



MAJOR ELECTRICITY USERS' GROUP

12 November 2007

Mr Alex Sim
Transpower Post-Breach Inquiry
Networks Performance Group
Networks Branch
Commerce Commission
By email to electricity@comcom.govt.nz

Dear Alex

Submission on Transpower's proposed administrative settlement

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission (the "Commission") paper titled *Draft decisions and reasons for not declaring control & draft decision on resetting Transpower's Thresholds* (the "Draft Decision"), dated 5th October 2007.
2. The discussion paper considers the Transpower document titled *Formal Settlement Proposal* along with an explanatory paper. If a settlement is acceptable to the Commission and Transpower it will be implemented through a deed (the "Deed"). The final terms and conditions of such a Deed are not part of this consultation. The Commission's preliminary view is¹ "*that not declaring control and accepting the settlement offer presented by Transpower would provide an acceptable solution of, over time, efficient operation of markets directly related to electricity transmission.*"
3. Subject to modifications MEUG supports the administrative settlement proposed by Transpower. Those modifications follow. References to questions refer to the questions in the draft decision:
 - a) Removing from paragraph G (i), Schedule 1 of the Formal Settlement Proposal the option for the EC to approve capital expenditure by a formal communication outside the approval process set out in rules 13.4 and 14.4 of Section III, Part F (question 1).
 - b) If the Grid Investment Test in the Electricity Governance Rules changes, then the Commission should have the option of amending the treatment of capital expenditure in the Deed (question 1).

¹ Draft Decision, paragraph 411

- c) Including in the Deed an undertaking by Transpower to implement the following recommendations in the Strata Energy report² for asset replacement, refurbishment and enhancement (question 5):
- i) Instituting a more rigorous challenge process with respect to project costs;
 - ii) Setting cost reduction targets and better monitoring performance with regard to managing replacement, refurbishment and enhancement capital expenditure and in achieving the least-cost objective;
 - iii) Establishing an open-book process of negotiating project costs under longer term alliancing agreements;
 - iv) Improving the accuracy of the cost-estimation process; and
 - v) Raising the focus throughout Transpower on achieving the least-cost objective.
- d) Including in the Deed an undertaking by Transpower to implement the following recommendations in the Strata Energy report³ for Information technology expenditure (question 5):
- i) Generally raising the focus throughout Transpower on achieving the least-cost objective;
 - ii) Taking steps to ensure the close observance of the recently introduced Rules for Procurement corporate policy;
 - iii) Introducing provisions into process and policy documentation requiring that, throughout the process of initiating, evaluating and implementing projects, the achievement of least-cost capital expenditure objective is explicitly considered and that the steps being taken (or intended to be taken) to achieve it are set out;
 - iv) Requiring that supporting and approving signatories to documentation approving capital expenditure satisfy themselves that all reasonable steps to achieve least-cost capital expenditure have been taken;
 - v) Setting capital expenditure cost reduction targets (at least for repeat replacement, refurbishment and enhancement capital expenditure);
 - vi) Better monitoring and measurement of performance in managing capital expenditure on IT (including the comparison of cost estimates with actual costs and developing better KPI/Balanced Scorecard measures);
 - vii) Investigating further the opportunities to utilise certain contracting practices (open-book, outcomes-based and alliancing) to deliver, not only the required project outcomes, but also least-cost capital expenditure.
- e) Clarifying that ex post approval by the Commission of non-Part F capital expenditure for force majeure or security of supply events will, in addition to the criteria proposed by Transpower, use the same definition of those events as defined in Transmission Agreements (question 6).
- f) The pseudo assets should be depreciated at the weighted average remaining lives⁴ of 13 years for the HVDC assets (not 4 years as proposed by Transpower), 14 years for the HVDC line (not 4 years), 31 years for substation assets (not 4 years) and 31 years for AC transmission lines (not 10 years) (refer question 9).

² Strata Energy report for the Commission, Review of Transpower's Capital Expenditure Plans, May 2007, page 65

³ Ibid, page 67

⁴ PriceWaterhouseCoopers letter to Transpower, "Pseudo Assets," page 2, table 1, 10th May 2007

- g) Only capital expenditure approved by the Commission or EC should, in the event of stranding or impairment, be recoverable through accelerated depreciation. Assets in the closing ODV as at 30 June 2006 or subsequent capital expenditure not approved should, in the event of stranding or impairment, be a cost to Transpower's shareholder. Any capital expenditure for a bi-lateral agreement or to meet the terms and conditions of a connection contract should, in the event of stranding or impairment be treated as specified in that contract. If Transpower accepted all or part of that risk, then that should not be recoverable by Transpower from its other customers (refer question 11).
- h) Transpower recalibrating the base operating expenditure to 2007/08 (question 13).
- i) Transpower confirming that investigation costs for preparation of Grid Upgrade Plans (GUP) are an expense for shareholders and only recoverable if a GUP is approved by the EC; rather than investigation costs being part of operating expenditure (question 13).
- j) Transpower demonstrating that management staff have an incentive in their remuneration to minimise operating costs subject to firm outputs (ie defined service levels) desired by consumers (question 14).
- k) The operating expenditure threshold is reviewed if any non-Part F capital expenditure approved annually is considered to materially affect the original assumptions for the operating threshold, ie the trade-off between capital and operating needs to be considered on an ongoing basis (question 14).
- l) An un-leveraged WACC be used leaving the incentive on Transpower's shareholders to minimise the cost of financing (question 15).
- m) Until such time as Transpower can explain what risk(s) it actually bears that would result in under-recovery of revenue to cover efficient costs other than a timing risk for counterparty default risk, the asset beta should remain at 0.25.
- n) Transpower agree to publish a detailed reconciliation of the interim rebate adjustment for every Designated Transmission Customer (question 22).
- o) Transpower agreeing to amend paragraph B, Schedule 3 to the Formal Proposal (refer question 25) as follows (new text in red and underlined):
- "Transpower will allocate costs to the System Operator function using the avoidable cost allocation methodology (ACAM) based on the Commerce Commission guidelines during the term of the current contract until such time as the Commission makes any change to that methodology. If ACAM is amended or replaced, Transpower will from that time onwards apply the new cost allocation methodology."***
- p) Retain the 35 working days requirement for compliance reporting unless Transpower can provide evidence of the practical constraints and costs it faces that justify shifting to 60 working days (question 27).
- q) Transpower providing cost estimates for annual and quarterly compliance reporting in order that the Commission can compare the potential benefits of more frequent reporting against the costs (question 27).
- r) Transpower agreeing with the Meyrick and Associates⁵ suggestion that "to allow future price thresholds to be set with a higher degree of accuracy, it would be desirable to require Transpower to supply more consistent data through time on the price and quantity of each of its key inputs and outputs."
- s) The Commission consult on the draft text of any proposed Deed before finalising.

⁵ Meyrick and Associates, memorandum to Commerce Commission, Transpower Opex provisions, last sentence, 17th November 2006.

4. Without the above amendments MEUG believe the proposal by Transpower may result in a negative net benefit compared to the efficiencies achievable with control net of the costs of imposing and complying with control.
5. Comments on the questions raised in the consultation paper are attached.

Yours sincerely



Ralph Matthes
Executive Director

Attachments:

- Ireland, Wallace & Associates Limited letter to MEUG, *Draft Guidelines: the Commerce Commission's Approach to Estimating the Costs of Capital* ("Draft Guidelines"), 2nd December 2005. This letter was attached to a MEUG submission to the Commerce Commission on the same date.
- Cameron Partners Limited letter to the Commerce Commission, Cost of Capital, 2nd December 2005

Appendix

| | EC question | MEUG comment |
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| Q1 | Do you agree with the Commission's framework for evaluating the decision regarding whether or not to declare control, or to accept Transpower's settlement offer? | Agree with the framework however the implementation should include a requirement to quantify as many of the trade-offs as possible. |
| Q2 | Capital expenditure Do you agree with the proposed treatment of capital expenditure? | There are 2 issues that need reviewing: 1. MEUG do not agree with the proposal that the EC can give Transpower "approval" by way of a formal communication that proposed costs are prudent rather than those costs being approved using the process in Part F, Section III of the Electricity Governance Rules as a reliability investment (rule 13.4) or economic investment (rule 14.4). Suggesting the rule process for approvals be bypassed in this way would lead to opportunistic behaviour by Transpower and without a rule based decision criteria, likely poor decisions by the EC. 2. The Commission (paragraph 226 and 227) assume the EC in applying the Grid Investment Test (GIT) will ensure only efficient investments are approved. If the EC do apply the GIT correctly we agree. However the EC is prone to direction from Ministers and the GIT may change. If that occurs, the Commission should have the ability to amend the Deed. |
| Q3 | Does the proposal, which restricts assets entering the RAB to the lesser of actual or the approved P90 value, and which allows Transpower to seek approval for any additional costs over and above P90, to place sufficient incentives on Transpower to minimise excessive costs (paragraph 231)? | At this stage the proposal is acceptable but as noted in the Draft Decision, improvements are needed to improve this process. |
| Q4 | What timing is appropriate for Transpower to recover costs associated with the purchase of land and easements (paragraph 228)? | If the proposed expenditure is approved by the EC then it should be recoverable as set out in the Rules (including the Transmission Pricing Methodology). To the extent the Rules are unclear; then the Rules should be fixed. Transpower should not be paid a WACC on any easements held as an option because Transpower are taking no risk; only actual costs should be passed through to customers. |
| Q5 | Transmission (Non-Part F Capex) threshold In the absence of Electricity Commission scrutiny, is the proposed transmission (non-Part F) capital expenditure threshold an appropriate interim measure? | In the control counterfactual efficiency gains would be achieved by implementing the recommendations in the Strata Energy report. Transpower make no offer to implement those recommendations in the proposed settlement and therefore it's doubtful those efficiency gains will be fully or even partially achieved. MEUG suggest that rather than pursue those efficiencies by controlling Transpower, they could be achieved by including in the Deed an undertaking by Transpower to implement the Strata Energy recommendations. |
| Q6 | Do you consider the Force Majeure and Security of Supply Event provisions appropriate? | This should only apply to force majeure or security of supply events as defined in Transmission Agreements. |
| Q7 | Is the absence of regulatory scrutiny for the investments associated with business support assets appropriate (paragraph 247)? | Yes |

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| Q8 | <p>Accounting for the RAB</p> <p>Is Transpower's proposal to adopt DHC appropriate (paragraph 258)?</p> | <p>Approach is reasonable. The effect of the stronger dynamic efficiency price signal by using DHC is muted by the less than optimal Transmission Pricing Methodology that largely socialises AC network expenditure. Improving allocation of AC transmission costs on a locational basis needs to be a high priority for the EC.</p> |
| Q9 | <p>Is there any reason that Transpower's proposal to align the financial reporting and regulatory asset books and the use of four pseudo assets, and depreciate these over 4-10 years, depending upon the class of asset, should not be accepted (paragraph 284)?</p> | <p>In so far as NPV neutral this is acceptable. However MEUG does not accept the argument that because of the expected large capital expenditure in the near term, Transpower should be given assistance to manage the high cash flow requirements by accelerated depreciation of the pseudo assets.</p> <p>Consumers (who ultimately pay transmission charges) collectively have less ability to finance this high cash flow requirement than Transpower or Transpower's shareholder. The efficient outcome is for Transpower to finance the capital expenditure. Accelerating depreciation for the pseudo assets is a less efficient outcome for NZ. Those assets should be depreciated at their average remaining economic life.</p> |
| Q10 | <p>Do you agree that Transpower's argument, that the WACC it has used historically did not incorporate a premium for asset stranding and impairment, should be accepted?</p> | <p>The treatment of stranding and impairment use to be part of the self-regulating ODV regime within a voluntary contractual framework. The historic WACC was fitted to that regime and Transpower argued at the time it was too low and consumers argued it was too high. MEUG do not agree with Transpower trying to re-litigate that prior regime to influence the outcome of deciding a future WACC.</p> |
| Q11 | <p>Is the proposal that cash-flows be adjusted to compensate for asset stranding and impairment through accelerated depreciation, appropriate?</p> | <p>For assets in the closing ODV as at 30 June 2006 there should be no cash flow adjustment for subsequent impairment or stranding. Transpower have been paid a WACC well above risk free to bear that risk.</p> <p>For capital expenditure approved to date or in the future by the EC⁶, accelerated depreciation for impairment or stranding is reasonable.</p> <p>For capital expenditure since 30 June 2006 not approved under Part F, any impairment or stranding risk is a direct cost to Transpower's shareholder. Transpower choose to invest in those works without any ex ante regulatory approval. Had ex ante approval been sought, a less costly more efficient mix of capital and operating costs might have been approved. Consumers cannot be held accountable for impairment and stranding risk for expenditure that they or any regulator acting on their behalf had no opportunity to challenge.</p> <p>Any capital expenditure for a bi-lateral agreement or to meet the terms and conditions of a connection contract should, in the event of stranding or impairment be treated as specified in that contract. If Transpower accepted all or part of that risk, then that should not be recoverable by Transpower from its other customers.</p> <p>For capital expenditure approved in the future by the Commission as part of the proposed non-Part F threshold, then accelerated depreciation for impairment or stranding is reasonable.</p> |
| | <p>Transmission asset replacement costs</p> | |

⁶ Approved capital expenditure covers those items approved under rule 16 (transitional provisions), rule 13.4 (approval of reliability investments) or rule 14.4 (approval of economic investments) of Part F, Section III of the EGR.

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| Q12 | Should the proposal that the ODV not be updated with the new replacement costs, resulting in there being no need to increase the customer EV accounts, and that the impact of updated replacement costs be calculated and adjustment provided to Transpower for past under- or over-valuation through the customer EV accounts, be accepted? | <p>MEUG suggests more information is needed on the impact of the Transpower proposal compared to the alternative of reconstructing the EV Account over time taking into account not just the revised RC of new capital expenditure since 1998 but also:</p> <ol style="list-style-type: none"> 1. Recognising that revaluations over time would have resulted in much higher ROI than WACC resulting in greater EV credits to customers; 2. Reviewing if that capital was actually efficient – the Strata Energy report would indicate Transpower have had less than efficient processes to ensure minimum capital costs; and 3. Reviewing operating costs over that period to ensure they were the lowest they could have been. |
| Q13 | <p>Operating costs</p> <p>Is Transpower's proposed base operating expenditure figure of \$199.61 million an appropriate level at which to set base operating costs?</p> | <p>No. MEUG suggest the base be re-calibrated to 2007/08 taking into account the following 2 factors:</p> <ol style="list-style-type: none"> 1. The GHD desktop review was completed in October 2006 and therefore the opening operating cost data is over 12 months old. The actual operating costs to the financial year ended 30 June 2007 should be independently reviewed as the opening base. 2. Paragraph 302 of the draft decision refers to "Transpower will need to undertake further investigations to develop a suitable alternative proposal to the 400 kV upgrade proposal that it has withdrawn and so it is unlikely there will be material changes in 2006/07 in terms of staff needs for investigation." This raises the question of who pays for investigation work on Grid Upgrade Plans (GUP) before they are tabled with the EC. MEUG believes Transpower should only be able to recover investigation costs related to specific GUP once approved by the EC. This provides an incentive on Transpower to put resources into the highest value GUP that are likely to be approved by the EC. To allow Transpower to recover GUP investigation costs through "normal" operating costs will give management an opportunity to use any efficiency gains on investigating unnecessary GUP options. |
| Q14 | Is the use of CPI – X, with X being set at 0, an appropriate basis by which to scale base operating expenditure in future years? Does this provide sufficient incentives for Transpower to pursue efficiency gains? | <p>Transpower management need to have a personal stake in receiving some of the gains of efficiency linked to firm outputs (ie defined service levels) desired by consumers. Without a personal stake and with some vague notion of what it is Transpower must deliver, the incentive on Transpower's management will be the existing "we must not let the lights go out" culture. Rather than seeing lower operating costs as an achievement, it will be seen as taking a risk the lights will go out and if that occurs under-spending will be seen as being irresponsible.</p> <p>Therefore MEUG do not believe the proposal will change the culture within Transpower or achieve the efficiency gains that exist unless Transpower demonstrate to the Commission that the remuneration of Transpower's staff is linked to achieving operating efficiencies linked to firm outputs (ie defined service levels) desired by consumers.</p> <p>MEUG is also concerned that the operating threshold is being set for the following 4 years but non-Part F capex is subject to annual review. Operating and capital spend are related and should be decided simultaneously.</p> |

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| Q15 | <p>Cost of capital</p> <p>Do you agree that Transpower's proposed WACC values are appropriate for the term of the settlement?</p> | <p>MEUG do not agree with the proposed WACC for three reasons:</p> <ol style="list-style-type: none"> 1. WACC is too high by up to 0.3% as a result of the "penalty to debt" implied by the simplified Brennan-Lally CAPM. Including debt leverage as part of WACC leads to a higher WACC than the least cost option of assuming zero leverage and leaving decisions on how to finance the enterprise to the shareholder. MEUG raised this issue on 2nd December 2005 when making a submission to the Commission on the draft cost of capital guidelines when we attached a copy of a letter from Ireland, Wallace & Associates. The same point was also made by Cameron Partners in their submission of 2nd December 2005. A copy of that submission is also attached. <p>WACC for setting prices should reflect the explicit acceptance of financing risks by Transpower's shareholder (note paragraph 83 in section 4.6.1 of Transpower's Explanatory Material report). WACC is simply the unleveraged cost of capital.</p> <ol style="list-style-type: none"> 2. The proposed asset beta of 0.375 appears unreasonable applying a "bottom up" test. Given Transpower's financing parameters the debt margin of 1% translates to an equivalent "asset beta" of 0.1 if the only risk borne by Transpower was the credit risk of its customers (customers bear all other business risks). When this asset beta is subtracted from the asset beta proposed of 0.375 the residual risk index is 0.275. The two significant risks covered are the "shocks" related to Transpower fixing the WACC for 4 years and forecast errors for real operating costs for 5 years. When expressed this way some 2% points of WACC are provided for these risks. MEUG believe that the business risk is overstated when a bottom up test is considered. |
| Q16 | <p>Cross-border leases</p> <p>Do you agree with the Commission's preliminary view that it should accept that its shareholders not be required to explicitly share the benefits of any future cross-border leases or structured finance arrangements?</p> | <p>Using an un-leveraged WACC as MEUG suggest (refer question 15 above) would leave the decision on whether to enter into a cross-border lease a matter for shareholders to decide. Shareholders then reap the rewards and also bear the costs if they make a wrong decision on a cross-border lease.</p> |
| Q17 | <p>Tax treatment</p> <p>Do you agree that the tax payable approach plus interest tax shield is appropriate?</p> | <p>Yes</p> |
| Q18 | <p>Depreciation</p> <p>Do you agree that Transpower's proposed treatment of depreciation is appropriate?</p> | <p>Yes</p> |
| Q19 | <p>Economic Value Accounts</p> <p>Do you agree with the proposed 'economic value' framework?</p> | <p>Yes except for revising the EV taking into account the change in replacement costs between 1998 and 2006 (refer question 12 above).</p> |
| Q20 | <p>Do you agree using Transpower's WACC is an appropriate interest rate to apply to balances of the EV Accounts?</p> | <p>Yes</p> |
| Q21 | <p>Do you agree with how Transpower proposes to adjust the EV Accounts so that its revenue</p> | <p>Refer answer to question 19 above.</p> |

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| | in 2006/07 and 2007/08 conforms to the new thresholds? | |
| Q22 | Interim rebate Do you agree with the Commission's preliminary view on the appropriateness of Transpower's revised price increases for both the 2007 and 2008 pricing years? | MEUG do not agree with revising the EV taking into account the change in replacement costs between 1998 and 2006 (refer question 12 above) without further information and analysis. To assist consumers track adjustments to ensure those are passed through, MEUG recommend Transpower publish a detailed reconciliation of the interim rebate adjustment for every Designated Transmission Customer. |
| Q23 | Quality threshold Transpower should continue to be subject to a quality threshold? | Yes |
| Q24 | Do alternative forms of quality threshold exist that may be superior in terms of achieving the objectives of the Purpose Statement of Part 4A of the Act, or the August 2006 and October 2006 GPS? | Yes. First, having service levels specified in the Benchmark Agreement that Transpower are accountable for and enforceable by counterparties would be a significant improvement. Second, shifting the interconnection services from a regulated function to a contractual basis as part of, or an additional new Benchmark Agreement for interconnection services. |
| Q25 | System operator services threshold Do you agree with the Commission's preliminary view to accept Transpower's proposed system operator services threshold, which effectively treats System Operator costs as pass-through costs? | No. The proposal embeds ACAM for the term of SOSPA even if the Commission revises its view on the efficient allocation of costs for non-core business activities undertaken by monopoly electricity businesses. MEUG recommend the Commission accept the proposal if Transpower agree paragraph B of Schedule 3 to the Formal Proposal be amended as follows (new text in red and underlined): "Transpower will allocate costs to the System Operator function using the avoidable cost allocation methodology (ACAM) based on the Commerce Commission guidelines during the term of the current contract <u>until such time as the Commission makes any change to that methodology. If ACAM is amended or replaced, Transpower will from that time onwards apply the new cost allocation methodology.</u> " |
| Q26 | Is the use of ACAM appropriate for the purpose allocating costs between Grid and System Operator functions? | No. MEUG agree with the concerns noted by the Commission in paragraph 251 of the draft decision. |
| Q27 | Compliance reporting Do you agree that Transpower's compliance reporting should be annually, and in a manner similar to current compliance reporting requirements? | MEUG are unsure of the "practical steps Transpower has to take" ⁷ that justify shifting compliance reporting from 35 working days to 60 working days. Until evidence is available to justify this significant delay, MEUG recommend the existing 35 working days requirement should stand. There may be advantages in requiring quarterly compliance reporting. This will add compliance costs but the benefit will be earlier warning of a trend towards a breach of the Deed. Quarterly reporting is becoming the standard for listed companies. MEUG suggest Transpower be asked to provide the cost of an annual |

⁷ Draft Decision, paragraph 355

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| | | and quarterly compliance reporting. |
| | Summary of evaluation | |
| Q28 | Do you agree that Transpower's offer is consistent with the Purpose Statement of Part 4A of the Act? | The components of the proposed settlement (eg RAB and WACC) are as expected. However the detail of the proposal is inferior in achieving the outcomes part of Part 4A of the Commerce Act relative to an alternative proposal that incorporates the recommended amendments in the cover letter to this submission. |
| Q29 | Do you agree that Transpower's offer is consistent with s 57E (b) of the Act, namely that it provides strong incentives to improve efficiency and provide services at a quality that reflects consumer demands? | MEUG's comment is the same as the answer to question 28 above. |
| Q30 | Do you agree that Transpower's offer is consistent with the GPS on Infrastructure incentives? | MEUG's comment is the same as the answer to question 28 above except replacing the reference to achieving the outcomes of Part 4A of the Act with the outcomes of the GPS. |
| | Net benefits assessment | |
| Q31 | Do you agree with the Commission's preliminary assessment of the net benefit of the settlement versus control? | <p>MEUG agree the counterfactual of no control is likely to be an inferior option⁸.</p> <p>MEUG disagree that the factual, that is Transpower's proposal, is clearly better than control.</p> <p>For example if the additional administrative and compliance costs associated with control relative to the settlement proposal were \$2m per annum between 2007/08 and 2010/11 this would have an NPV cost of \$10m at a 7% discount rate.</p> <p>The breakeven additional efficiency gains required under the control option relative to the settlement proposal on both non-Part F capex (assuming constant real \$120.7m over 1007/08 to 2010/11) and operating expenditure (\$199.6m pa) is 0.7%. In other words if under control efficiency gains in excess of 0.7% relative to the settlement offer can be achieved, then control is a better outcome.</p> <p>MEUG suggest this is a finely balanced proposition. Under control most of the proposed improvements to the settlement proposal set out in the cover letter to this submission could be achieved and hence a 0.7% efficiency gain relative to the proposed settlement is realistic. To ensure a settlement is indeed the most efficient outcome, MEUG recommend the settlement be accepted with the amendments set out in paragraph 3 of the covering letter to this submission.</p> |

⁸ Draft Decision, paragraph 380