this model has a counter intuitive relationship with leverage. Expanding on that comment, the simplified Brennan-Lally CAPM model gives the result that the less gearing, the lower the cost of capital. As virtually all firms of any size use leverage or gearing, and consider debt to be cheaper than equity in terms of fund raising, it is obvious that there is something wrong with the Brennan-Lally model. This is basically recognised by the Commission at para 6.5.10 and 6.5.11.

5.4 At para 6.5.12 of the EDS Input Methodologies Reasons Paper the Commerce Commission describes the counter intuitive result of the simplified Brennan-Lally CAPM as being an anomaly which it then sets out to correct by assuming a notional leverage which it proposes to use across all industries that are regulated.

5.5 In short, the Commerce Commission has adopted a model that does not accurately reflect the competitive market and then has made an arbitrary adjustment to try to shoe horn it into a suitable model. In my view this must be wrong in principle.

6 Easements

6.1 At para 4.4.69 of the Input Reasons Paper the Commerce Commission allows Transpower, in some circumstances, the ability to obtain a return on capital for "*transmission corridor investments*" and "*land and easement investments*" before an active line uses them. However, this same approach does not apply to the cost of land acquired to gain an easement with the intention of on-selling some or all. In that case the cost that can be included is the cost of establishing the easement as determined by an independent valuer.

6.2 The rationale for the early inclusion of "*transmission corridor investments*" and "*land and easement investments*" is that these have option value to current consumers prior to being used and, if not included until utilised, Transpower will not have an incentive to minimise their cost by buying in advance when the

opportunity arises. However, inclusion first requires that their purchase be approved by a regulator on a cost benefit basis.

6.3 The reason for **not** including other land easements seems to lie in para 4.4.70 where the Commerce Commission points out that assets not commissioned do not normally earn a return on capital expended and that exclusion of other land easements is consistent with the earlier Administrative Settlement.

6.4 In fact the Draft Input Determination does **not** reflect the decision in relation to transmission corridor land and land easement investments. Clause 2.2.6 only applies as from commissioning date and then only brings in "easements" at valuation. "Easement land" is excluded and there is no reference to transmission land corridors.

6.5 The 2009 GPS provides (emphasis added):

> *"**Planning ahead***
>
> *89. The Government is concerned to ensure that the necessary planning and securing of consents (or designations) and land access rights for investments in the transmission system will meet needs.*
>
> *90. The Commission should encourage Transpower to identify and secure appropriate interests in land, designations and resource consents required for transmission corridors well in advance of urgent needs. Transpower should be able to recover the reasonable net costs of doing this work.*
>
> *91 The risks in maintaining grid reliability resulting from uncertainties in demand forecastings and easements should be managed conservatively.*
>
> *92 This should help the essential process of maintaining stakeholder confidence in ongoing security of electricity supply even if, at times, there is some loss of flexibility around investment choices and some additional cost for electricity consumers."*

6.6 Leaving aside the lack of consistency between the Input Reasons Paper and the Draft Input Determination and looking only at the Input Reasons Paper, the problems with the draft decision are at least these:

(a) At least at this stage, absent any definition, it is not clear what are transmission corridors and land and easement investments on the one hand compared with land purchased to gain an easement with the intention of on-selling on the other. The inference I draw is that to qualify as a transmission corridor Transpower must purchase the land without any intention of reselling any part of it. That appears too high a threshold and could encourage the excessive retention of land;

(b) Often, the easiest and most effective way to acquire an easement or a transmission corridor is to buy the land, create the required rights and then on-sell. Yet that is exactly what is discouraged. I understand that the exclusion of easement land follows what Transpower asked for in the Administrative Settlement. However, that should be amended in light of the specific direction in the 2009 GPS;

(c) The need for a regulator's approval may result in unacceptable delays for the vendor with a consequential loss of opportunity;

(d) The need for a regulator's approval will risk publicity that then increases price expectations. Transmission corridors require contiguous land. In a competitive market an entity trying to acquire contiguous blocks for development will try hard to avoid publicity about one acquisition to avoid raising expectations on the part of other land owners. Purchases will often be handled by agents with title being taken in the name of nominees to obscure who is the true owner;

(e) In a competitive market where contiguous land is required a purchaser is usually prepared to buy the available land and hold it for a period well in advance of intended use in order to maximise its opportunity to acquire the

adjacent land. The relevant holding costs are then factored into its projected returns;

(f) The requirement that where land is acquired for the purpose of resale it is only the costs associated with establishing the easement **as determined by a valuer** that is allowed to be brought in is an ambiguous concept. Is the vendor auditing the costs or valuing the easement? Although the former would be consistent with para 4.4.70 of the Input Reasons Paper and the 2009 GPS, that is not brought down into the Draft Input Determination which, at clause 2.2.6(1)(b), proposes the latter. Moreover, for valuation purposes a valuer should assume a willing but not anxious buyer and a willing but not anxious seller. But the problem for Transpower is that it will often be necessary to pay more than the opportunity cost of the land as it is a buyer of necessity with the vendor being less than willing. Also there will be no real alternative purchaser of the easement;

(g) In competitive markets, the holding costs of an asset acquired somewhat in advance of use will, if the likelihood of use is reasonable, be capitalised. That does not seem to be contemplated here.

6.7 As noted the Draft Input Determination does not reflect the draft decisions in relation to transmission corridors and land and easement investments. But it also does not reflect the draft decision in relation to easement land in that this is totally excluded (even although the asset on it has been commissioned) whereas the draft decision in the Input Reasons Paper at least allows the cost of establishing the easement. This is probably more a drafting issue in relation to the Draft Input Determination.

6.8 In addition to land acquired for potential easements, the opportunity occasionally arises to acquire land on sites seen as needed for permanent future expansion (e.g. land next to a congested substation or by an anticipated new generation site). Such land is intended to be used for, say, a substation, rather than a transmission

corridor. Transpower then has the option of buying from a willing seller at a favourable price in advance of the need (and consequential "commissioning of the asset") or not buying until the need is imminent. If the latter alternative is adopted the vendor is likely to be an unwilling vendor able to exploit Transpower's (and the transmission grid's) need in terms of the price then extracted especially if this vendor has developed the land since Transpower forwent the opportunity of early acquisition.

6.9 It is consistent with both conduct in a competitive market and the spirit of the 2009 GPS that Transpower be entitled to acquire the land and immediately bring it within its Regulatory Asset Base. This is provided such expenditure is either within the approved Minor capex budget or able to be approved ex ante. This would be for the long-term benefit of consumers as the alternative would be likely to be much dearer in the long-term. However, if no return on the capital expenses incurred can be earned on such land in the meantime, a rational Transpower would forego the opportunity to make an efficient investment.

7 "Minor Capex"

7.1 At para 4.4.65 of the Input Reasons Paper the Commerce Commission sets out which assets can be entered into the Regulatory Asset Base of Transpower. This refers to major capex and commissioned minor capex. The distinction between "*Minor Projects*" and "*Major Capital Expenditure*" is in the Transpower IPP Reasons Paper, although, as it impacts an asset valuation for cost of capital purchases, it should be considered an input methodology issue.

7.2 In particular, "*Minor capital expenditure*" to the extent it is expenditure in relation to enhancement projects,[4] includes in the Transition Year, individual project expenditure up to \$1.5m or enhancement programmes with a value of less than \$5m. Thereafter individual projects up to \$5m qualify as minor capex.

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[4] It also includes asset replacement, asset refurbishment, information and system technology and business support capital expenditure.

7.3 That division between major and minor is inconsistent with the 2009 GPS, at least in relation to transmission services. That, at paras 8.7 and 8.8, draws the division at $20m although it does still require Commission approval, albeit on a more streamlined basis, for minor works.

7.4 Importantly, in relation to minor capex Transpower has the ability to substitute projects within the approved budget. This ability mimics a competitive market situation. The low threshold for "Minor capex" limits that flexibility. This is contrary to the encouragement of investment seen in s52A(1)(a), the 2009 GPS and the 2006 Policy Statement.

7.5 A low threshold will also encourage asset replacement (i.e., like with like) rather than efficiency enhancing asset enhancement and will discourage Transpower from seeking innovative solutions.

7.6 Paragraphs 5.9.1 (in part) and 5.9.2 of the Transpower IPP Reasons Paper state:

> *"5.9.1 … Accordingly, ex-post approval for Minor capital expenditure will only be provided in exceptional circumstances, where Transpower can demonstrate that it was unable to foresee it and that it is essential to maintain the security of supply of the national grid and cannot be deferred. This will apply from, and to RCP1.*
>
> *5.9.2 The amount of any ex-post approval of Minor capital expenditure must not be included in any wash-up, but will be entered into Transpower's RAB."*

7.7 Even in the case of new proposals the test in para 5.9.1 is extremely stringent. This does not mimic the flexibility of competitive markets let alone reflect an incentive to invest especially as the capital expenditure has been fixed up to 6 years in advance. It would also incentivise slowing down projects that were scheduled to be completed in the next Regulatory Control Period but are progressing quicker than expected. This breaches the competitive market approach and the incentive to invest requirement.

8 Event Charges

8.1 Under the Draft Input Determination, para 3.1.4(1)(b) Transpower is entitled to treat as a recoverable cost any instantaneous reserves availability charge which is allocated to it under Rule 11.5.1 of Section IV of Part C of the Electricity Governance Rules. That is, this cost can be "*passed through*" to consumers – see the Input Reasons Paper at paras 7.4.10ff. In the Transpower IPP Reasons Paper at para 4.3.13(a) the Commerce Commission then reduces the allowed base operating expenditure by $1.55m for instantaneous reserves availability charges because these are now a pass through cost.

8.2 I understand this was something sought by Transpower. However, a problem arises in clause 3.1.4(2) of the Draft Input Determination. That states:

> *"(2) For the purpose of subclause (1)(b) a recoverable cost excludes;*
>
> *(a) any 'event charges' payable by **Transpower** as defined under 11.5.2 of Section IV of Part C of the Electricity Governance Rules 2003, or any rule dealing with 'event charges' in any subsequent legislation, or any rule that supplements or replaces that rule; and*
>
> *(b) any instantaneous reserves availability charge incurred by **Transpower** in relation to an asset remaining out of service after an initial period of fourteen consecutive days out of service."*

8.3 That exclusion of event charges is dealt with in the Input Reasons Paper at para 7.4.19 but only by way of a "*throw away*" line:

> *"In addition, the quality framework and event charges will provide incentives around asset availability and avoiding unplanned outages through appropriate maintenance."*

8.4 An event charge is payable by the owner of an asset connected to the National Grid if that asset is the "cause" of an under frequency event. Importantly, even under the existing regime the Electricity Commission considers that this does

not require a faulty asset – it is sufficient that the asset merely causes the event. That approach is supported by the opinion of Mr Bryan Gundersen of 27 May 2010 obtained by the System Operator. An under-frequency event could occur because of the actions of third parties (e.g., a fork lift operated under a transmission line, a farmer burning off nearby, etc). No amount of maintenance will prevent such events.

8.5 That approach is reinforced by the changes proposed for the regime as contained in the final decision of the Electricity Commission released in the last month. This makes it clear that the charge applies regardless of fault.

8.6 The charge is then applied to reduce the instantaneous reserve costs payable by all (including the participant charged). An argument by Transpower that such a potentially "no fault" charge was ultra vires as being a penalty was rejected on the grounds that it was simply an allocation mechanism for the instantaneous reserves costs – the charge is rebated back to those who bear the instantaneous reserve costs proportionately.

8.7 On this basis "event charges" should be treated as part of the instantaneous reserve costs and should be treated as a recoverable cost, certainly to the extent that the charges arise from circumstances outside of Transpower's control. It is after all, part of the cost of "doing business" in this sector. The generators, who are also exposed to event charges, will treat them like that. It would be particularly unfair if the event charge was not able to be passed through but the charge for instantaneous reserves was reduced because the event charge is then rebated back proportionately (including to Transpower). There is also the risk, at least in the second Regulatory Control Period, of double counting because of the impact on revenue of a breach of quality standards.

8.8 Accordingly, the logic of the Commerce Commission is wrong and also, even to the extent it has some validity, it does **not** mimic a competitive market.

9 Reconsideration of the Price Path

9.1 Any price regulated entity faces the risk that its prices cannot be changed despite a material change in its operating environment. That is particularly so in that the Regulatory Control Periods are now of 4 or 5 years duration. In light of this, Part 4 of the Commerce Act contemplates a reopening of the decisions of the Commerce Commission during the course of the Regulatory Control Period – see ss52Q, 52T(1)(a) and 52X.[5]

9.2 Although those provisions do not actually **require** the Commerce Commission to amend if a material change occurs they are an obvious indication that Parliament did not intend the price determinations to be unresponsive to changed circumstances. They also contemplate non-material amendments.

9.3 Also relevant is s54V under which the Commerce Commission is required to take into account the Electricity Governance Rules and Regulations and any decisions made under them and any guidelines issued by the Electricity Commission. Section 54V(3) then provides:

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5 To the extent relevant they provide:

*"**52Q Amendment of section 52P determination***

(1) A section 52P determination may be amended in a material way only after the Commission has consulted with interested parties, but may be amended in a non-material way without prior consultation.

(2) However, the Commission is not required to conduct an inquiry before amending a determination.

…

52T Matters governed by input methodologies

(1) The input methodologies relating to particular goods or services must include, to the extent applicable to the type of regulation under consideration, -

…

(c) regulatory processes and rules, such as -

…

(ii) identifying circumstances in which price-quality paths may be reconsidered within a regulatory period; and

…

52X Amendment of input methodologies

If the Commission proposes to amend an input methodology by making a material change, section 52V applies as if the amendment were a new input methodology."

> *"(3) The Commerce Commission must, if asked by the Electricity Commission to do so, reconsider a section 52P determination and, to the extent that the Commerce Commission considers it necessary or desirable to do so, amend the determination, to take account of any matter referred to in subsection (2)."*

9.4 As required by s52T(1)(c)(ii) the Commerce Commission has made draft decisions as to when the individual price-quality path for Transpower will be reconsidered. The trigger events are (with emphasis added) set out at para 7.6.4 of the Input Reasons Paper. That reads:

> *"7.6.4 Transpower's IPP may be reconsidered if one of the following events has occurred:*
>
> - *a catastrophic event, for which the **costs** of rectifying the impact of the event over the remainder of the regulatory period 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 a legislative or regulatory requirement that has a **material** impact on **costs**."*

9.5 It will be noted that a request by the Electricity Commission is **not** one of the specific trigger events. Presumably, this is intended to be covered by the fourth bullet point.

9.6 What the Commerce Commission considers is "*material*" is then described at para 7.6.6:

> *"7.6.6 In the context of the above descriptions, the concept of materiality is important. The Commission's draft decision is that, in the context of deciding whether to*

> *reconsider a price-quality path, 'material' means 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, as determined by the Commission in its IPP determination. The Commission proposes taking into account the impact over the remainder of the period, rather than just the year in which the event occurs, as the importance of reconsideration from Transpower's perspective is likely to be greater the earlier it is in the period. Events occurring late in the period can be considered at the price reset."*

9.7 Enterprises in a competitive environment are likely to alter their prices (or exit the market) if there is a material event or a material error is found in their pricing. Regulated suppliers do not have that ability.

9.8 As noted earlier (see Part 2 above) the Commerce Commission in the EDS Input Methodologies Reasons Paper did see some parallels between regulated industries and long-term contacts in competitive markets. Such long-term contracts inevitably have widely drawn force majeure clauses that will **not** be dependent on a materiality test of such severity. They will also often have a price adjustment clause driven off CPI or some other index that usually kicks in annually or at least periodic review and often both.

9.9 If there is a change in the legislative or regulatory requirement in a competitive market that is likely to affect all suppliers leading to all suppliers increasing their prices. The Commerce Commission, at para 7.6 of the Input Reasons Paper, gives, as an example under this head, a change in tax law. In a competitive market all suppliers will be affected and are likely to respond accordingly within a short time of any such change.

9.10 That position should apply all the more so to regulated entities like Transpower if the extra cost arises because of new industry specific regulation. Suppose the Electricity Commission was to proceed with its proposed unconditional service guarantee. It would be quite wrong if Transpower were then unable to pass on

the cost because that cost was under the threshold. There should be **no** threshold before such a cost could be recouped.

9.11 Against that background, the Commerce Commission's definition of materiality appears very harsh even when allowing that the 5% relates to all revenues for the remainder of the Regulatory Control Period rather than in a single year.

9.12 The first point to note is that the impact is confined to only the **costs** of the event (compare para 2.7.3 of the Transpower IPP Reasons Paper which refers to "impact" **not** "costs of rectification"). As well as having cost consequences an event may also have revenue effects. Clause 41.4 of the Benchmark Transmission Agreement[6] allows the customer to suspend payment of grid charges if there is a continuous interruption of supply at a connection point that lasts 24 hours or more, even if caused by a force majeure event.

9.13 Leaving that aside and turning to the level of the threshold, elsewhere in the Input Reasons Paper the Commerce Commission has relied on Generally Accepted Accounting Standards. One relevant standard is the NZ IAS 1. That, at para 7, gives a definition of "*material*" as being:

> *"Material Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor."*

9.14 That is, it is a matter of judgment with the note to the definition making it clear that it is the judgment of a person with a reasonable knowledge of business and economic activities and accounting and a willingness to study information with reasonable diligence. An earlier standard SSAP-6 gave more definitive guidelines. Under that variation of 10% or more in the appropriate base amount was generally material, 5% or less was not with it being a matter of judgment

where the variation was between 5% and 10%. Here the "*appropriate base amount*" would be pre-tax profit. Although under NZ IAS 1 it is more a matter of judgment the previous standard is still likely to "inform" that judgment.

9.15 Using the revenue and earnings before tax of Transpower for the year to 30 June 2009, it had transmission revenues of $629,880,000 and total earnings before tax of $124,523,000. On this basis, 5% of one year's transmission revenue is $31,494,000 which is 25.3% of earnings before tax. On the other hand 10% of all profit is equal to $12.5m with 10% of regulated profit being somewhat lower. I do recognise that the Commerce Commission is looking at the revenue for the remainder of the Regulatory Control Period rather than one year but, clearly, a single event could have a material impact on Transpower's financial statements in terms of NZ IAS 1/SSAP-6 without there being a re-opening of its price path. Even an event with a $12.5m pa impact which occurred within 2½ years of the end of the period would not cross the threshold yet would be material for accounting purposes.

9.16 Making matters worse is that, at least in relation to catastrophic events, the 5% is after allowance for insurance **and** the potential to substitute projects within the capital and operating budgets. Suppose the event costs are $40m, well above the $30m threshold, but by deferring some capital expenditure totalling $11m to the next Regulatory Control Period the actual costs to be incurred in the Regulatory Control Period fall to $29m. The deferred capital work is still required. The total impact is still $40m. Yet there is no re-opening. There is also the issue as to whether it is appropriate to defer the other capital works. It appears from para 7.6.5 that this will be a decision made by the Commerce Commission at the time. But deferral of capital expenditure previously accepted as being appropriate is contrary to the thrust of s52A(1)(a), the 2009 GPS and the 2006 Policy Statement. Compulsory deferral should not be required.

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[6] As provided for in Part F Section II Schedule F2 of the Electricity Governance Rules.

9.17 In any event, when considering what is material, most people would focus more on the absolute amount rather than the percentage impact. That approach was evident in the decisions of the old Electricity Market Surveillance Committee and the Electricity Appeal Panel when considering whether or not a price already fixed for electricity could be re-opened which remedy was only available if the pricing error was such as to "*materially financially disadvantage any Spot Market Participant*" – Rule 4.5 of Section G of Part 2. See the Decision D4/100 of 4 July 2000 of the Market Surveillance Committee affirmed by the Appeal Panel on 8 November 2000 – A2/100.

9.18 In the Administrative Settlement the threshold was set at $5m. The new threshold is about 6 times that. There has been no change in the regulatory requirements that would indicate the previous approach was wrong, rather the introduction of s52A(1)(a) is the other way. Moreover, as the Commerce Commission acknowledges at para 2.5.7:

> *"The settlement was finalised after extensive consultation with Transpower and with other interested parties, and will likely have informed the expectations of Transpower and interested parties as to how regulation of Transpower might be implemented under Part 4."*

9.19 It would also appear to be inconsistent with the Australian approach – see para 7.6.10 of the Input Reasons Paper.

9.20 Relevantly the threshold applies to each event. That is, two separate events each with a 4% impact on revenue for the remainder of the Regulatory Control Period would **not** lead to a reopening even although the total impact could be almost $60m.

9.21 As already noted Transpower is moving into a period of high indebtedness to fund major capital works. If there is then an uncompensated for material adverse impact, financiers will be less inclined to lend to Transpower and, so,

will charge more. This will create **disincentives** to invest contrary to s52A(1)(a), the 2009 GPS and 2006 Policy Statement.

9.22 The justification appears in para 7.6.23 where the Commission states that:

> *"a materiality threshold should:*
>
> - *be high enough to justify the costs that will be incurred in reopening a path, and provide appropriate incentives for suppliers to manage risk:*
> - *provide for reasonable sharing of risk between a supplier and consumers; and*
> - *be low enough so that a supplier's financial position is not severely damaged by an event that is outside its control."*

9.23 The proposed threshold does **not** provide a reasonable risk sharing – Transpower's upside is always controlled and is non-existent or minimal. It should not bear excessive downside.

9.24 Nor is it appropriate that the downside protection only cuts in to avoid "*severe damage*" to Transpower's financial position. The directors of a trading company in a competitive market would be justifiably criticised if they refrained from responding to adverse events until the financial position of their company was likely to be severely damaged.

9.25 Although the first criterion of having to be high enough to justify the costs of re-opening a path has some validity the force of that is considerably reduced by the requirement laid down in para 7.7.5 that, generally, Transpower should bear the costs of reconsideration (although that obligation should not arise if the trigger event is the result of regulatory change). In any event, that consideration does not justify a $30m cost threshold.

9.26 Likewise, although a supplier should have an incentive to manage risk, a $30m threshold is way above any normal incentive.

9.27 The position becomes even worse when the Draft Input Determination is considered. As noted, para 7.6.6 of the Input Reasons Paper refers to the "*impact of the event*" and fixes the definition of materiality as being 5% of the allowable revenue for the year in which the event occurred but "*taking into account the impact over the remainder of the regulatory period*". It also contemplated that both the Capex and Opex effects were to be considered.

9.28 In contrast, clause 3.7.2(1)(iv) of the Draft Input Determination uses the term "*the cost of rectification*" and runs the 5% assessment only over the:

> *"… the years of the* ***regulatory period*** *remaining on and after the date on which the expenditure to remediate the event is proposed to be incurred by a value at least equivalent to 5% of the* ***allowable revenue*** *in the year of the event.*"

9.29 The first problem is the use of the words "*the years of*". This implies that only complete years are to be taken into account. That is wrong in principle and in equity. Why should any part of the relevant period be arbitrarily excluded simply because it is not a whole year? It would be ludicrous if an adjustment could be made because the impact was, say $28m pa and the trigger date was two years one day before the end of the Regulatory Period but not if the event was one year 364 days before the end.

9.30 Even leaving aside the issue that the revenue impact should also be considered, the second problem is that the reference point in the Draft Input Determination is the "*costs of rectification*" coupled with the trigger being, not the date of the event, but the date expenditure to remediate the event is intended to be incurred. There could well be earlier expenditure as a direct consequence of the event that may not be "*the cost of rectification*" when read with the expression "*expenditure to remediate the event*".

9.31 To illustrate this, suppose a fisher, trawling illegally, severs one of the Cook Strait cables. Transpower could be faced with:

(a) An event charge;

(b) Extra instantaneous reserves extending well beyond the 14 days grace intended to be allowed;

(c) Immediate investigation costs;

(d) Planning costs;

(e) Actual replacement costs;

(f) If within the second Regulatory Control Period, quality penalties.

9.32 On one reading of clause 3.7.2(1)(iv) only (d) and (e) count and then only from the date work starts. This has to be wrong.

9.33 In summary, the threshold is simply not consistent with the outcomes in competitive markets and appears to unduly fetter the power of the Commission as contained in ss52Q, 52X and 54V(3). It also renders the legislative intention of permitting changes illusionary.

9.34 It is also inequitable. This is particularly so if the cost arises as a result of regulatory change.

9.35 Such a high threshold is also a discouragement to investment.

D. PROCEDURAL LEGAL ISSUES

10 Inadequate Detail in Input Methodology

10.1 Under s52T the Input Methodology is required to include methodologies for determining the cost of capital and valuation of assets (including depreciation) in

sufficient detail so that Transpower is reasonably able to estimate the material effects of the methodology on it – see s52T(1)(a)(i) and (ii) when read with s52T(2). All material decisions relating to:

(a) How the cost of capital calculations works in practice, including when it is applied to new assets; and

(b) How depreciation should be calculated;

should be in the Input Determination.

10.2 One material aspect of the Input Methodologies is the impact of such methodologies on cash flow. As the Commerce Commission acknowledges at para 1.2.1 of the Input Reasons Paper, in order to address the problem of aging transmission assets and low levels of investment in the transmission grid over an extended period of time, Transpower is having to invest huge sums of money in upgrading the grid. Over $3 billion is currently budgeted. This means that timing as to when Transpower can start to recover the cost of and a return on new assets is highly material and needs to be part of the Input Methodology.

10.3 Unfortunately, some key decisions on these issues appear in the Transpower IPP Reasons Paper. They should be in the Input Reasons Paper but can, in any event for appeal purposes, be treated as being Input Methodology decisions – the Commission cannot avoid an appeal by wrongly leaving major impact decisions to the IPP.

11 Information Disclosure

11.1 Transpower is, of course, to be subject to an information disclosure regime under s54F as well as an individual price-quality path determination which will impose a revenue cap.

11.2 It will be necessary for Transpower to maintain a set of accounts consistent with the requirements of the IPP determination which will require it to follow the relevant input determinations.

11.3 Unfortunately, the Draft Input Determination imposes two separate accounting regimes on Transpower. By way of example, in relation to anything that involves the application of WACC, the Commerce Commission requires two different WACCs to be applied, one WACC for the disclosure requirement and one for the IPP[7] with, in the case of works under construction, neither being what Transpower uses to capitalise interest until commissioning (where Transpower follows GAAPs).

11.4 There are also other mismatches.

11.5 There is a very clear emphasis in the Act on the requirement that the benefits of regulating prices must outweigh the costs of regulation – see for instance ss52G(1)(c), 52I(3)(c), (4). On this basis, the form of regulation ought to try to minimise the compliance costs. Requiring two sets of accounts to accommodate different components or methodologies does not meet that test.

11.6 The only justification can be that s53A requires the information disclosure regulation to ensure that sufficient information was readily available to interested persons to assess whether the purpose of Part 4 of the Commerce Act is being met.

11.7 I can see why disclosure is required using the same methodology as in the Input Determination and Individual Price-quality Path Determination so that interested persons can see whether or not Transpower is observing the requirements imposed on it. But to say that a different method of calculation is required to see if the purpose of Part 4 of the Act is being met implies the Commerce

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[7] The difference arises from the use of a different percentile ranking, a different base period (June v August) and the disclosure WACC is to change annually.

Commission is not confident that what it is imposing on Transpower will fulfil the purpose of Part 4! I would be surprised if the Commission held that view.

11.8 In any event s53A should be read with the qualification that information should not be required if the cost providing the information outweighs the benefit.

11.9 The WACC rate in the final determination will be known. The Commission, for its purposes, can continue to publish an updated WACC each year for Transpower. Any interested person can then form their own judgment as to how out of kilter the two WACCs are. The Commission should not be imposing on Transpower the extra cost burden of having to prepare separate accounts using a different, and annually changing WACC.

11.10 Further, to provide comparability, the same relevant percentile should be used. The current proposal creates the risk for Transpower that should the disclosure WACC go down over time interested busy bodies may say Transpower is receiving excessive profits. Yet, if the very real risk that the disclosure WACC will rise comes to pass, no-one will say Transpower is earning too little! This differential approach to price control WACC versus disclosure WACC creates asymmetrical publicity risks for Transpower.

11.11 Moreover, although Transpower must make its disclosure accounts available on request (subject to a payment of a fee – s53E), so far it has not received any requests for such accounts. Although not of itself decisive, this emphasises that the expense of preparing separate accounts is outside the scheme of Part 4.

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