



T R A N S P O W E R

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Dear Michael

Commerce Commission: Cross Submission on Draft Decisions and Reasons for Not Declaring Control & Draft Decisions on Resetting Transpower's Thresholds (Draft Decisions)

1. Introduction

In this cross submission on the Commerce Commission's Draft Decisions, Transpower focuses on issues raised in the submissions of other interested parties. Transpower does not believe that any submission raises issues that should delay the finalisation of this process or materially alter the conclusions of the Commerce Commission's Draft Decisions. Transpower notes that a number of the issues raised by submissions are not directly related to the proposed settlement, but reflect concerns with other aspects of the regulatory or commercial environment.

2. Comment

2.1. Economic value framework

The submissions generally support continuation of the economic value (EV) framework as proposed by Transpower.

A number of parties suggest, however, that there should be greater transparency in relation to the EV accounts (Contact (pp 3-4), Meridian (pp 2 and 6), and Unison (p 28)). They submit that the EV accounts should be audited and disclosed as part of compliance reporting. The submissions ask for greater transparency as to the effect on the EV accounts of the price increases for the 2006/07 and 2007/08 pricing years as well as greater transparency as to the relative impact of the settlement on the HVDC and AC revenue requirements. MEUG (pp 3 and 9) suggests that Transpower should publish a detailed reconciliation of the interim rebate adjustment for every designated transmission customer.

Transpower agrees that improving transparency for customers of the EV accounts is desirable. Transpower proposes to publish the audited, customer EV account information, including customer balances, as part of its annual compliance reporting. Transpower considers that this should largely meet the concerns for transparency noted in submissions. In addition, Transpower will also continue to meet with, and disclose information to customers as part of its normal pricing round.

Contact (p 4) suggests that it would be helpful if Transpower were to publish indicative forecast prices for the next three years at the time of formal notification of next year's price increase. Transpower notes that this is not an issue directly related to the settlement but acknowledges that such indicative information is likely to be useful to customers. However, the current regulatory framework does not facilitate, with any certainty, a forward looking forecast of the revenue requirement and prices. Several key inputs to Transpower's revenue setting are reset or established on an annual basis (e.g. capital expenditure threshold and Part F capital investments) and as such any indicative forecast prices would need to be heavily caveated.

2.2. Revenue requirement

2.2.1. Interrelationship with transmission pricing methodology

Contact (p 4) notes a need for greater clarity as to the interrelationship between the transmission pricing methodology and the revenue path. Meridian (pp 1-6) suggests that (in effect) separate thresholds should apply to HVDC and AC assets, with the operating cost allowance split between HVDC and AC. On the other hand, Mighty River Power (pp 3, 7-8) questions why the administrative settlement proposal covers the establishment of separate revenue requirements for the HVDC and AC assets. It considers that the allocation of costs between different assets and services is properly addressed by the Electricity Commission's transmission pricing methodology.

Transpower notes that the determination of separate HVDC and AC revenue requirements is a continuation of the status quo. Transpower already calculates and has audited these separate revenue requirements and will continue to do so during the settlement period. Transpower notes that it will continue to report separately on the revenue requirements applying to the HVDC and AC assets. The separate reporting should provide a significant degree of transparency to HVDC and AC customers.

Todd (pp 1-4) raises concerns about the impact of the transmission pricing methodology on the competitiveness of distributed generation. In Transpower's view, the appropriateness of Transpower's transmission pricing methodology is not a relevant consideration for the Commerce Commission's evaluation of the administrative settlement, because the transmission pricing methodology is the subject of a deliberately separate regulatory regime administered by the Electricity Commission.

The Commerce Commission's statement in paragraph 84 of the Draft Decisions that it does not typically scrutinise the apportionment of prices is particularly pertinent to Transpower, because there is a specific, non-Commerce Commission regulatory regime for allocation of Transpower's revenue requirement in Part F of the Electricity Governance Rules. Transpower's transmission pricing methodology (Schedule F5), benchmark transmission agreement (Schedule F2) and the categories of designated transmission customers (Schedule F1) are all matters for the Electricity Commission. The Electricity Commission, following extensive consultation, has reached a final position on all of those matters, which is now embodied in Part F. Furthermore, responsibility for authorising Transpower's transmission pricing methodology was specifically removed from the Commerce Commission when subpart 2 of Part 4A of the Commerce Act was repealed in 2004.

Although this is not the appropriate place for a detailed analysis, Transpower notes that Todd's synopsis of the South Taranaki litigation in its submission is not a complete representation. There are other relevant factors not mentioned in Todd's account.

2.2.2. Treatment of HVDC customers

Transpower disagrees with Contact's suggestion (p 4) that the HVDC charges have increased disproportionately in recent years. Similarly, it rejects Meridian's suggestion (p 1) that the HVDC charges have been greater than HVDC costs; and that HVDC customers are cross-subsidising AC customers (Meridian pp 2 and 6).

Transpower applies a cost allocation methodology to determine the costs that relate to the HVDC system. Transpower's allocation methodology ensures that HVDC customers are allocated only those costs that are attributable to the HVDC assets and that there is no cross-subsidisation.

Meridian (p 5) suggests that it is unclear at this stage how much of the increase in charges implied by the administrative settlement will apply to the HVDC assets. It notes, "we understand from Transpower that the charges for the HVDC will increase by many multiples of the average 10.2% increase in 2006/07".

HVDC charges have increased mainly due to revaluations of assets under ODV and as a result of HVDC prices being held flat in previous years through the application of a commercial rebate¹ applied by Transpower in 2005/06. There has been an increase in the customer EV balance which, consistent with Transpower's published EV methodology, results in the negative balance being recovered through HVDC charges over time.

¹ The Commercial Rebate was a Shareholder rather than Customer Charge.

2.3. Valuation of regulatory asset base

Transpower notes the general support for use of the 2006 ODV as the basis for establishing the starting regulatory asset base, and for Transpower adopting a DHC methodology.

2.3.1. Notional assets

Contact (p 5) and Meridian (p 7) indicate a concern with the notional assets (referred to as 'imaginary' or 'fictional' assets in the two submissions), which have been optimised into the RAB using the ODV methodology. They question whether, in changing to a DHC methodology and setting the RAB, these assets should be included in the revenue requirement and depreciated over time, along with the physical assets in existence. Their preference is to exclude such assets from the RAB.

While the ODV approach does create 'notional' assets it also results in the optimising out of the asset base of real assets that are in existence and being used. In fact the optimised depreciated replacement cost (ODRC) of the HVDC assets is significantly lower than the depreciated replacement cost (DRC). Excluding 'notional' assets from the RAB would amount to 'cherry picking' the valuation to Transpower's disadvantage.

Meridian suggests as an alternative, that the assets be optimised out of the RAB if or when Meridian invests in physical assets at Benmore. Transpower notes this again amounts to 'cherry picking' to Transpower's disadvantage.

Meridian (p 7) suggests that the adoption of an ODV containing notional assets, as part of the RAB, is inconsistent with the Commerce Commission's approach to the gas pipelines. Whilst Meridian's explanation of this suggested inconsistency is unclear, Transpower considers that the approach adopted in the gas decisions is similar to the approach it is proposing in the administrative settlement. ODV, which may or may not include notional assets depending on the relevant optimisations, is used to generate the starting RABs for both Vector and Powerco, as with Transpower. Further, no more than the actual capital expenditure during the term of the settlement will be added to the starting RAB, as is the case with Vector and Powerco.

2.3.2. Treatment of Pole 1

A specific issue of concern to the South Island generators is the treatment of Pole 1, given its removal from service. Contact (p 5) notes that the HVDC assets are valued on the basis that a capability equivalent to 1000 MW is provided. Contact (pp 6-7) suggests that if Pole 1 is not returned to service then Transpower will be recovering revenue on assets, which are not providing a service.

Transpower notes that it has recently determined that, pending a final decision on Pole 1, it will exclude the mercury arc valve converters from the asset base from 21 September 2007, for the purposes of calculating its revenue requirement.

Unison (p 25) and Meridian (p 8) suggest that because Transpower has already recovered the full cost of Pole 1, Transpower should bear the cost of any write-down. Transpower does not agree with this interpretation. It is true that the ODV Handbook allows assets with less than three years of remaining life to be restated as having a maximum of three years remaining life, and that this means that after depreciation is deducted for the year, the asset is re-valued upwards by an amount equal to the depreciation. However, Transpower has not treated the revaluation gains as a shareholder benefit. Instead, it has credited these to the customer EV accounts. The increase in the customers' EV accounts and the depreciation are therefore offsetting. As a result, Transpower has not earned more than the full value of these assets.

2.3.3. Treatment of asset stranding

MEUG suggests (pp 3 and 6) that Transpower should bear the risks of asset stranding for investments not approved by the Electricity Commission. For assets approved by the Electricity Commission, the costs of write-offs or asset stranding should be borne by customers. Meridian (p 8) suggests that Transpower should bear the costs of all stranding and asset impairments.

Transpower notes that its starting RAB has been subject to optimisation using the ODV methodology. Thus, on this basis, all system fixed assets in the starting RAB have been subject to scrutiny. Transpower notes also that stranding and impairment are asymmetric risks, which need to be compensated either by adjusting WACC or through cash flows. Transpower's proposed approach is consistent with the Commerce Commission's draft WACC Guidelines, which state "the Commission prefers to handle the risks of adverse events, stranding and optimisation by adjusting cash flows, rather than by adding a margin on WACC".²

2.3.4. Pseudo assets

A range of views was expressed on the proposed use of pseudo assets to align the financial and regulatory asset books.

Some submissions (MEUG (pp 2 and 6) and Meridian (pp 10 - 11)) are concerned about the impact on customer's cash flows of the increased revenue requirement that might result from implementing the pseudo asset approach. MEUG proposes that Transpower could more efficiently finance these assets than could customers. These submissions suggest a longer depreciation rate to reduce the impact on customers. On the other hand, Unison (pp 11 and 25) suggests that administrative costs would

² Commerce Commission, *Draft Guidelines: The Commerce Commission's Approach to Estimating the Cost of Capital*, November 2005, pp 27-28.

be reduced by aligning the two asset books immediately, and dealing with the impact through the EV accounts. Meridian suggests (p 11) that Transpower could continue to have separate regulatory and financial asset books.

Transpower notes it has proposed the alignment to reduce compliance costs and improve transparency for customers. These benefits would not be achieved if Transpower continues operating the two books. The benefits will be achieved earlier, the faster the regulatory and financial asset books are brought into line. Offsetting this is the concern about the impact on customers' cash flows while the adjustment is made. Transpower's proposed depreciation rates are aimed at balancing these two factors.

Contact (p 6) questions the inclusion of Pole 1 as a pseudo asset given its belief that Transpower has fully recovered the costs of this asset. It notes that this issue is of particular concern if Pole 1 is not returned to service, because Transpower would then be recovering a return from an asset that is not providing a service

As discussed above, Transpower has removed the mercury arc valve converters from the RAB pending a final decision on the fate of Pole 1. Transpower notes also that it has not fully recovered the cost of Pole 1 and that a recovery of any residual value would be appropriate if the asset is written off.

Meridian also suggests (p 11) that Transpower has already earned a 'fair' rate of return on the HVDC assets via the ODV methodology, and that there is no increase in service resulting from the revaluation. Transpower notes that its pseudo asset proposal has no net impact on the value of assets. The proposed treatment of the pseudo assets has been designed to ensure the transition from ODV has an NPV = 0 impact on Transpower and its customers.

2.4. Capital expenditure

Submissions generally supported Transpower's proposed approach to capital expenditure, including the treatment of transmission corridor investment.

MEUG (pp 1 and 5) did not support the suggestion that the Electricity Commission be able to approve capital expenditure by way of a formal communication outside the Part F approval processes. Transpower notes that this approach could only be used if there were no applicable Part F processes and that support for any proposed capital expenditure would be at the discretion of the Electricity Commission, subject to a clear net benefit being demonstrated by Transpower. Thus it could not be used to circumvent the current Part F requirements.

2.4.1. Non Part F capex threshold

Vector (p 2) and Mighty River Power (p 10) question whether current non-Part F capital expenditure should be made subject to Electricity Commission approval in the

future. Vector is concerned with the potential cost of such an approach relative to the benefits. Mighty River Power notes this approach may lead to investment delays.

Transpower acknowledges concerns that the proposed approach may lead to increased regulatory costs. Transpower's primary objective is to ensure that, whatever form of regulatory scrutiny is ultimately put in place, it is appropriate for the circumstance; it provides certainty and flexibility for Transpower; accountabilities are clearly defined; and the regulatory mechanisms are consistent with the principles of good regulation.

Unison (p 24) notes its concern that a technical breach of the non-Part F threshold could lead to the disproportionate outcome of the Commerce Commission declaring control of Transpower. Unison suggests that a more appropriate outcome would be to either disallow recovery of capital expenditure over the threshold or to deduct the amount of the breach from the subsequent year's threshold. Transpower considers that these suggestions may be more proportionate than declaring control.

MEUG (pp 2 and 5) advocates that Transpower be required, by way of commitments made under a deed, to implement the recommendations in the Strata Energy report on non-Part F capital expenditure prepared for the Commerce Commission.

Transpower notes that the settlement proposal provides that the Commerce Commission will review Transpower's non-Part F capital works plan each year. The review is to provide assurance (among other things) that "Transpower has proactively pursued and implemented process improvements and delivered on commitments made to review the scope for improvements to its non-Part F capital works processes around (a) procurement audit, (b) review of open book tendering for R&R³, and (c) PAD templates⁴". Transpower considers that MEUG's concerns can be met by the process of annual review of Transpower's non-Part F expenditure, and Transpower's commitment to process improvements.

MEUG (pp 2 and 5) also suggests that the force majeure provisions in the non-Part F capex threshold be aligned with the definitions of these in the Transmission Agreements. The force majeure provision in the Benchmark Agreement relates to 'acts of God', war, civil disturbances, etc, while the provision in the settlement refers *inter alia* to there being no forecast capital expenditure for an event in the applicable threshold. The settlement force majeure provision has been tailored to its particular purpose, which is different from the purpose in the Benchmark Agreement.

2.5. WACC

MEUG (pp 3, 8, and attachments), Contact (p 8) and Meridian (pp 2 and 11) suggest that the WACC proposed by Transpower is too high.

³ Replacement and Refurbishment (R&R)

⁴ Project Approval Document (PAD)

The WACC proposed by Transpower in the settlement is based on the Commerce Commission's methodology and parameters. Transpower has accepted the Commerce Commission's approach in the context of the settlement package, which balances the requirements of the Commerce Commission and Transpower.

Transpower does not consider the WACC to be high, particularly when compared, as noted by Unison (pp 2 and 14-20), to the WACC that might apply under control.⁵ The draft decisions paper on the control of Vector and Powerco's gas businesses suggests that under control, among other things, WACC would likely be selected from the 75th percentile, resulting in a significant uplift in Transpower's allowed revenue requirement.

2.6. Operating costs

MEUG (pp 3 and 7) proposes that the operating costs be recalibrated to 2007/08. Transpower notes that the base operating expenditure was subject to review by GHD conducted over a four to five month period. The base operating expenditure forms an integral part of Transpower's settlement proposal to apply over a five-year period and cannot be considered in isolation from the indexing of operating expenditure or other aspects of the settlement.

Further, Transpower notes that incentive regulation operates by establishing ex ante constraints, and allowing businesses to keep the benefits of outperforming the requirements while bearing the costs of under performing. Changing the constraints part way through a regulatory period would compromise this framework.

MEUG (pp 3 and 7) suggests that the investigation costs for Grid Upgrade Plans (GUPs) should be regarded as an expense to shareholders and only be recoverable from customers if a GUP is approved by the Electricity Commission, rather than investigation costs being part of operating expenditure. Transpower notes that preliminary investigation work undertaken, for example, to identify a preferred option, is treated as operating expenditure. This accounting approach is consistent with GAAP. Development of a specific or preferred investment option is generally capitalised and in some cases the point of capitalisation could precede the actual date of submission of the GUP proposal to the Electricity Commission. Irrespective of the timing, capitalised investigation costs would not be recovered if the GUP were not approved by the Electricity Commission.

2.7. Quality threshold

Unison (pp 29) proposes that the quality threshold be replaced by a requirement for full disclosure of quality information. In its own submission, Transpower has set out its position on the appropriateness of the Commerce Commission using a quality

⁵ Unison (p 3) advocates that a 75th percentile WACC should be applied consistently under all forms of regulation including administrative settlements and control.

threshold, and suggested an alternative arrangement in line with that proposed by Unison.

Contact (p 7) suggests that under the proposed administrative settlement, there is no linkage to service and that Transpower could, in an extreme case, "determine its revenue requirement on the national grid based on the assets, and remove them all from service, but still be able to recover its revenue". Transpower notes that explicit asset service measures are included in the Benchmark Agreement and interconnection rules, which do not need to be replicated in the settlement. Moreover, the new obligations within the Benchmark Agreement and interconnection rules place specific constraints and binding conditions on Transpower's ability to make unilateral changes to asset configurations and/or service measures in the case of both connection and interconnection assets. Once the Benchmark Agreement and interconnection rules come into effect, changes to the grid configuration may only be made in accordance with the outage protocol or subject to a net benefit test. Transpower therefore believes that the concerns stated by Contact are unfounded.

Meridian also suggests that Transpower should continue to be subject to a quality threshold (p 9). Transpower does not agree with this, for the reasons set out in Transpower's earlier submission. Transpower considers that full disclosure of quality information would provide a workable alternative to the current threshold.

2.8. System operator threshold

MEUG (pp 3 and 9) recommends that in relation to the system operator threshold, ACAM should be used "until such time as the Commission makes any change to that methodology. If ACAM is amended or replaced, Transpower will from that time onwards apply the new cost allocation methodology".

Transpower notes that the system operator service is governed by a contract agreed with the Electricity Commission. Transpower is not, therefore, able to amend unilaterally the relevant cost allocation methodology.

2.9. Compliance reporting

MEUG (pp 3 and 9) recommends that the 35 days compliance-reporting framework be retained unless Transpower can provide convincing evidence to the contrary. Transpower suggested extending the reporting timeframe because of the time taken to obtain audited financial accounts (generally not available until late August), and then to prepare the EV accounts (which use data from the audited accounts) and compliance statements. Transpower considers that a month is required, following release of audited financial accounts, to prepare the EV accounts and the compliance statements and to have them independently reviewed. Transpower concurs with Vector's comments that the settlement is relatively intrusive, and notes that the requirement to report on individual elements of the settlement is likely to lengthen the preparation time. Transpower therefore remains strongly of the view

that a 35 day period is too short, and that 60 days is a reasonable but still challenging deadline for compliance reporting.

MEUG (pp 3 and 9) suggests that Transpower should provide cost estimates for annual and quarterly compliance reporting. Transpower considers that the cost of annual compliance reporting is in the order of \$200,000. Quarterly reporting is likely to result in similar costs being incurred each quarter (i.e. \$200,000) depending on whether there is an independent review. Transpower notes that its assets last a significant length of time and that reporting on a quarterly basis is unnecessary, onerous and potentially misleading as the commissioning of particular assets and individual expense items could change each quarter's report. Transpower considers that the costs of quarterly reporting would exceed any benefits that might exist.

If you have any questions please do not hesitate to contact me.

Yours sincerely



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