

4 September 2007

Dr Ralph Craven  
Chief Executive Officer  
Transpower New Zealand Limited  
PO Box 1021  
WELLINGTON

Dear Ralph

## **VERIFICATION OF TRANSPOWER'S TRANSMISSION PRICES**

I am writing to you to brief Transpower on the Commission's stance in relation to Transpower's anticipated publication of its transmission prices and to outline our expectations of Transpower under rule 9.2 of the Electricity Governance Rules 2003 (**Rules**)<sup>1</sup>.

As you know, consequent on the Minister of Energy's recent notification of amendment of the Rules adopting Transpower's transmission pricing methodology (**TPM**), the TPM was adopted as a schedule to the Rules. The Rules came into force on 1 September 2007 and the TPM is effective from 1 April 2008.

The Commission understands that Transpower is still developing its transmission prices, anticipates completing them by early October 2007 and intends to publish them, consistent with rule 9.2.1, in late October/early November 2007.

Rule 9.2.2 requires Transpower to demonstrate to the Commission that its transmission prices are consistent with the TPM. The Commission suggests that Transpower provides its internal audit programme and an internal auditor's report on the consistency of the prices with the TPM by mid October for it to consider whether Transpower has met its obligation. The Commission is also requiring that some time after Transpower's October Board meeting, a director's certificate is provided to confirm consistency of the prices with the TPM. The rationale for this request is set out in the following paragraphs.

In addition to Transpower's obligation under rule 9.2.2, the Commission has the discretion under rule 9.3.1 to appoint an auditor to confirm whether the transmission prices have been calculated in accordance with the TPM. Transpower is required to meet the auditor's costs.

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<sup>1</sup> References in this letter to rules are to rules in section IV of part F of the Rules

The Commission has carefully considered whether it should exercise its discretion to appoint an auditor. On balance, it has decided that it is not justified at this point for a number of reasons:

- (a) Transpower has the primary responsibility for ensuring that transmission prices are consistent with the TPM and demonstrating this fact to the Commission.
- (b) This will be the first year of the TPM. The Commission believes that, until the prices are published and transmission customers respond, it would be premature to engage in the audit exercise.
- (c) There are options available to purchasers if they are concerned about inconsistency, such as the process anticipated under rule 10.1.2 and under the benchmark agreements.
- (d) The Commission considers that the type of audit contemplated by the Rules is at the comprehensive end of the spectrum, which would require substantial Commission and external resource and time to undertake in accordance with the Rules. This type of audit is not achievable within the current timeframes.
- (e) Transpower has already indicated to the Commission how it proposes to demonstrate consistency with the TPM (an outline of the internal audit programme provided by Transpower is attached to this letter).

However, the Commission is entitled to commence an audit at any time and will therefore watch purchasers' responses to Transpower's published prices with interest.

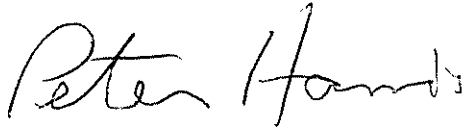
In respect of Transpower's obligation under rule 9.2.2 to demonstrate to the Commission that its prices are consistent with the TPM, Transpower's proposed internal audit programme represents an important component of its duty to us. However, it is not exhaustive. Given the significance of the adoption of the TPM and the consequential Rule changes, and the impact on the transmission customers of the new prices, the Commission requires Transpower to also supply it with a directors' certificate stating that the directors are satisfied that:

- (a) the transmission prices are consistent with the TPM;
- (b) the processes for ensuring consistency and calculation are robust; and
- (c) the design and implementation, and reporting of the outcome, of the internal audit, were in accordance with best practice.

Please contact Mervyn English at the Commission to discuss the precise terms of the directors' certificate and the likely timing of receipt of it.

To ensure understanding of the Commission's approach, a copy of this letter will be published on our website. The Commission also intends to publish the executed directors' certificate and Transpower's internal auditor's report when they become available.

Yours sincerely

A handwritten signature in black ink that reads "Peter Harris". The signature is written in a cursive style with a large, stylized 'P' and 'H'.

Peter Harris  
**Deputy Chair**

## **Objective and Scope of Transpower's Internal Audit**

Transpower has in place systems and models to calculate transmission prices in accordance with the transmission pricing methodology (TPM). An independent auditor has been contracted to review Transpower's application of the TPM. The objective of the review is to provide Transpower with a reasonable degree of independent assurance that the input sources, calculation processes and models developed by Transpower are compliant with the TPM and will produce charges consistent with the TPM. Subject to the findings of the review, it is envisaged that the conclusion of the review will be confirmation that:

- The input sources used for the calculation model and processes are consistent with the requirements of the TPM.
- The calculation model and processes will produce charges that comply with the requirements of the TPM.

## **Approach**

The specific procedures to be performed will include:

- Identify Transpower's inputs to the pricing model and processes.
- Confirm the source(s) of the inputs.
- Document the inputs to the pricing calculations as specified in the TPM.
- Cross check the inputs being used by Transpower against the inputs specified by the TPM. Confirm that the inputs being used by Transpower are consistent with the intention and requirements of the TPM.
- Document the pricing calculations specified in the TPM.
- Re-perform pricing calculations using inputs provided by Transpower. This may involve the auditor preparing a high level model to undertake the calculations and/or reviewing reperformance checks that Transpower has undertaken. Where Transpower has applied its judgement to interpret the TPM, the auditor will not assess the reasonableness of this judgement, but will review the basis on which Transpower has applied its judgement in order to ensure that the decision-making process has been clearly documented.
- Confirm that the customer requirements variation specification provided to the developers of the Zemindar Pricing Application model is consistent with the TPM. Transpower will advise the auditor of the relevant variation requests.
- Review the testing undertaken by Transpower of the Pricing Application model and associated systems. Confirm the reasonableness or otherwise of these tests. If necessary, the auditor may request Transpower to run additional tests.
- Conclude whether or not the processes and models will produce transmission prices compliant with the TPM.