

9 November 2007

Transpower Post-Breach Inquiry

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Dear Michael

Commerce Commission: Draft Decisions and Reasons for Not Declaring Control & Draft Decisions on Resetting Transpower's Thresholds

1. Introduction

Transpower supports the Commerce Commission's conclusion that Transpower's proposed revised thresholds provide for outcomes which are consistent with the s57E purpose statement objectives. In Transpower's view, the thresholds proposed in the settlement are more appropriate to Transpower's circumstances than the price path threshold. The reset of Transpower's thresholds will provide Transpower with a more stable regulatory environment for the next four years, and we believe are a step towards appropriate long-term regulatory arrangements.¹

Transpower observes that the development of the settlement proposal to its current form results from an extensive period of negotiation between the Commission and Transpower. The settlement is a package, which balances the requirements of the Commission (e.g. the WACC methodology and inputs) and Transpower's preferences (e.g. the use of DHC).

Transpower comments on some aspects of the Commission's Draft Decisions paper below.

¹ Transpower's preferred long term arrangements are discussed in the submission it made on the Ministry of Economic Development's discussion document reviewing Parts 4 and 5 of the Commerce Act.

2. Comment

2.1. Alignment of financial reporting and regulatory asset books

Transpower supports the Commission's position that the alignment of the financial reporting and regulatory asset books would provide net benefits.

Transpower notes that Tim Fairhall's commentary on Transpower's proposal discusses the pseudo assets approach as an IFRS deemed cost adjustment. However, the pseudo assets proposal is an alternative to an IFRS deemed cost adjustment. The pseudo assets proposal is a means of simplifying the move to DHC, by aligning at 30 June 2006 the ODV and financial books. The pseudo assets will be separate from the financial accounting book.

The pseudo assets will depreciate over a relatively short period. Transpower will obtain a return on capital (WACC) and a return of capital (depreciation) on the pseudo assets. This return will be equal in NPV terms to the return that Transpower would have obtained from using the ODV book.

2.2. Operating expenditure

The Commission notes (para 306) that Transpower's position at the time of the post breach inquiry was that a price path of CPI+7% to CPI+10% was required, but that its initial settlement proposal for the operating expenditure cost path was CPI+1.5%.

The juxtaposition of those statements implies a significant change in Transpower's position, even if that was not the Commission's intention. Transpower notes that while its forecasts have changed somewhat, the requirements of an overall price/revenue path are different to the requirements of the operating expenditure path. The revenue path is more significantly affected by the large increases in Transpower's capital expenditure than is operating expenditure.

2.3. Cost of capital

Transpower's proposed WACC was based on the Commission's published WACC methodology and the input parameters proposed by Dr Lally in September 2006. Transpower did not have access to Dr Lally's updated advice on the impact on WACC of the changes to the corporate tax rate in time to include this in its settlement offer. This has resulted in the difference observed between Transpower's proposed WACC, and the Commission's WACC.

Transpower believes it is appropriate for the Commission to consider an adjustment to Transpower's WACC to reflect the full impact of the proposed tax changes in line with the Commission's latest expert advice.

2.4. Quality threshold

2.4.1. Need for quality threshold

The Commission concludes that a quality threshold should continue to apply to Transpower, notwithstanding the quality obligations placed on Transpower by the benchmark agreements and interconnection rules administered by the Electricity Commission. The Commission notes that Transpower's preferred position is that there be no quality threshold.

Transpower accepts that some form of incentive on Transpower's quality performance is appropriate. However, it also considers that for the two reasons discussed below a threshold is not the appropriate mechanism.

The first reason is that Section 57G requires thresholds to be set "for the declaration of control". However, the Commerce Commission does not have powers under Part 4A to make any authorisation or to accept any undertaking in respect of all or any component of Transpower's quality standards. Transpower considers therefore that it is inappropriate for a quality threshold breach (in the absence of any other threshold breach) to give rise to a post-breach inquiry as to whether or not control should be imposed.

The second reason is that the Electricity Commission also has jurisdiction over quality, so continuation with a quality threshold exposes Transpower to regulation of quality by two separate regulators, with the potential for conflicting requirements, and/or additional compliance costs. The Electricity Commission has established the requirements it considers necessary to ensure Transpower delivers the quality its customers require. It can change its requirements should it consider additional regulation is necessary.

Transpower notes also the high probability that Transpower will breach the quality threshold, solely because of the statistical variability of grid events, which may affect grid services. Given this variability and the way the threshold is set, Transpower will almost invariably breach the quality threshold in any five-year period.

2.4.2. Alternative forms of quality threshold

The Commission asks whether an alternative form of quality threshold would be desirable. Transpower considers that information disclosure could meet the Commission's concerns.

As noted by the Commission, the benchmark agreements and interconnection rules address the nature and quality of the connection and interconnection services, and the information that Transpower should provide to its designated transmission customers. The Commission is concerned, however, that only Transpower's customers are entitled to receive the information on Transpower's performance.

Transpower considers the Commission's concern about the 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. Any requirement for different information would add to Transpower's compliance costs.

The Commission expresses concern that there are no consequences for Transpower if it breaches the quality obligations imposed by the benchmark agreements and interconnection rules. Transpower is exposed to potential financial liability if it breaches the capacity service measures (capacity rating, level of impedance for lines, voltage rating) and the customer service measures (length of time to report on breaches of other service measures, respond to complaints about service, provide incident reports and consult affected customers before planned outages). Under the Electricity Governance Rules, the Rulings Panel can also impose a fine for any breach of the rules.

The availability and reliability service measures (annual unavailability, number of interruptions and unserved energy due to planned and unplanned outages) are for information and are not enforceable. In general, however, Transpower believes that reporting against these service measures is sufficient to expose any lack of quality in Transpower's services, and the potential reputational damage of service failure provides a strong incentive to continue to deliver a high standard of quality.

2.5. Other comments

Transpower agrees with the Commission's overall conclusion that there are net benefits from accepting the settlement offer. Transpower, however, wishes to make a number of comments on the Commission's analysis as set out below.

The Commission suggests that, in the absence of its intervention, Transpower would have earned excessive profits. Transpower remains of the view that the operation of the Economic Value framework was such that Transpower would not earn excess profits. Without the Commission's intervention, the profile of price increases would have differed. However, over time the recovery of revenue would have been the same in NPV terms.

Transpower does not believe the Commission's statement (para 379) that Transpower has attempted to "thwart the operation of Part F of the Rules" is justified. Transpower has worked with the Electricity Commission to interpret, clarify and operationalise the Part F rules since their inception and subsequent development, and has sought to apply the rules consistent with its reasonable understanding and interpretation of those rules as they have evolved.

Whilst Transpower believes it is important to highlight the above points for the record, Transpower considers that the proposed thresholds are more appropriate than the price path, and that the settlement will provide Transpower with a more stable regulatory environment.

If you have any questions please do not hesitate to contact either myself or Richard Fletcher, Regulatory Strategy Manager.

Yours sincerely



Howard Cattermole
Acting Chief Executive