



T R A N S P O W E R

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29 July 2004

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Dear Paolo

Transpower submission on the revised Draft ODV Handbook released 9 July 2004

Introduction

1. We welcome the opportunity to provide a submission on the revised draft ODV Handbook (“the draft ODV Handbook”). This draft ODV Handbook is a significant step forward in a number of areas. Some of the issues Transpower raised in previous submissions have now been addressed in the draft ODV Handbook. In particular:
 - Investments approved by the Electricity Commission (“EC”) do not have to be optimised.
 - The EVA requirements strike a good balance between retaining the theoretical pureness of the ODV methodology whilst at the same time being pragmatic.
 - Part 1 of the draft ODV Handbook reads significantly better than the earlier draft.
2. In addition, the updated timetable is most welcome, in particular, the release of the final ODV Handbook before the end of August 2004. From Transpower’s perspective this is essential, as Transpower is required to notify customers of new transmission charges before 31 December 2004 and the ODV valuation in accordance with the Handbook is a component of the calculation of new transmission charges. Any further delays in the release of the new ODV Handbook will make it very difficult for Transpower to comply with this requirement.

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3. In this submission, substantive comments focus on the material issues where the rationale for the approach taken in the draft ODV Handbook is not clear. Some more minor issues are set out in the table on page 4. The issues raised in this submission (with one exception as explained in the table) are also noted as suggested amendments in a "red-lined" version of the draft ODV Handbook (attached).
4. The material issues are:
- allowable planning period for transmission assets (para. 2.30);
 - easement replacement costs (para. A28); and
 - Electricity Commission approved investments at risk (para. 2.35).

Allowable Planning Period

5. This point has been addressed in previous submissions to the Commission. Transpower continues to argue that the allowable planning period for future load growth for transmission assets should be 35 years and not the 15 years stated in paragraph 2.30. The basis for allowing a longer planning period is:
- a. the fact that most transmission assets last for more than 50 years, with some transmission lines having a total life of 70 years; and, accordingly,
 - b. the revised planning period of 15 years only allows for growth over 30% of the life of most assets and only 21% of the life of some transmission lines.
6. In order to minimise life cycle costs, a longer planning period is necessary.
7. Transpower notes that one of the goals of optimisation is to minimise the life cycle costs of assets. Paragraph 2.19 states:
- "The most cost efficient design is one that minimises the present value of the total costs of the assets and their use over their standard life. In undertaking life cycle cost analyses to determine the most efficient design an ELB may take into account: (i) the capital and operating costs over the life of the asset; (ii) other costs that are incurred by the ELB as a result of the asset; and (iii) the cost of losses to the extent that these are caused by the existing load and the allowed future load growth."*
8. Given that this is a stated aim of optimisation, it is necessary for the planning period to be closer to the actual life of the assets. As Transpower has previously submitted, it is often more cost effective to have a step change and build assets that will last their physical life, rather than build assets on an incremental basis, that have to be replaced after only 15 years because capacity has been exhausted.

9. The principles set out in paragraph 2.19 (to achieve efficiency) are very similar to the efficiency objectives for the Electricity Commission's Grid Investment Test under Part F. Part F states that the objectives of the Grid Investment Test include:

- promoting economic efficiency (Section III, rule 6.3.1); and
- enabling selection of transmission upgrade options that maximise the total net benefits (Section III, rule 6.3.4).

It follows that the ODV Handbook should allow the most efficient outcomes, as contemplated by the Grid Investment Test objectives.

10. Therefore, the planning period for transmission assets should be extended to 35 years, to enable the most economically efficient solution to be chosen.

Easement Replacement Costs

11. Easements have special treatment in the draft ODV Handbook. Paragraph 1.4 identifies three types of assets. Namely, assets that deteriorate in service (e.g. transmission assets); assets that do not deteriorate in service, but have alternative uses (e.g. land); and assets that neither deteriorate nor have an alternative use (e.g. easements).

12. The table below summarises the different treatment each asset type receives in the draft ODV Handbook.

	Assets that deteriorate	Assets that do not deteriorate
Assets with alternative uses	Replacement cost	Market value (effectively Replacement Cost)
Assets with no alternative uses	Replacement cost	Historical cost

13. A significant implication of the above is that an asset with no alternative that does not deteriorate should not be valued at replacement cost. In Transpower's view, this is inconsistent. ODV is fundamentally a replacement cost methodology.

14. A new entrant to the market or an electricity lines business deprived of its asset base would have to pay the replacement cost for all system fixed assets *at that time*, regardless of whether the asset deteriorated or had an alternative use. Transpower does not see why the fact that easements have no alternative use and do not deteriorate should impact on whether historical or replacement cost methodology is used. (i.e. why is there a variance for the valuation of easements compared to land?) In addition, in today's environment, easements are just as much a part of the operating asset base as the physical lines.

15. As noted by Transpower at the Commerce Commission Conference on the previous draft of the ODV Handbook dated 23 December 2003, easements are likely to become a significant portion of Transpower's asset base over time. Currently, easement costs are approximately 40% to 50% of the cost of obtaining the land. Add to that the fact that land prices are likely to appreciate at a faster rate when compared to most other assets, the need for easements to be valued at replacement cost becomes even greater.
16. Finally, different treatment of land and easements creates a perverse incentive to buy land instead of easements. The underlying purpose for a lines business in acquiring land or easements is the same. However, under the proposed rules buying land allows capital appreciation whereas obtaining easements does not have the same advantage.
17. Therefore, it is submitted that easements should not be treated differently from other assets and be valued at replacement cost.

Electricity Commission Approved Investments (para 2.35)

18. Transpower welcomes the fact that EC approved investments are not subject to optimisation. However, to ensure that regulatory certainty remains, EC approved investments should also be exempt from building block replacement costs. In other words, EC approved investments should be entered into the asset base at the actual project cost.
19. Without this exemption Transpower will suffer a loss when investments cost more than the building blocks, even though the EC is satisfied that the project costs are efficient. This will disincentivise Transpower from undertaking certain investments. For example, thermal upgrades usually cost more than the incremental increase in the ODV value that results from the thermal upgrades. However, in many cases they are the most economically efficient solution, particularly where the investments will delay much larger investment for several years. This particular example was also discussed in Transpower's cross submission of 30 April 2004.

Other Issues

Ref	Issue	Suggested Solution
General	Inconsistent use of “shall” and “must”, and “should”.	<p>Clause 1.6 provides that the draft ODV Handbook sets out mandatory rules. However, in many instances, the Handbook is not clear whether or not a rule is mandatory. For example, it is clear that clauses 2.7, 2.9 and 2.10 are mandatory because the rules impose obligations by use of the words “shall” or “must”. However, clauses 2.13 and 2.14 are recommendations only, because the rules do not impose obligations (only recommendations) by use of the word “should”.</p> <p>Where the word “shall” or “must” is used in one clause, and “should” is used in another, legal principles of interpretation will hold that the Handbook “should” means something different from “shall” i.e. the Handbook intends that “should” must be read consistently with one of its ordinary meanings i.e. “... used to give or ask advice or suggestion ...”: <i>Concise Oxford Dictionary</i></p> <p>The attached “redlined” version of the draft ODV Handbook does not address this point, as it involves a comprehensive review of all provisions to determine whether in fact they are mandatory (where “must” or “shall” should be used) or suggestions (where “should” should remain). Transpower recommends that this review be undertaken.</p>
General	Nowhere in the ODV Handbook is a materiality threshold set for the ODV valuation as a whole. This may cause auditors some uncertainty. In 2001, some difficulty arose during the ODV audits when the Commerce Commission auditors used a lower level of materiality than had been applied by the external reviewers.	<p>The ODV report should set the materiality threshold to be applied by valuers and reviewers. This will increase the certainty for both valuers and reviewers.</p> <p>Transpower suggest an overall materiality threshold of 5% is appropriate. In Transpower’s experience, applying a materiality threshold below 5% requires a degree of accuracy that is not easily achieved.</p>

Ref	Issue	Suggested Solution
2.29	This paragraph requiring disclosure of significant areas of demand growth is ambiguous. It is not clear whether the disclosures relate to increases in demand within a load forecast or from one load forecast to the next. i.e. is the regulation seeking disclosure on areas of the grid with abnormally high growth or areas where there have been significant changes in growth assumptions from one load forecast to the next?	The paragraph should be rewritten to remove this ambiguity.
1.8 & 2.59	The EV test is circular in that it is difficult to determine whether the write down will be greater than 1% without actually applying the test.	As a proxy, the test could be expressed in terms of the ODRC of the assets in question instead of the likely write down.
2.65.2	This requirement excludes ODV value from the list of figures to be disclosed.	Include ODV as one of the figures to be disclosed in the ODV report.
A.5	It is not clear whether the requirement of multipliers to be additive applies to all multipliers or not.	Multipliers should not be additive for seismic and IDC factors as logically these factors should be applied after all of the multipliers have been built in. Therefore, A.5 should state that this requirement specifically applies to the multipliers disclosed in A.9, A.10, A.14, A.15, A.19 and A.20.
B.6	This section is not referred to elsewhere in the ODV Handbook and could contradict EC approved investments (para. 2.35)	Delete B.6 from the draft ODV Handbook.

Final Comments

20. Transpower looks forward to the finalised ODV Handbook being published before the end of August 2004.

Yours sincerely



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Regulatory Strategy Manager

Attachment: "Red-lined changes to the draft ODV Handbook"