

WPI Pulp

Winstone Pulp International Ltd
Karioi Pulp Mill
State Highway 49
PO Box 48, Ohakune 5461
New Zealand
Telephone +64 6 385 8545
Facsimile +64 6 385 8547

Pulp Marketing and Sales
Level 22, 120 Albert St, Auckland
PO Box 6268 Wellesley St
Auckland 1036, New Zealand
Telephone +64 9 302 1187
Facsimile +64 9 302 1182



February 27, 2006

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

Winstone Pulp International Limited

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

Winstone Pulp International would like to thank the Commerce Commission for their invitation to provide a submission on their Intention to Declare Control of Transpower. We are pleased to submit our views for the Commission's consideration.

Introduction

1. Winstone Pulp International (WPI) owns and operates a pulp mill situated at Karioi, near Ohakune, in the central North Island of New Zealand. Electricity is a key input into the processing of wood and the price paid for electricity impacts significantly on the company's bottom line performance.
2. WPI contracts directly with Transpower and has a contract with them for transmission services. WPI is an electricity market participant as defined in the Electricity Governance Rules (EGR) and holds separate energy hedge contract arrangements with an electricity generator/retailer to manage electricity price risks.
3. Electricity supply is critical to WPI operations and obtaining a fair and reasonable price for electricity services is vital. In recent weeks we have received notice from Transpower on their intended price increases. In our view, Transpower's price proposals do not represent a fair and reasonable price for the services we receive. However, we have been unable to negotiate any changes in price with Transpower for these monopoly services.

Changes in transmission prices and price control

4. Most New Zealand exporters are price takers on world commodity markets; as such, increases in costs cannot necessarily be recovered through increased sales prices. Winstone Pulp International has recently faced significant increases in the cost of electricity including significant upward movements in energy prices. In addition Transpower has given

notice of large increases in the transmission charges faced by Winstone Pulp International. These increases in electricity charges are occurring at a time when world commodity prices, for our products, are falling in real terms.

5. Under previous transmission pricing regimes Winstone Pulp International has faced uncertainty regarding its transmission charging. In the mid 1990s Transpower's prices were set in relation to an annual load flow analysis which made prices impossible to predict and extremely volatile on a year to year basis. These prices movements did not reflect any changes to the service required or delivered to WPI. Transmission prices subsequently became more stable under the pricing methodology and price regulating regime that existed prior to 2005.
6. The period of stable transmission prices appears to be at an end. WPI is concerned that as a monopoly, Transpower is able to set whatever prices it likes and consumers have no ability to resist, manage or avoid these increases.
7. WPI understands that under previous regulatory controls Transpower's pricing was set in accordance with the Optimised Deprival Valuation (ODV) of its assets and Transpower's weighted average cost of capital (WACC) as agreed with the Government through Transpower's Statement of Corporate intent. The combination of these controls meant that Transpower could not charge for assets that exceeded those required to deliver the service and could only make an appropriate rate of return on the ODV assets. In principle, WPI believes that these controls were appropriate.
8. To ensure consumers were not charged more than they should have been Transpower established the Economic Value Adjustment (EVA) mechanism. Overcharges from one year were returned to customers in subsequent years. Whilst not perfect, this mechanism did provide a degree of fairness and was a relatively transparent method of ensuring Transpower did not over-recover.
9. WPI has contributed to the EVA account balance and considers that this overpayment should be immediately refunded to us and to other Transpower customers. If this was to occur, then WPI agrees with NZIER's conclusion that it should not be included in the price threshold breaches. However, if the EVA balance was not to be returned to Transpower's customers, then it would be appropriate to consider them as a component of the price threshold breaches.
10. WPI understands that the current regulatory regime involves both the Electricity and Commerce Commissions. In addition, we understand that the Electricity Commission approves the infrastructure investments Transpower needs to make to meet forecast consumer demand. We understand the Commerce Commission sets price thresholds and performance levels to ensure consumers are charged an appropriate price. WPI considers that, in principle, this arrangement is an appropriate regulatory regime.

Transpower's performance

11. WPI supports appropriate and timely investment in transmission infrastructure and believes that this can best be achieved by all parties cooperating in the EGR investment decision making processes.
12. WPI believes that, as a general rule, increases in volume should, over time, produce an appropriate rate of return for capital investments made to supply that demand. Price increases should be unnecessary. We also support the Commission's application of an efficiency factor, noting that there have been technology gains in transmission engineering. With this in mind, any price increases should be fully justified and open to scrutiny and, if

necessary, subject to regulatory control. As a customer of Transpower, WPI have not received satisfactory information and justifications that support the price increases.

13. WPI considers that Transpower has not complied with the regulatory processes and has increased prices in a cavalier manner. We agree with the Commission that Transpower has acted in a manner inconsistent with Part 4A of the Commerce Act.
14. The concept of increasing prices prior to making capital investments is a luxury only a monopoly service could consider. Manufacturing industries that are facing these unreasonable increases have no way of passing them on to their customers. In addition Transpower is receiving payment for a service that it is clearly not providing. This cannot be justified.
15. WPI considers that Transpower's behaviour has been typical of a monopoly that has failed to consider the consequences of its actions on those it serves and the economy in general. Control is therefore justified and necessary.

Benefits of control

16. The Commission's calculation of the potential benefits of control¹ takes into account the direct benefits of price reductions through efficiency and timing of investments. WPI considers that those benefits are considerable and should be pursued.
17. In addition to the direct benefits of price control, WPI considers that there are significant indirect economic benefits of control that the Commission has not included in its calculation. WPI considers that increased transmission charges would have a negative effect on manufacturing output and investment and that control would have a positive effect. Therefore, WPI considers that the Commission may have understated the benefits of control.
18. Transpower currently provides minimal guarantee of the quality of its service. The definitions of service are largely input rather than output based. WPI believes that a benefit of control may be to expose Transpower's service levels to increased and more transparent scrutiny.

Conclusions

19. WPI considers that Transpower's actual and proposed price increases are inappropriate and should be immediately withdrawn.
20. In addition, WPI believes that Transpower should immediately return the total balance of the EVA account to its customers.
21. In addition, WPI believes that Transpower should refund to its customers the price increases charged in 2005.
22. WPI considers that Transpower should engage with the regulatory processes and not impose price adjustments until investments have been approved and costs incurred.
23. WPI considers that based on Transpower's behaviour it is unlikely that Transpower will comply voluntarily with regulation.

¹ Intention to Declare Control document page 11

24. WPI considers that Transpower's increases are a clear breach of the Commission's price thresholds and are in conflict with Government policy. WPI fully supports the Commission's intention to take control of Transpower.

WPI would be pleased to answer any questions from the Commission relating to our submission and we commend the Commission for the position it has taken on transmission pricing.

Yours faithfully

A handwritten signature in blue ink that reads "Saunders". The signature is written in a cursive, flowing style.

Paul Saunders
WPI Pulpmill Manager