



# MAJOR ELECTRICITY USERS' GROUP

27 February 2006

Mr Rodney Doyle  
Chief Advisor  
Transpower Post-Breach Inquiry  
Network Performance Group  
Networks Branch  
Commerce Commission  
By email to [electricity@comcom.govt.nz](mailto:electricity@comcom.govt.nz)

Dear Rodney

## **Submission on Intention to Declare Control of Transpower**

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission (the "Commission") report "*Intention to Declare Control – Transpower New Zealand Ltd,*" dated 31 January 2006.
2. Subject to:
  - a) considering information that Transpower table as part of this consultation round; and
  - b) assuming the control regime will be designed to mesh with Part F regulated by the Electricity Commission (EC); then

MEUG agree on the evidence of the Commission that it should declare control of Transpower under s57H of the Commerce Act.

3. Comments on matters of detail as they first appear in the report and in advance of receiving the Transpower response to the Commission report follow:
  - a) The Commission treatment of the Economic Value Account (EV) adjustment charge (p7, p20, p43) is deliberately to favour Transpower on a without prejudice basis pending receipt of information from Transpower. Determining the correct treatment of the EV adjustment to date is important because it is the only measure consumers, Transpower and the Commission have of assessing the value of excess returns from the date of the first threshold breach. Transpower's shareholder should receive an appropriate return on its capital but should not expect to retain excess profits identified in a post-breach inquiry.

Proven excess profits from the date a breach occurs need to be refunded otherwise Transpower will have an incentive to defer as long as possible the commencement of a control regime because in the meantime Transpower can "bank" the excess profits. Consumers have no influence over the pace of the post-breach inquiry: that is in the hands of the Commission and Transpower.

- b) Paragraphs 138 to 190 (p42-55) consider Transpower's recent performance in terms of revenues and costs and relevance to whether control is desirable. No MEUG members were advised of the reasons for the recent transmission price increases before they were announced. This is also an important factor to consider regarding the recent behaviour of Transpower. MEUG consider consultation, communication and transparency important goals for transmission services and the market as a whole.

The intention of Part F of the Electricity Governance Regulations is to assist Transpower and transmission customers enter into transmission contracts that can reflect where possible individual customer trade-offs on service standards and price. The failure of Transpower to communicate beforehand on the reasons for such a significant price rise due 1 April 2006 does not bode well for implementing a more customer focussed approach envisaged by Part F. Hence MEUG strongly recommend that an effective control regime should be designed to mesh with Part F.

- c) MEUG note that the WACC used in table 3 (p59) is sourced from Transpower and should not necessarily be accepted as the relevant WACC to be used in the control regime phase<sup>1</sup>.

- d) After an analysis of available information paragraph 213 (p60) of the Commission paper states,

*"The Commission is of a view that Transpower is effectively seeking to pre-fund substantial investments ..."*

Two factors that might be contributing to Transpower raising prices in anticipation of large capital requirements are self-imposed constraints on raising equity and credit ratings. MEUG note that the Transpower Statement of Corporate Intent (SCI) states<sup>2</sup>,

*"Transpower will seek to manage its future capital requirements without recourse to additional equity injection by the shareholder. To achieve this and maintain an appropriate credit rating will require a higher proportion of retained funds."*

It's questionable whether the SCI constraint on equity would occur for a comparable business that was not owned by the Crown<sup>3</sup> when an enterprise was contemplating such a significant capital expenditure programme.

Transpower maintain a credit rating far higher than the minimum BBB rating recommended by Treasury for SOE<sup>4</sup>. Maintaining a self-imposed very high credit rating in conjunction with restrictions to equity input by shareholders will contribute to significant price increases to meet credit rating agency ratios and higher retained profits.

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<sup>1</sup> In considering any submissions by Transpower on WACC MEUG are likely to reference the Commerce Commission report *"Draft Guidelines – the Commerce Commission's approach to estimating the cost of capital,"* circulated by email 20 October 2005 and the MEUG submission of 2 December 2005 enclosing a report from Ireland, Wallace & Associates on WACC.

<sup>2</sup> Refer Transpower, Statement of Corporate Intent 2005/06, p6.

<sup>3</sup> Note this phrase matches Transpower's principle objective a) as set out in s4 of the SOE Act to be "as profitable and efficient as comparable businesses that are not owned by the Crown." Ibid, p4.

<sup>4</sup> Refer Treasury, *Statement of Intent for the year ending 30 June 2006*, December 2005, in the section titled "Efficient management of the Crown's assets and liabilities" ([www.treasury.govt.nz/soi/2006/10.asp](http://www.treasury.govt.nz/soi/2006/10.asp)) under the subsection heading "Financial viability" states;

*"SOEs need to maintain their long-term financial viability, with one measure being their credit ratings. We expect SOEs to maintain an investment-grade credit rating (triple-B or higher). The five SOEs currently rated meet this standard."*

These issues are also interrelated with the appropriate WACC formula to apply in a control regime. MEUG have for a long time suggested a WACC formula whereby financing policy is a matter for the shareholder rather than transmission customers. Even taking the WACC formula used by Transpower (and by the Commission itself) which has WACC increasing as the debt to equity ratio rises, the least cost approach is to have 100% equity. For capital charging the lowest rate should be used for pricing services.

As noted in paragraph 3 c) above MEUG is likely to have further comments in the cross-submission round on WACC following receipt of Transpower's response to the Commission report.

- e) It can reasonably be assumed that if Transpower have used 7% as the appropriate WACC for calculating 2006/07 revenue<sup>5</sup> then that rate is likely to be towards the middle to upper limit of the appropriate discount rate. Therefore MEUG suggest the Commission also assume a 7% discount rate rather than the conservative value<sup>6</sup> of 10% applied in the Commission paper for calculating the NPV of the benefits of control (paragraph 237 and 238, p64). Seven percent is also the discount rate the EC assumed in the Initial Statement of Opportunities in July 2005<sup>7</sup> and the default rate for the Grid Investment Test if the EC does not determine any other rate<sup>8</sup>. Using a 10% discount rate instead of 7% significantly understates the NPV of the benefits of control.

4. MEUG look forward commenting on the submissions of other parties.

Yours sincerely



Ralph Matthes  
Executive Director

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<sup>5</sup> Commerce Commission report, *Intention to Declare Control – Transpower NZ Ltd*, table 3, p59

<sup>6</sup> Ibid, footnote 92, p64, refers to the 10% discount rate as a "conservative value."

<sup>7</sup> Electricity Commission, Initial Statement of Opportunities, July 2005, section 4.2, p38

<sup>8</sup> Electricity Governance Rules, Part F, section III, schedule F4, clause 14.