



MAJOR ELECTRICITY USERS' GROUP

30 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

Cross-submission on Transpower's proposed administrative settlement

1. This is a cross-submission by the Major Electricity Users' Group (MEUG) in relation to 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. Ten parties including MEUG made submissions.
2. After reviewing the submissions of other parties; the comments in the MEUG submission of 12th November 2007 remain largely unchanged. There are some enhancements to our overall view and those are noted in the paragraphs that follow. These are ordered in relation to the Draft Decision questions. Similarly rebuttal comments are made on some significant points of difference.

Non-part F capex threshold (Q5)

3. Mighty River Power (MRP) note¹:

Mighty River Power notes that we question whether the additional Electricity Commission scrutiny of Transpower's "non-Part F" investments is warranted and we have concerns this may result in less timely investment.

4. Vector (page 2) note:

In particular, Vector queries whether current non-Part F expenditure should be made subject to EC approval in the future and subject to a non-Part F threshold in the interim.

5. MRP and Vector essentially argue non-Part F work is largely replacement of existing assets, the work is necessary and adding a compliance regime on top will add costs but no benefits as the work would undoubtedly be approved. MEUG disagree. The quantum of the non-Part F work is significant, being \$120.7m in 2007/08² and 44% of budgeted capital over the three years

¹ MRP, paragraph 69

² Draft Decision, paragraph 235

2006/07 to 2008/09³. Strata identified⁴ over-estimates of forecast asset replacement and refurbishment leading to the thresholds by Transpower being overstated by 5% and IT expenditure forecasts being overstated by 15%. The Strata report is independent evidence that there is a material risk of inefficient practices for non-Part F expenditure. Therefore MEUG agree with the proposal by Transpower and the Commission that there be an interim threshold until such time as the Electricity Commission develops processes to consider such expenditure. There will be added compliance costs, but some of those are likely to be new systems within Transpower that are needed in any case to realise the efficiency gains identified by Strata.

Accounting for the RAB (Q8 to 11 and Transmission asset Replacement Costs (Q12)

6. Contact Energy (CEN)⁵ and Meridian Energy Ltd (MEL) recommend the opening Regulatory Asset Base (RAB) needs to consider "imaginary" assets in the current ODV (eg⁶ "*fictional transformer and switchgear at Meridian's Benmore power station*") and assets since retired since 2006 (eg Pole 1). MEUG agrees. The Commission also needs to be satisfied that there are no other imaginary assets or assets with marked changes in service levels since 2006.

Cost of capital (Q15)

7. MEUG's view that the proposed settlement Weighted Average Cost of Capital (WACC) is too high was supported by CEN⁷:

It is Contact's view that under the proposed Administrative Settlement, Transpower faces very low revenue risk in comparison to other similar businesses. This is demonstrated by the fact that Transpower can remove assets from service and suffer no loss of revenue. On this basis, Contact suggests that Transpower's level of risk is overstated.

8. And MEL⁸:

Meridian submits that Transpower faces no revenue risk – Transpower has taken assets out of service and suffered no loss of revenue. Payment of charges is legislated. Transpower should earn little more than the return on a risk-free asset.

Meridian also submits that the Commission should scrutinise any difference between the return Transpower can earn on an investment via its revenue requirement and the return Transpower uses to assess whether an investment should proceed under Part F. The lower of these rates or a near risk free rate should apply in both calculations.

It is not clear from the Administrative Settlement what WACC is going to be used for non-Part F investment decisions. The same rate as we suggest above should also apply to this category of investment.

9. The latter point raises another issue that we intended to raise in our original submission but inadvertently omitted⁹. That relates to whether a single WACC applied to all of the RAB is appropriate.
10. Assets built and used to meet the terms and conditions of bi-lateral agreements will have contract specific rates of return. From anecdotal reports MEUG believe these dedicated asset contracts usually have provisions whereby any stranding risk is borne by the customer. There is no counterparty risk for Transpower. In effect these are financing contracts.
11. MEUG believe it's unreasonable that Transpower should earn a full WACC on its total asset base including assets covered by bi-lateral contracts that are essentially financing contracts, ie the WACC for those assets is essentially the cost of debt. Therefore either the WACC for Transpower as a whole should be revised downwards or those assets with a lower than average WACC should be separately accounted for.

³ Draft Decision, paragraph 247

⁴ Draft Decision, paragraph 250

⁵ CEN, p4

⁶ MEL, p7

⁷ CEN, p8

⁸ MEL, p11

⁹ The MEUG comment in relation to Q15 of our original submission referred to three points of disagreement with the proposed WACC. In fact that submission only listed two points.

12. There may be other classes of assets and different levels of risk that could also be identified.

Quality threshold (Q23 & 24)

13. MEL¹⁰ noted:

In summary, we accept that it is difficult to monitor quality in terms of a robust link between price and quality and that some of this framework rests with the Electricity Commission in terms of regulated service measures. However, the allowable revenue quantum is in the Commission's jurisdiction and Meridian suggests there is an increasing onus on the Commission to be reactive when it is clear that services are being charged for but not provided (as is the case currently with fictional, stood down or decommissioned assets).

14. MEUG agree there may be a case for the transmission threshold and non-Part F capital expenditure threshold to be adjusted in the event certain pre-defined quality or service standards are not met. This will fill an important gap in the current regime whereby Transpower customers can have a requirement to pay for services even after Transpower has removed assets or other resources to provide those services. MEUG has no specific suggestions in mind as this is an area that would have to mesh with the soon to commence Transmission Agreements and regulated interconnection services. This will need some careful analysis. Nevertheless the Commission may wish to reserve as part of the settlement (or failing that in any control regime) an option to adjust the revenue path in the event of material loss of service.

15. In relation to the question of alternative forms of quality threshold, Unison¹¹ noted:

However, this does not mean that full disclosure of quality information is not important. As the Commission notes in paragraph 346, the benchmark agreements and Interconnection Rules do not require Transpower to make a complete public disclosure of its reliability performance. We therefore suggest that the proposed quality threshold is replaced with a requirement for full disclosure.

16. On the same point Transpower¹² noted:

Transpower considers the Commission's concern about lack of public information could be addressed by requiring Transpower to disclose specified information using the information disclosure regulations. The information could mirror the quality threshold in the Commerce Act (Transpower Thresholds) Notice 2007, with reporting by way of information disclosure rather than threshold compliance. Transpower could also be required to disclose to the Commerce Commission the information provided under the benchmark agreement and interconnection rules.

17. MEUG believe there is merit in considering the suggestions by Unison and Transpower to make more transparent the quality and service metrics for transmission services. Note that while Transpower refer to making Transmission Agreement(s) (note that is not just the Benchmark Agreement) and interconnection rules data available to the Commission, MEUG suggests there may be benefits in making that information available to the public.

System Operator services threshold (Q25)

18. MRP¹³ and Vector both suggest there is no need for a separate System Operator threshold because the EC can enforce compliance as it would any other contract. MRP also suggest because the System Operator service is likely to be uncontested, there is little incentive on Transpower to cross-subsidise costs and therefore what value does the threshold add? MEUG disagree. Over the last few years the service operator (SO) and transmission asset owner (TAO) parts of the business have developed separate identities and brands. This has been helpful to customers and we believe, probably useful within Transpower itself. Having a separate revenue threshold for the System Operator service complements the existing and likely trend towards increased separation of the SO and TAO roles.

¹⁰ MEL, p9

¹¹ Unison, p29

¹² Transpower, p4

¹³ MRP, paragraph 33 to 38

Concluding comments

19. As originally submitted it is not clear Transpower's settlement proposal would be better than a control regime that largely mirrored the settlement with the added modifications proposed by MEUG.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. Matthes', with a long horizontal stroke extending to the right.

Ralph Matthes
Executive Director