Comalco New Zealand Limited

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21 February 2006

Attention: Michael Clark
Transpower Post-Breach Inquiry
Network Performance Group
Networks Branch
Commerce Commission
P O Box 2351
Wellington

Dear Mr Clark

SUBMISSION ON THE TRANSPOWER POST-BREACH INQUIRY

Introduction

1. This submission is made by Comalco New Zealand Limited (*Comalco*), on behalf of Comalco Power (N.Z.) Limited (*Comalco Power*) and New Zealand Aluminium Smelters Limited (*NZAS*). It is made in response to the Commission's consultation paper titled 'Regulation of Electricity Line Businesses, Targeted Control Regime, Intention to Declare Control, Transpower New Zealand Ltd' (the *Paper*) of 31 January 2006. Nothing in this submission is confidential.

2. Comalco agrees with the Commission's intention to control Transpower, at this stage. As the post-breach inquiry proceeds, it is hoped that an administrative settlement can be reached that avoids the Commission assuming control of Transpower.

Discussion

<u>Investment Cost Recovery</u>

3. Transpower's recent and intended price rises are completely unjustified. It is very clear from Transpower's own media release of 25 November 2005 and subsequent statements that Transpower fully intends to fund a significant amount of their intended capital investment programme by

extracting the money from customers first, making the investments and then charging customers for a return on the investment that the customers have funded. Only an uncontrolled monopoly can get away with that sort of behaviour. It is even more galling that the price increases relate to pre-funding investments that have yet to even be approved by the Electricity Commission.

4. Comalco agrees with the statements made by the Commission in paragraph 218 of the Paper. As a general principle, in competitive markets, capital required for new investment comes from a combination of:

   - earnings retained within the company;
   - borrowing, or
   - capital injected from new and/or existing shareholders.

5. If the investment proves to be a good one, then the funders of the investment will obtain an appropriate return on the capital they have invested.

6. In a competitive environment, companies cannot fund new investment through raising prices as this results in a loss of customers. The whole regulatory regime applying to Transpower and the distribution networks is intended to mimic the forces applying in competitive markets and constrain the exercise of monopoly power.

<u>Pre-Commitment Costs</u>

7. Comalco agrees with the sentiments expressed by the Commission in paragraphs 111 and 206 of the Paper. Comalco does not agree that costs incurred in the pre-commitment phases of a project should automatically be approved for recovery from consumers. In a normal commercial environment such costs are capitalised into the value of an asset once the asset is completed. If the asset is not completed, because the investment is no longer deemed worthwhile, the costs incurred are expensed at the ultimate cost to the shareholder. Comalco sees no reason why Transpower should have a guaranteed return of such costs from customers.

8. These costs are a normal part of any business where there is some risk that potential investments do not proceed to completion for whatever reason. Transpower should not be insulated from these risks – to do so invites a less diligent effort by Transpower in its project evaluation processes.

9. Transpower is not currently committed to an investment in any 400 kV circuits or increase in the capacity of the HVDC link. Any costs incurred by Transpower to date, on investigation or preparation for any of those investments, must be carried by Transpower until those investments are completed and the assets commissioned. Then they can enter the regulated asset base and Transpower can recover them. However,

should any of the projects not proceed, the associated costs should be immediately expensed at the cost to the shareholder.

Funding Sources

10. It is very clear that it is most inappropriate for Transpower to raise prices to customers to fund capital investment. As previously discussed, Transpower must be restricted to funding capital investment from retained earnings, borrowing and shareholders.

11. Comalco is concerned that this inappropriate behaviour is driven by an agreement with the Government that is identified on page 6 of Transpower's Statement of Corporate Intent for 2005/06:

> *'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.'*

12. This statement makes it clear that the Government and Transpower have agreed that Transpower will not seek capital injections from the shareholder. Transpower is therefore restricted to funding capital expenditure through retained earnings and debt financing. Transpower's ability to borrow further is not limitless and therefore it will look to fund a significant amount of capital expenditure from retained earnings. Hence its large price increases and announcements that the dividend to the Government will be reduced – but not reduced to zero.

13. As discussed before, in a competitive environment, Transpower simply could not raise prices to fund capital investment. It is not appropriate for Transpower to use its monopoly power to raise prices because of these funding constraints. The real issue lying behind Transpower's inappropriate pricing behaviour is an apparent inability to receive a capital injection from the sole shareholder – the Government.

Where To Now?

14. If the Electricity Commission approves major investment programmes like the proposed 400 kV circuits and the HVDC upgrades, Transpower will probably not be able to fund these from retained earnings (given that prices are controlled) and further borrowing. Transpower will therefore require an equity injection to undertake the programme.

15. An equity injection could come from capital from the Government shareholder. The Government needs to address this issue now and contribute to the solution. Comalco hopes that this can be done, and a settlement reached, before the Commission irrevocably concludes it must assume control of Transpower.

General

16. We would be happy to discuss any questions or comments you may have in relation to the points and recommendations raised above. If you would like to discuss Comalco's comments further, please contact me.

Yours faithfully

Michael Scotton
Power Manager