

## WPI Pulp

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Transpower Post-Breach Inquiry  
Network Performance Group  
Networks Branch  
Commerce Commission  
P.O. Box 2351  
Wellington

## Winstone Pulp International Limited

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

1. Further to the Commission's publication of the submissions received on their Intention to Declare Control of Transpower Winstone Pulp International are pleased to submit the following cross-submission for the Commission's consideration. This cross-submission follows the first submission made by Winstone Pulp International dated 27th February 2006.

#### Acceptance of the breach

2. In their submission<sup>1</sup>, Transpower agree the company breached the thresholds but argue the breaches are "explainable." Transpower report in their Economic Value Statements an accumulated economic gain attributable to customers at 30 June 2005 of approximately \$101 million. This is equivalent to excess charges of \$151 million, i.e. \$101 million grossed up for tax. This is a measure of excess profits. Transpower claim this accumulated excess profit was necessary to cover rising operating costs for the ageing asset base, some interim grid augmentation and planning, capacity building and some investment (particularly in easements) in anticipation of approval for some very large grid upgrade investments.
3. Winstone Pulp International believes these explanations are questionable and the retention of the surplus unjustified for the reasons set out below.

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<sup>1</sup> Submission to the Commerce Commission on the Intention to Declare Control of Transpower, Transpower, February 2006

### ***New investments not subject to building block approach***

4. Transpower has assumed that the transmission investments under an approved Grid Upgrade Proposal (GUP) will be charged on the same basis as existing grid assets. Winstone Pulp International considers that this assumption is incorrect and the allocation of the costs for the Tactical Transmission Upgrades (TTU) and the GUP investments may be on an entirely different basis.
5. Transpower states that:

*“Transpower’s approach to revenue setting was developed under a self regulatory environment and was designed explicitly to ensure that Transpower earns zero economic profits (i.e. no excessive profits accrue)”*  
(Transpower submission page 10, paragraph 12)
6. Winstone Pulp International agree with Transpower’s view on this but in addition considers that, in the self regulatory environment, grid enhancements were to be recovered through a commercial contract between Transpower and the customers that benefited from the upgrade. Through offering these commercial arrangements Transpower would be signalling the long run cost of transmission and its customers would have an incentive to seek lower cost alternatives to transmission. Once contracts were in place the costs of the upgrades would be allocated efficiently to beneficiaries.
7. It is acknowledged that, due to free - riding issues, multilateral agreements appear to have been difficult to achieve under the self regulatory environment. Under the Electricity Governance Rules (Part F) the role of the Transpower customer, in regards to investment approval, has been taken by the Electricity Commission. Therefore, recovery of new investment costs should be subject to the transmission pricing methodology being developed under Part F and not necessarily treated the same as recovery of costs for existing sunk assets (e.g. building blocks approach). It is not Transpower's right to seek recovery for new investment related costs on the same basis as the existing sunk assets.
8. We understand that under the self regulatory environment Transpower’s New Investment Agreements had a significantly lower WACC than that used to determine the revenue requirement for existing assets. This reduced WACC reflected the lower optimisation risk to Transpower.
9. If Transpower’s building block approach to upgrades is allowed, then the risks associated with any over-build must fall on Transpower’s shareholder. It is not clear if this is Transpower’s view or if it will claim some immunity from the optimisation of TTU and GUP investments because they have been approved by the Electricity Commission and included in the Regulatory Asset Base (RAB). This point is important in identifying the potential for value transfer between current and future grid users and the incentives on Transpower to make efficient investments.
10. Details of which parties will be the contractual counterparties to Transpower and the formula for recovering approved new investments are still work-in-progress. At best it was presumptuous of Transpower to retain excess returns of \$101 million plus raise charges partly to cover costs relating to yet to be approved new investments. Those excess returns should have been rebated to customers and Transpower should have worked through the Part F process as to how new investment costs are to be recovered.

### ***Lowest efficient costs***

11. Under the building block approach to both existing assets and capital expenditure, Transpower include an additional cost of operating and maintenance expenditure<sup>2</sup>. Transpower justifies the level of these charges by reference to external international benchmarking schemes such as ITOMS. Our understanding is that these benchmarking schemes have received some criticism regarding their ability to compare transmission companies operating in very different environments.
12. Winstone Pulp International believes that if the Transpower organisation were benchmarked against New Zealand manufacturing organisations significant inefficiencies may be seen. We consider that the components of Transpower's building block calculated revenue requirement should be exposed to independent external review.
13. We support MEUG's view that the estimate of excess profits to date by Transpower is likely to be light because:
  - some costs are unlikely to be the lowest efficient costs possible (e.g. Transpower's claimed WACC),
  - the question of whether some claimed expenses should be capitalised as noted below (in particular the treatment of easements procured for yet to be approved investments) and,
  - questions regarding the appropriate allocation of costs between customers and shareholders.

### ***Capitalisation of costs***

14. Preparatory work and capacity building for possible large grid upgrade investments should be capitalised as part of that yet to be approved work rather than immediately expensed. If this is not the case, current consumers are likely to be paying for benefits received by future customers.

### ***Summary***

15. Winstone Pulp International considers that the points raised in its initial submission to the Commission remain relevant. In addition we believe that the information contained in the extensive submissions made and funded by Transpower, demonstrates that without external scrutiny we cannot be assured that the organisations cost's are efficient.
16. We consider that the building block approach taken by Transpower may not be appropriate for the grid upgrade investments. If the building block approach is to be used, we consider assurances need to be gained regarding the optimisation of those assets to avoid current customers paying for future customers benefits (e.g. Transpower should only be able to charge for the grid that is required to meet today's customer demand).
17. Winstone Pulp International considers that the above issues need to be resolved before transmission prices are increased.

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<sup>2</sup> See Figure 6.5 Transpower February 2006 submission

18. MEUG are making a detailed commentary on many of the points raised above and Winstone Pulp International supports their submission.
19. Winstone Pulp International does not view control by the Commerce Commission of any company lightly. In this case the benefits to the market are clear. Transpower will also benefit by having greater clarity over its ability to recover efficient costs. We agree that Transpower should be controlled

Yours faithfully



Paul Saunders  
Pulpmill Manager