Submission on draft determination and input methodologies for Part 4 regulation of Transpower

From

Contact Energy Limited

Introduction

This submission by Contact Energy Limited ("Contact") responds to the Commerce Commission's development of regulations that will apply to Transpower under Part 4 of the Commerce Act (the "Act").

Specifically, our response addresses the draft decisions and issues identified in the following documents:

- Commerce Commission, "Draft" Commerce Act (Transpower Input Methodologies) Determination 2010, published on 2 July 2010 ("the IM Draft Determination").
- Commerce Commission, Individual Price-Quality Path (Transpower), Draft Reasons Paper, 28 June 2010 ("the IPP Draft Reasons Paper").
- Commerce Commission, Input Methodologies (Transpower), Draft Reasons Paper, 25 June 2010 ("the IM Draft Reasons Paper").

In this submission, we refer to a report by Andrew Shelley of Charles River Associates on the Economic Value account balances, entitled "Balance of the EV Account for Transpower's HVDC Assets", 8 August 2010 (the "Shelley Report"). This report is attached to, and forms part of, our submission.

This submission is structured as follows:

- Section A explains why Contact believes appropriate investment in the grid is essential
- Section B explains why decisions in relation to the Economic Value account framework are necessary
- Section C explains why rolling over existing Economic Value account balances would not promote the long term interests of consumers
- Section D explains Contact's views in relation to the Draft determination i.e. future Economic Value account application

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Executive Summary

Contact supports appropriate development of the national grid and Transpower earning an appropriate return in relation to that development. Transpower is best placed to manage the risks associated with transmission system development and should be incentivised appropriately for doing so. The regulatory framework that supports Transpower's decision making in this regard is required to produce outcomes that are consistent with those in competitive markets.

In terms of the components of that framework that are material for Contact:

- The HVDC and Economic Value Account ("EV account") components of Transpower's revenue requirements are significant; in recent years, Contact's HVDC charges have averaged ~NZ$19m per annum, with the EV account component of those charges averaging around NZ$2m per annum.
- Transpower is now two years into a 10 year, NZ$5 billion CAPEX programme for major core-grid upgrades, and its total revenue requirement in contributing to those developments is expected to increase from NZ$625 million per annum in 2010/11 to NZ$1,153m per annum in 2019/20. For end users of Transpower's services, this could result in increases in overall transmission charges by around 60% per annum by 2015.

The materiality of these issues and the impact of these decisions on consumers make the omission of any discussion of the EV account existing balances in the IPP Draft Reasons paper a matter of great concern to Contact.

There is no evidence on which the Commission can base its judgment that the existing EV account balances represent an appropriate starting point for the EV account recovery process proposed. Indeed, analysis of the existing balances and how they were disclosed highlights that they are not consistent with thhose of competitive markets:

- The level of disclosure about HVDC and HVAC account balances has been insufficient to allow Transpower's customers to properly understand the movements in the EV account balances (i.e. the individual HVDC and EV HVAC account balances), and the drivers of movements in these balances. The publishing of only net balances has masked underlying (diverging) trends in the EV HVDC and EV HVAC accounts.
- During the period prior to the settlement, and therefore before there was any disclosure of the individual EV account balances, those individual EV account

balances ballooned; with the EV HVDC account balance increasing (becoming more negative) by over NZ$85m from 2003 to 2007 and the EV HVAC account balance increasing (becoming more positive) by over NZ$55m over the same period. Transpower bore no cost risk and hence its incentives to manage costs were low.

- Between 2007 and 2009 the EV HVDC account balance increased from an opening debt of NZ$62.4m to a closing debit balance of NZ$102.8m. This outcome was driven primarily by the substantial increase in instantaneous reserve ("IR") costs that was initially borne by Transpower as a direct result of its decision to decommission Pole 1 of the HVDC link. Transpower's decisions led to ancillary services costs of NZ$15.8m and NZ$28.6m being incurred in 2008 and 2009 respectively, which were included as OPEX in Transpower's required revenue.
- Transpower's treatment of IR costs has had the ***same effect*** as if the costs were treated as pass-through costs, even though the Commission supports the view that IR costs must not be treated as pass through costs and noted the undesirable incentives and signals that would be provided should they be passed through.
- This passing through of IR costs (either directly or through the EV account) has significantly eroded the value of loss and constraint rentals to Contact; Transpower's customers are paying for risks taken by Transpower, yet not receiving the benefits. This highlights inconsistencies with the EV account mechanism and the Transmission Pricing Methodology ("TPM"), as well as deficiencies with the TPM itself.
- IR costs have been allocated in a way whereby HVDC customers subsidised HVAC customers.
- Transpower's decisions around Pole 1 have distorted pricing in the IR market, and in the energy market.

The Commission must ensure that only the components of the existing balances that can clearly be identified as consistent with outcomes that would apply in a workably competitive market and promote the long-term benefit of consumers are carried forward. Even when only accounting for appropriate treatment of OPEX costs, the appropriate closing EV HVDC balance for 2009 is NZ$68m, or ~NZ$35m less (lower debit) than the closing balance identified by Transpower, and assumed by the Commission to be applicable.

The fact that the existing balances are being 'ring-fenced', and an amended mechanism is being proposed for the post-settlement period, supports Contact's submission that the existing balances are not appropriate. These issues cannot be permitted to continue under any EV account mechanism that exists post-expiry of the settlement because that will lead to similarly unsatisfactory outcomes in the future.

Contact does not believe that the Commissions proposed amendments to the EV mechanism go far enough, and submits that, in order to ensure outcomes associated with the EV account are consistent with those that would occur in competitive markets:

- Separate accounts for HVDC and HVAC OPEX (with their own individual CPI caps) must be created and maintained, with disclosure of cost allocation methodologies to those accounts being to a standard required by electricity distribution businesses.
- IR costs attributable to HVDC projects must be capitalised as part of project costs **not** treated as recoverable, pass-through or OPEX. This should occur during the transitionary period as well as post settlement.
- IR costs that are not directly attributable to HVDC projects should be treated as OPEX, with appropriate allocations to the HVDC account.
- As a quality measure, when there is an HVDC Pole outage, reserve costs should not be recoverable (via pass through, recoverable cost or OPEX costs or otherwise), and no 14 day 'grace period' should apply either.
- Recovery of EV account balances over the subsequent regulatory control period can only occur if issues around the allocation of IR costs, separation of HVDC and HVAC accounts for OPEX, and certainty around cost allocation mechanisms have been resolved.

Section A: Appropriate investment in the grid is essential

Contact understands and recognises the value in having an efficient transmission grid that connects generation with customers.

Contact supports appropriate development of the national grid and Transpower earning an appropriate return in relation to that development. This is because Transpower is best placed to manage the risks associated with transmission system development and should be incentivised appropriately for doing so.

Because of the key role Transpower plays in connecting generation with customers, and because it is the sole supplier of these services in New Zealand, the role of regulation in ensuring the signals that it receives in relation to grid investment are appropriate is pivotal and of great importance to customers of Transpower's services and to end users of energy.

Customers and consumers require certainty that Transpower has appropriate incentives to invest; to improve efficiency, and to share the benefits of efficiency gains. Customers and consumers also need certainty that the returns being earned by Transpower are not excessive. Where these aspects are not present, signals to customers of transmission services are distorted, and this will flow through to how energy products are provided (and priced) to end users.

For these reasons, the regulatory framework for Transpower must produce outcomes that are consistent with those applying in competitive markets, which is the requirement of the Part 4 purpose statement.

In reviewing the Commission's draft determinations and reasons papers, Contact has used the requirements and benchmarks established in the Act to assess the suitability of the proposals.

In this respect, as a general matter, Contact's view is that a mechanism like the EV account is not necessary to provide Transpower with appropriate investment incentives. Contact considers that mechanisms which provide the appropriate investment incentives for Transpower and reduce the red tape associated with investments are more important than provisions such as the EV account in promoting that investment. Indeed:

- As the Commission recognises, the EV account framework has been part of a construct which has generated *"low levels of investment in the transmission grid over an extended period of time"*. This has not been in the best interests of consumers.
- The ostensibly large debit balance in the HVDC account and the uncertainty associated with its recovery under the new Part 4 regime has not prevented Transpower from planning to invest $672 million to commission Pole 3 of the HVDC link in advance of HVAC projects.

Furthermore, the Commission's draft decision to 'wind-up' the existing EV accounts over a period of nine years, and resetting the mechanism with adjustments, supports Contact's submission that these existing balances are not appropriate.

Section B: Why decisions in relation to the EV account framework are necessary

Materiality of issue for Contact as a customer of transmission services

Reflecting their essential role in delivering energy to end users, transmission services are core to Contact's business as a generator and a retailer. Transmission services cannot realistically be avoided and form a significant cost for Contact.

Furthermore, transmission charges are forecast to increase substantially over the next decade. By their nature, transmission services are capital intensive.

Transpower is now two years into a 10 year, NZ$5 billion CAPEX programme for major core-grid upgrades, and its total revenue requirement for those developments is expected to increase from NZ$625 million per annum in 2010/11 to NZ$1,153m per annum in 2019/20.

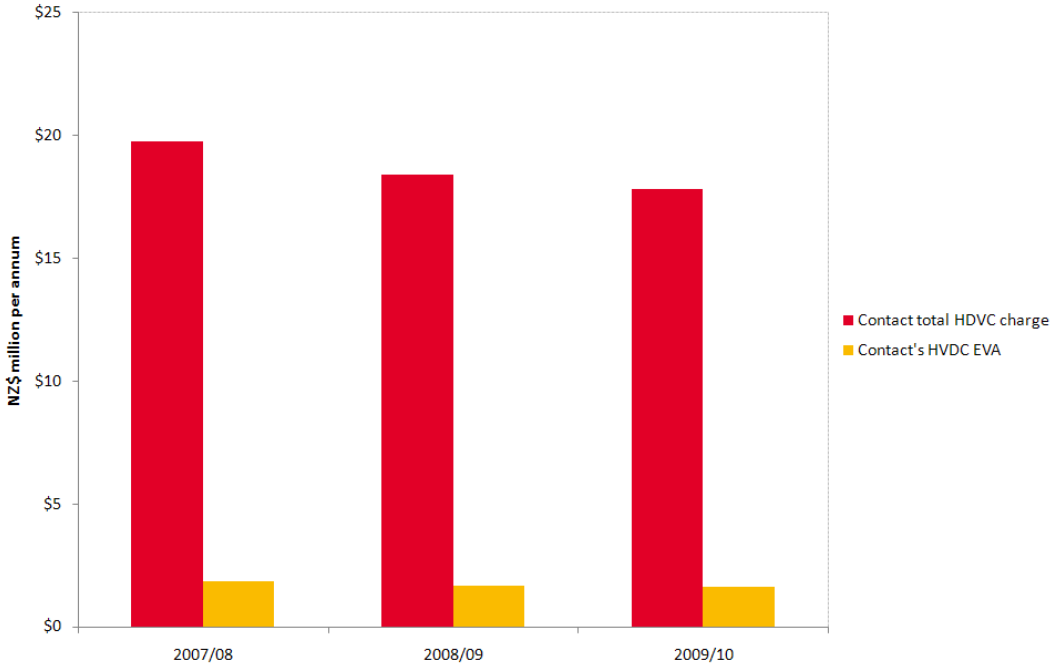
For end users of Transpower's services, this could result in increases in overall transmission charges of around 60% per annum by 2015 (assuming the current TPM applies).

Transpower impose separate charges for transmission HVDC and HVAC services. HVDC charges are, currently, levied only on South Island generators (Contact, Meridian and Trustpower) via the TPM. HVDC charges comprise around 85% of Contact's transmission charges. Again these are forecast to increase. Indeed, of the increase in Transpower's total revenue requirement noted above, the total increase for the HVDC component would be from NZ$85m per annum to approximately NZ$160m per annum over the same period. Of this total amount, Contact's cost share is around 23%.

Accordingly, for Contact, the HVDC and the EV account components of Transpower's revenue requirements are very important.

In recent years, Contact's HVDC charges (i.e. Contact's share of total HVDC charges) have averaged approximately NZ$19m per annum, with the EV account component of those charges averaging around NZ$2m per annum.

Figure 1: Contact Energy HVDC and EV component charges



These figures reflect the annual cost of EV account ***payments***, which are themselves calculated based on the balances of the EV accounts estimated by Transpower. These ***balances*** are themselves material; the closing debit balance for the EV HVDC account in 2009 was NZ$102.8m (i.e. HVDC customers to pay Transpower) with the EV HVAC account closing credit balance in 2009 being NZ$108.8m (i.e. Transpower to pay HVAC customers).

For these reasons, ensuring that the draft recommendations and reasons provided by the Commission, particularly in relation to the EV account, best meet the Part 4 purpose statement and send appropriate signals to all market participants is important, not only for Contact, but for "NZ Inc".

How the EV account affects Transpower's revenue

We have identified the importance of the HVDC component of Transpower's revenue requirement and the EV account, as being a critical element of the Commission's draft decisions and determinations.

Transpower's EV account framework records *"economic gains or losses"* during a regulatory period. Value is gained or lost when Transpower achieves a return on operating capital that is above or below its cost of capital. Economic gains or losses are then accumulated in customer EV accounts – Transpower maintains one for HVDC customers ("EV HVDC") and another is maintained for HVAC customers ("EV HVAC").

Transpower adjusts its pricing in any year by seeking to recover (or return) these past losses or gains. Transpower's prices increase when Transpower seeks to recover monies it believes it should have recovered in the past, but which it has not in fact recovered for some reason. Conversely, if Transpower believes it has over-recovered from its customers it will, in principle, return that money in the future via, in effect, reduced prices.

In neither case is the accumulated money a "debt" owed by Transpower or by customers. The Commission's concern about obligations being transferred to new customers reflects this.

Decisions in relation to the EV account are required in order to promote long term interests of consumers

As a broad matter of principle, Contact believes that given:

- the materiality of the EV account;
- its influence on Transpower's revenue requirements and pricing decisions; and
- its impact on all market participants' decision making and thereby its impact on consumers,

it is critical that issues associated with it are dealt with by the Commission in its determinations on the regulation of Transpower under Part 4. Dealing with these issues explicitly will best promote the long term interests of consumers.

Such an approach will give customers of transmission services certainty about this aspect of Transpower's pricing and enable customers to take actions which are impacted by these issues based on a more complete and certain information set.

The Commission has, to date, appeared to undertake limited analysis of the EV account and its balances. It has also not addressed these issues as part of its input methodologies for Transpower. Contact's view is that issues associated with the EV account are best dealt with as input methodologies, as these deal with the existing value of the accounts (as the EV account is an asset – see Shelley report) and the allocation of costs (see Shelley report).

Such an approach is consistent with the specific purpose provision for input methodologies which is to *"promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part"*.

Specifying input methodologies for the EV account framework would provide certainty of rules etc for Transpower and consumers.

Decisions in relation to the EV account must promote long term interests of consumers

While dealing with issues relating to the EV account as part of the input methodologies for Transpower is Contact's preferred approach, we are aware that the Commission has so far dealt with these issues – to the extent it has done so at all – in its IPP Draft Reasons Paper. Regardless of where it is dealt with, Contact believes the issues described in this submission must be dealt with so as to best meet the purpose of Part 4.

The central and primary objective of Part 4 is to promote the long-term benefit of consumers. The method by which this is achieved is to promote outcomes that are consistent with outcomes produced in competitive markets such that Transpower:

- has incentives to innovate and to invest, including in replacement, upgraded, and new assets; and
- has incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- shares with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and
- is limited in its ability to extract excessive profits.

However, if something does not promote the long term interests of consumers it cannot accord with the purpose statement regardless of what other merit it might have.

We highlight below how, in Contact's experience, and as a matter of practical reality, it is Contact's view that a charging system such as the EV account could not be sustained in a workably competitive market, and that key decisions which have driven the EV account balances are not aligned with workable competition.

As is illustrated throughout this submission, the current approach is sending incorrect signals to Transpower's customers and can cause them to act in a manner which is inefficient and detrimental for consumers. In no way can this be said to *"be in the long term best interests of consumers"*.

Section C: Rolling over existing EV account balances would not promote long term interests of consumers

The draft determination in the IPP Draft Reasons Paper proposes that the full amount of the EV HVDC account balance, as at the expiry of the settlement period, should be recovered from HVDC customers by the end of the second new regulatory control period, with the balance (including interest) being equally apportioned over each year of the first and second regulatory periods.

If this approach was adopted, Contact's contribution to the EV HVDC account balance recovery would be approximately NZ$6.2m per year over those two regulatory periods, or an increase of around NZ$4.4m per year compared to the current costs incurred by Contact.

The materiality of these issues and the impact of these decisions on consumers make the omission of any discussion of the existing balances in the Commission's IPP Draft Reasons Paper a matter of great concern to Contact. A number of Transpower's major customers highlighted these concerns to the Commission in advance of the draft decisions being released so we are surprised and disappointed by the extremely limited coverage of these issues in the decision documents[1].

For the reasons explained in this section, Contact believes a decision which allows Transpower to recover the existing balances as proposed would not be consistent with the outcomes that would be prevalent in a market with workable competition, and certainly cannot be in the best interests of consumers.

In summary, this is because Contact does not believe that the existing EV account balances represent an appropriate starting point. They do not reflect a starting balance that is consistent with competitive market outcomes and therefore allowing recovery of these balances will simply serve to perpetuate and entrench incorrect signals being sent to market participants.

Reason 1: The EV mechanism permits inefficiency

The Commission has expressed the view that workably competitive markets involving long-term contracts can provide useful insights when weighing up various options for setting input methodologies under Part 4 of the Act. As explained earlier, while Contact accepts that investment in New Zealand's national grid is important, Contact does not consider it

[1] IPP Draft Reasons paper, paragraph 3.9.6

inevitable that an EV account approach as currently implemented is something that would emerge in a workably competitive market.

In a workably competitive market, a firm tendering for long term contracts would not be able to include a mechanism which provides that it can recoup all its costs if it has failed to forecast correctly (particularly if there is a systemic underestimation by that firm over a period of time). The fact that some costs may be more controllable than others does not alter this – this is the nature of this type of contract – an allocation of risk between customer and supplier.

The Commission recognises that Transpower has *"limited ability to provide robust forecast expenditure information"*, but by endorsing the EV account process has already allowed Transpower time to *"come up to speed"*. Such benevolence is not the hall-mark of a workably competitive market and the Commission has not identified why continuation of such an approach is in the long term interests of consumers.

Contact's view is that such a mechanism is not necessary to provide Transpower with appropriate investment incentives.

In allowing this mechanism, Contact believes that the Commission has erroneously elevated consideration of Transpower's interests ahead of those of consumers. This approach is inconsistent with the s.52(A) purpose statement which, as the Commission recognises, has as its central purpose the promotion of the long term best interests of consumers.

The Commission has focused on some details of the settlement at the expense of similar monitoring or focus on whether other key elements of the settlement are managed in a way that is consistent with promoting the long term interests of consumers. The fact that Transpower may have greater incentives to invest with the EV framework is not relevant to the extent that the overriding outcome is not consistent with the long term interests of consumers.

For the reasons explained later in this submission[2], there are alternative mechanisms that will be materially better in achieving the s.52(A) purpose.

[2] See section D

Reason 2: Lack of disclosure of balances

Contact believes that there is no evidence on which the Commission can base its judgment that the existing EV account balances represent an appropriate starting point for the EV account recovery process proposed.

One issue contributing to this is in relation to the manner of disclosure of those account balances over time.

It was only as a result of Transpower's administrative settlement with the Commission in 2007 that Transpower was required to publish its EV account balance components for the HVDC and HVAC systems. However, even at that time, there was limited ability for Contact or others to engage in any meaningful debate on the then existing balances (which the Commission rolled forward in the administrative settlement).

This was because, prior to that time Transpower merely published the aggregate balance of the two EV accounts rather than each account separately. In contrast to the position up to 1998 when Transpower had amassed an EV account of some NZ$600m (which was subsequently written off to zero as it did not reflect a cash outflow), these published disclosures showed, by the later part of the period, the aggregate balance moving in the right direction (i.e. a reduction in aggregate EV account balance).

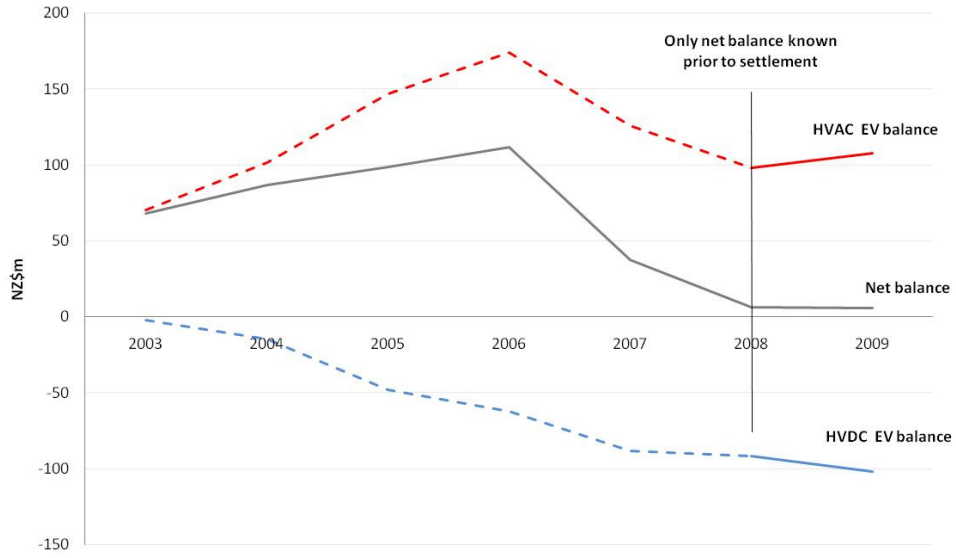
Information Disclosures for year	Balance disclosed
30 June 2003	$68m to customers' credit
30 June 2004	$86.9m to customers' credit
30 June 2005	$98.7m to customers' credit
30 June 2006	$111.6m to customers' credit
30 June 2007	$37.4m to customers' credit

Having EV account balances that trended (or were trending) towards zero over time would support the purpose of the EV account itself, in ensuring that Transpower's return on operating capital over time was not higher or lower than its permitted rate of return (WACC.

However, these aggregate figures were, in fact, hiding a very different trend, which was not evident from Transpower's aggregated disclosures. It was not until after the administrative settlement submissions that Contact had sufficient information to enable it to calculate that the EV account balance in fact reflected a debit of $88.1 million for HVDC customers.

Accordingly, while the EV account in aggregate seemed to be reducing, this was in fact only the result of the HVAC account becoming significantly positive and the HVDC account becoming significantly negative.

Figure 2: Individual components of the EV account and net balance



The lack of disclosure about individual HVDC and HVAC account balances meant that, because of the link between the amount of recovery and the overall HVDC charging regime, decisions made by Contact prior to the settlement as to the relative merits of generation (e.g. in terms of location), which assumed that the net balance reflected immateriality between the absolute levels of the component balances, were based on incomplete and inaccurate information. The signals being sent by the disclosure of the net balance only hid the true signals that would have been made explicit by disclosure of the individual component balances.

For the EV HVAC account balance, the method of recovery of these charges via distribution charges makes it difficult for Transpower customers such as Contact to discern the size of the relative component balances as these costs are typically passed through to consumers.

The level of disclosure about HVDC and HVAC account balances has been insufficient to allow Transpower's customers to properly understand the movements in the EV account balances (i.e. the individual HVDC and EV HVAC account balances), and the drivers of movements in these balances.

This level of disclosure would not be acceptable to customers of services in a competitive market, particularly given the materiality of the balances involved. Insufficient incentives on Transpower to provide services (at the time when the EV account balances grew materially divergent), of a quality that reflected consumer demands means a central and primary objective of regulation was not achieved. The lack of disclosure meant that this failure was not evident to Transpower's customers.

Reason 3: Balances inherently contain charges that do not promote consumers' best interests

Transpower's transmission pricing is subject to the 2008 Notice[3], which gives effect to Transpower's administrative settlement with the Commission, entered into under the previous Part 4A of the Act. The administrative settlement followed the Commission's post breach inquiry of Transpower for its repeated breach of its price path thresholds (in both 2003 and 2004) and its substantial price increases in late 2005.

The settlement reflected a material shift away from the previous Information Disclosure and Thresholds regimes, under which Transpower was self regulated and set its own revenue requirement. The Commission has previously expressed its concerns that Transpower over-recovered from its customers prior to the Settlement, and that the initial settlement did not take into account those over-recoveries[4]:

"..the Commission, having considered the issue further, is of the view that the proposed settlement did not take into account Transpower's over-recovery of revenue from its customer during that period"

This statement reinforces the divergence between actual outcomes that occurred and what would be observable under workable competition. Should such outcomes have prevailed during that period, Transpower would not have been able to over-recover as alternative providers with efficient costs (and associated cost recovery) would have entered the market (if they were not already in the market) and eroded any excess return. The Commission's assessment approach is based on the assumption that on average (over time) only normal returns will be earned by businesses that operate efficiently. EV account balances driven by revenues that were over-recovered could not be borne of efficient operation, and could not be in the best interests of consumers.

[3] The 2008 Notice came into effect from 1 June 2008.
[4] *"Decision and reasons for not declaring control of Transpower New Zealand Limited & Decision to reset Transpower's thresholds"* paragraph 303, Commerce Commission, 12 May 2008.

During the period prior to the settlement, the EV account balances ballooned; with the EV HVDC account balance increasing (becoming more negative) by over NZ$85m from 2003 to 2007 and the EV HVAC account balance increasing (becoming more positive) by over NZ$55m over the same period. Transpower bore no cost risk[5], and hence its incentives to manage costs were low.

A key driver of this was ODV revaluations where changes in HVDC asset replacement costs changed the net book value of some key assets. These were material; the downwards revaluations of the 1997/98 year totalled almost NZ$490m[6]. While these under-valuations were netted off against the over-recovery, the fact that the net impact may have been neutral does not detract from the issue that the existing EV balances are largely driven by a series of choices which produced outcomes which were inefficient and far from being what would be observable in a competitive market.

The Commerce Act (section 52T(1)(a)(ii)) requires that there is an Input Methodology for the valuation of assets. The IM Draft Reasons Paper however, does not examine the initial assets values inherent in the EV account balances, but seems to merely assume that the values from the settlement period are reasonable. This is concerning, given the materiality of the revaluations that occurred[7].

The Commission cannot have any confidence that recovery of the current EV account balances will contribute to outcomes which are in the long term interests of consumers.

Contact is concerned that these issues (which the Commission has identified and discussed in previous decisions) are not discussed in detail in the draft determinations and reasons papers. Contact also considers that no formal decision can be properly made in relation to the draft determinations unless these issues have been fully and properly dealt with.

Specific example of uncertainties inherent in existing EV balances – IR cost treatment and allocation

Transpower's treatment of IR costs as OPEX had same effect as being pass-through

The previous section identified some key issues relating to the EV account arising from decisions made prior to the settlement. Unfortunately for customers and consumers,

[5] See Shelley report, section 3.4.
[6] See Shelley report, paragraph 57
[7] See Shelley report, section 3.3 for further discussion on Revaluations and the EV Account

decisions that created outcomes that weren't equivalent to those that would exist in workably competitive markets were not restricted to the pre-settlement period.

Between 2007 and 2009 the HVDC EV account balance increased from an opening debt of NZ$62.4m to a closing debit balance of NZ$102.8m. During these years, the HVAC EV account balance reduced from an opening credit balance of NZ$174.2m to a closing credit balance of NZ$108.8m.

This outcome was driven primarily by the substantial increase in IR costs[8] that was borne (at least initially) by Transpower as a direct result of its decision to decommission Pole 1 of the HVDC link. By decommissioning Pole 1, additional reserves were required to cover the risk of tripping of the remaining HVDC asset (Pole 2). We discuss the commercial impacts of these decisions later in this response[9].

Transpower's decisions led to ancillary services costs of NZ$15.8m and NZ$28.6m being incurred in 2008 and 2009 respectively. In the previous years since 2003, these costs had never exceeded NZ$3.8m, but in 2009, the ancillary service charges were equivalent to more than three times the **total** cost of all Transpower's maintenance on transmission lines, HVAC substations, HVDC substations/cables, IT and communications and investigations.

These IR costs were foreseeable and identifiable in terms of their likely materiality. That is, Transpower knew that significant IR costs would be incurred when making their decision around the decommissioning of Pole 1. This decision is partly a result of the construct to which we alluded earlier that generated *"low levels of investment in the transmission grid over an extended period of time"*.

The Commission's refusal to allow Transpower to classify these IR costs as 'pass-through' costs as part of Transpower's amended settlement clearly supports these propositions[10]:

"In assessing Transpower's proposal, the Commission has considered whether amending the settlement to allow instantaneous reserve costs to be passed through to consumers would better promote the purpose of Part 4 than retaining the existing settlement." (para62)

"…the Commission considers that the key issue in deciding if Transpower's proposal to amend the settlement should be accepted is whether treating instantaneous reserve costs as

[8] Instantaneous reserve is procured based on the size of the single largest contingent event that could occur during a particular trading period. Generators offer instantaneous reserves at the same time as they make energy offers (www.electricitycommission.govt.nz)
[9] See section "Commercial impacts of current EV account management"
[10] *"Decision and reasons for not amending Transpower's administrative settlement to include Instantaneous Reserves Fees as pass-through costs"*, Commerce Commission, 22 June 2009.

a pass-through cost better promotes the Purpose Statement than providing for them as Indexed Operating Expenditure. As is explained above, the decision is based on the combination of factors, such as the foreseeability of cost increases, the manageable magnitude of costs, the binding settlement agreement, as well as the undesirable incentives and signals that would be provided should the Commission agree to amend the settlement. Likewise, the Commission considers that Transpower is better placed to manage these costs than its customers. Therefore, the existing settlement better promotes the Purpose Statement than the proposed amendment to the settlement." (para128)

Clearly, the Commission saw these costs as being within the control of Transpower and that their treatment as pass-through would be inappropriate in meeting the purpose statement in the Act. Importantly, the Commission also noted that treatment of the IR costs as pass-through costs would create undesirable signals and incentives in the market for transmission services. This was at least partly due to Transpower being better placed to manage this risk than its customers.

This analysis is supported by the fact that Transpower has previously requested pricing for reserve hedges from parties, including Contact, during the period where issues with Pole 1 occurred. Transpower was clearly aware of the costs being driven by its actions.

Contact submits that Transpower's treatment of IR costs as OPEX is inappropriate, as that allocation had the ***same effect*** as if the costs were treated as pass-through costs. As we have shown above, the Commission supports the view that IR costs must not be treated as pass through costs and noted the undesirable incentives and signals that would be provided should they be passed through.

The important point here is that because of this allocation Transpower was able to ensure it would always recover these IR costs from its customers; and its shareholder took on no risk as a result. This is perverse, given the foreseeability of the costs and their materiality. Transpower could, for example, have deferred other non-essential OPEX to ensure that the IR costs remained within the OPEX cap, but the methodology used meant that Transpower was effectively guaranteed to recover these costs. Through judgemental, and what Contact submits is inappropriate, allocation of OPEX costs Transpower ensured the foreseeable consequences of its own decisions around Pole 1 were effectively fully subsidised by its customers. This is despite the fact that the Commission supports the view that this is a poor outcome in terms of the purpose statement of the Act, will create undesirable signals and incentives in the market for transmission services and that Transpower is best placed to manage such risks.

In the section "What an EV account mechanism needs to fulfil to meet the Commerce Act test – Contact's suggested approach", Contact proposes alternative mechanisms that will be materially better in achieving the s.52(A) purpose in terms of the treatment of future IR costs.

Allocation method for OPEX was not/is not consistent with competitive market outcomes

Contact submits Transpower's allocation of IR costs under the OPEX category was inappropriate and does not reflect an outcome that would be observable in a competitive market.

The OPEX component[11] of Transpower's revenue requirement is capped under the administrative settlement and is adjusted by the annual movement in CPI. This CPI adjustment provides a measure of the increase in the general level of costs that might be reasonably expected in a competitive market.

Transpower's treatment of costs has meant that, although operating costs for both the HVAC and HVDC system increased by more than the movement in CPI, there was a reduction in charges to HVAC customers with an equal and offsetting increase in charges to HVDC customers. This was driven by costs being pro-rated based on the actual relative contribution of total HVAC and HVDC costs; HVAC costs are many times larger than HVDC costs.

Specifically, for the HVAC system[12]:

- Actual operating costs increased by NZ$16.9m or 10.1% from 2007 to 2008, and by a further NZ$17.5m or 9.5%from 2008 to 2009.
- Although actual OPEX increased by more than the capped rate for total OPEX, Transpower reduced the allocation of OPEX to HVAC customers by NZ$0.85m or 0.47% from 2007 to 2008, and by a further NZ$3.72m or 2.08% from 2008 to 2009.

For the HVDC system[13]:

- Actual operating costs for the HVDC system increased by NZ$11.20m or 58.6% from 2007 to 2008, and by a further NZ$12.4m or 40.9% from 2008 to 2009.
- Transpower's allocation of OPEX costs to HVDC customers increased by NZ$8.9m or 43.5% from 2007 to 2008, and by a further NZ$7.6m or 26.1% from 2008 to 2009.

[11] As noted earlier, there are no separate OPEX components for HVAC and HVDC.
[12] Shelley report, paragraph 74
[13] Shelley report, paragraph 75

Essentially, costs were allocated in a way whereby HVDC customers subsidised HVAC customers.

The cross subsidisation created by Transpower's allocation of costs is not consistent with the outcomes that would be observable in a workably competitive market where an increase in the costs of serving one group of customers (in this case HVDC customers) should not result in a decrease in the price charged to a different group of customers (in this case HVAC customers).

It is also directly at odds with the Commission's own statements on cross subsidisation. The Commission has previously noted in its decisions on the regulation of gas pipelines businesses that[14]:

"Prices must be structured in such a way that cost recovery is met without cross-subsidisation. Cross-subsidisation across activities and/or individuals is generally inefficient."

The Commission noted that, in relation to this cross subsidisation:

"The consumers of one product were supporting the consumers of another product. This does not send appropriate signals for resource allocation and use;"

Transpower's treatment of costs under the OPEX component of its revenue requirement has sent inappropriate signals for resource allocation and use. Contact identifies some practical examples of the impacts of these inappropriate signals later in this response.

What would the EV account balances be if Transpower's treatment of OPEX costs was consistent with that of a workably competitive market?

The Shelley report identifies the materiality of the EV account balances if they were derived and managed under the conditions of a workably competitive market[15].

We identified that the CPI cap provides a measure of the increase in the general level of costs that would be observable in a workably competitive market. Under Transpower's allocation of costs, HVAC costs increased at a rate higher than this measure. In a competitive market, the outcome would be that allocated costs would increase by CPI only, with the

[14] http://www.comcom.govt.nz/assets/Imported-from-old-site/RegulatoryControl/GasPipelines/ContentFiles/Documents/comcom-gascontrolinquirydraftreport-may2004.pdf

[15] Calculations of these balances are presented in Appendix E of the Shelley report

additional increase being unrecoverable (i.e. a loss to Transpower). This aligns with the Commission's view that Transpower is best placed to manage these risks, which were foreseeable.

To the extent that the CPI cap is a proxy for a competitive market, the Shelley report[16] identifies that one would therefore expect the allocation of allowed OPEX to HVAC customers to increase by 4.0% (i.e. the CPI movement for the 2008 year) or NZ$7.2m from 2007 to 2008 and 1.9% (i.e. the CPI movement for the 2009 year) (NZ$3.5m) from 2008 to 2009, with a total value of NZ$189.9m in 2009. This is considerably higher than the NZ$174.7m allocated by Transpower. The corresponding increases in HVDC costs would be 4.0% (NZ$0.8m) from 2007 to 2008 and 1.9% (NZ$0.4m) from 2008 to 2009, with a total value of NZ$21.6m in 2009. This is considerably lower than the NZ$36.8m allocated by Transpower.

Because there is a range of possible allocations that would be consistent with workably competitive markets (with the CPI proxy being just one), the Shelley report identifies four commonly accepted allocation methods in order to highlight the relativity of the resulting EV account balances to that determined by Transpower[17].

Approach A: the increase in IR costs is removed from the cost allocation calculation because, as identified by the Commission, that increase in costs would not be passed on to consumers in a workably competitive market. The EV balances are then calculated using Transpower's own allocation methodology;

Approach B: the allocated OPEX costs are indexed forwards at CPI from 2007 as this reflects the allowed increase in total allowed OPEX and is one proxy for how costs might be expected to move in a competitive market (refer Shelley report paragraphs 79 and 80);

Approach C: the costs allocated to the HVDC are set equal to the Shelley report estimate of stand alone cost (refer Shelley report paragraph 85). The cost allocated to the HVAC system is the residual difference between total allowed OPEX and the allocation to the HVDC system. The EV account balances calculated using the estimate of stand alone cost are an upper bound estimate of the balances that would occur in a competitive market; and

Approach D: the costs allocated to the HVDC are set equal to incremental costs (refer Shelley report paragraph 85). As with Approach C, the cost allocated to the HVAC system is the residual difference between total allowed OPEX and the allocation to the HVDC system.

[16] Shelley report, paragraph 80
[17] Shelley report, section 4.4

The EV account balances calculated using the estimate of incremental cost are a lower bound estimate of the balances that would occur in a competitive market.

Approaches A, C and D all exclude recovery of the increased IR costs. This aligns with our submission that the Commission has indicated that these costs should not be passed through to customers, but that Transpower's actions have yielded the same result as if they were passed through, with Transpower's shareholder taking no risk in this regard.

The Shelley report notes the resulting EV account balances[18]:

Approach A: with no increase in ancillary service charges, the EV account balances at the end of 2009 when applying Transpower's methodology are a NZ$68.0m debit (owing from customers) for the HVDC, and a NZ$74.0m credit (owing to customers) for the HVAC. The net balance of the EV account is a NZ$6.0m credit at the end of 2009.

Approach B: with allocated OPEX constrained by a CPI cap, the EV account balances at the end of 2009 are a NZ$78.9m debit (owing from customers) for the HVDC, and a NZ$84.9m credit (owing to customers) for the HVAC. The net balance of the EV account is a NZ$6.0m credit at the end of 2009.

Approach C: if the HVDC is allocated costs equal to stand alone cost excluding the unrecoverable IR costs, then the EV account balances at the end of 2009 are a debit balance of NZ$75.2m for the HVDC and a credit balance of NZ$81.2m for the HVAC. The net balance of the EV account is a NZ$6.0m credit at the end of 2009.

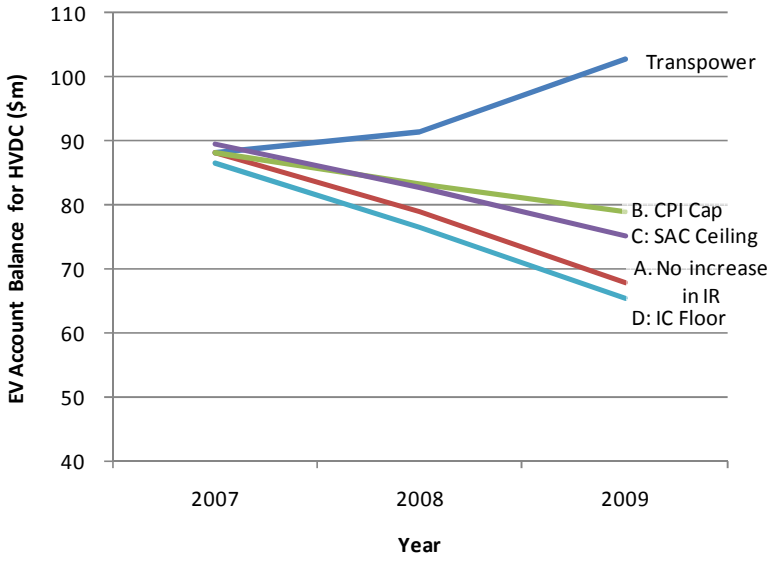
Approach D: if the HVDC is allocated costs equal to incremental cost excluding the unrecoverable IR costs, then the EV account balances at the end of 2009 are a debit balance of NZ$65.5m for the HVDC and a credit balance of NZ$71.5m for the HVAC. The net balance of the EV account is a NZ$6.0m credit at the end of 2009.

None of the approaches alters the current net credit balance of NZ$6.0m (at the end of 2009); they simply provide outcomes for component HVDC and HVAC accounts that would be observable in a workably competitive market, and which do not create cross-subsidisation between the HVDC and HVAC accounts. They all indicate a declining EV HVDC account balance over time, as shown below.

[18] Shelley report, paragraph 90.1 to 90.4

Figure 3 indicates how the allocation used by Transpower results in an EV HVDC account balance that is between NZ$27.6m and NZ$37.3m higher (i.e. more in favour of Transpower) than the outcomes that would be present in a market with workable competition.

Figure 3: EV HVDC balances (absolute values) as determined under workably competitive conditions[19]



Contact's view on the most appropriate allocation

Contact believes that the most appropriate allocation, and resulting EV account balance is that identified in Approach A, with the increase in IR costs removed from the cost allocation; consistent with the Commission's proposition that increases in these costs would not be passed on to customers in a workably competitive market[20]. This approach produces a closing EV HVDC debit balance for 2009 of NZ$68m in favour of Transpower, or ~NZ$35m less (lower debit) than the closing balance identified by Transpower, and assumed by the Commission to be applicable (an assumption that Contact considers to be incorrect).

Inconsistencies with, and links to, the Transmission Pricing Methodology

Contact's concerns around the existing EV account balances, and in particular the treatment of IR costs within them, are compounded when considering the resulting inconsistencies with other key methodologies impacting on the market for transmission services.

The current Transmission Pricing Methodology ("TPM") is effectively a simple sunk-cost allocation methodology which allocates the costs of the HVDC to South Island generators. Contact firmly believes this is inappropriate as it suggests that South Island generators are

[19] Shelley report, paragraph 93
[20] Shelley report, paragraph 84

the only beneficiaries of the HVDC asset. Any simple analysis of actual HVDC flows makes it clear that this is not the case. Even proponents of the current allocation will find it more difficult to support once the HVDC is augmented with Pole 3 in 2012 and island-based signals reduce.

Because the current TPM assigns responsibility for HVDC costs to South Island generators it is difficult to see how the Commission could support a mechanism which does not apply the same logic to the allocation of costs within the EV accounts. The cross-subsidisation highlighted earlier in this response (in the section "Allocation method for OPEX was not/is not consistent with competitive market outcomes") blurs the signals between HVDC and HVAC customers, with ancillary service costs specific to HVDC assets being spread across both groups of customers in a way that has detrimental effects on customers of transmission services. Given that the ancillary service costs for Pole 1 decommissioning related specifically to an HVDC asset, but were allocated by Transpower to both HVAC *and* HVDC OPEX within its revenue requirement calculations (and hence flow through to the EV account balances) why are HVDC charges via the TPM solely attributed to South Island generators? The Commission's position on the beneficiaries of certain assets is confusing and inconsistent in terms of how costs relating to these assets are to be recovered.

In addition, the marginal value of the HVDC to Contact reduces with the pass through of IR costs (whether directly or through the EV account), as this significantly reduces the benefit of the HVDC loss and constraint rentals. Those paying HVDC charges are effectively taking on the risk incurred by Transpower, while not receiving the benefits of funding that asset. Again, this highlights deficiencies in the TPM, but also the inconsistency between EV account treatment and the TPM.

Contact acknowledges that oversight of the TPM is currently the domain of the Electricity Commission (the "EC"), but the Commission is responsible for monitoring the appropriateness of Transpower's revenue recovery via the EV accounts. Accordingly, Contact submits that this issue is one the Commission must consider as the regulator of a service whose outcomes are those that would prevail in a market with workable competition.

In light of the potential impacts on consumers, Contact submits that the Commission must consider the inconsistencies between the TPM and the treatment of costs under the EV accounts.

Commercial impacts of current EV account management

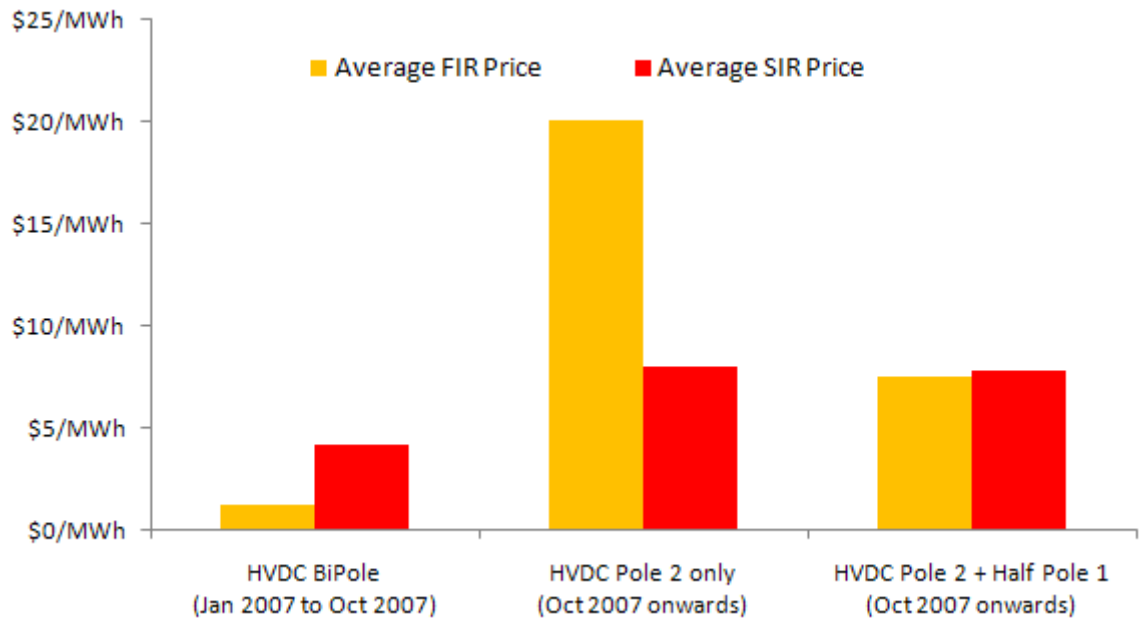
As described above, HVDC charges make up ~85% of the transmission charges that Contact pays each year, and hence they are a major focus of cost management and business optimisation. Any lack of transparency in the costs associated with the HVDC (like reserve availability charges) or distortions to signals because of inefficient cost allocations impact on the commercial decisions that Contact makes. This is elaborated in the following practical examples.

- Transpower's decisions regarding the decommissioning of Pole 1 of the HVDC lead to an increased requirement for IR, which as a result of Transpower's treatment of those costs had a material impact on the EV account balances. While both Pole 1 and Pole 2 were available, the risk needing to be covered by IR was spread across both Poles. The increased IR requirement following the decommissioning of Pole 1 drove up reserve prices because of the limited amount of IR capacity available in the market. Importantly, aside from interruptible load (IL), additional reserve often comes at the direct expense of energy (i.e. if a 1MW increase in reserve is provided by a generator that means 1MW less of energy can be provided). Given that the energy market is limited in terms of capacity (i.e. the margin between the total MW available (total theoretical capacity less capacity out for maintenance) and demand), large increases in reserve requirements can drive major changes in both reserve and energy markets.

  Figure 4 below shows how prices in the reserve market (both for FIR and SIR)[21] increased materially when Pole 1 was unavailable, with average SIR prices almost doubling, and FIR prices increasing by a factor of 16. Even now with Pole 1 being available on a limited basis ("half pole") reserve prices are much higher than they were prior to its decommissioning. Contact both sells and buys reserve, but is typically a net buyer so increased reserve prices are typically a negative impost. Other buyers and sellers of reserve also have to deal with these signals.

[21] FIR and SIR are the two types of reserve offerings; FIR (Fast Instantaneous Reserve) is a type of instantaneous reserve that is available within six seconds of an unexpected generator or transmission outage. SIR (Sustained Instantaneous Reserve) is available within 60 seconds and must be available for 15 minutes.

Figure 4: Average Reserve price when HVDC north transfer ≥ 500 MW



Clearly, Transpower's decisions around Pole 1 altered pricing in the IR market in a material way, and will have impacted on prices in the energy market. The impacts may have been quite different if the cost allocation method used by Transpower was consistent with a workably competitive standard.

- In managing the profile of its generation assets, Contact has to factor in how peak injection of generation from South Island hydro assets impacts the HVDC charges, including because these charges are based on HAMI (historical anytime maximum injection) – a measure reflecting shares of maximum peak injection. For example, an additional 20MW of injection from South Island hydro (for a trading period) could result in additional HVDC charges of ~NZ$0.5m p.a. There would need to be an adequate spot market return on this generation, for an appropriate duration (which is limited by inflows), to overcome the cost of the additional HVDC charges. Because of the uncertainty around the level of IR charges and how they are charged, analysing the additional generation vs. incremental HVDC charges "balance" is even more difficult.
- Were these charges more transparent, they would likely flow through to Contact's offers of generation into the spot market. Because visibility of these charges is inadequate, Contact's offer strategy is different than it would be were there more transparency.
- The lack of transparency around the IR component of the EV account balances has also affected the appropriateness of Contracts for Difference ("CFDs") purchased, as we allow for HVDC loss and constraint rentals in identifying volume requirements. We may have over/under hedged our real requirements, as a result.

- Forward pricing estimates from Transpower have not included EV recovery costs until very recently. These costs of recovery provide an additional hurdle for South Island generation investment options. The investment models that Contact uses for South Island generation investment proposals have not included the additional EV charges now indicated by Transpower.

Conclusions on existing EV balances

Contact believes a decision to recover the existing balances as proposed would not be consistent with the outcomes that would be prevalent in a market with workable competition, and certainly cannot be in the best interests of consumers.

The problems with the EV account balances prior to the settlement and the lack of transparency around them were effectively institutionalised via the administrative settlement with little or no robust analysis of those balances. Contact's view is that those balances were inappropriate at that time. As demonstrated above, these problems have been exacerbated during the period of the administrative settlement to the point where they are now demonstrably unreliable. Accordingly, Contact submits that the Commission can have no confidence in those starting positions and no confidence that they will send appropriate price signals to the market.

To illustrate, even when only accounting for appropriate treatment of HVDC/HVAC allocations under the OPEX cap (i.e. without adjustments for the other factors) *Contact submits that the closing 2009 EV HVDC balance should be a NZ$68.0m debit (owing from customers), and a NZ$74.0m credit (owing to customers) for the EV HVAC*[22].

The Commission must ensure that only the components of the existing balances which the Commission can clearly identify as being consistent with outcomes that could be sustained in a workably competitive market, and which promote the long-term benefit of consumers, can be carried forward to be recovered.

In addition, these issues cannot be permitted to prevail in any EV account mechanism that exists post-settlement as similar outcomes are likely to prevail that are not consistent with those of competitive markets. Contact's proposals in this regard are set in Section D.

[22] Via application of 'Approach A', noted earlier.

Section D: Draft determination; future EV application

Commission's draft decision to 'wind-up' existing mechanism supports need for material changes

The Commission's draft determination proposes that the full amount of the HVDC EV account balance, as at the expiry of the settlement, be recovered from HVDC customers by the end of the second regulatory control period, with the balance (including interest) being equally apportioned over each year of the first and second regulatory periods. Effectively, the Commission is 'winding-up' the existing balances over a period of nine years, and resetting the mechanism with adjustments (which we discuss further below).

The fact that the existing balances are being 'ring-fenced', and an amended mechanism is being proposed for the post-settlement period, supports Contact's submission that the existing balances are not appropriate. The effective disestablishment of the existing mechanism by the Commission affirms this view is correct.

Contact submits that any EV account mechanism which applies after the settlement has expired must rectify the issues we have outlined to this point. If this is not done, there are risks (outlined further below) that could lead to outcomes even less consistent with competitive outcomes than those that have occurred to date.

What an EV account mechanism needs to fulfil to meet the Commerce Act test – Contact's suggested approach

Contact submits that the following changes are necessary in order for Transpower to meet, or best meet, the s.52(A) purpose statement. Each change taken individually and all the changes when viewed in aggregate, will be materially better at achieving the s.52(A) purpose statement than the proposals in the Commission's IPP Reasons Paper.

Pole 3 commissioning risks should be borne by party best placed to manage them

The Commission has identified a 'transitionary period' which will include the period when Transpower has indicated it will commission Pole 3 of the HVDC. Transpower has indicated that it expects IR costs to be incurred during the commissioning, and Contact expects that these costs will be material. We have shown above[23] the impacts on both the IR and energy markets that previous decisions relating to HVDC assets have had.

[23] See section "Commercial impacts of current EV account management"

Contact submits that all HVDC project related IR costs associated with the commissioning should be capitalised as part of the project.

If this does not occur, it would appear that the transition period covering Pole 3 commissioning is knowingly allowing recovery of IR costs as occurred in relation to Pole 1 decommissioning.

Contact has requested (to Transpower) that this classification be formalised, to allow further discussion in this submission, however no formal response has yet been provided by Transpower. Contact's request is attached to this submission.

Separate accounts are required for HVDC and HVAC OPEX

Contact has identified the magnitude of the cross-subsidisation that has occurred as a result of Transpower's allocation of costs under the OPEX component of its revenue requirement calculations. Even when only accounting for appropriate treatment of HVDC/HVAC allocations under the OPEX cap (i.e. without adjustments for the other factors) this suggests that the HVDC EV balance should only be between $65.5m and $75.2m under various approaches that would occur in workably competitive markets; some NZ$27m to NZ$37 less than Transpower has calculated (and is attempting to recover). Contact does not accept that recovery at the level desired by Transpower is appropriate.

In what appears to be an acknowledgment that issues do indeed exist with these allocations, the Commission proposes in its draft determinations, two measures to rectify some of these issues[24]:

- By requiring consultation on the reasonableness of both HVDC and HVAC costs in aggregate, as part of the review of Transpower's OPEX proposal; and
- Requiring Transpower to publish its methodology for allocating costs between EV accounts, and the amount of those costs, as part of its compliance statement.

Contact does not believe that these proposed measures are sufficient to ensure that the EV account balances, and changes to the components of those balances, will achieve outcomes that are consistent with those that would be observable in competitive markets.

[24] The IPP Draft Reasons Paper, paragraph 3.6.1.

The proposed consultation process on the reasonableness of Transpower's costs (in aggregate) provides customers (and consumers) with no additional information on which they can judge the appropriateness of the allocation proposed by Transpower. The requirement on Transpower to publish an allocation methodology via a compliance statement will not create a sufficient incentive for Transpower to allocate costs appropriately. The Commission has not, to date, addressed the issues arising in relation to Transpower's cost allocations, so the onus would be on customers of transmission services to question the allocations; but even then there are no stated consequences for inappropriate allocations. Therefore, Contact does not expect the proposed measures to rectify the issues identified with the current cost allocations.

Contact submits that the only way an appropriate allocation of costs within the EV accounts can be assured is via the creation and maintenance of separate accounts for HVDC and HVAC OPEX, with their own individual CPI caps.

Cost allocation methodologies should align with those for Electricity Lines Businesses (ELBs)

Transpower should be required to publish details of the allocation methodology applicable for each of these individual EV accounts, to a level consistent with that required of ELBs[25]. Detailed commentary on the drivers of any changes in these individual accounts is also a requirement that customers of transmission services can reasonably require.

Contact's proposal to create separate HVDC and HVAC EV accounts will reduce the likelihood of the current cross-subsidisation occurring in the future. We have already identified that this has lead to the current HVDC EV account balance being NZ$34.8m more negative (i.e. a larger debit) than would be observable under certain workably competitive market conditions[26].

[25] Supported by the Shelley report, see paragraph 120
[26] See section "What would the EV account balances be if Transpower's treatment of OPEX costs was consistent with that of a workably competitive market?"

IR costs must be CAPEX for HVDC projects, including transitionary period

Contact has identified how Transpower's inclusion of significant IR costs resulting from the decommissioning of Pole 1 as OPEX had the same effect as if those costs were treated as pass-through costs; a classification which the Commission explicitly rejected, when Transpower requested to be allowed to do so, as being inappropriate.

Contact submits that Transpower recovered these IR costs from its customers through an inappropriate allocation methodology, with its shareholder taking no risk. Contact's view is supported by the Commission's acceptance that:

"…neither the combination of circumstances nor the likely magnitude of the instantaneous reserve costs were unforeseeable"

We note again the significance of this allocation, with IR costs totalling NZ$44.4m over 2008 and 2009 collectively.

The draft determination proposes that IR costs should be treated as recoverable costs. Contact does not agree, including given what in our view are the very limited differences between recoverable costs and pass-through costs[27]. This approach would increase uncertainty for Transpower's customers because the classification of costs may change and impact on their charges from Transpower.

In its draft determination, the Commission notes that there would be "unmanageable costs" on Transpower if IR costs were treated as OPEX. While the draft determination is silent on the exact reasons for this, Contact assumes that this assertion is driven by concerns around the foreseeability and/or predictability of future IR costs on Transpower. This is, however, directly at odds with the Commission's previous statements around IR cost predictability in its rejection of Transpower's proposed settlement amendment.

We have noted that there will be IR costs associated with the commissioning of Pole 3 of the HVDC. Given the materiality of the investment, it is likely that the IR costs could exceed those associated with decommissioning of Pole 1. Transpower is in the best position to manage these costs because it is managing the timing, staging, construction and overall project development of the upgrade.

[27] The only notable difference appears to be that the Commission can revisit the classification of a recoverable cost at a later date (without consultation).

Contact understands and recognises the value in having good quality measures to drive the right behaviour. It is also essential to have key performance measures that have clear commercial drivers that are simple and easy to measure.

Contact therefore submits that:

- IR costs attributable to HVDC projects must be capitalised as part of project costs (i.e. included in CAPEX) **not** treated as recoverable, pass-through or OPEX costs. **This allocation should occur for the transitionary period as well as post settlement.**
- IR costs that are not directly attributable to HVDC projects should be treated as OPEX, with appropriate allocations to the HVDC account). Once Pole 3 is commissioned, the HVDC poles will be effectively self covering (with expected transfer levels) and IR availability charges should be minimal.
- As set out in the Commission's draft determination, when there is an HVDC Pole outage, reserve costs should not be recoverable (via pass through, recoverable cost or OPEX or otherwise). We submit, however, and differently from the Commission's expressed view, that there should also be no 14 day 'grace period' in favour of Transpower. This becomes a strong commercial quality measure on Transpower to manage risks appropriately, similarly to other parties in the market.

These conclusions and their links to treatment for the existing asset (i.e. Pole 1 and 2) are summarised in the table below:

Asset	CAPEX	OPEX*	Commentary
Pole 3 Project	✓	×	Reserves should be capitalised to project.
Pole 1 and 2	×	✓	As per current status; incentive on Transpower to make Pole 1 available to minimise risk exposure
HVDC Bi-pole	×	✓	Incentive on Transpower to make HVDC poles available to minimise risk exposure. Low IR availability costs when both poles are available.

* OPEX consequence of asset unavailability, **cost to Transpower**.

The above proposals will help ensure Transpower is incentivised to be efficient in its planning and execution of investments, as required by the applicable regulation.

Any alternative classification – including the one proposed by the Commission – would see risk transferred to customers who are not best placed to manage that risk. As identified by the

Commission, Transpower needs incentives to manage costs appropriately in order to create outcomes that are analogous with those applying of workably competitive markets:

…the incentive to manage risk and manage costs appropriately… is consistent with the concept that a well-functioning workably competitive market would apply the risk to those who can best manage those risks. Encouraging Transpower to manage its risk and costs provides Transpower with incentives to improve efficiency and provide services at a quality that reflects consumer demands (consistent with section 52A(1)(ii)).

The risk for customers of similar outcomes to those that applied with the decommissioning of Pole 1 is accentuated by the fact there are no quality measures associated with the commissioning of Pole 3. Customers have no assurance that Transpower, with the knowledge that the existing allocation of the resulting costs will simply be recoverable from customers, will not take inappropriate risks during this upgrade. The only appropriate way to ensure Transpower is incentivised to manage this risk is to not permit it to be recovered as OPEX, pass-through or recoverable costs. This also reinforces the need to have IR costs during the transitionary period (which includes Pole 3 commissioning) treated as project CAPEX where relevant.

This puts the onus on Transpower to improve its forecasting of costs, an issue on which the Commission has previously commented and one that has driven the ballooning of EV account balances to a level of divergence of over NZ$200m. Allowing costs to be classified as recoverable is not a decision that would be permitted in a market with workable competition, and it is certainly not in the best interests of consumers.

Risk with regulatory control period 're-set' of EV account balances

The Commission's draft determination proposes that post settlement, recovery of an EV account balance accrued during the term of a regulatory control period should occur within the next regulatory control period. Contact understand that this means that payments for each year within a regulatory control period will be determined so as to re-set the EV account balance to zero by the end of that period.

Contact submits that this approach is only suitable if issues around the allocation of IR costs, separation of HVDC and HVAC accounts for OPEX, and certainty around cost allocation mechanisms have been resolved. If not, we expect that the cost allocations which we have seen to date and which contributed to the ballooning of the existing EV account balances will occur again, but be expected to be recovered over a much shorter time period.

The absolute levels of the existing balances are not appropriate (as we have identified above[28]) but the perpetuity of the recovery has helped to reduce year-on-year variability. However, with what is effectively a regulatory control period re-set, a major cost increment that occurred mid-period could result in a substantial cost needing to be recovered towards or at the end of the relevant period. This would mean the volatility of EV account repayments/recoveries would increase from year 1 to year 5 of the regulatory control period.

Allowing revenue requirements to be adjusted within regulatory periods

If issues around, for example, the classification of IR costs and OPEX can be appropriately remedied, Contact sees value in revenue requirements being adjustable within regulatory periods as opposed to being 'washed-up' at the end of each period. A final year wash-up increases variability in charges to customers and creates uncertainty, which Contact submits is inherent in the existing mechanism, to the detriment of transmission service customers.

Contact considers, however, that a suitable threshold is required to eliminate material errors in forecasting of costs being introduced within a regulatory period.

Consistency in WACC reporting required for certainty

Transpower is required to publish a WACC estimate for: (a) information disclosure purposes, and (b) as part of the determination of the revenue requirement. These WACC are typically different, and create confusion for customers of transmission services seeking to understand the appropriateness of Transpower's return, and how this aligns with regulatory requirements.

Contact submits that a single WACC should be produced and applied consistently by Transpower for ease of interpretation by customers of transmission services.

Accounting treatment of EVA balances

The value of the EV assets is recovered via an annual addition to (or subtraction from) the Maximum Allowable Revenue (MAR) plus an interest charge on the balance of the account, charged at the WACC.

Contact submits that EV account balances are a financial asset; something that generates a future stream of cash-flows and should be treated as such. The recovery mechanism

28 Contact's view on the most appropriate allocation

established by the Commission, and amended through the draft determination, seeks to set out how those cash-flows will be recovered over time. This is similar to the way costs for Transpower's physical assets are recovered[29].

[29] The Shelley report (section 5.1) presents an economic view of EV account balances as an asset.

Conclusions

There is no evidence on which the Commission can base its judgment that the existing EV account balances represent an appropriate starting point for the EV account recovery process proposed. Analysis of the existing balances and how they were disclosed highlights that they are not representative of outcomes that would occur in a competitive market, and that they are not in the best interests of consumers:

- The level of disclosure about HVDC and HVAC account balances has been insufficient to allow Transpower's customers to properly understand the movements in the EV account balances (i.e. the individual HVDC and EV HVAC account balances), and the drivers of movements in these balances. The publishing of only net balances has masked underlying (diverging) trends in the EV HVDC and EV HVAC accounts.
- During the period prior to the settlement, and therefore before there was any disclosure of the individual EV account balances, those individual EV account balances ballooned; with the EV HVDC account balance increasing (becoming more negative) by over NZ$85m from 2003 to 2007 and the EV HVAC account balance increasing (becoming more positive) by over NZ$55m over the same period. Transpower bore no cost risk and hence its incentives to manage costs were low.
- Between 2007 and 2009 the EV HVDC account balance increased from an opening debt of NZ$62.4m to a closing debit balance of NZ$102.8m. This outcome was driven primarily by the substantial increase in IR costs that was initially borne by Transpower as a direct result of its decision to decommission Pole 1 of the HVDC link. Transpower's decisions led to ancillary services costs of NZ$15.8m and NZ$28.6m being incurred in 2008 and 2009 respectively, which were included as OPEX in Transpower's revenue requirement.
- Transpower's treatment of IR costs has had the ***same effect*** as if the costs were treated as pass-through costs, even though the Commission supports the view that IR costs must not be treated as pass through costs and noted the undesirable incentives and signals that would be provided should they be passed through.
- This passing through of IR costs has significantly eroded the value of loss and constraint rentals to Contact; Transpower's customers are paying for risk taken by Transpower, yet not receiving the benefits. This highlights inconsistencies with the EV account mechanism and the Transmission Pricing Methodology ("TPM"), as well as deficiencies with the TPM itself.
- IR costs have been allocated in a way whereby HVDC customers subsidised HVAC customers.

- Transpower's decisions around Pole 1 have altered pricing in the IR market, and in the energy market.

The Commission must ensure that only the components of the existing balances that can clearly be identified as consistent with outcomes that would apply in a workably competitive market and promote the long-term benefit of consumers are carried forward. Contact submits that even when only accounting for appropriate treatment of OPEX costs, the appropriate closing EV HVDC balance for 2009 is NZ$68m, or ~NZ$35m less (lower debit) than the closing balance identified by Transpower, and assumed by the Commission to be applicable.

The fact that the existing balances are being 'ring-fenced', and an amended mechanism is being proposed for the post-settlement period, supports Contact's submission that the existing balances are not appropriate. These issues cannot be permitted to continue under any EV account mechanism that exists post-expiry of the settlement, because that will lead to similarly unsatisfactory outcomes in the future.

Contact does not believe that the Commissions amendments to the EV mechanism go far enough, and submits that, in order to ensure outcomes associated with the EV account are consistent with those that would occur in competitive markets:

- Separate accounts for HVDC and HVAC OPEX (with their own individual CPI caps) must be created and maintained, with disclosure of cost allocation methodologies to those accounts being to a standard required by electricity distribution businesses.
- IR costs attributable to HVDC projects must be capitalised as part of project costs **not** treated as recoverable, pass-through or OPEX. This should occur during the transitionary period as well as post settlement.
- IR costs that are not directly attributable to HVDC projects should be treated as OPEX, with appropriate allocations to the HVDC account.
- When there is an HVDC Pole outage, reserve costs should not be recoverable (via pass through, recoverable cost or OPEX costs or otherwise), and no 14 day 'grace period' should apply either.
- Recovery of EV account balances over the subsequent regulatory control period can only occur if issues around the allocation of IR costs, separation of HVDC and HVAC accounts for OPEX, and certainty around cost allocation mechanisms have been resolved.