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Dear Alex

## Transpower Regulation Workshop

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Genesis Power Limited, trading as Genesis Energy, welcomes the opportunity to provide a submission to the Commerce Commission (“the Commission”) on the workshop held on 2 and 3 March 2010 to discuss the framework for regulating Transpower.

### **Genesis Energy’s Activities and Interest**

Genesis Energy is a significant participant in the energy and ancillary services markets that trade over Transpower’s transmission grid. Genesis Energy has nearly 2,000 MW of grid-connected generating capacity in the North Island and expects to acquire significant capacity in the South Island in the near future. This means that Genesis Energy is an existing Transpower customer with respect to a number of connection assets and will soon become a customer with respect to the inter-island HVDC link.

Genesis Energy also serves a retail market share of over 25%.<sup>1</sup> For most of those customers, transmission charges (and distribution charges) are bundled into our customer tariffs and invoices. As such, Genesis Energy acts as an intermediary in the contractual chain between Transpower and our customers.

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<sup>1</sup> As measured by connection numbers (ICPs) and including connections served by Energy Online (a wholly-owned subsidiary).

The activities described above mean that Genesis Energy has a strong interest in the price and quality of the services provided by Transpower as interconnected grid owner, HVDC owner, connection asset counterparty and system operator. Genesis Energy also has an interest in the ability of the transmission grid to provide a reasonably unconstrained platform that supports competitive electricity trading relatively free from constraint-based market power effects.

### **This Submission**

Genesis Energy understands that the Commission will consult mid-year on draft input methodologies for Transpower. If Parliament enacts the Electricity Industry Bill as drafted, then Genesis Energy understands that the Commission will also consult in the 12 months leading up to 1 October 2011 on an input methodology to replace the current rules administered by the Electricity Commission for approval of major capital expenditure (the “Part F” rules).

Genesis Energy has not to date engaged at a level of detail with the Commission’s price-quality path regulation under the amended Commerce Act 1986, but does have significant experience with the operation of the Part F regime and with Transpower in general. Given this background, this submission provides Genesis Energy’s preliminary views on the following topics relevant to the Commission’s current deliberations:

- incentives for efficient investment;
- incentives for operating cost savings;
- incentives to achieve various quality dimensions;
- the system operator; and
- competition dynamics.

The remainder of this submission deals with each of the above topics in turn.

### **Incentives for Efficient Investment**

Genesis Energy welcomes transfer of Transpower’s capital expenditure regulation from the Part F regime to the Commission’s price-quality regulation framework. Genesis Energy believes that the United Kingdom and Australian approaches to incentive-based regulation of capital investment are superior to the project-by-project *ex ante* approval regime operated under Part F.

The Electricity Commission experience is that having an *ex ante* approval role has drawn the regulator towards micro-managing Transpower and duplicating its grid planning and project design engineering roles. In our view, this has led to:

- an unproductive contest between engineers at Transpower and the Commission over project timing and design details that are not particularly material in the context of Transpower's asset base, its capital expenditure programme and the value of the electricity traded over Transpower's transmission system;
- uncertainty for Transpower regarding its capital expenditure programme and an uncomfortable and dependent relationship with the regulator;
- confusion for community, industry and regulatory stakeholders regarding who holds responsibility for grid planning; and
- unnecessary delays and loss of flexibility in terms of grid planning and investment.

Genesis Energy hopes that the Commission will not repeat the mistakes of the Electricity Commission and will adopt an approach that places responsibility for grid planning clearly and unambiguously with Transpower.

Genesis Energy expects that a good incentive-based regulation regime would more closely resemble the Ofgem and Australian Energy Regulator (AER) regimes than the Part F regime and would involve the following:

- Transpower and the Commission agree an *ex ante* cap on capital expenditure for each regulatory period based on Transpower's asset management planning;
- Transpower is allowed to earn above the regulated return if it controls capital expenditure below the agreed cap while still meeting quality standards;
- Transpower is exposed to the risk of earning less than the regulated return if it fails to control expenditure to within the agreed cap or fails to meet service standards;
- the regime requires Transpower to take full responsibility for demonstrating the public benefits of major capital expenditure projects using a grid investment test (GIT) or similar cost-benefit framework;

- the regime imposes and enforces strong transparency obligations on Transpower and requires Transpower to take into account issues raised in submissions from consumers and interest groups;
- the regime incorporates a “soft” *ex post* prudency test (or safety net mechanism) designed to provide some risk to Transpower of expenditure not being rolled into the regulatory asset base, but designed to promote investment by focussing on reasonableness rather than optimality;
- Transpower has the option of seeking *ex ante* project approval from the regulator for very large capital expenditure projects for which it would not be reasonable to expect Transpower to bear the risk of *ex post* prudency review.

Genesis Energy is concerned with the Commission’s proposal to subject all projects with a value greater than \$1.5 million to project-specific *ex ante* approval. Genesis Energy acknowledges that analysis is to be “commensurate with dollar value” but considers that a \$1.5 million threshold is far too low and is likely to draw the Commission into counter-productive micro-management.

### Operational Expenditure

Genesis Energy supports the use of an efficiency carry-over mechanism that ensures Transpower shares efficiency gains with customers over time, but that maintains Transpower’s incentive to make efficiency gains at a constant level rather than tapering off towards the end of each regulatory period.

It is disappointing that Transpower’s earlier under-expenditure on maintenance means that operational expenditure is higher now than it should otherwise have been. Genesis Energy understands from Transpower’s presentation that the “wave” of extra expenditure in coming years essentially includes both deferred maintenance expenditure from earlier years and extra expenditure resulting from the deteriorating condition of the poorly maintained assets.

Genesis Energy considers that it would be preferable to allow Transpower to recover the deferred maintenance expenditure rather than trying to claw back past surpluses. There could however be a case for penalising Transpower for the extra remediation expenditure needed because of the deteriorated condition of the assets. In theory, this would provide Transpower with the correct incentive to minimise asset life cycle costs. However, in practice, it may not be possible to separate costs out in this way and it may be preferable simply to allow full recovery of the forecast additional expenditure.

## Quality Standards

Genesis Energy supports the proposal to phase in an incentive mechanism for quality standards. Genesis Energy is generally comfortable with the proposed quality dimensions (loss of supply event frequency, system unavailability, total interruptions and average unplanned outage duration).

Genesis Energy also accepts that it would be desirable to phase in the incentive mechanisms over successive regulatory periods, with a measurement-only approach adopted in the transition period. Genesis Energy notes that the Commission proposes raising the quality penalty and reward to as high as 2% of Transpower's maximum allowable revenue (MAR). Genesis Energy considers that this is a good initial proposal, but that as experience with the regulatory regime develops, the Commission should continue to review whether a lower or higher percentage of MAR would be appropriate.

## System Operator

Genesis Energy notes that the Electricity Industry Bill, as currently drafted, provides Transpower with statutory protection for its role as system operator. It is common in other jurisdictions for the system operator to be a separate entity from the grid owner and for the system operator to have an ownership structure that encourages independence and responsiveness to market development needs.

If statutory protection is preserved, then the Electricity Authority will be in a weak negotiating position with respect to the system operator service provider agreement (SOSPA) and with respect to requiring the system operator to be responsive to market development needs. If the system operator is reluctant to alter its systems in response to demand from the market regulator and market participants then it can severely hamper and delay market development that has an overall economic benefit.

Notwithstanding the above, it is not immediately clear that there is a constructive role for the Commission to play in terms of improving the performance of the system operator or becoming involved in the relationship between the Electricity Authority and the system operator. As such, Genesis Energy submits that the Commission should maintain a watching brief on system operator price and quality (including responsiveness).

## Competition Dynamics

Genesis Energy would like to comment on two areas where transmission regulation has a particular interface with competition dynamics. These are as follows:

- an unconstrained grid provides a better platform for wholesale and retail competition than a constrained grid; and
- pre-emptive investment in transmission capacity designed to “enable” generation projects or “unlock” resources can have the effect of subsidising particular generation development projects, which has an effect on competition in the generation investment market.

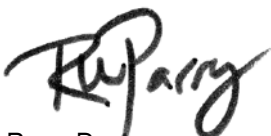
Genesis Energy considers that the Electricity Commission has not addressed either of these issues very satisfactorily and that the Commission will need to consider how it will view these matters.

With respect to the first matter, Genesis Energy considers that the optimal level of congestion on the transmission grid is lower (and the optimal capacity higher) than would be determined by an engineering assessment of the capacity required to meet reliability standards alone. Genesis Energy recommends that the Commission should consider as part of its Part F replacement work, whether it is desirable for Transpower to attribute some level of deemed benefit to investments that relieve some measure of grid congestion. The deemed benefit would proxy the dynamic efficiency gains of effective competition in the generation and demand control markets.

With respect to the second matter, Genesis Energy considers that there may be situations from time to time where it would be desirable for Transpower to invest in additional transmission capacity in recognition of the option value provided by that investment. However, Transpower and the Commission need to be mindful of the affect that this approach can have on competition in the generation investment market.

If you would like to discuss any of these matters further, please contact me on 04 495 3348.

Yours sincerely



Ross Parry

Regulatory Affairs Manager