



MAJOR ELECTRICITY USERS' GROUP

13 March 2006

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

Dear Rodney

Cross-submission on Intention to Declare Control of Transpower

1. This is a cross-submission by the Major Electricity Users' Group (MEUG) covering the Commerce Commission (the "Commission") report "*Intention to Declare Control – Transpower New Zealand Ltd*," dated 31 January 2006 and submissions by twenty parties, including MEUG, tabled with the Commission by 27 February 2006.
2. In our first submission MEUG gave conditional support to the Commission intention to invoke control of Transpower. Having now read the submissions of other parties MEUG find no reason to modify that position.
3. Other conclusions follow, with each forming the section titles for the balance of this cross-submission:
 - a) There is no doubt Transpower breached its thresholds;
 - b) The breach is material as evidenced by the annual and cumulative excess returns to date reported by Transpower and these appear to be understated;
 - c) The assumption by Transpower that new investment costs can be recovered using EVA=0 pre-empts the Part F requirement those costs be recovered using the yet to be finalised Transmission Pricing Methodology;
 - d) There are a number of concerns on past and forecast operating and capital costs that cast doubt on the underlying rationale and explanation by Transpower that the large excess returns to date plus the proposed 19% increase in transmission prices are necessary;
 - e) Without control consumers would have no immediate protection from Transpower charging excessive prices, incurring inefficient costs, misallocating costs and biasing future consideration of investment options by the Electricity Commission (EC);
 - f) Aspects of this post-breach inquiry are useful for designing a control regime or as a basis for an administrative settlement; and
 - g) There is a reasonable consensus to review the regulatory framework.

There is no doubt Transpower breached its thresholds

4. Transpower has self-reported it breached its thresholds at each of the three assessment dates to date¹. Consequently a post-breach inquiry was necessary.

The breach is material as evidenced by the annual and cumulative excess returns to date reported by Transpower and these appear to be understated

5. Transpower report in their Economic Value (EV) Statements an accumulated economic gain attributable to customers at 30 June 2005 of approximately \$101 million. This is equivalent to excess charges of \$151 million, ie \$101 million grossed up for tax. This is a measure of accumulated excess charges and consequent profits assuming the EV Statements have been appropriately calculated by Transpower since the company started using and publishing an EVA=0 protocol from and including the year ended 30 June 1996.
6. MEUG has supported the concept of EVA=0 and ODV along with EV Statements for sunk assets. However we have raised concerns on the application of those approaches by Transpower for a number of years. The recent release (only last week) by Transpower of EV statements for the last 2 years confirms our view that the accumulated economic gain attributable to customers at 30 June 2005 is significantly understated. A good example of this is the inconsistent approach Transpower has used in calculating WACC for different purposes and, in the view of MEUG, a tendency to bias values of parameters in favour of its shareholder. This and other concerns over treatment of expenses and costs are discussed later in paragraphs 12 and 13.

The assumption by Transpower that new investment costs can be recovered using EVA=0 pre-empts the Part F requirement those costs be recovered using the yet to be finalised Transmission Pricing Methodology

7. When Transpower commenced an EVA=0 approach and published EV Statements in 1996 the regulatory framework governing transmission comprised:
 - a) Recovery of sunk costs valued at ODV using EVA=0;
 - b) New grid investments to be subject to new investment agreements including cost recovery; and
 - c) Light handed regulation based on information disclosure with the threat of heavier handed regulation.
8. It is important to note only sunk costs were subject to ODV and the EVA=0 regime. Transpower in describing the history to transmission revenue setting do not mention the distinction between how sunk and new investments were to be treated².
9. In the late 1990's new "core" grid investment stalled as counterparties were reluctant to enter into long term contracts. Attempts to reach an industry self-regulating approach through voting rights and obligations for new grid investment failed although most of the underlying philosophy to facilitate a contractual basis for Transpower supplying services to transmission customers has migrated through to Part F of the Electricity Governance Rules (The "Rules"). That includes new investments being approved by the EC and the costs recovered by Transpower through an EC approved Transmission Pricing Methodology.
10. Recovery of sunk costs valued at ODV using EVA=0 was made mandatory until such time as the EC made any changes as part of the yet to be developed Transmission pricing Methodology.

¹ Transpower submission, paragraph 5

² Ibid section 3.31, p38

11. Transpower however have pre-empted the EC determination of a new Transmission Pricing Methodology for new investment and decided to recover costs for yet to be approved new investments using the EVA=0 protocol that applies to sunk assets. MEUG believes Transpower have no statutory right to take such action.

There are a number of concerns on past and forecast operating and capital costs that cast doubt on the underlying rationale and explanation by Transpower that the large excess returns to date plus the proposed 19% increase in transmission prices are necessary

12. Setting aside the point in the last section that Transpower has no right to pre-empt the new Transmission Pricing Methodology for new investments, there are doubts on the EV Statements to date and forecast costs and revenue requirement as follows. These can only be considered a sample because MEUG has not had the resources to comprehensively analyse all submissions partly because the information is dispersed and not user friendly. Even if MEUG had sufficient resources it appears not all relevant information has been made public in any case. The Commission is in the best position to undertake the appropriate analysis of the relevant issues raised.
13. The issues and concerns MEUG wishes to inform the Commission on include:
- a) Some of the claimed operational expenses and assets against which a capital charge is applied appear inappropriate or have insufficient justification, eg
 - i) The following capital costs included for 2006/07 are inappropriate until such time as EC approval is obtained and subject to EC decisions on how the costs are to be recovered in the new Transmission Pricing Methodology:
 - \$49.8m capital expenditure for projects submitted to the EC for approval for which a decision is pending³; and
 - \$47.9m capital expenditure that has not been submitted or is yet to be submitted to the EC for approvals⁴.
 - ii) Capital expenditure designated "IT & Other" is significant (CRA report as approximately \$70m pa)⁵ but not subject to either EC approval or adequately specified and/or justified as necessary to maintain the operating capability of the existing network or support new investment. MEUG has insufficient information to assess if this very large level of expenditure covers activities other than that for the Asset Owner function of Transpower. For example are any of the costs related to the upgrade of SPD? in which case those should be a charge against the System Operator. Or are costs for fibre optic communication assets that have a potential value for telecommunication suppliers? The Commission needs to consider if all the claimed IT costs are solely for use of the transmission asset owner or if they have value and therefore costs should be allocated to other functions.
 - b) Apparent omission by Transpower to include the annual indexed value adjustment in the forecast revenue requirement for 2006-2007 and 2006/07 to 2010/11.⁶

Transpower⁷ in opposition to the Commission's "in principle decision" to require it to adopt Indexed Historic Cost ("IHC") instead of Historic Cost ("HC") for Regulatory Asset Valuation ("RAB") states:

³ Ibid, paragraph 264.

⁴ Ibid, paragraph 264.

⁵ CRA report prepared for Transpower, *The Costs and Benefits of Regulating Transpower*, 27 February 2006, table 3, p11, lists "Implied IT & Other" for 2006/07 as \$70.1m.

⁶ Transpower submission Figures 6.4 (p 142) and 6.5 (p 146). In contrast with Figure 5.3 (p 118) Figures 6.4 and 6.5 do make explicit a "Reval Adj" in the "Revenue Requirement" box in the Pricing Methodology.

⁷ Transpower, "Submission to the Commerce Commission on Regulation of ELBs: Valuation of the Regulatory Asset Base Decision Paper", November 2005.

"Given anticipated capital commitments and assuming inflation of 2.5%, revenues under the Commission's approach over the period 2006-2015 would be reduced by ca. \$800million from revaluation adjustments."

If Transpower has assumed HC instead of IHC for RAB purposes then Transpower is planning to collect revenues equivalent to the inflation adjustment in excess of what the Commission would expect under the IHC basis. The magnitude of the omission of the indexed value adjustment in the determination of the Revenue Requirement is large (initially up to say 2.5% or based on a WACC of approximately 6% potentially over one-third of the capital charge). The annual impact is shown on the chart on page 9 of the Transpower submission. The "annual difference in revenue"⁸ effect is approximately \$75m year 1, \$75m year 2, \$100m year 3 and increasing to almost \$200m in year 7.

The Commission and Transpower should clarify whether or not Transpower's revenue requirement 2006/07 to 2010 is prepared on a HC or IHC valuation basis. If the Commerce Commission determines the methodology to be applied is IHC and Transpower in determining its revenue requirement has employed HC methodology then the proposed HC based price increases encapsulate excess revenue of \$800m for the period 2006/07 to 2010/11.

- c) In its Pricing Methodology Transpower has treated works under construction as entering RAB on an "as commissioned" basis which is noted as being acceptable to the Commission. Further, Transpower has stated that it will not change to its preferred basis of "as-spent" without the Commission's endorsement.⁹ Transpower provides the principle reason for its need to change is "... to relieve balance sheet pressures during period of intense construction ..."¹⁰

MEUG believes that the changes Transpower have proposed and/or reflected in its Pricing Methodology (principally by adopting HC for RAB purposes and proposing "as-spent" for works under construction) is driven by self-imposed capital structure constraints such as the need to avoid additional capital injections from its shareholder and the target credit rating band. This issue is covered later on in paragraph 13 h).

- d) Some of the claimed expenses may not be efficient (lowest cost), eg
- i) Transpower suggest transmission prices are at a cyclical low¹¹ and reflect an under-investment backlog that must now be filled. MEUG disagrees. A more plausible explanation for decreasing unit costs for transmission is a combination of better asset utilisation matching demand growth and Transpower was previously inefficient and has become more efficient. Unfortunately the Transpower submission quoted only from selected parts of various benchmarking reports against peer transmission companies to defend its operating efficiency record. The partial way this information was presented casts doubt on whether a balanced view has been given to the Commission¹².
- ii) Ireland, Wallace & Associates ("IWA")¹³ has reviewed Transpower's cost of capital and concludes it is overstated by up to 1.1%.

There are a number of biases introduced by Transpower in its various estimates of the WACC employed to establish the capital charge in its EV accounts and pricing methodology. Specifically, tax assumptions and the market risk premium employed in the EV accounts increase the WACC estimate and hence capital charge above an "efficient cost." These biases are

⁸ Also includes works under construction on an "as commission basis" would reduce revenues by about \$300million over the same period in addition to the indexed value adjustment of \$800million.

⁹ Transpower submission paragraph 307, page 97.

¹⁰ Ibid paragraph 307, page 97.

¹¹ Ibid, figure 4.1, p70

¹² MEUG full disclosure of benchmarking studies by email on 2 March 2006 but were advised by Transpower that the information would not be released on the grounds of commercial confidentiality.

¹³ See attached letter from Ireland, Wallace & Associates Limited, *Estimating Cost of Capital*, 13 March 2006

carried forward and compounded in the pricing methodology WACC estimate by employing an inconsistent and inappropriate risk free rate and employing a higher underlying asset beta.

IWA also refer to a "penalty to debt" inherent in both the Commerce Commission and Transpower's application of the CAPM model resulting in IWA's view that financing policies of Transpower should be based on an efficient capital structure and therefore irrelevant for pricing purposes.

For its pricing, EV and other assessments by the Commerce Commission, financing policies should be disregarded and the least cost WACC should be used as its base line. Transpower and its shareholder otherwise should be free to set their own financial policies.

- iii) An unexplained and permanent reduction in the depreciation tax shield and consequent increase in effective tax rate as evidenced by the increase in tax provision revenue building block of \$11.8m for 2005/06 and \$7.4m in 2006/07¹⁴.
- e) Some of the expenses relate to future large scale investment decisions and therefore the efficient costs associated with these projects should be capitalised and recoverable once approved and subject to an EC decision on the cost recovery price path, eg
 - i) Investigation expenditures have increased \$14m and \$4m for the prior years 2004/05 and 2005/06 and are forecast to decrease in 2006/07 by \$2.4m. The cumulative change over 2004/07 is \$15.6m. This is clearly related to future as yet to be approved investment and should be capitalised. If Transpower is allowed to expense as it sees fit any level of Investigation work then it is likely to become inefficient and wasteful. For example there will be little constraint on "investigations" being undertaken on a whim or being used to provide employment for staff until a "real" investigation commences.

By capitalising all investigation work and providing recovery of those capital costs only if EC approval is obtained creates incentives on Transpower to either:

- find benefiting party(s) to underwrite the investigation costs; or
- take the risk the project may not receive approval and therefore be a cost to shareholders. In this case Transpower will be incentivised to carefully select and investigate only those projects they believe are most likely to proceed.
- ii) Similarly "Capability Development" expenses increased in 2005/06 by \$19m¹⁵. The forecast "Capability Development" costs for 2006/07 has not been separately identified by Transpower and therefore it is unclear if those costs are part of the \$14.8m increase in "Departmental Expenditure/Other Expenditure" or \$22.7m increase in "Operating Expenses" between 2005/06 and 2006/07¹⁶. Wherever "Capability Development" costs have been allocated they should have capitalised just as "Investigation expenditure" should have been capitalised as noted in the preceding paragraph.
- iii) Property related capital expenditure planned for 2006/07 of \$92.8m¹⁷ due to, *"A change in Transpower's land and easement policy results in this amount being included in forecast operating capital."* MEUG disagree that inclusion of land and easements for as yet to be approved investments should be included or that once approved they are immediately included in the asset rate base.

¹⁴ Ibid, Figures 5.3 (p118) and 6.4 (p142).

¹⁵ Ibid, paragraph 382, p119.

¹⁶ Ibid, there is insufficient information in Figure 6.4 (p142) or the explanatory text of paragraph 453 (p142 to 144) on "Capability Development" cost changes between 2005/06 to 2006/07.

¹⁷ Ibid table 6.3, p143, paragraph 295 and 296.

The incentives problem noted for "Investigations" above applies equally to treatment of land and easements. In particular we are concerned that there is no framework or apparent incentive for Transpower to negotiate the least cost acquisition of easements and that Transpower seeks to immediately include such easements in operating capital independent of the purpose for which the easements were acquired. Further, we are concerned that Transpower seeks not only to recover through the capital charge easement expenditure incurred not only for the purposes of providing future customer service but also that associated with any "*visually amenable upgrade*."¹⁸

- iv) As noted above capital expenditure designated "IT & Other" is significant but not subject to either EC approval or adequately specified and/or justified as necessary to either maintain the operating capability of the existing network or support new investment.
- f) Shareholders rather than customers should bear some of the costs, eg
 - i) The finance lease arrangements consist of a gross loan liability of \$732.7m as at 30 June 2005¹⁹ (refer note 7 of EV accounts) and loan assets of \$532.7m together with obligations to post additional security should credit criteria not be met. There is no transparency with these arrangements supporting \$200m of operating capital. Given that the lease payments represent a finance component (interest) and an operating component (depreciation) and may also include clauses such as stipulated asset values upon termination which in turn will have consequences for true economic costs, additional disclosures are required before customers can be satisfied that the attributed "operating cost" component of the lease payments are "fair and efficient." Given the permanent reduction in the depreciation tax shield noted in 13 d) iii) above, any "tax benefit" of the lease could well have been reserved entirely for shareholders at the expense of customers.
 - ii) Abnormal regulatory costs such as those associated with breaches of the regulatory threshold should be borne by the shareholder with only independently justified efficient industry compliance costs borne by customers.
- g) Customers should not continue to finance operations through Transpower's retention of the balance of the accumulated economic gain attributable to customers at 30 June 2005 of approximately \$101m.
- h) The Transpower submission confirms MEUG's opinion²⁰ that the revenue requirement is determined by Transpower managing its future capital requirements without recourse to its shareholder for new equity and its objective of maintaining a AA band credit rating. The quantum and timing of forecast price increases are driven by these financing imperatives.

Absent either or both of the new equity and debt rating constraints then additional price profiles are available to Transpower and can be examined as counterfactuals by the Commerce Commission.

¹⁸ Ibid, paragraph 267

¹⁹ Transpower Economic Value Statements for the year ended 30 June 2005, note 7. The EV Statements were emailed to MEUG 3 March 2006 following MEUG request of 2 March 2006.

²⁰ MEUG submission, 27 February 2006, paragraph 3d).

Without control consumers would have no immediate protection from Transpower charging excessive prices, incurring inefficient costs, misallocating costs and biasing future consideration of investment options by the Electricity Commission

14. If control is not implemented (and the 19% price increase not reviewed) MEUG note the following detrimental effects²¹:
- a) Customers will have no immediate protection from Transpower charging excessive prices, incurring inefficient costs, or misallocating costs. Some examples of the areas of doubt MEUG has regarding inappropriate, inefficient and misallocated costs were described in the preceding section. This is a material issue because the 19% increase is equal to an additional cost to consumers of \$94.4m²² per annum. Only by implementing a control regime can the Commission assure consumers whether the increase is justified; or if not determine what the total revenue requirement should be.

To put this into perspective the EC has undertaken a very rigorous review of various Interim Grid Expenditure requests submitted by Transpower. Transpower note that the first of these, termed "Tactical Transmission Upgrades," totalling \$158.2m submitted April 2005 have been partly approved (\$91.5m) and some not approved (\$24.6m). It's inconsistent that the EC should rigorously review the TTU costing \$158.2m but an ongoing annual impost of \$94.4m (NPV of \$695m²³) does not have the same rigorous regulatory oversight.
 - b) Without control Transpower will incur and seek to expense various pre-development costs rather than capitalising them. This lowers the total capital cost of transmission GUP proposals below their true cost, ie the true economic cost should be inclusive of many of the project pre-development costs that Transpower seeks to have excluded by incurring them earlier than otherwise would be necessary and thereafter treating them as sunk costs. The EC when comparing Transpower GUP proposals with alternatives will not be comparing the costs on an even-playing field basis. This will lead to inefficient over-investment in transmission and under-investment in alternatives. Only through immediate control of Transpower can explicit decisions that are enforceable be made on the appropriateness, allocation and recovery of costs. To leave these decisions with Transpower in the current environment may be good for Transpower and its shareholder; but it will not deliver least cost total delivered energy to consumers.

Aspects of this post-breach inquiry are useful for designing a control regime or as a basis for an administrative settlement

15. The EVA=0 and ODV approach has been useful over the last 10 years for existing assets even though MEUG has had concerns over how it has been applied. EV Statements are a useful tool for tracking accumulated excess profits/losses over time using established methodologies defining differences with GAAP. A building block approach will be needed when implementing a longer term control regime within an EVA=0 framework.

²¹ These are in addition to the benefits and costs of control versus no control identified by the Commerce Commission in the discussion paper.

²² Transpower submission, paragraph 452

²³ Back of envelop estimate assuming \$94.4m over 10 years at 6% discount rate.

Reasonable consensus to review the regulatory framework

16. Several submitters, including MEUG and Transpower, questioned whether the current regulatory framework comprising Commission responsibilities under the Commerce Act and EC responsibilities under the Electricity Act are robust. The issues raised by submitters varied; nevertheless there was a reasonable consensus that a review is required.
17. MEUG have made submissions to Government that a review of regulatory structures is needed but should not take place until post the EC decision on the first GUP proposal, ie after mid this year. The advantage of deferring a review until after that date is two fold. First, it would be detrimental to deflect industry resources to a review when those same resources need to focus on the first GUP round. Second, there are likely to be valuable lessons from the initial GUP. In the meantime both the Commission and EC should continue as is; including as MEUG understands a reasonable degree of discussion to avoid duplication and conflicts between the two regulators.

Concluding comments

18. Transpower have breached its thresholds and self-reported accumulated excess profits that are significant and probably understated.
19. MEUG agree it would be desirable to invoke control by the Commission. An immediate benefit would be the protection of consumers from otherwise excessive prices and possibly inefficient and misallocated costs. Transpower will also benefit by gaining clarity of how costs are treated and recovered.
20. Later this year a review of the relationship and integration of the regulatory regimes governing transmission should be undertaken.

Yours sincerely



Ralph Matthes
Executive Director

Attachment, Ireland, Wallace & Associates Limited letter, *Estimating the cost of capital*, 13 March 2006