



**T R A N S P O W E R**

*Howard Cattermole  
Tel: (04) 495 7077  
Fax: (04) 495 7100  
Howard.cattermole@transpower.co.nz*

Transpower House, 96 The Terrace,  
PO Box 1021, Wellington,  
New Zealand  
Telephone +64-4-495 7000  
Facsimile: +64-4-495 7100  
www.transpower.co.nz

13 March 2006

Network Performance Group  
Commerce Commission  
PO Box 2531  
WELLINGTON

By e-mail: [electricity@comcom.govt.nz](mailto:electricity@comcom.govt.nz)

## **Cross Submission on the Commerce Commission's Intention to Declare Control of Transpower**

1. In this cross submission on the Commerce Commission's (Commission) Notice of Intention to Declare Control, Transpower has focused on those issues raised in the submissions of other interested parties. In particular, Transpower has:
  - i. clarified further that it is not pre-funding capital expenditure;
  - ii. clarified the treatment of EV balances;
  - iii. outlined why funding sources and capital structure are not relevant to the control decision;
  - iv. noted the concerns of other parties that the Commission has not undertaken sufficient analysis to determine excess profits;
  - v. noted the concerns of other parties that the Commission has overstated the benefits of control and understated the costs of control;
  - vi. noted what appears to be a commonly held view that there is need for a co-ordinated review and reform of the existing regulatory arrangements for transmission;
  - vii. responded to the concerns of some submitters around the process adopted by Transpower to communicate prices for the forthcoming year ("2006" prices"); and
  - viii. noted the timetable concerns of other submitters.

13 March 2006

---

## **i) Prefunding and the timing of investment cost recovery**

2. The Commission's Report suggests that there is evidence that Transpower's planned price increases would enable it to prefund its unapproved capital expenditure programme.
3. A number of submissions express concerns as a result of the conclusions on prefunding set out in the Commission's Report<sup>1</sup>. However, there appear to be a range of interpretations as to what the Commission's Report and/or submitters mean by the term "prefunding". For example, Comalco appears to interpret prefunding to mean that Transpower intends to fund its capital programme through increased prices in advance of expenditure being incurred, make the investment and then charge customers again via a return on the investment. This is incorrect as explained in Transpower's primary submission and summarised below. Mighty River Power defines pre-funding as "increasing prices ahead of expenditure, either approved or unapproved" but exclude from this definition preparatory work which is expensed as an operating cost.
4. The issue of pre-funding has been addressed in some detail in Transpower's primary submission and in the reports prepared by CRAI<sup>2</sup> and NERA<sup>3</sup>. In its primary submission Transpower set out an explanation of the accounting policies it applies to recover a return on capital investment and provided a detailed breakdown of what investment has and hasn't been included in annual revenue requirements, both historically and in relation to the proposed 2006/07 pricing year.
5. For the avoidance of doubt, this cross submission summarises the main points set out in Transpower's primary submission. The key points to note are as follows:
  - Transpower bases its revenue requirement for a particular pricing year on a forecast of work activity and investment by reference to its business plan.
  - The effect of regulatory, contractual and financial reporting requirements (including the misalignment between Transpower's financial year and the pricing year) means that the revenue requirement forecasts are necessarily made some 12 months in advance of prices coming into effect (refer below).

---

<sup>1</sup> Comalco, Mighty River Power and MEUG

<sup>2</sup> Section 3.4, *The Costs and Benefits of Regulating Transpower*, CRA International, 27 February 2006

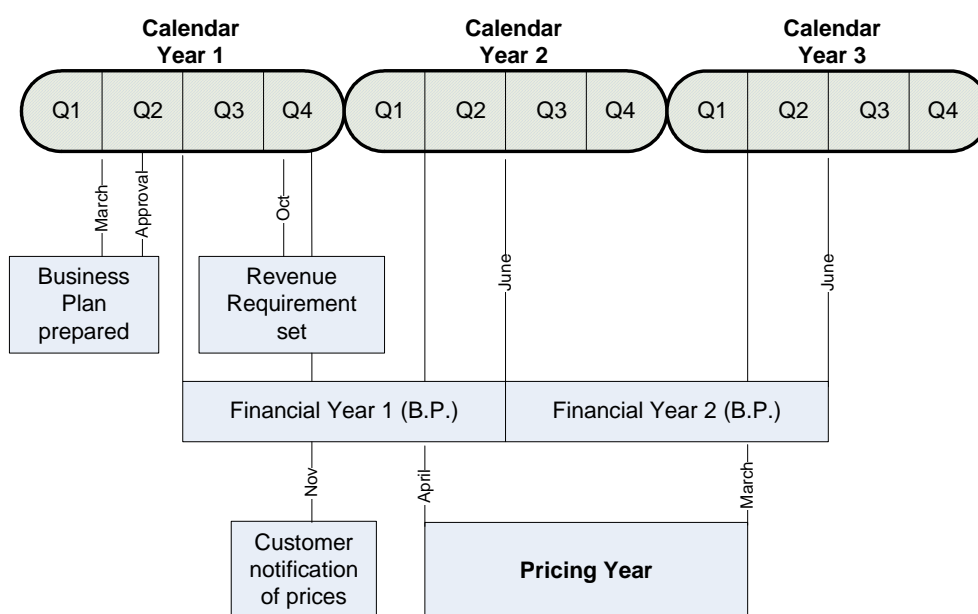
<sup>3</sup> Section 7, *Declaration of Control of Transpower*, NERA, 24 February 2006

13 March 2006

- Transpower recovers a return on investment on an “as commissioned” basis – financing costs for works under construction are accrued and capitalised when the project enters into service. The exception to this is property related investment as described in paragraph 15 below.
- Transpower makes assumptions as to what projects (i.e. capital investments) will be commissioned during the forecast period. The assumptions encompass projects that require EC approval and those that do not require EC approval.
- The cost of project investigation and other feasibility work is expensed as it is incurred in line with standard accounting treatment and consistent with the derivation of ODV transmission replacement costs.

### Forecasting revenue requirements in the pricing year

- As set out in its primary submission, Transpower determines its revenue requirement using a building blocks approach. The various building blocks are calculated annually using forecast information for “year 2” of Transpower’s business plan<sup>4</sup>.
- Figure 1 illustrates the relationship between Transpower’s financial year and the pricing year and the timing and sequence related to setting the revenue requirement.



**Figure 1: Schematic of business planning/price setting timings**

<sup>4</sup> For example, prices for 1 April 2006 were set based on the 2005/06 business plan agreed in mid-2005, using the forecast costs and expenditures for the 2006/07 financial year (i.e. the second year of the 2005/06 business plan).

13 March 2006

---

8. Points to note from Figure 1 are:

- Transpower is currently bound by contract and regulation to a pricing year commencing 1 April. In common with most other crown owned entities, Transpower's financial year extends from July to June.
- Transpower's business plan is prepared in March/April and approved in June. This includes the detailed expenditure forecasts for the financial ahead (July to June) termed Year 1 and the forecast for the second year (Year 2).
- Bearing in mind the misalignment of "pricing" and "financial" years, the Year 2 business plan forecasts are considered to most closely reflect anticipated costs in the pricing year and hence Year 2 forecasts are used as the basis for determining the revenue requirement.
- The revenue requirement for the pricing year (as reflected in customers' charges) is set around October<sup>5</sup> based on the business plan projections (updated to reflect the actual position for the financial year ending 30 June of that year). Customers are notified of the new prices in November/December in accordance with contractual requirements to provide customers with a minimum of 3 months notice prior to new prices coming into effect.
- Revenue requirements are therefore forecast some 12 months in advance of prices coming into effect.

9. Establishing business plan budgets and expenditures on a forward looking basis is a normal and essential business practice and is an appropriate basis on which to set revenue requirements for the pricing year. The forecasts are based on the best available information at the time. However, consistent with the limitations of any forecasts, and in keeping with Transpower's monopoly status, there is an accompanying process to ensure that over/under-recovery that occurs due to variance against forecasts is addressed in future revenues/prices (i.e. via the EV adjustment mechanisms discussed elsewhere in Transpower's submissions).

**Works under construction**

10. An important issue in relation to the timing of investment cost recovery is the accounting treatment for works under construction (WUC). Transpower currently capitalises financing costs associated with WUC into the project cost and then adds the total project cost (including

---

<sup>5</sup> Following completion of the ODV and EV statements

13 March 2006

---

capitalised financing costs) to the regulatory asset base (RAB), once the project is commissioned into service.

11. Transpower has proposed to the Commission that in future Transpower should be permitted to roll-in to the RAB the value of new investment on an "as spent", rather than an "as commissioned" basis. The benefits of such an approach have been set out by Transpower in a previous submission to the Commission.<sup>6</sup>
12. Transpower's preference for the "as spent" approach is consistent with the approaches that Transpower understands are applied by regulators in, for example, Australia, the United Kingdom, and the Irish Republic. It is also noted that, in response to concerns about the lack of transmission investment in the US, the US Federal Energy Regulatory Commission (FERC) has also recently proposed pricing reform rule changes to implement treatment similar to that advocated by Transpower<sup>7</sup>. FERC states:

*"The Commission believes that allowing public utilities to include up to 100 percent of prudently incurred transmission related CWIP [Construction Work in Progress] in rate base and permitting them to expense prudently incurred pre-commercial operations costs will further the goals of section 219<sup>8</sup> by relieving the pressures on utility cash flows associated with their transmission investment programs and providing up-front regulatory certainty"*

### **The timing of cost recovery associated with investment**

13. A consequence of using forecasts for revenue setting is the need to forecast the level of commissioned projects during the pricing year. This includes both projects which fall under EC jurisdiction for approval and other capital expenditures.
14. As a result, the forecast of commissioned projects will necessarily include capital expenditure associated with projects that have yet to be finalised for submission to the EC. It is important to note that the 2006/07 forecast operating capital (and revenue requirement) does not include capital investment associated with the construction of major projects currently being considered by the EC as part of Transpower's

---

<sup>6</sup> Transpower New Zealand Ltd: Submission to the Commerce Commission on Regulation of ELBs: Valuation of the Regulatory Asset Base Decision paper – November 2005

<sup>7</sup> United States of America Federal Energy Regulatory Commission: 18 CFR Part 35, Promoting Transmission Investment through Pricing Reform (issued November 18, 2005).

<sup>8</sup> Section 219 of the Federal Power Act specifically charges the Commission (FERC) with the responsibility to establish, by rule, incentive (and performance-based) rate treatments for the transmission of electric energy for the purpose of benefiting consumers by ensuring reliability and reducing the cost of delivered power by reducing transmission congestion. These objectives are similar to those contained within s57E.

13 March 2006

---

2005 GUP. This is because the major projects are not expected to be commissioned in 2006/07.

15. Property acquisition typically is required to be progressed at an early stage in a project's lifecycle and hence is the most likely form of capital expenditure to result in approval timing issues. In its primary submission Transpower set out its policy in relation to land and easement purchases and how this forecast expenditure is reflected in revenue requirements. Land and easements associated with the North Island 400kV line and future planned investment in Auckland are included in the average operating capital used for calculating the 2006/07 revenue requirement. Progressing the purchase of land and easements prior to these major projects being formally approved is, in Transpower's view, prudent and reasonable and, in the case of the 400kV, is consistent with the directive of the Minister of Energy as well as having the support of the EC. The important point to note is that in the event that these projects do not proceed, the pricing impact of including them in the revenue requirements would be "reversed" via removal from the operating capital base and through the operation of the EV customer account.
16. The net effect on the 2006/07 revenue requirement, of project investments forecast for the 2006/07 period, where approval is either pending or has not yet been sought, is \$10.7m or 2.2% of the total 19.1% price increase (refer to Section 4 Para 263-266 of Transpower's primary submission). Of this, land and easement expenditure associated with the North Island 400kV line and future planned investment in Auckland accounts for 1.3% of the overall 19.1% price increase.
17. To the extent that any capital investment is forecast and subsequently not approved by the EC or, in the case of projects not subject to EC approval, forecast capital expenditure does not go ahead as planned, any over recovery is returned to customers through the operation of the customer EV account.

#### **Operating expenditure associated with future investment**

18. Transpower treats costs associated with preliminary investigative work (for example, conceptual design, solution evaluation and feasibility planning for major projects) as operating costs and these are expensed

13 March 2006

---

as incurred in line with standard accounting practice<sup>9</sup> and consistent with ODV transmission replacement costs<sup>10</sup>.

19. These operating costs are clearly recovered in advance of projects being committed and/or being approved by the EC (if appropriate). Transpower does not consider this to be “pre-funding”. The evaluation of project options to meet future demand which may include “build” and “no build” solutions is an essential activity for Transpower to undertake. By its nature some investigative work may be abortive whilst other work may lead to projects being developed to a stage where they are submitted for approval and are ultimately commissioned into service.
20. As set out in Section 5 of Transpower’s primary submission the investigative work required to define tactical transmission upgrades and the content of the GUP has contributed to the increase in Transpower’s overall operating cost base over the past three years.
21. Comalco has argued that should projects not go ahead as planned then Transpower will over recover as a result of such a policy and further suggested that Transpower should bear this risk. Transpower believes this analysis to be overly simplistic. A more detailed comparison against the policies adopted by companies operating in “competitive” marketplaces has been provided in NERA's report.<sup>11</sup>
22. In competitive industries companies expect to earn a WACC return after paying for feasibility studies. ENA identifies in its submission that if Transpower were to bear the risk of “non-recovery” of investigative costs then it would be appropriate to consider an increase in the Company’s risk premium (and target rate of return) to account for this additional risk. Transpower agrees with this underlying logic, but questions how such an approach could be implemented in a manner that did not create additional regulatory complications.

**ii) Treatment of balances in the customer economic value account**

23. Several submissions highlighted issues regarding the treatment of balances in the customer economic value (EV) accounts. Whilst many of these issues are addressed in Transpower’s primary submission,

---

<sup>9</sup> Financial Reporting Standard 3 (FRS 3), paragraph 5.7 states “The cost of an item of property, plant and equipment does not include expenditure incurred in deciding whether the item should be acquired or constructed; for example, feasibility costs or the costs incurred in evaluating a number of proposals for acquisition or construction. Such amounts are never capitalised because they are not directly attributable to bringing the item to working condition for its intended use.”

<sup>10</sup> To be economically neutral, the ODV replacement costs would need to include an allowance for direct operating costs. Currently, replacement costs only include those costs that can be capitalised consistent with FRS-3.

<sup>11</sup> Section 7.2, *Declaration of Control of Transpower*, NERA, 24 February 2006

13 March 2006

---

Transpower wishes to discuss further those issues that appear to be of greatest concern to other interested parties.

### **EV Balances are not generally caused by over-recovery**

24. The analysis of Transpower's EV balance undertaken by PwC indicates that the bulk of the EV customer balances have been driven, not by over-recovery, but rather by asset revaluations.<sup>12</sup>
25. This outcome is consistent with how the revenue requirement methodology is designed to work. In setting its revenue requirement, Transpower generally does not attempt to forecast revaluation movements because they are unpredictable. Hence, it is expected that revaluation gains or losses represent the largest proportion of the EV balances.
26. As at 30 June 2005, the EV balance was \$99 million. The make-up of that balance is revaluations and interest, netted off against net operating profit after tax (NOPAT) losses. Rebates provided to customers since 2000 are the main driver of the NOPAT losses.

	<b>\$ million</b>
NOPAT (after rebates) <sup>13</sup> – cash portion	- 51
Revaluations – non-cash portion	98
Interest	52
<b>EV Balance</b>	<b>99</b>

**Table 1: Make-up of EV Balance at 30 June 2005**

27. This analysis demonstrates that the current EV balance does not represent cash gains. Instead the balance represents “non-cash” gains, and interest on those non-cash gains<sup>14</sup>.

### **Returning the EV balance to customers**

28. Several submitters argue for the immediate return of the EV balance. In Transpower's view this is inappropriate for a number of reasons.
  - a. As noted above, the net EV balance represents accumulated non-cash gains arising through asset revaluation. Immediately returning a non-cash gain to customers in the form of a cash

---

<sup>12</sup> Section 4 & Appendix A, *Transpower New Zealand Limited: Development and Application of EV Methodology to Revenue Setting*, PricewaterhouseCoopers, February 2006

<sup>13</sup> Per PwC's report, forecast errors and other factors have resulted in a \$55 million over-recovery. This has been more than offset by the \$106 million of rebates that have been paid to customers.

<sup>14</sup> Interest is earned on the outstanding EV balance at Transpower's cost of equity.

13 March 2006

---

rebate has a significant effect on the cash flows of Transpower and is not an appropriate or equitable treatment, and imposes an asymmetric risk to Transpower.

- b. The treatment of EV balances is now regulated in accordance with the provisions of the "Pricing Booklet". The pricing booklet states that EV balances are to be returned to (or recovered from) customers at the lower of one-third of the EV balance or 10% of transmission revenue<sup>15</sup>. The main driver behind this formula is to minimise price fluctuations. An immediate return of the EV balance (or conversely an immediate recovery of negative EV balances) could result in significant price fluctuations. Reducing price volatility was one of the drivers for the development and introduction of the current transmission pricing methodology.

It is also important to note that the EV regime is designed symmetrically, i.e. EV losses are expected to be recovered from customers, just as EV gains are to be returned to customers. Customers' views on the process would undoubtedly differ if the issue were the recovery by Transpower of EV losses.

- c. EV balances attract interest and so parties should remain economically neutral on the issue as to when the balance is returned.

### **iii) Sources of Funding and Transpower's Capital Structure**

29. Several submissions raised issues around how Transpower should be funding the planned transmission upgrades. Transpower wishes to address those points below.

#### **The Role of Government**

30. Various submitters have raised the issue of the Crown possibly funding an element of the proposed programme of future investment; in other words, the Crown (and by inference taxpayers) contributing to the cost of the investment, and consequently grid users paying a reduced amount.
31. In Transpower's view, this approach would be inconsistent with the current regulatory framework and governance model for Transpower.
32. Transpower does not express any further views on the matter of "subsidisation" of grid investment in this way. It is raised here simply to draw a distinction between this "funding" issue and others relating to "capital structure", that are discussed below.

---

<sup>15</sup> Pg 13, *Pricing for Grid Connection Services*, Transpower

13 March 2006

---

33. In Transpower's view, several submissions do not always make this distinction and as a consequence it is not always clear exactly what views are being expressed.
34. The following comments assume that Transpower is funded by a mix of debt and equity and that a full (commercial) return is sought by the providers of that funding.

### **Transpower's Capital Structure**

35. In Transpower's view, the comments on capital structure overstate the role of capital structure on the "costs" incurred by Transpower and borne by transmission customers.
36. Finance theory indicates that, within reasonable limits, the source of funding (debt or equity) has no impact on the value of the firm i.e. WACC is not affected by the source of funding. Hence, transmission charges should also not be affected.<sup>16</sup> For example, were the shareholder to inject equity into the business, and the level of debt funding required were to decrease correspondingly, this should have no material impact on Transpower's building block based revenue requirement<sup>17</sup>.
37. The most important issue is that the regulatory regime allows Transpower to generate sufficient cash flow to sustain all reasonable capital structures and allow the choice, as to the most efficient capital structure, to be made.
38. Transpower's current intention is to fund future grid investment predominantly through the use of debt, and to a lesser extent retained earnings<sup>18</sup>.

### **Transpower's Credit Rating**

39. MEUG has suggested that Transpower's maintenance of a AA credit rating is unnecessary given the Treasury's minimum SOE credit rating is BBB and that the maintenance of a AA credit rating will lead to higher

---

<sup>16</sup> Mathematically, the capital structure of an enterprise does not affect the value of the enterprise in jurisdictions where dividends are not taxed in the hands of shareholders and where interest paid is tax deductible. That said, there are real world limitations which make certain funding structures, such as 100% debt, unrealistic.

<sup>17</sup> This assumes that footnote 16 above holds. It is worth noting that Transpower's WACC formula largely conforms with standard finance theory, (i.e. WACC varies 8 basis points between a 0% debt WACC and a 100% debt WACC). In contrast, the Commission's WACC formula varies 80 basis points.

<sup>18</sup> While, Transpower currently expects to be able to finance future grid investment without recourse to the shareholder for additional funds, this is subject to Commission decisions on asset valuation, treatment of works under construction and the current control inquiry.

13 March 2006

---

transmission price increases than would be the case with a lower credit rating<sup>19</sup>.

40. Transpower disagrees with this assertion for the following reasons:
- a. MEUG implies that Transpower's "need" to maintain a high credit rating is a driver behind the price increases. This is not correct. Transpower's price increases are not justified on the basis of maintaining a credit rating within the AA band, they are justified based on the use of robust building block revenue requirement methodology. Whilst Transpower believes that maintaining a credit rating within the AA band is desirable (as discussed below), Transpower's credit rating is an effect of its revenue levels (and cash flows) and not the driver of them.
  - b. Whilst in theory it may be true that a lower credit rating could be accommodated on a lower level of transmission revenue, this is not in the long term interests of consumers. Transpower believes that maintaining a credit rating within the AA band is necessary to ensure access to efficient debt funding given the current circumstances and investment outlook. Consumers will pay for a lower credit rating through a higher cost of debt, which in turn increases the WACC and therefore higher transmission charges. Hence, in the long-term, consumers are likely to face higher charges if Transpower's credit rating falls.
  - c. The Treasury's policy is for SOEs to "maintain an investment-grade credit rating"<sup>20</sup>. It does not necessarily follow that a BBB rating should therefore be the target credit rating or indeed the most appropriate credit rating for Transpower.

#### iv) **No Excess Profits Demonstrated**

41. A number of submissions support and reinforce the submission made by Transpower that the Commission's Report does not demonstrate sufficient evidence to support a conclusion that Transpower is currently earning excess profits. For example, Vector states that:<sup>21</sup>

"While the Commission has stated that Transpower's actions may lead to excessive profits and inappropriate inter-generational transfers, the analysis provided by the Commission is not sufficient to support these views."

---

<sup>19</sup> Pg 2, *Submission on Intention to declare Control of Transpower*, Letter from MEUG to Commerce Commission, 27 February 2006

<sup>20</sup> Subsection entitled "Financial Viability", *Statement of Intent for the year ending 30 June 2006*, Treasury

<sup>21</sup> Vector – Intention to Declare Control of Transpower, page 3.

13 March 2006

---

42. As noted by Mighty River Power:<sup>22</sup>

"the CC has assessed the direct benefits of control as being the difference between actual prices and the price threshold – resulting in an assessed benefit from limiting excess profits in 2006/07 of \$35.8m. Mighty River Power does not consider that the price thresholds - as they are presently set – are suitable for anything beyond an initial screening of ELBs to determine whether a price control inquiry may be warranted."

43. These submissions support Transpower's submission that the thresholds were designed as a screening mechanism only, and impute nothing about the efficient level for transmission prices. Accordingly, an "unexplained" breach of the thresholds does not necessarily mean that the relevant LELB is earning excess profits or that its behaviour is otherwise inconsistent with the purpose statement in section 57E of the Act.

44. One of the key points of Transpower's primary submission is that a full building blocks assessment is the only satisfactory way of determining whether Transpower has earned excess profits.<sup>23</sup> This view is also supported by the submissions made by other interested parties. Those interested parties also express concern that the Commission's Report does not adequately explain the reasons for departing from the approach outlined in the Commission's *Assessment and Inquiry Guidelines* ("Guidelines")<sup>24</sup>.

45. The Commission's Report suggests that a building blocks analysis, as described in the Guidelines, is not feasible until it is known which elements of Transpower's plans for future investment are to proceed. In addition to the views already expressed in its primary submission, Transpower concurs with Mighty River Power's observation that:<sup>25</sup>

"it appears anomalous to Mighty River Power that the CC has ruled out using a building block approach because of uncertainty about future investment, while at the [same] time making assumptions about

---

<sup>22</sup> Mighty River Power – Submission in Response to the Commerce Commission's Intention to Declare Price Control on Transpower New Zealand Ltd, paragraph 36.

<sup>23</sup> Transpower – Submission to the Commerce Commission on the Intention to Declare Control of Transpower, section 4.4.2.

<sup>24</sup> Transpower notes that the Expert Panel on Energy Access Pricing released on 10 March 2006 a *Draft Report to the [Australian] Ministerial Council on Energy* discussing, amongst other things, the relevance of price thresholds and Total Factor Productivity analysis for gas and electricity distribution and transmission businesses. Transpower refers the Commission to the Expert Panel's discussion on, inter alia, pages 13, 94, 98 and 103. In Transpower's view, the report of the expert panel provides further evidence that the Commission cannot be satisfied that observed prices in excess of a TFP-based price threshold is an appropriate measure for excess profits.

<sup>25</sup> Mighty River Power – Submission in response to the Commerce Commission's Intention to Declare Price Control on Transpower New Zealand Ltd, paragraph 35.

13 March 2006

---

Transpower's future investment (timing and efficiency) to estimate by far the largest parts of the quantified benefits of price control."

46. Mighty River Power, Powerco and Vector all express concerns that the departure from the building blocks based analytical framework outlined in the Guidelines creates significant regulatory uncertainty. For example, Powerco notes that:

"16. ...the approach applied in Transpower's case differs from that foreshadowed in the Inquiry Guidelines. Powerco believes that the Commission has not adequately justified its unexpected departure from the procedures it set out in the Inquiry Guidelines...

19. The novel and unexpected approach applied by the Commission in its Position Paper provides a tangible example of heightened regulatory uncertainty...

20. An immediate and direct impact associated with this increase in regulatory risk is an increase in the cost of capital..."

47. Transpower supports Powerco's concerns in this regard.

48. The Guidelines were issued following consultation with the industry, in part because the Commission recognised that:<sup>26</sup>

"...lines businesses' incentives to comply with the Commission's thresholds depend, to some extent, on what they consider might happen if they were identified to have breached the thresholds...the objectives of the Part 4A regulatory regime may not be achieved if lines businesses were inclined to be unduly cautious or averse to uncertainty about the consequences of their conduct in relation to thresholds."

49. The stated purpose of Guidelines is to:<sup>27</sup>

"...inform interested parties of the Commission's broad process and analytical framework for assessing threshold compliance and for undertaking post-breach inquiries under the targeted control regime. The objective of doing so is to **increase certainty and transparency** in respect of the Commission's approach to these tasks."

50. Although the Commission has indicated that the Guidelines are not intended to be overly prescriptive and that the Commission needs to be able to respond to particular circumstances that may be relevant to a threshold breach, there is nothing in the Guidelines or the Commission's consultation around the Guidelines to suggest that in undertaking a post threshold breach inquiry the Commission would reject the analytical

---

<sup>26</sup> Commerce Commission, Assessment and Inquiry Guidelines, paragraph 11.

<sup>27</sup> Commerce Commission, Assessment and Inquiry Guidelines, Paragraph 5.

13 March 2006

---

framework outlined in the Guidelines in favour of an entirely new approach, as it has done in its Report.

51. Transpower considers that the weight of submissions on the lack of evidence as to excess profits (and related concerns as to the Commission's process) is overwhelming and should not be ignored by the Commission. In the absence of a formal building blocks based assessment of Transpower's past prices, the Commission cannot be satisfied that Transpower is currently earning excess profits or that any purpose statement concerns otherwise exist. Similarly, any forward looking analysis can and should be undertaken by reference to a building blocks approach.
52. As Transpower has noted in its primary submission, it believes that any building blocks assessment will demonstrate that no excess profits have or are likely to be earned by Transpower when assessed in the context of section 57E. Transpower has also noted, however, that section 57I requires the Commission to consult further on any assessment of Transpower's pricing behaviour on any basis other than that outlined in the Commission's Report.

**v) Benefits of Control Overstated/Costs of Control Understated**

53. Several submissions question the adequacy of the net benefits analysis outlined in the Commission's Report.
54. Mighty River Power, Powerco and Vector all suggest that the Commission's Report does not provide sufficient evidence to support the potential benefits of control that have been identified. For example, Vector states:<sup>28</sup>

"...Vector does not believe there is robust evidence to support investment efficiency gains of 5 or 10% as benefits of control. These gains would imply that the regulator has a significant comparative advantage over the company's management in the operational detail required to prudently operate and expand transmission networks."

55. Similarly, ENA, Mighty River Power, Powerco, Unison and Vector all suggest that the Commission's Report does not adequately consider the potential costs of control, such as those that may result from regulatory error. For example, Vector states that:<sup>29</sup>

"...there are two related areas of costs which therefore should be included in the analysis.

---

<sup>28</sup> Vector – Intention to Declare Control of Transpower, page 2.

<sup>29</sup> Vector – Intention to Declare Control of Transpower, page 2.

13 March 2006

---

First, the cost of a transmission failure or constraint due to a delay in the investment programme. Vector notes that there are world-wide examples of transmission failures (North-East of USA and Canada (2003), Italy (2003), and UK) even under regulatory oversight of the kind contemplated by control in New Zealand. Outage costs in the North East of the USA were estimated as much as US\$6 billion. It is even possible that constrained transmission could lead to a reduced supply similar to the New Zealand winter of 2001 which the Treasury estimated as a \$200 million cost to the economy.

Second, in Vector's experience reactive capital expenditure often costs about double the amount of pro-active capital expenditures, and accordingly we seek to proactively monitor and maintain assets. The proposal to delay transmission investment carries the risk that investment occurs too late leading to costs that are considerably higher because of the need to accelerate the build programmes or implement solutions that are sub-optimal..."

56. These submissions all support Transpower's view that the potential benefits of control identified in the Commission's Report are overstated, while the potential costs of control identified in the Commission's Report are understated.<sup>30</sup> In these circumstances, Transpower considers that the Commission cannot be satisfied that control will result in net benefits to consumers.

**vi) The Commission's Report highlights fundamental issues with the current regulatory regime**

57. A number of submissions suggest that the Commission's Report highlights fundamental issues with the current regulatory regime within which Transpower is required to operate. For example, the Electricity Networks Association notes that:<sup>31</sup>

"The fact that Transpower is placed in this situation, despite the complex regulatory regime governing its commercial activities, illustrates the inadequacies and undesirable complexity of that regime"

58. Transpower agrees that there is considerable uncertainty around how Part F and Part 4A are intended to interface and the respective roles and accountabilities of the Commission, the EC and Transpower. In Transpower's view, this uncertainty has been exacerbated by the lack of a detailed operational memorandum of understanding between the Commission and the EC, such as that contemplated by the current GPS in October 2004.

---

<sup>30</sup> Transpower – Submission to the Commerce Commission on the Intention to Declare Control of Transpower, section 8.

<sup>31</sup> ENA – Submission on Post-Breach Inquiry: Reasons to Control Transpower, page 3.

13 March 2006

---

59. Transpower has been raising concerns about the current regulatory regime and the need for a more integrated regulatory framework for some time. For example, in its submission on the Commission's draft decisions on resetting Transpower's thresholds from 1 July 2005, Transpower set out its views on the limitations of the current price path threshold methodology and advocated a move to a more orthodox form of regulation based on an ex ante building block approach to setting allowed revenues. More recently, in its submission to the MED on the transfer of jurisdiction under Part 4A from Commission to EC, Transpower elaborated on some of the key deficiencies of the current regulatory regime and made a number of suggestions for possible reform to reflect international best practice<sup>32</sup>.

**vii) Transpower's communication and approach in relation to announcing the 1 April 2006 price changes**

60. A number of submitters have indicated their concern relating to the process of communication adopted by Transpower associated with the announcement of prices for the forthcoming year ("2006" prices").

61. Transpower has for some time been foreshadowing increased operational expenditure that goes hand-in-hand with the grid investment projects that have been, and will continue to be, undertaken over the next 5+ years. This has been set out in various public statements and in our formal submissions to the Electricity Commission and the Commerce Commission over the last year.

62. In terms of timing, the prices announced in November 2005 were set and communicated to customers in the normal course of Transpower's business planning cycle and in accordance with Transpower's regulatory and contractual obligations.

63. Prior to prices being notified to customers it is Transpower's policy to call each customer to explain the basis of any new charges. In addition each customer is provided with an information pack which, in relation to the 2006-07 price announcements included:

- A covering letter setting out the proposed Transmission Charges from 1 April 2006 including a summary explanation as to why Transpower's overall revenue requirement had increased from the previous year.
- A Formal Notice
- Appendix K to the pricing booklet (Year specific data for year ending 31 March 2007)
- A schedule of grid charges

---

<sup>32</sup> Transpower – Submission to the Ministry of Economic Development: Jurisdiction under Part4A of the Commerce Act in respect of Transpower – December 2005.

13 March 2006

---

- Pricing reports – April 2006
  - Summary of annual rates and charges
  - Pricing summary
  - Connection charge component
- 64. Transpower's Posted Terms and Connection Contracts require it to give its customers not less than 3 months' notice of any variation to the grid charges resulting in price changes and this is normally done sometime in December of the previous year to ensure that customers have at least 3 months clear notice prior to the start of the pricing year on 1 April. To illustrate this, the dates of previous annual price announcements were 8 December 2004 (for the 05/06 pricing year), 22 December 2003 (for 04/05) and 6 December 2002 (for 03/04).

**viii) Truncated timetable does not provide a reasonable opportunity for interested persons to give their views on the Commission's Report**

- 65. Mighty River Power and Unison express concerns with the process followed by the Commission. In particular, Unison notes the truncated timetable adopted by the Commission and emphasises the need to maintain the integrity of the consultation process.<sup>33</sup>
- 66. Transpower shares these concerns and reiterates the view set out in its primary submission and its recent correspondence with the Commission that the importance of the issues canvassed in the Commission's Report, not only to Transpower, but to the wider electricity industry and consumers generally, is such that the consultation timetable does not provide the reasonable opportunity required by section 57I for interested parties to give their views.<sup>34</sup>
- 67. Transpower understands that the Commission's timetable is driven largely by its desire to make a final determination ahead of Transpower's proposed prices taking effect, i.e. at 1 April 2006. However, the fact that Transpower's customers, who have quite different incentives and motives to Transpower in relation to the Commission's decision, have expressed similar concerns to Transpower in relation to the Commission's consultation process reinforces the comments already made by Transpower that this timetable, and the Commission's proposed process, is insufficient to address these very important, complex and wide-ranging issues. While acknowledging the Commission's desire to consider the issues prior to 1 April, the weight of submissions on this issue suggest that the public interest strongly favours a more considered process to ensure that all relevant evidence is available to, and can be properly analysed and

---

<sup>33</sup> Unison – Submission on Intention to Declare Control of Transpower, page 6.

<sup>34</sup> Transpower – Submission to the Commerce Commission on the Intention to Declare Control of Transpower, Section 1.6.

13 March 2006

---

taken into account by, the Commission prior to any final decision on imposition of control.

68. It is not now possible to revisit the time frames allowed for initial submissions on which subject Transpower has already expressed its views. However, the Commission should now review the process going forward, in the light of the issues identified in the submissions and cross-submissions, and ensure so far as possible that the future process is appropriate. Given the significant and complex decisions it faces, it would be anomalous, and inconsistent with good regulatory practice, were the Commission not to follow its usual practice of holding a conference, including receipt of any further information required to address issues identified at (or in the lead-up to) that conference.

### **Concluding Comments**

69. If the Commission has any questions or requires further clarification of anything contained in this cross submission, Transpower is willing to assist in any way that it can.

Yours sincerely



Howard Cattermole  
Regulatory Strategy Manager