

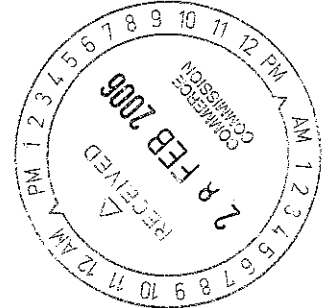


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Mr Paolo Ryan
Transpower Post-Breach Inquiry
Network Performance Group
Commerce Commission
PO Box 2351
Wellington

27 February 2006

Dear Paolo



Intention to declare control of Transpower

Vector appreciates the opportunity to comment on the Commission's preliminary intention to declare control of Transpower. Vector notes that the detailed regulatory regimes for Transpower and other electricity lines businesses are different, so this submission focuses more on generic issues.

From the community's perspective, the security of energy supply is the one critical issue facing New Zealand. In particular, from Vector's perspective, the supply of electricity into the Auckland region. Industry participants are investigating a variety of options to ensure sufficient energy is available, however the transmission system plays a crucial role in delivering that energy. Transmission investments have long lead times and any failure in transmission will have significant economic and reputational consequences.

Vector's view is that security of supply is paramount.

This submission outlines Vector's views in relation to:

- The assessment of the costs and benefits of control;
- The form of control;
- The definition of excess profits; and
- The EVA adjustment account.

Costs and Benefits of Control

The decision to intervene is not taken lightly in any regulatory regime. In Vector's view, the appropriate basis for such a decision is a robust assessment of the costs and benefits of the intervention. In this respect, Vector does not believe that the only costs of control would be administrative.

Vector is of the view that the transmission upgrade to Auckland is needed sooner rather than later and it is taking active steps to manage the security risk facing the region. The

Commission has included the delay in transmission investment as a benefit of control. Vector believes there are two related areas of costs which therefore should be included in the analysis.

First, the cost of a transmission failure or constraint due to a delay in the investment programme. Vector notes that there are world-wide examples of transmission failures (North-East of USA and Canada (2003), Italy (2003), and UK) even under regulatory oversight of the kind contemplated by control in New Zealand. Outage costs in the North-East of the USA were estimated as much as US\$6 billion. It is even possible that constrained transmission could lead to a reduced supply similar to the New Zealand winter of 2001 which the Treasury estimated as a \$200 million cost to the economy.

Second, in Vector's experience reactive capital expenditure often costs about double the amount of pro-active capital expenditures, and accordingly we seek to proactively monitor and maintain assets. The proposal to delay transmission investments carries the risk that investment occurs too late leading to costs that are considerably higher because of the need to accelerate the build programmes or implement solutions that are sub-optimal. For example redundancy margins may be insufficient to take any lines out of service during upgrades.

In terms of the investments themselves, Vector does not believe there is robust evidence to support investment efficiency gains of 5 or 10% as benefits of control. These gains would imply that the regulator has a significant comparative advantage over the company's management in the operational detail required to prudently operate and expand transmission networks. In Vector's view, the quantification of this benefit is not an established principle and should not be included in the cost benefit analysis.

The Form of Control

Vector notes that it is difficult to assess the net benefit of control in the absence of any description of the control regime that would apply to Transpower. While the Commission cannot prejudge the form of control, it is important for consultation purposes that the key elements of a likely control approach (or even scenarios of control) are defined. For example, the Commission suggests that control would ensure benefits relating to more efficient investment (better timing and lower capital costs), but does not state how those benefits would be achieved and the role it would take relative to the Electricity Commission.

Vector is becoming increasingly concerned that the dual regulatory system that applies to Transpower is in turn distracting it from providing a robust, reliable transmission grid. Notwithstanding our concerns about the cost benefit analysis, it is difficult to discern how control by the Commerce Commission would result in an improved investment programme over that which will result from the Electricity Commission fulfilling its role to scrutinise Transpower's investments. It is not clear how the Commerce Commission's role in controlling prices will interact with the Electricity Commission's Part F process.

Vector requests that the Commission provide further information on how it might implement control, so stakeholders can better understand how the two processes will work together.

Definition of Excess Profits

The Commission's analysis shows that Transpower has deliberately breached its price threshold and its proposed price increases, in this instance, signal its intention to breach again. Under Part 4A, it is appropriate that deliberate breaches result in further investigation.

While the Commission has stated that Transpower's actions may lead to excessive profits and inappropriate inter-generational transfers, the analysis provided by the Commission is not sufficient to support these views.

The Commission's definition of revenues above those implied by the thresholds is a new measure for "excess profits" which is not discussed in the paper. In its previous processes, the Commission has defined excess profits as those exceeding that required to sustain an efficient business's "normal" profits. Such shifts in approach and definitions create significant regulatory uncertainty.

Vector observes that it is common-place for regulators to approve the smoothing of prices in advance of actual investments in order to avoid "rate-shock", whereby customers are exposed to significant step-changes in charges. Similarly, electricity generators have increased prices smoothly in advance of significant new investments and have stated that such increases are needed to fund new investments. This suggests to Vector that as long as there is reasonable certainty that the investments will be needed within a reasonable time horizon then inter-temporal price smoothing need not be inefficient, or lead to excess profits measured over a suitable time horizon. In our view, it is the lack of certainty about some future transmission investments and who will be contract counterparties that calls into question Transpower's justifications for price increases at this point.

Nevertheless, Vector believes the price increases by themselves are not sufficient reason to impose control and a full cost-benefit analysis that recognises the possible risks of regulation is necessary to form an intention to declare control.

EVA Adjustment Account

The EVA adjustment account is a further factor which should be considered in the analysis. Vector notes that the Commission has reserved its position on the EVA adjustment account, which has, in effect, allowed Transpower to increase its charges by not refunding the balance of the account to customers. In Vector's view, it is unacceptable for Transpower to unilaterally discontinue the EVA account without first discharging its balance. The EVA account essentially provided Transpower with a smoothing mechanism to avoid significant

shifts in charges and revenues over time and essentially removed any, or at least most risks from Transpower.

Vector considers that under a thresholds or control regime greater risks and rewards sit with the business and so an EVA account is not necessary or desirable in inducing more efficient performance. Moreover, it is quite improper for Transpower to have failed to refund over-recovery of revenue earned under the previous regulatory regime applying to Transpower. Customer acceptance of Transpower carrying a balance in the EVA account in favour of customers was conditional on it being refunded over time with compensation for the time value of money.

Vector considers that the Commission should take this into account in its analysis and any controls should enforce the refund of the outstanding balance before it is (appropriately) discontinued. In Vector's view this would promote regulatory certainty and consistency and any enforcement of the EVA adjustment would not be retrospective since the EVA account was a carrying account for refunds owing to customers in future.

Conclusions

Vector shares the Commission's concerns over Transpower's significant proposed price increases. However, we are equally concerned that transmission investments proceed in a timely and efficient manner and that there needs to be full and robust consideration of these factors in the Commission's cost benefit analysis.

Vector believes that security of supply into the Auckland region is of critical importance. In our view there is now insufficient headroom in transmission capacity to accommodate further delay of transmission investment, whether intentional or otherwise.

Please feel free to contact me if you have any queries or would like further information on the points raised in this letter.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Paul Hodgson', written over a horizontal line.

Dr Paul Hodgson
Group Regulatory Affairs Manager