



Comalco New Zealand Limited

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13 March 2006

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

Dear Mr Clark

CROSS-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 submissions made on the Commission's consultation paper titled 'Regulation of Electricity Line Businesses, Targeted Control Regime, Intention to Declare Control, Transpower New Zealand Ltd' of 31 January 2006. Nothing in this submission is confidential.
2. This submission focuses on the appropriateness of Transpower's costs and in particular the allocation of costs between the shareholder and customers and the timing of the incidence of costs on customers. Transpower's submission on this issue has provided some useful information, but there are still many unanswered questions.

Capital Constraints

3. Comalco remains concerned at the impact of the apparent funding constraint imposed on Transpower¹. MEUG and other submitters also raised this concern. Statements by Transpower in its November 2005 submission to the Commission on valuation issues², suggest that Transpower wishes to load as much capital expenditure into the regulatory asset base (RAB) as soon as possible to reduce the financial impact of the funding constraint.

4. In this submission, Transpower makes a number of statements concerning the impact of the funding constraint on its ability to fund its investment programme. In particular, Transpower states in paragraph 16:

'Ensuring adequate funding relies on sufficient cashflows being generated. This is especially the case for Transpower, given the significant capital programme which the company is facing over the short to medium-term, and its inability to access equity capital markets.'

5. This statement clearly indicates that Transpower's apparent inability to access an equity injection requires an alternative source of cash to fund its investment programme.

6. Paragraph 18 of Transpower's submission explains further that Transpower's ability to fund the programme is highly sensitive to the treatment of revaluations and works under construction.

7. Concerning works under construction, paragraph 25 goes on to say:

'In view of the cashflow effects, Transpower recommends that capital expenditure be recognised in the RAB as it is incurred, rather than when the associated project is commissioned.'

8. While assets are being constructed they are not generally providing useful services to customers and therefore customers should not be expected to pay for them. It would certainly be completely inappropriate to include as yet unapproved capital expenditure in the RAB.

9. At paragraph 28 of this submission, Transpower identifies its revenue shortfall from the conventional treatment of works under construction as \$300 million over the 2006-2015 period. However, looking at this from the customers' perspective, the conventional treatment of works under

¹ This constraint is described in Transpower's Statement of Corporate Intent for 2005/06 where Transpower states that it: '...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.'

² Submission to the Commerce Commission on Regulation of ELBs: Valuation of the Regulatory Asset Base Decision Paper, Public Version, November 2005.

construction will prevent customers paying \$300 million inappropriately in advance to Transpower over this period.

10. It is very clear that the apparent inability to secure an equity injection from the shareholder is causing Transpower to advocate inappropriate capital expenditure allocation methodologies. Such allocations will result in funds being prematurely extracted from customers before they receive any benefits from the associated assets.

Land and Easements

11. Transpower's allocation of the costs of land and easements required for transmission routes is puzzling. In paragraph 296 of its submission on the intention to declare control, Transpower states in relation to a Transpower policy change:

'...land and easements enter the regulatory asset base on EC approval or commencement of construction of the asset to which the land relates, whichever is the earlier.'

12. Yet at paragraph 540, Transpower states that it does not currently recover the costs of investments until they are commissioned. These two statements conflict. Comalco agrees with the approach in paragraph 540, but considers that Transpower is actually applying the approach in paragraph 296.
13. Paragraphs 263-264 identify expenditure on property for the NI 400 kV and Auckland North Isthmus of \$59.5m and that this has been included in the RAB for pricing purposes. Neither project has been approved yet, and no associated assets have been commissioned, so their inclusion in the RAB is not appropriate.
14. These values should be backed out of the RAB and the price increase for 2006/07 reduced accordingly.
15. Comalco shares the concerns expressed by Mighty River Power³ in its submission. Questions must be asked about how exactly Transpower is setting its prices and revenue requirements and whether or not these processes have the necessary rigour.

Cross-Border Lease

16. Paragraph 566 discusses some of the possible impacts of a downgrade of Transpower's credit rating. It is noted that collateral may need to be posted as part of the cross-border lease agreement.

³ Paragraph 62 of Mighty River Power's Submission In Response To The Commerce Commission's Intention To Declare Price Control On Transpower New Zealand Ltd

17. This transaction was performed as part of improving the efficiency of funding and thus is of benefit to the shareholder. If the cross-border lease arrangement constrains Transpower's financing activities, any increased costs relating to this should be borne by the shareholder and not customers.

Credit Rating

18. A recent paper by the Australian Energy Market Commission considers that an appropriate credit rating for a transmission network service provider should be within the investment grade rating of AAA to BBB⁴. This paper goes on to say that an appropriate benchmark is BBB as this rating achieves an appropriate balance between the interests of consumers, regarding price, and the incentives on the transmission provider to undertake efficient investment.
19. If Transpower wishes to maintain a higher credit rating, any costs associated with this, over say a BBB benchmark, should be borne by the shareholder and not customers.

Economic Gains

20. Transpower goes to great lengths to explain how consumers are made whole by the operation of the EV adjustment⁵. This is not strictly correct to the extent that customers' WACC differs from interest accruing on the balance of the EV account. Leaving this aside, the balance of the HVAC EV account for customers is much more commonly positive than negative, leading to regular EV rebates. This suggests a tendency to over-recover HVAC costs⁶.
21. What are most interesting are Transpower's economic value statements. Note 3 of the statement for the year ending 30 June 2005 reveals an accumulated economic gain from monopoly activities attributable to customers of \$101.8m. For the previous year, the amount was \$88.9m. These are substantial sums that appear to be growing. Why has this accumulated amount not been returned to customers?
22. The large sum in this account conflicts with Transpower's assertions that the operation of the EV adjustment effectively makes consumers whole

⁴ Pages 64 and 65 of the 'Review of the Electricity Transmission Revenue and Pricing Rules, Transmission Revenue: Rule Proposal Report, Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, by the Australian Energy Market Commission, February 2006.

⁵ This adjustment allows Transpower to remit any over-recovery of costs to customers in subsequent periods, but also to recover any under-recovery of costs. The intention is not to allow Transpower to add any economic value to its business at the expense of customers.

⁶ This is not unexpected since the charges for interconnection assets are based on peak demand and if this grows significantly each year, it will lead to an over-recovery of HVAC interconnection costs.

regardless of the time-profile of cost recovery. It also conflicts with assertions that Transpower has not recovered its cost of capital over time.

Regulatory Costs

23. Comalco is greatly concerned at the allocation of these costs between customers and shareholders. Transpower commissioned eight reports from consultants to append to its own lengthy submission. Control of Transpower will possibly affect Transpower's value and that is of keen interest to the shareholder, but much less so to customers.
24. Costs incurred by Transpower to defend its value must be attributed to the shareholder as it benefits from this defence. Customers do not and therefore it is completely improper to recover such costs from them.
25. It is inefficient to allocate regulatory costs that benefit the shareholder, to customers. This provides an enormous incentive for Transpower to spend as much as it can in order to defend its value, as these costs would be just a straightforward pass-through to customers. If the costs are allocated to the shareholder, and not recovered from customers, it is likely that much more discipline will be applied to Transpower's expenditure here.
26. The eight consultants reports appended to Transpower's submission are likely to be only a taste of what will come next. The Commission's own expenditure is likely to increase in response to the volume of material provided by Transpower. Allocating Transpower's expenditure in these areas to the shareholder correctly aligns the costs with those who have the incentive to bear those costs and have the ability to control them.

Concluding Comments

27. Transpower has justified its very large price increases as being necessary to cover significantly increased capital expenditure and the associated increase in resources required to manage that expenditure. It is very clear that the funding constraint imposed by the shareholder has forced Transpower to look for other, inappropriate, avenues to fund these costs.
28. It is clear that Transpower wishes to change the way it is accounting for works under construction so that these enter the RAB as expensed, but prior to commissioning the assets, thus driving prices up. Transpower is already including property purchased well in advance of commissioning in the RAB. Regardless of accounting rules, this is not economically proper as it misaligns the cost recovery with the flow of benefits. Transpower argues that the operation of the EV adjustment makes consumers whole, but Comalco contends that this is only partially true.

29. It is very clear that this inappropriate change in approach is being driven by an inability to secure an equity injection from the shareholder. The Government must seriously consider providing the capital that Transpower requires to proceed with approved investments.
30. Comalco agrees that the assessment of whether or not Transpower has made excess profits should be made using a building-block approach. The Commission should strongly query the size, nature and efficiency of the building blocks that Transpower proposes should be used. In particular, the Commission needs to carefully separate out costs that should be borne by the shareholder from costs that should be borne by customers.
31. It is clear that the price increase that is to apply from 1 April 2006 is not appropriate. Therefore, the Commission must act to prevent the increase being applied. Controlling Transpower may be the only way to achieve this.

General

32. 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

A handwritten signature in black ink, appearing to read 'M Scotton', written in a cursive style.

Michael Scotton
Power Manager