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Dear Karen

Meridian Energy's submission on Transpower's input methodologies determination and draft reasons paper

Introduction

- 1 Meridian Energy Limited (*Meridian*) thanks the Commerce Commission (*Commission*) for the opportunity to submit on the development of regulation to apply to Transpower under the new Part 4 (of the Commerce Act) regulatory regime. This submission responds to the following documents released by the Commission:
 - 1.1 Individual Price-Quality Path Transpower Draft Reasons Paper (June 2010) (*Price-Quality Draft Reasons Paper*);
 - 1.2 Input Methodologies Transpower Draft Reasons Paper (June 2010); and
 - 1.3 Draft Commerce Act (Transpower Input Methodologies) Determination 2010.
- 2 As a consumer of transmission services, Meridian looks forward to the commencement of a new regulatory regime which is fair to both Transpower and Transpower's consumers. In this respect, Meridian's interests are aligned with the Commission – we are concerned to ensure that the Commission puts in place the best possible regulatory regime applying to Transpower. In the context of Part 4, this means that:
 - 2.1 first and foremost, regulation must promote the long term interests of consumers of transmission services. As the Commission has done in the airports process, "consumer" should be interpreted broadly to include both the immediate acquirer of transmission services and the end consumer;

- 2.2 regulation must promote consistency and certainty for consumers of Transpower's services; and
 - 2.3 the regulatory regime must provide strong incentives for efficiency, cost minimisation and quality of service, while also allowing Transpower to earn a fair and normal return on its capital (consistent with the Commission's NPV=0 principle).
- 3 Meridian appreciates the work done by the Commission to date in formulating the regulation to apply to Transpower. We are also conscious that we are entering the consultation process at a relatively late stage. With that in mind, and recognising the Commission's difficult timeframe, we have restricted our submission to issues arising mainly from the Price-Quality Draft Reasons Paper. We reserve our position on the more substantive "building blocks" input methodologies which are the subject of the Input Methodologies Transpower Draft Reasons Paper.
- 4 Consistent with the purpose of Part 4, in making our submission we have at all times considered whether the Commission's proposals will promote outcomes consistent with those produced in workably competitive markets such that the regulatory objectives in the purpose statement are achieved. For Meridian, there are three elements which we see as crucial to achieving that purpose:
 - 4.1 Pricing for transmission services must be at a level such that Transpower recovers from its customers no more than a reasonable rate of return. Importantly, pricing must be cost reflective and there must be no element of monopoly profit;
 - 4.2 Regulation must create incentives that would typically be seen in workably competitive markets. That is, Transpower must face incentives to minimise its costs, efficiently invest in (and maintain) transmission assets, and generally provide a quality service at lowest cost to the consumer; and
 - 4.3 Regulation must set a high standard for quality and reliability of service (while avoiding "gold-plating" of its assets) and provide incentives to improve quality and reliability over time.
- 5 In addition to this submission, Meridian has engaged NERA Economic Consulting to prepare a report on Transpower's treatment of operating costs under the settlement (*NERA Report*), which we attach to this submission.
- 6 Finally, Meridian has previously made submissions to the Commission on matters which are addressed in the Price-Quality Draft Reasons Paper. We expressly incorporate the following submissions into the record for this consultation process and refer the Commission to the parts of the submissions that address issues considered in this submission:
 - 6.1 Meridian Energy "*Submission to the Commission's on its draft decision not to declare control of Transpower*" (9 November 2007);

- 6.2 Meridian Energy “Cross submission on the Commission’s proposed rejection of Transpower’s proposal to amend its administrative settlement” (24 October 2008).

Executive summary

- 7 Meridian has three main concerns with the Commission’s proposed regulation to apply to Transpower.
- 8 Our primary concern is with the Commission’s draft decision to carry over the full amount of the HVDC economic value account (*DC EV account*) into the Part 4 regime. This draft decision implies an annual positive 20% economic value adjustment (*EV adjustment*) to HVDC prices over the next nine years. With such a significant impact on prices, Meridian expects that the Commission would carefully consider whether the balance of the DC EV account might result in prices over time that are inconsistent with what would be observed in a workably competitive market. However, the Commission passes over this issue in its Price-Quality Draft Reasons Paper without proper discussion.
- 9 Below we discuss three issues with the DC EV account balance that we submit gives the Commission legitimate grounds to doubt whether its draft decision to carry over the full balance is correct in light of the purpose of Part 4. We conclude that there is a portion of the balance that likely represents over-recovery by Transpower and therefore should not be carried over. In light of our submission, Meridian believes that the Commission has a duty to properly assess whether the carry over of the full balance of the DC EV account would promote the purpose of Part 4. The basic question the Commission needs to ask is “does the balance of the DC EV account actually represent under-recovery of a normal rate of return on the HVDC assets?”
- 10 The second main concern is with the Commission’s decision to treat instantaneous reserve availability charges (*IR costs*) as a Recoverable Cost. The Commission had decided as recently as last year that the treatment of IR costs as part of opex was the approach that would best promote the purpose of Part 4. In rejecting Transpower’s proposal to treat IR costs as a pass through cost, the Commission found that IR costs were foreseeable, could be controlled to some extent by Transpower, and would create appropriate incentives for Transpower to efficiently manage its transmission assets.
- 11 Meridian submits that IR costs should remain part of Transpower’s opex for largely the same reasons the Commission gave in its IR costs decision last year. In the alternative, Meridian has identified two other possible approaches to IR costs (but less efficient) which the Commission should give careful consideration to.
- 12 Thirdly, Meridian has some concerns with the Commission’s proposed quality standards. First, the 5 year historical data set that the Commission intends to use to set targets, caps and collars reflects a period of poor performance by Transpower and should not be used to set quality standards. An historical data set of at least 7 years is required. Secondly, the Commission’s proposal to exclude bi-pole availability from the incentive regime in the first regulatory control period (*RCP1*) leaves Transpower with no

13 Finally, Meridian is keen to ensure that Transpower provides bi-pole availability at all possible times, especially during the commissioning of Pole 3. This is the most efficient outcome and consistent with what we would expect to see in a workably competitive market. Meridian is keen to ensure that Transpower will use its best endeavours to ensure bi-pole availability.

14 The table below summarises Meridian’s key submissions in respect of the Commission’s draft decisions.

Key issue	Commission’s draft decision	Meridian’s response
Balance of DC EV account to be carried over	Carry over the full balance of the DC EV account to the Part 4 regime	Meridian disagrees. There is a portion of the DC EV account balance which should not be carried over into the Part 4 regime. That portion represents over-recovery of HVDC charges and to carry over that balance would be inconsistent with the purpose of Part 4.
EV framework	Retain a similar EV framework with the following key features: <ul style="list-style-type: none"> ▪ capex, pass through and recoverable costs, and other building block inputs subject to a wash up ▪ balance of EV account at the end of one regulatory period to be recovered in full by the end of the next regulatory period (i.e. resetting the EV account to zero for the start of each regulatory period). 	Meridian agrees. However, Transpower must be incentivised to increase the accuracy of its forecasts in order to avoid inconsistent and uncertain pricing for the HVDC service.
Instantaneous reserves costs	Treat as a Recoverable Cost.	Meridian disagrees. IR costs should be treated as part of opex, with a reasonable amount attributed to IR costs under the opex cap. This is

		<p>consistent with the Commission's decision on the treatment of IR costs in 2009 and the nature of IR costs as foreseeable and within the control of Transpower. Importantly, it would also maintain appropriate incentives on Transpower to minimise IR costs.</p> <p>Meridian also suggests alternative but less efficient approaches to the treatment of IR costs.</p>
Number of revenue requirements	One revenue requirement covering HVAC and HVDC	<p>Meridian disagrees.</p> <p>The Commission's decision risks inappropriate HVDC price increases and incorrect allocation of opex costs.</p> <p>Consistent with the NERA's advice to Meridian, the Commission should at least establish separate opex caps for HVDC and HVAC.</p>
Content of compliance statement	The Commission will require Transpower to publish a written statement confirming Transpower's compliance (or otherwise) with the individual price-quality path set by the Commission.	<p>Meridian agrees.</p> <p>In addition to the Commission's proposed information requirements for the compliance statement, Meridian submits that Transpower should be required to disclose a comparison of its forecast and actual revenue requirements for the HVDC service, broken down into component forecasts.</p>
Quality measures	Apply a performance incentive regime with a symmetrical approach allowing for penalties and rewards	<p>Meridian generally agrees with the Commission's overall approach.</p> <p>However, Meridian disagrees</p>

	Use targets, caps and collars to be set performance standards	<p>with the Commission's following draft decisions:</p> <ul style="list-style-type: none"> ▪ to set the targets, caps and collars based on a historical data set of five years from 2004/05 to 2008/09 ▪ to not include bi-pole availability in the performance incentive regime for RCP1 ▪ Not to enforce quality target in RCP 1.
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Economic value account

Introduction

- 15 Meridian's primary concern in relation to the EV account is with the amount of the balance of the DC EV account that is to be carried over into the new Part 4 regulatory regime.
- 16 As the largest consumer of HVDC transmission services, the impact of any decision by the Commission on the appropriate amount of the DC EV account balance to be carried over will significantly impact Meridian. The EV adjustment component of HVDC pricing is substantial – in recent years HVDC prices have included an annual positive 10% EV adjustment. Such an increase will also inevitably filter through to end consumers in the form of higher retail prices for electricity.
- 17 It is appropriate that Meridian should be concerned that the balance of the DC EV account is fair to all parties and does not result in prices over time that are inconsistent with what would be observed in a workably competitive market. Three particular issues with the DC EV account give Meridian grounds for concern:
- 17.1 there has been a considerable lack of transparency with respect to the EV accounts, particularly prior to Transpower's administrative settlement with the Commission in 2008;
- 17.2 given Transpower was effectively an unconstrained monopolist prior to the settlement, and the Commission has previously acknowledged that Transpower over-recovered during the period prior to the settlement,¹ there are legitimate grounds for questioning whether inputs into the EV accounts during this period reflected returns that would be seen in a workably competitive market; and

¹ Commerce Commission "Decision and Reasons for Not Declaring Control of Transpower New Zealand Limited & Decision to Reset Transpower's Thresholds" (13 May 2008), paragraph 303.

- 17.3 Transpower's method for allocating operational expenditure during the settlement period appears to have had the effect of cross-subsiding the operating costs associated with providing HVAC transmission services at the expense of HVDC customers.
- 18 The sum of these concerns is that Meridian is not satisfied that the current balance of the DC EV account will result in prices over time that are consistent with what would be seen in a workably competitive market. We elaborate on these issues below.

Context for the Commission's draft decisions on the EV account

- 19 The EV account has been a feature of Transpower's pricing in two distinct periods: prior to Transpower's administrative settlement with the Commission and post-settlement. The distinction arises from the fact that, prior to the settlement, the EV account was a commercial construct which formed part of Transpower's pricing for transmission services. Post-settlement, the EV account became part of the regulation applying to Transpower under Part 4A of the Commerce Act. One of the more significant differences between the two periods is that, under the settlement, Transpower's revenue requirement is set on the basis of a prescribed building blocks approach, whereas prior to settlement the revenue requirement was set by Transpower at its discretion.
- 20 As well as endorsing the economic value framework, the settlement carried over the balance of the DC EV account as at 30 June 2008, which had by then grown to -\$88.1 million (to be recovered from HVDC customers).
- 21 The DC EV account has accumulated a balance in a way that is structural. As the Commission acknowledges, this is not ideal from a regulatory perspective and is at odds with the EV account's nature as a wash up mechanism. The key drivers of the structural balance appear to have been:
- 21.1 a series of substantial revaluations in the years prior to the settlement. Transpower revalued its assets downward, and whenever it did so it credited the change in value against the DC EV account;
 - 21.2 since settlement the retirement of Pole 1 in the HVDC link has seen Transpower spend more on Ancillary Reserves (mainly IR costs). This has caused Transpower to overspend its opex cap and the subsequent reductions it is required to make to remain within the cap have had the effect of cross-subsidising the operating costs associated with providing HVAC transmission services at the expense of HVDC customers;
 - 21.3 the rule restricting recovery of the EV account to 10% of the forecast revenue requirement, combined with the provision of interest, has meant the current balance is almost perpetual.
- 22 The introduction of the Part 4 regulatory regime requires the Commission to determine new regulation to apply to Transpower. This includes requiring the Commission to

- 22.1 what should the design of the EV framework or wash up regime going forward be; and
- 22.2 how much of the current balance of the DC EV account should be carried over to the new Part 4 regime.

The Commission's draft decisions

- 23 The Commission's draft decisions on the DC EV account are as follows:
 - 23.1 the full amount of the DC EV account balance at the expiry of the settlement is to be recovered from HVDC customers by the end of the second RCP (a period of nine years). The balance (plus any forecast interest) must be apportioned equally over each year of the first and second RCPs;
 - 23.2 the use of a DC EV account will continue under the Part 4 regulatory regime. All economic gains or losses in respect of the HVDC service must be calculated annually and must be transferred to the DC EV account. At the end of each RCP, the closing balance of the DC EV account (plus forecast interest) must be fully apportioned over each year of the next RCP so that the balance of the DC EV account returns to zero by the end of the next RCP; and
 - 23.3 the balance of the DC EV account will accrue interest at Transpower's cost of capital.

Some initial comments on the EV account

- 24 Meridian is conscious that it is standard regulatory treatment of transmission services to apply a revenue cap, and it is standard for a revenue cap regime to include a wash up mechanism to account for divergences from forecasts. We agree with the Commission that an EV framework should be a part of the regulation applying to Transpower. We also broadly agree with the shape of the wash-up regime which the Commission proposes. However, Meridian expects the number of items that can be washed up into the EV account should reduce over time. For example, we would expect capital costs to be excluded within two RCP.
- 25 Our key concern lies with the amount of the balance of the DC EV account to be carried over into the new Part 4 regime. The importance of this decision by the Commission cannot be understated. The Commission's proposal to allow Transpower to recover the full balance of the DC EV account over two RCPs implies an annual positive 20% EV adjustment to HVDC prices over the next nine years.
- 26 The Commission must recognise that the EV adjustment component of HVDC prices is just as significant as other building block inputs into the calculation of prices. The

- 27 Meridian submits that the Commission can only carry over that part of the balance of the DC EV account that the Commission is confident would result in prices over time that are consistent with what would be observed in workably competitive markets. Framed another way, the Commission needs to ask “does the balance of the DC EV account actually represent under-recovery of a normal rate of return on the HVDC assets?”
- 28 In this context Meridian is not alleging a breach of the settlement. Nor is Meridian re-litigating the decision to endorse the EV account balance at the start of the settlement. But we are firm in our view that the Commission now faces a separate decision as to how much of the DC EV account balance should be carried over into the new Part 4 regime, and it has a legal obligation to be satisfied that any balance carried over and recovered by Transpower from its customers is consistent with outcomes that would be observed in workably competitive markets.
- 29 Once the Commission has decided the appropriate amount of the DC EV account balance to carry over into the Part 4 regime, Meridian agrees that the proper method for Transpower to recover the balance is through adjustments to future prices. Meridian wishes to make it clear that this is not an exercise in allocating the balance of the DC EV account to particular parties. The balance of the DC EV account cannot be allocated in this way. The EV account represents a claim made by Transpower to future revenue, not a past debt.
- 30 In any one year the balance of the DC EV account is applied to customers in the same proportion as HVDC charges, and under the Transmission Pricing Methodology HVDC charges are applied in proportion to HAMI in that year. If, going forward, a South Island generator was to reduce generation (or cease altogether) then its exposure to future allocations of the DC EV account would also reduce (or cease). The Commission appears to recognise this important aspect of the DC EV account at paragraph 3.9.17 of the Price-Quality Draft Reasons Paper.
- 31 However, we disagree with the Commission’s description of the balance of the DC EV account as “being essentially a liability owed by another party”.² To describe the DC EV account balance as a liability or debt is plainly incorrect and undermines the basic principles of the EV framework. As we point out above, the EV account can only be recovered (or returned as it may be) by future prices. If anything can be described as essential about the EV account, it is its nature as an input into the calculation of Transpower’s revenue requirement.

² Price-Quality Reasons Paper, paragraph 3.9.17.

- 32 As Meridian has previously written to the Commission advising of the correct legal status and accounting treatment of the EV account,³ it would be helpful if the Commission referred to the EV account correctly and avoided the connotations associated with the terms “liability” and “debt” – terms which describe something that the balance of the EV account is clearly not.
- 33 Finally, we note that the Commission appears to allow a consideration of the proposed asset swaps between Meridian and Genesis Energy Limited to influence its judgement in respect of its proposed treatment of the balance of the EV account (in particular the timing of recovery). We remind the Commission that its task is to make principled regulatory decisions which promote the purpose of regulation under Part 4. Concerns regarding the implications of any changes in ownership of South Island generation assets are the concern and responsibility of the parties to any such transactions, not the Commission. The parties to any asset swap transaction are likely to factor into their considerations the EV account within the context of commercial negotiations.

Balance of the DC EV account to be carried over

- 34 Meridian’s concern regarding the balance of the DC EV account to be carried over is ultimately a concern about regulation which promotes the purpose of Part 4.
- 35 The Commission is tasked with implementing regulation which promotes outcomes consistent with outcomes produced in workably competitive markets such that the regulatory objectives in the purpose statement are achieved. One crucial outcome is that prices should, over time, be consistent with what would be seen in a workably competitive market. In other words, pricing should be cost reflective and allow Transpower no more than a normal return in the long run.
- 36 If the balance of the DC EV account to be carried over would result in prices over time that allow Transpower to recover more than a normal return, then that full balance cannot be carried over. To do so would be wrong in law and fly in the face of the Commission’s FCM principle. An important consideration here is that it is prices *over time* that is what matters. We recognise that, because of the nature of EV account, adjustments in any given year to prices may not necessarily result in prices that are entirely cost reflective or represent a normal return for that year.
- 37 Meridian submits that there are three key reasons which strongly indicate that carrying over the full amount of the balance would result in prices over time that are consistent with what would be seen in a workably competitive market. We discuss these reasons now.

³ Meridian Energy, Letter to Brent Alderton “*Legal Status of the Economic Value Account (EVA)*” (16 June 2010).

Lack of transparency

- 38 The level of transparency in regard to the EV account has always been a matter of concern for Meridian. In 2007, we submitted on the significant deficiencies in transparency of the EV account during consultation on the Commission's decision whether to declare control of Transpower.⁴
- 39 When discussing a lack of transparency, we wish to make it clear that we are referring to a lack of adequate information from Transpower regarding movements in the EV account. One question permeates our views on this subject: has sufficient information been made available in order to understand what the DC EV account balance and adjustments relate to, and with sufficient detail such that customers can meaningfully respond? In Meridian's view, the answer to this question is no.
- 40 The lack of transparency is particularly evident in the period prior to settlement, where there were no rules in place regarding the operation of the EV account or any reporting requirements in respect of it. During this period, Meridian had access to two sources of information only:
- 40.1 Transpower's Pricing for Grid Connection Services 2001 which discussed at a high level how EV adjustments were made; and
 - 40.2 Transpower's annual report, which contained very brief statements relating to the EV account.⁵
- 41 This information was simply not sufficient for Meridian or the Commission to understand the key movements in the EV account. For one, the EV account was an aggregate account – that is, the EV account applied to both the HVAC and HVDC services, even though those services are entirely separate and have different cost inputs and revenues. But perhaps more importantly, Transpower has never provided a detailed breakdown of the reasons for changes to the balance of the DC EV account. Meridian and other HVDC customers have essentially been left to make an educated guess as to what has contributed to changes in the balance of the DC EV account. Information provided prior to the settlement permitted only a general inference: that Transpower had forecast its revenue requirement, the actual revenue requirement did not equate to that forecast, and therefore the DC EV account balance has changed.
- 42 While the situation has improved considerably under the settlement, it remains unclear what drives the yearly change to the balance. Transpower's compliance statement of course describes the various cost components of the HVDC service, and whether the overall forecast revenue requirement matches with the ex-post calculated revenue requirement. But it does not clearly articulate what component forecasts were incorrect and why they were incorrect. A qualitative statement describing the key reasons for a change in the DC EV account balance would have provided more transparency.

⁴ Meridian "Submission to the Commerce Commission on its draft decision not to declare control of Transpower" (9 November 2007) page 6.

⁵ For example, see Transpower's 2006/07 Annual Report which gives two sentences describing the purpose of the EV account followed by the current balance of the account (although it should be noted that the balance is not disaggregated into the DC and AC EV customer accounts).

- 43 Meridian considers that, as a large consumer of the HVDC service – paying tens of million dollars per year for the service – we are entitled to know with a reasonable level of confidence what we are paying for. In respect of the DC EV account, it is plain that we cannot be sure. That being the case, we also have doubts whether the Commission has legitimate grounds to be confident of what the balance represents.

Consistency with workable competition standard

- 44 In the period prior to settlement, Transpower was effectively an unconstrained monopolist. The only regulatory constraint on pricing faced by Transpower was the thresholds regime introduced in 2004, and Transpower consistently breached the applicable thresholds.

- 45 The Commission has itself recognised that Transpower over-recovered during this time:⁶

However, 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 customers during that period. As such, adjustments through the EV customer account should be made for both over-recovery and past under valuations during the period 1998-2006 or should be made for neither. Having discussed this matter further with Transpower, it now proposes that it will not adjust the EV customer account for past under valuation of assets. The Commission has accepted Transpower's offer as a pragmatic solution to balancing the two matters.

- 46 We note the Commission's basic point that Transpower's under valuation of its assets was netted off against its over-recovery. However, Meridian has serious doubts as to the robustness of this method of netting off. The approach by the Commission seems distinctly unscientific. The Commission states that the netting off was a "pragmatic solution to balancing the two matters". While it may have been pragmatic at the time, it remains unclear whether the two values (under valuation vs. over-recovery) did in fact equate to zero. Further, in matters as important as this, we would expect to see the Commission making *principled* decisions.

- 47 In this context, there is no objective reason to conclude that Transpower's pricing and revenue during this period reflected the workably competitive level. This directly impugns the DC EV account balance relating from this period. The DC EV account balance of -\$88.1 million (as at the time of the administrative settlement) is simply the proportion of revenue that an unconstrained monopolist thought it was entitled to receive.

- 48 In the absence of any clear affirmation from the Commission that inputs into the DC EV account at this time were consistent with the workable competition standard, Meridian submits that Transpower must demonstrate to the Commission and to HVDC customers that the balance accrued from this period is fair. Otherwise, the Commission runs the

⁶ Commerce Commission "Decision and Reasons for Not Declaring Control of Transpower New Zealand Limited & Decision to Reset Transpower's Thresholds" (13 May 2008), paragraph 303.

risk of setting prices under the Part 4 regime which will allow Transpower to recover more than a normal return over time. The purpose of Part 4 explicitly requires the Commission to make regulatory decisions that limit the ability of suppliers from extracting excessive profits. The Commission needs to be sure that carrying over the balance of the DC EV account from the period prior to the settlement will not defeat the purpose of regulation under Part 4.

Allocation of operational expenditure inconsistent with workably competitive market outcomes

- 49 Meridian also considers that the balance of the DC EV account relating to the post-settlement period is likely to contain a portion which represents over-recovery of HVDC revenue by Transpower. In particular, it has become apparent to Meridian that the method in which Transpower was allocating operating costs under the opex cap was having the effect of cross-subsidising the operating costs associated with providing HVAC transmission services at the expense of HVDC customers. Meridian engaged NERA Economic Consulting to prepare a report which addresses this concern and the discussion below is a summary of the report's reasoning and conclusions.

Transpower's treatment of opex over-run

- 50 One feature of the settlement was that the level of operating costs to be included in the calculation of Transpower's required revenue during this period was to be determined by reference to a 'base amount' of \$199.61 million in the 2006/07 year, to be escalated annually by the CPI.⁷ A further feature of the settlement was that separate operating cost thresholds were not established for AC and DC customers (or for AC and DC assets).⁸ Rather, it was left to Transpower to determine how to allocate the benchmark allowance between these two customer groups from year to year. Transpower contends to have made that allocation by employing a 'causer pays' principle, ie:⁹

'[T]he primary purpose of the operating cost regulation was to allow Transpower to recover a level of operating costs consistent with efficient outcomes. To achieve this, we determined that as far as possible customer charges should reflect actual costs. Accordingly, the methodology adopted was to (ex post) adjust the recovery of the operating cost allowance to *best reflect the causers of the operating costs. Economically, this is consistent with allocative efficiency.*' (emphasis added).

- 51 At the end of each year, Transpower has implemented the following ex post adjustment process:

⁷ Commerce Commission "Decision and Reasons for Not Declaring Control of Transpower New Zealand Limited & Decision to Reset Transpower's Thresholds" (13 May 2008), pages 73-77.

⁸ Commerce Commission "Decision and Reasons for Not Declaring Control of Transpower New Zealand Limited & Decision to Reset Transpower's Thresholds" (13 May 2008), page 77.

⁹ Howard Cattermole, General Manager Corporate Services, Transpower, "Letter to Meridian Re Economic Value Accounts" (28 June 2010).

- 51.1 *outturn* operating costs are apportioned between AC and DC customers, ie, the proportion of total outturn operating costs perceived by Transpower to have been 'caused' by AC customers is included in the EV account for AC customers, and likewise for DC customers;
- 51.2 total outturn operating costs are then compared to the benchmark allowance for the year, and the quantum of over- or under-recovery calculated; and
- 51.3 any under- or over-recovery is then shared between AC and DC customers based on their attributed share of outturn operating costs to ensure that the total charged to customers' EV accounts equals the benchmark allowance.

52 Table 1 summarises Transpower's allocation of operating costs to AC and DC customers in the EV accounts between 2007 and 2009 using this methodology.¹⁰ It shows that although Transpower recovered only its benchmark allowance in each year (ie, the base allowance inflated annually by the consumer price index (CPI)), the retrospective re-allocation process has resulted in it attributing a greater and growing share of the operating cost threshold to DC customers, and a declining fraction to AC customers.

Table 1: Allocation of Operating Costs through the EV account

	2007		2008		2009	
	AC	DC	AC	DC	AC	DC
	\$m	\$m	\$m	\$m	\$m	\$m
Outturn Opex						
Maintenance	110.9	11.1	126.4	8.5	135.8	8.4
Intercompany	6.3	6	6.4	5.7	11.9	5.4
A+G	50.9	0.3	52.2	0.3	54.8	0.3
Ancillary Services	0	1.7	0	15.8	0	28.6
Total, AC vs. DC (A)	168.1	19.1	185	30.3	202.5	42.7
Total Outturn Opex (B)	187.2		215.3		245.2	
Opex Cap (C)	199.6		207.6		211.5	
Re-allocation (D) = (B) - (C)	-12.4		7.7		33.7	
Proportion of Outturn Opex	90%	10%	86%	14%	83%	17%
Re-allocation (E)	11.1	1.3	-6.6	-1.1	-27.8	-5.9
Charge to EV Account (A) + (E)	179.2	20.4	178.4	29.2	174.7	36.8
<i>Annual % Change in Outturn Opex</i>	-	-	10.1%	58.6%	9.5%	40.9%
<i>Annual % Change in Opex Charge</i>	-	-	-0.5%	43.5%	-2.1%	26.1%
<i>CPI</i>			4%		1.9%	

53 We explained above that the significant shift in the incidence of operating costs over the period of the settlement was caused primarily by unprecedented increases in

¹⁰ Treatment of Operating Costs. A report for Meridian. 30 July 2010. P6.

Transpower's IR costs,¹¹ which were attributed solely to DC customers.¹² Over the period, DC customer's share of the operating cost allowance increased from **10 to 17 per cent**. The rate of change in operating costs allocated to the DC EV account also increased at a rate well in excess of the movement in the CPI over the period, ie, the operating costs charged to the DC EV account increased by **43.5 per cent** in 2008 and by **26.1 per cent** in 2009.

54 Meanwhile, Transpower allocated a declining proportion of the operating cost allowance to AC customers. Over the period, AC customer's share of the operating cost allowance fell from 90 to 83 per cent. Moreover, the operating costs charged to the AC EV account fell by 0.5 per cent in 2008 and by 2.1 per cent in 2009 (compared to 4 and 1.9 per cent increase in the CPI over the same period). These reductions occurred despite outturn AC operating costs increasing by 10.7 and 9.5 percent, respectively in 2008 and 2009.

55 Transpower's allocation of operating costs therefore compounded the negative balance of the DC EV account over the term of the settlement, and had the opposite effect on the balance of the AC EV account. The methodology has therefore had a material effect on the prices ultimately paid by AC and DC customers, as determined by the application of the Transmission Pricing Methodology. In 2008 and 2009, the application of Transpower's ex-post approach will have:

55.1 increased retrospectively the HVDC revenue requirement, and so the level of HVDC charges to be levied upon South Island generators; and

55.2 reduced retrospectively the HVAC revenue requirement, and so the level of connection and interconnection charges to be levied upon AC customers.

56 In other words, the ex-post adjustments will have in both years resulted in HVDC charges being *higher* and HVAC charges *lower* than they would otherwise have been without such adjustments. Transpower's method for allocating operational expenditure during the settlement period has therefore had the effect of cross-subsiding the operating costs associated with providing HVAC transmission services at the expense of HVDC customers.

Implications of Transpower's treatment of opex over-run

57 Meridian asked NERA to consider the manner in which Transpower has allocated operating costs between AC and DC customers during the period of the settlement. Specifically, we asked it to consider whether the ex-post methodology employed by Transpower is an approach that would be observed in a workably competitive market,

¹¹ This is reflected in the substantial growth in ancillary service costs highlighted in Table 1.

¹² Sufficient reserve generation is procured by the System Operator in each 30-minute trading period to cover the possible sudden loss of the largest generating unit in each island. If the HVDC link, which is treated as a generating unit, is the largest supplier into an island, the System Operator allocates to Transpower, as the link's owner, a major share of the costs of the reserves it must procure for that island for that period.

and whether it is likely to have promoted allocative efficiency in the manner contended. In short, NERA concluded that:¹³

57.1 a firm in a workably competitive market would neither contemplate nor be able to implement the ex-post adjustments that Transpower has undertaken; and

57.2 by adopting the approach that it has, Transpower is likely to have *reduced* allocative efficiency.

58 NERA explain that prices in workably competitive markets generally reflect the efficient costs that producers are caused to incur to provide a good or service to a particular customer. However, it points out that it is not possible for Transpower to give effect to this principle through its ex-post re-allocation. Because the operating costs that Transpower could recover during the period were capped, any decision to allocate a *greater* proportion of the operating cost allowance to one group of customers meant allocating a *lesser proportion* to another.¹⁴

59 Specifically, Transpower's decision to allocate a growing proportion to DC customers meant allocating a shrinking proportion to AC customers, and attendant downward pressure on HVAC charges. NERA explain that the trouble with such an approach is that the downward pressure on HVAC charges was not precipitated by AC customers causing Transpower to incur fewer costs over the period. In fact, AC costs *increased*, as Table 2 illustrates.¹⁵

Table 2: Annual Percentage Change in Operating Costs

	AC			DC		
	2007	2008	2009	2007	2008	2009
	\$m	\$m	\$m	\$m	\$m	\$m
Total Outturn Opex	168.1	185	202.5	19.1	30.3	42.7
Annual % Change	-	10.1%	9.5%	-	58.6%	40.9%
Opex Charged to EV Account	179.2	178.4	174.7	20.4	29.2	36.8
Annual % Change	-	-0.5%	-2.1%	-	43.5%	26.1%

60 In other words, the downward pressure on HVAC charges did not indicate a reduction in the (efficient) operating costs associated with providing transmission services to AC customers. Rather, the reduction simply reflects the fact that it was not possible for Transpower to allocate more operating costs to DC customers without reducing the allocation to AC customers. NERA point out that the net result is that Transpower has not in fact given effect to the 'causer pays' principle. Rather, it has provided the misleading signal to AC customers that they have caused it to incur fewer operating costs over the period, when in fact those costs have increased.

¹³ Treatment of Operating Costs. A report for Meridian. 30 July 2010. P6.

¹⁴ Treatment of Operating Costs. A report for Meridian. 30 July 2010. P8

¹⁵ Treatment of Operating Costs. A report for Meridian. 30 July 2010. P 8.

- 61 NERA liken Transpower's approach to:
- 61.1 levying a congestion charge on a sub-set of the motorists that elect to travel along a stretch of road during peak periods; and
 - 61.2 making off-setting payments to the remaining motorists that travel along the same stretch of road during peak periods.
- 62 NERA consequently conclude that it was impossible for Transpower to simultaneously provide appropriate price signals to DC and AC customers through the application of its ex-post re-allocation methodology. Any allocative efficiency gains from providing a stronger signal to one group of customers were undone by sending inappropriate signals to others. It concludes that the counterintuitive outcome whereby increases in AC operating costs result in downward pressure on HVAC charges could not reasonably be expected to arise in a workably competitive market, and is likely to have harmed allocative efficiency. Meridian also notes that Transpower did not consult on this approach.
- 63 NERA also emphasise that 'causer pays' pricing is only consistent with workably competitive market outcomes, and can only promote allocative efficiency, when consumers know the prices that they will pay (and so the underlying costs) *before they decide to consume a good or service*.¹⁶ However, the ex post nature of Transpower's methodology for allocating operating costs means that customers do not know the costs that they will face until *after* they have been incurred. In other words, the price signal is provided after the relevant conduct has taken place.
- 64 The basic point that NERA makes is that it is then too late for customers to take action to reduce or avoid the impact of those costs.¹⁷ Moreover, the ex-post charge provides no useful gauge to customers of their likely allocation in the coming year, since there will be an equivalent ex-post adjustment at year's end. Consequently, even if Transpower's methodology could reasonably be said to reflect the 'causers' of operating costs (which it cannot for the reasons described above), the retrospective allocation entails no allocative efficiency benefits, because AC and DC customers are not able to change their behaviour in response to the signal.
- 65 NERA again liken Transpower's approach to levying an undisclosed congestion charge on a motorist that has already driven along a stretch of road. Levying such a charge cannot elicit efficient consumption decisions because:
- 65.1 the motorist cannot subsequently undo her decision so as to avoid the imposition of the charge, even if it turns out to exceed the benefits that she obtained; and
 - 65.2 the charge provides no reliable indication of the potential future cost of driving that route, since the congestion charge will change in the interim by an unknown amount.

¹⁶ Treatment of Operating Costs. A report for Meridian. 30 July 2010. P8

¹⁷ Treatment of Operating Costs. A report for Meridian. 30 July 2010. P8

- 66 The ex-post allocation of operating cost is therefore incapable of enticing desirable behavioural change. The exercise consequently serves no useful purpose. For this reason, NERA concludes that the approach would not be seen in a workably competitive market, and is likely to have reduced allocative efficiency.¹⁸
- 67 NERA suggests that establishing ex-ante operating cost allowances for AC and DC customers and persevering with those thresholds would have been more consistent with a workably competitive market outcome, and more likely to promote allocative efficiency by providing an enduring price signal. Such an approach would have prevented downward pressure from being placed on HVAC charges at a time of rising costs, and provided AC and DC customers with much greater certainty over the future effects on HVAC and HVDC charges.
- 68 It observes that one means of giving effect to this principle would have been to establish separate ex-ante operating cost thresholds for AC and DC customers at the outset of the settlement period based on their respective shares of the initial 'base amount' of \$199.61 million, and to escalated those thresholds annually in line with the CPI. Table 3 below illustrates the allocation between AC and DC customers that would have arisen under such an approach.

Table 3: Allocation based on Ex-Ante Threshold

	AC			DC		
	2007	2008	2009	2007	2008	2009
	\$m	\$m	\$m	\$m	\$m	\$m
Opex Cap	199.6	207.6	211.5	199.6	207.6	211.5
Proportion of 2007 Opex		90%			10%	
Allocation based on 2007 Ratio	179.2	186.4	189.9	20.4	21.2	21.6
Opex Charged by Transpower	179.2	178.4	174.7	20.4	29.2	36.8
Difference	0.0	-8.0	-15.3	0.0	8.0	15.3
Effect on EV Account Balance		-23.3			23.3	

- 69 A conspicuous feature of this alternative is the substantial reduction to the negative balance of the DC EV account. Specifically, establishing separate ex-ante operating cost thresholds for AC and DC customers and eschewing ex-post adjustments so as to replicate more closely the outcome of a workably competitive market would have reduced the negative balance of the DC EV account by **\$23.3 million**, and had an equal and opposite effect on the balance of the AC EV account.

Commission cannot carry over the full DC EV account balance

- 70 The discussion above demonstrates that the Commission should not carry over the full amount of the DC EV account balance to the Part 4 regime. The way in which

¹⁸ Treatment of Operating Costs. A report for Meridian. 30 July 2010. P8

Transpower has allocated opex essentially represents an indirect over-recovery of HVDC revenue by Transpower.

71 In the Commission's letter to Meridian dated 1 June 2010 the Commission stated:

With regard to Transpower's treatment of operating costs in 2008 and 2009, the settlement does not constrain how Transpower allocates costs to certain customers. The operating expenditure threshold provides only an overall cap on total costs. The Commission's preliminary view is that there has been no breach of the settlement in this respect.

72 While Transpower's method of allocating opex may not have been a breach of the settlement, there still remains a separate question as to how much of the DC EV account balance should appropriately be carried forward. In fact, the Commission is legally obliged to ensure that all inputs (which includes the EV adjustment) into pricing under the Part 4 regime result in prices over time that are consistent with workably competitive market outcomes. The fact that the settlement omitted to supervise Transpower's allocation is not a virtue, and does not dictate the substantive question of what is correct for Part 4 going forward.

Relationship with the Electricity Commission's Transmission Pricing Methodology

73 As the Commission is aware, Meridian has raised these concerns with the Commission. In the Commission's letter to Meridian dated 1 June 2010 the Commission stated:

In relation to Transpower's behaviour under the settlement, the Commission accepts that it receives information on Transpower's compliance with the terms of the settlement under clause 9 of the Commerce Act (Transpower Thresholds) Notice 2008 and has a discretion to enforce a breach of the settlement under section 54M(2) of the Act. In this sense, the Commission is responsible for monitoring Transpower's compliance with the rules regarding the management of the EV accounts. The Commission notes, however, that any debt recorded in an EV account is charged to Transpower's customers under the form of benchmark agreement that is mandated under the Electricity Governance Rules. Grid charges under those agreements are set in accordance with the transmission pricing methodology, which is currently determined by the Electricity Commission. The Commission's preference is not to interpose itself in contractual arrangements between Transpower and its customers.

74 This is a very troubling line of argument from the Commission. Meridian is raising these issues with the Commission because the issues go to the overall revenue and pricing of Transpower. It is the Commission's responsibility to be sure that it is satisfied Transpower's future pricing and revenue will be consistent with the workable competition standard.

75 The Commission's response raises the spectre of complaints regarding Transpower's pricing and revenue "falling between the cracks". If the Commission responds to a complaint by saying "Transpower's pricing is implemented via the Transmission Pricing

- 76 If the Commission continues to hold this view then Meridian submits it has serious implications for the integrity, and plain utility, of the regulatory regime. We request that the Commission consult further on the interrelationship between the roles of the Commission and the Electricity Commission (*EC*), and in particular how complaints going to Transpower's revenue requirement will be handled.
- 77 Meridian believes that a more formal framework to oversee questions relating to pricing and revenue complaints is required, with decisions on "jurisdiction" to deal with complaints to be made independently of the Commission and EC. And while we accept that some of these issues cannot fall to be determined specifically under the Part 4 regulatory regime, they nonetheless have a significant bearing on the legitimacy of the overall regulatory regime applying to Transpower. A particularly concrete example of the uncertain interrelationship between the Commission and the EC undermining the regulatory regime can be seen in the Commission's reticence to set separate revenue requirements because of doubts that such a decision would amount to setting pricing methodologies¹⁹ – a role which will likely be reserved to the new Electricity Authority should the Electricity Industry Bill be passed. Meridian therefore suggests that the Commission take seriously our request to consult further on the interrelationship with the Electricity Authority.

Summary: EV account balance

- 78 In the Price-Quality Draft Reasons Paper, the Commission does not address the question of whether it is appropriate and consistent with the purpose of Part 4 to carry over the full balance of the DC EV account. This is surprising, given that EV adjustments have a considerable impact on the prices charged to consumers of the HVDC service. A regulatory regime which must promote the long term interests of consumers must ensure that any input into the calculation of prices does not result in prices that allow a supplier to earn excessive profits over time. Meridian is therefore surprised that the Commission has failed to give this issue an appropriate level of attention.
- 79 At the very least, the submissions above make clear that there are legitimate grounds for doubt as to whether the DC EV account balance is fair to consumers. More than likely, there is a portion of the balance that represents over recovery by Transpower and will result in prices going forward that are over and above what would be observed in a workably competitive market. If the Commission does not address this issue, it runs the risk of implementing regulation that fails to meet the purpose of Part 4.

¹⁹ Price-Quality Draft Reasons Paper, paragraphs 3.6.8-3.6.9.

Design of the EV framework

- 80 Meridian generally agrees with the Commission's proposed EV framework (as distinct from the question of the DC EV account balance to be carried over). The key aspects of the proposed framework are:²⁰
- 80.1 recovery of balance carried over from the settlement over the first two RCPs – that is, nine years;
 - 80.2 recovery of the DC EV account balance accrued during the term of a RCP within the next RCP. As a basic example, if the DC EV account balance is \$10 million (negative or positive) at the end of a RCP, it will result in EV adjustments of \$2 million per year (negative or positive) over a five year RCP;
 - 80.3 wash ups (which are the basis for inputs into the EV account) will apply to both major and minor capex, pass-through and recoverable costs, and other specified building block components; and
 - 80.4 the balance of the EV account will accrue interest at a rate equivalent to Transpower's cost of capital.
- 81 Meridian considers it important that the balance carried over from the settlement be recovered over a period of at least two RCPs. The Commission's draft decision implies an annual positive 20% EV adjustment (approximately) to HVDC prices over the next nine years – a significant increase on the maximum permitted EV adjustment of 10% of the forecast revenue requirement under the settlement. Aside from the difficulties Meridian has with regulatory decisions creating sudden fluctuations in the prices it faces for transmission services, we are concerned to ensure that the Commission does not implement a recovery period for the settlement EV account balance that is less than currently proposed.
- 82 Such a decision by the Commission would result in even more substantial price shocks than is currently proposed – an outcome that would be entirely inconsistent with what would be observed in a workably competitive market and something that the Commission has been concerned to avoid in the regulation of other regulated sectors under Part 4.
- 83 Another broad concern for Meridian is that the proposed wash up framework may result in uncertainty for consumers of transmission services, at least in the short run. This is because wash ups cause uncertainty in that prices become inconsistent and it is difficult to get an accurate fix on what is a "normal" price.
- 84 The Commission's draft decision to make capex subject to wash ups seems reasonable in light of Transpower's problems with capex forecasting. Meridian understands that, as a temporary measure, a wash up will ensure that Transpower's recovery over time is no less and no more than a normal rate of return (assuming other building blocks are consistent with a normal rate of return). However, our general support of this position is

²⁰ Price-Quality Draft Reasons Paper, section 3.8.

tempered by a desire for certainty. As a consumer which is also a commercial business, Meridian needs relative certainty in relation to the costs of our business. Large divergences between forecast and actual capex will diminish this certainty.

- 85 Meridian therefore emphasises the importance of incentivising Transpower to improve accuracy in forecasting. The EV framework must not become a crutch which supports inaccurate forecasting. In this respect, we agree with the Commission’s characterisation of the approach to wash ups for capex as “interim”.
- 86 We note that the move to an EV framework which resets the EV account balance to zero at the end of each RCP removes any limits on the amount Transpower can recover in EV adjustments in any one year. Under the settlement, that limit was set at 10% of the forecast total revenue requirement. Meridian understands the Commission’s desire to avoid the situation that has arisen under the settlement where the DC EV account balance has risen dramatically and systematically. However, should the Commission implement its draft decision to apportion the balance from the previous regulatory RCP over the next RCP, it will have exposed HVDC customers to potentially large variations in pricing. It is in this context that the importance of ensuring Transpower faces appropriate incentives to increase the accuracy of its forecasting becomes apparent. The ideal outcome in Meridian’s view would be a decreasing reliance over time by Transpower on the EV framework as forecasts improve.

Separate HVDC and HVAC revenue requirements

- 87 The Commission proposes to set one revenue requirement (or Maximum Allowable Revenue) for Transpower, covering revenue from both its HVAC and HVDC services.²¹
- 88 Meridian disagrees with the Commission’s draft decision. Meridian has previously submitted to the Commission that Transpower should be subject to separate revenue requirements for its HVAC and HVDC services.²² The concerns that Meridian specified in its previous submission on this point still apply – that is, we are concerned to ensure that Transpower is constrained in its ability to increase prices and operating costs for the HVDC service and, in particular, is constrained in its ability to cross-subsidise between the two services.
- 89 The Commission acknowledges these concerns in the Price-Quality Draft Reasons Paper but considers that they may be addressed by other measures. Specifically:
- 89.1 by assessing and consulting on the reasonableness of the HVAC and HVDC costs, in aggregate, as part of its review of Transpower’s operating expenditure proposal; and
 - 89.2 requiring Transpower to report its methodology for allocating costs to HVAC and HVDC, and the resulting costs in its compliance statement.

²¹ Price-Quality Draft Reasons Paper, paragraph 3.6.1.

²² Meridian “*Submission to the Commerce Commission on its draft decision not to declare control of Transpower*” (9 November 2007), page 4.

- 90 These measures are not sufficient to address the problems associated with a single revenue requirement. The Commission itself acknowledges that the assessment and consultation on the reasonableness of the HVAC and HVDC costs is *in aggregate*. It is precisely this aggregated approach to Transpower's opex that causes the potential problems Meridian signalled in its previous submission to the Commission.
- 91 An augmented compliance statement will not assist to address these problems either. First, the Commission is making an assumption that a form of information disclosure – the compliance statement – is sufficient to control the behaviour of Transpower. Information disclosure can only bring to light deficiencies in the performance of Transpower, not enforce appropriate behaviour. Further, information disclosure is only useful where there is a threat of more heavy-handed regulation. If the Commission follows the path it prefers in its draft decisions, it needs to make clear to Transpower what the consequences might be should its behaviour not be consistent with the workable competition standard.
- 92 Secondly, it is unclear what the Commission is proposing to be disclosed in the compliance statement. It merely states that Transpower will be required to “report its methodology for allocating costs to HVAC and HVDC, and the resulting costs in its compliance statement”,²³ and also proposes requiring Transpower to separately calculate and disclose its HVAC and HVDC revenue requirements.
- 93 For the compliance statement to be effective as a form of information disclosure, it needs to provide consumers (and other interested persons) with sufficient information to assess whether Transpower's commercial behaviour is consistent with the purpose of Part 4. Sufficient information would necessarily imply a detailed disclosure of breakdown of costs in respect of both HVAC and HVDC services. Below we discuss the level of detail that would be required in the compliance statement to allow HVDC customers to assess whether Transpower is correctly allocating costs.
- 94 However, even if there were a detailed breakdown of costs and a disclosure of Transpower's HVAC and HVDC revenue requirements, this will still not be sufficient to prevent the potential cross-subsidisation between HVAC and HVDC. The decision remains with Transpower, at its discretion, what quantum of cost within the pooled opex cap to attribute to each of the HVAC and HVDC services. There is therefore an inherent risk that a greater proportion of opex will be attributed to the HVDC service than is justified.
- 95 In the NERA Report, the authors suggest an alternative approach to Transpower's opex which lends support to the need for separate revenue requirements which we discuss at paragraphs 68 and 69 above.
- 96 A separate opex cap for the HVDC and HVAC services would eliminate the possibility of Transpower allocating opex in a way that is inconsistent with workably competitive market outcomes, as it has done in the past under the settlement. However, it would not necessarily prevent the possibility that charges for the HVDC service increase at a rate that does not reflect the costs of providing the service. Under the Commission's draft proposal, Transpower is permitted within the single revenue requirement to

²³ Price-Quality Draft Reasons Paper, paragraph 3.6.5.

allocate the costs of providing each of the services at its discretion. Meridian therefore recommends that the Commission sets separate revenue requirements for the HVAC and HVDC services to avoid the issues outlined above.

- 97 The Commission appears to be concerned by the possible enactment of the Electricity Industry Bill, which (in the words of the Commission) may preclude the Commission from setting pricing methodologies for Transpower. As discussed above, this approach raises the spectre of complaints regarding Transpower's pricing and revenue "falling between the cracks". This is an issue that clearly needs to be addressed. However, Meridian cannot be confident in light of the Commission's draft decisions that it will be addressed.

Treatment of instantaneous reserves costs

Commissions' draft decision

- 98 The Commission's draft decision on the treatment of IR costs is that they should be treated as a Recoverable Cost. A Recoverable Cost is a cost that does not meet the Pass-Through Cost criteria, but may nonetheless be recovered by suppliers in addition to maximum prices and Pass-Through Costs. As Meridian sees it, the only material difference between the two cost categories is that the Commission may revisit the categorisation of a cost as a Recoverable Cost at the start of a regulatory period (without necessarily consulting with interested parties).
- 99 The Commission reasons that the benefits of Transpower bearing the IR costs do not outweigh the unmanageable costs that would be imposed on Transpower if IR costs were treated as opex.²⁴ Key to that decision appears to be the view of the Commission that Transpower has little control or ability to forecast IR costs.
- 100 To ensure that Transpower has incentives to avoid extended outage of the HVDC assets, the Commission proposes that Transpower not be able to recover any IR costs relating to HVDC outages of more than 14 days in duration. Meridian submits that quality measures on the HVDC are still required to ensure optimal availability.

Commission's decision inconsistent with purpose statement

- 101 Meridian is surprised at the Commission's decision to treat IR costs as a Recoverable Cost. We disagree with the Commission and consider that its decision is plainly inconsistent with the purpose of Part 4.

²⁴ Price-Quality Draft Reasons Paper, paragraph 7.4.20

- 102 The Commission's decision is a complete reversal on its decision last year to treat IR costs as part of opex. In that decision, the Commission expressed its view with clarity:²⁵

...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 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.

- 103 Of particular note is that the Commission considered that the treatment of IR costs as part of opex "better promotes the Purpose Statement" than Transpower's submission that IR costs ought to be treated as a pass-through cost. In the decision, it is apparent that the Commission has in mind the purpose of Part 4 when it speaks of the "Purpose Statement". At paragraph 62, the Commission states that:

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.

- 104 Other parts of the Commission's earlier decision are instructive:

The fact that Transpower would be exposed to an increased level of instantaneous reserve fees by removing Pole 1 is indisputable. The question then, becomes whether or not Transpower could or should have foreseen the magnitude of this expense... the Commission considers that neither the combination of circumstances nor the likely magnitude of the instantaneous reserve costs were unforeseeable.²⁶

The Commission considers that allowing instantaneous reserve fees to be treated as a pass-through cost would reduce the incentives on Transpower to manage 'moral hazard' problems associated with its role as grid-owner. Such moral hazard problems arise 'when the [regulated entity] is not provided with the right incentives to minimise the costs or likelihood of occurrence of exogenous events (for example through spending on insurance, safety or security

²⁵ Commerce Commission "Decision and Reasons for not amending Transpower's administrative settlement to include Instantaneous Reserves Fees as Pass-Through Costs" (22 June 2009), paragraph 128.

²⁶ Commerce Commission "Decision and Reasons for not amending Transpower's administrative settlement to include Instantaneous Reserves Fees as Pass-Through Costs" (22 June 2009), paragraphs 79 and 86.

measures)'... It should be noted that resultant pressure on Transpower's profit, should its costs increase, is also not an unintended outcome of the settlement. The operating expenditure cap in the settlement agreement has been designed to impose incentives and discipline on Transpower, encouraging it to manage its costs appropriately and apply downward pressure on costs. The objective is for Transpower to become more efficient, and share efficiency gains, over time, with consumers.²⁷

The Commission considers that the terms of the settlement as agreed, which already include a provision for instantaneous reserves in the operating expenditure allowance, is a more appropriate treatment of costs than to classify these as pass-through costs. Likewise, the incentive to manage risk and manage costs appropriately, as provided by the settlement, 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)).²⁸

The Commission concludes that Transpower may have some ability to manage its costs, and that this cost should appropriately be borne by Transpower as part of its operating expenditure allowance under the settlement. As discussed above, this is consistent with section 52A(1)(ii). The Commission also considers that the Transpower's current operating expenditure allowance limits its ability to extract excessive profits, consistent with section 52A(1)(iv).²⁹

- 105 In sum, the Commission considered that IR costs are foreseeable, are able to be controlled to a significant extent by Transpower, and that the incentives that flow from the treatment of IR costs as part of opex are "consistent with the concept that a well-functioning *workably competitive market* would apply the risk to those who can best manage those risks".
- 106 Meridian also wishes to remind the Commission that not only was its earlier decision made with reference to the overall purpose of Part 4 but, as the above excerpts of the decision demonstrate, it was made with particular reference to the regulatory objectives in the purpose statement.
- 107 In Meridian's view, the Commission's earlier decision is the correct one. Meridian submits that the crucial problem with the Commission's proposed treatment of IR costs is that it removes any incentives on Transpower to minimise IR costs. This is both economically inefficient and is directly inconsistent with the purpose of Part 4. As the party responsible for investment and maintenance of the grid, Transpower is best placed to insure against rising IR costs. The ability of Transpower to control IR costs was seen by the Commission in 2009 as a key ground for treating IR costs as part of Transpower's opex. We see no change in circumstances that would warrant the Commission to now depart from that decision. Indeed, the Commission's draft decision

²⁷ Ibid, paragraphs 105 and 107.

²⁸ Ibid, paragraph 115.

²⁹ Ibid, paragraph 122.

does not even reference its earlier decision nor describe any change in circumstances that would justify such a reversal.

- 108 The clearest example of how the Commission's decision-making influences Transpower's incentives to manage and maintain its transmission assets appropriately can be seen in the circumstances surrounding Transpower's management of Pole 1 of the HVDC link and the Commission's decision not to allow Transpower to treat IR costs as a pass-through cost. After decommissioning Pole 1 in 2008, Transpower's exposure to IR costs increased substantially. Because of the rising IR costs, Transpower applied to the Commission for an amendment to its settlement to treat IR costs as a pass-through cost.
- 109 As discussed above, the Commission rejected Transpower's request deciding that IR costs should be treated as part of opex. Transpower subsequently recommissioned Pole 1 in order to reduce its exposure to IR costs and the availability of Pole 1 has since been relatively high. Had the Commission decided to allow Transpower to treat IR costs as a pass-through cost, the incentive to recommission Pole 1 and thereby minimise IR costs would not have been present and it is unlikely Pole 1 would have been made available.
- 110 Transpower has several other options to control IR costs through efficient asset management, including:
- 110.1 managing the availability of Bipole (and including pole 1);
 - 110.2 timing periods of planned unavailability to minimise the impact on IR costs; and
 - 110.3 in relation to the forthcoming commissioning of Pole 3, managing the commissioning process appropriately to minimise IR costs.
- 111 Another option available to Transpower to minimise IR costs is to pursue financial hedge arrangements and, in its 2009 decision on IR costs, the Commission noted the possible benefits of such arrangements.³⁰ The Commission then proceeded to comment that:³¹
- Transpower has failed to provide any evidence that it had explored or even contemplated whether or not it would be appropriate or beneficial to enter into financial hedge arrangements in order to mitigate the risk of incurring higher instantaneous reserves costs following its decision to (partially) stand down Pole 1.
- 112 Again, Meridian cannot identify any material change in circumstances that would make this reasoning any less relevant to the Commission's task in determining regulation under Part 4. However, the Price-Quality Draft Reasons Paper again makes no such reference to the possibility of Transpower entering financial hedge arrangements to

³⁰ Commerce Commission *"Decision and Reasons for not amending Transpower's administrative settlement to include Instantaneous Reserves Fees as Pass-Through Costs"* (22 June 2009), paragraphs 120-122.

³¹ *Ibid*, paragraph 122.

minimise IR costs. Meridian understands that Transpower may have been making efforts to establish such hedging arrangements, however it is not clear whether any arrangements are in fact in place.

- 113 If the Commission is to essentially reverse its decision of last year on IR costs and proceed with its draft decision, the Commission's credibility as a principled and consistent decision-maker will be severely undermined. This issue goes to the heart of regulatory commitment. Meridian submits that the Commission's brief reasoning for its draft decision is simply not sufficient to displace its earlier, and more thoroughly considered, decision. It also seems apparent that the Commission did not have the purpose of Part 4 in mind when it made its draft decision, as the purpose is not mentioned anywhere in its reasoning.
- 114 The Commission suggests that if a Recoverable Cost becomes able to be better forecast or more controllable, or if the price-quality path is able to include more sophisticated incentive mechanisms, the Commission may revisit its decision on the categorisation of a cost as a Recoverable Cost. It would be helpful if the Commission would specify what it had in mind in respect of IR costs when it made this statement. As far as Meridian is aware, the only material event in the near future which will impact on IR costs is the commissioning of Pole 3. However, the introduction of a new asset which is intended to increase Transpower's ability to control IR costs only supports the assertion that it is within Transpower's power to control the IR costs it is faced with.
- 115 Meridian cannot see what the Commission is intending to achieve with the categorisation of IR costs as a Recoverable Cost, or indeed the Recoverable Cost category itself. Part 4 permits the Commission to revisit its input methodologies decisions and section 52P determinations at any stage, so long as it consults on the change.³² This narrows down the material difference between Pass-Through Costs and Recoverable Costs to simply a consultation issue.

Summary: Treatment of IR costs

- 116 Meridian submits that treating IR costs as part of opex is the approach that will best promote the long term interests of consumers of HVDC transmission services. Such an approach will ensure that Transpower is faced with appropriate incentives to efficiently manage its assets and to control the amount of IR costs it incurs. The Commission's draft decision to treat IR costs as a Recoverable Cost will only succeed in allowing the costs to increase beyond what is already an excessive amount. This is a cost that Transpower can and should be required to control.
- 117 Should the Commission decide that the treatment of IR costs as part of opex will be materially better at meeting the purpose of Part 4, Meridian would expect the Commission to consult on the amount of IR costs that would be included in Transpower's opex cap. As a general principle, only those IR costs that are efficiently incurred should be included as part of the opex cap.

³² Commerce Act 1986, ss 52X and 52Y.

Alternative approaches to the treatment of IR costs

- 118 While Meridian considers that the treatment of IR costs as part of opex is the approach that best meets the purpose of Part 4, we have identified other possible approaches to the treatment of IR costs for the Commission to consider.
- 119 Broadly, the alternative approaches are as follows:
- 119.1 a cost sharing arrangement, whereby the Commission allocates a percentage of IR costs that Transpower must absorb itself (i.e. not included as part of opex) and the remainder may be passed through; and
 - 119.2 a capacity obligation, whereby Transpower would absorb any IR costs while HVDC availability was below a specified capacity, and any IR costs incurred where HVDC availability is above the specified capacity would be passed through.
- 120 Prior to the Commission releasing its most recent consultation material on the regulation to apply to Transpower, Meridian presented to the Commission in detail on these alternative approaches. Meridian would be happy to further discuss with the Commission, Transpower and other interested parties the alternatives to the treatment of IR costs we have suggested here.

Compliance statement

- 121 Meridian supports the Commission's draft decision that Transpower must, on an annual basis, publish a written statement that confirms its compliance, or otherwise, with the individual price-quality path set by the Commission. Meridian also agrees with the Commission's draft decision to require Transpower to demonstrate the appropriate allocation of cost and adjustments to the HVDC and HVAC revenue requirements. While Meridian reiterates that such a disclosure will not be sufficient to address the problems that arise with the setting of a single revenue requirement, we welcome any step towards greater transparency.
- 122 In addition to the Commission's proposed information requirements for the compliance statement, Meridian submits that Transpower should be required to disclose a comparison of its forecast and actual revenue requirements for the HVDC service, broken down into component forecasts. This would enable Meridian and other HVDC customers to assess which particular forecasts are incorrect for that particular financial year and the source of any DC EV account balance adjustments. This information would also be useful to detect trends in forecasting and to allow Meridian and other HVDC customers to assess whether the accuracy of Transpower's forecasts are improving.

Quality

123 Meridian strongly supports the introduction of quality standards for assessing Transpower's performance and we agree with the Commission's general approach to quality standards. We are still considering the full implications of the Commission's draft decisions and as such we may address the quality standards to apply to Transpower in more depth in a cross submission, however we wish to make the following brief submissions.

124 Meridian disagrees with the following draft decisions of the Commission:

124.1 the draft decision to use historical data from the period 2004/05 to 2008/09 to set targets, caps and collars; and

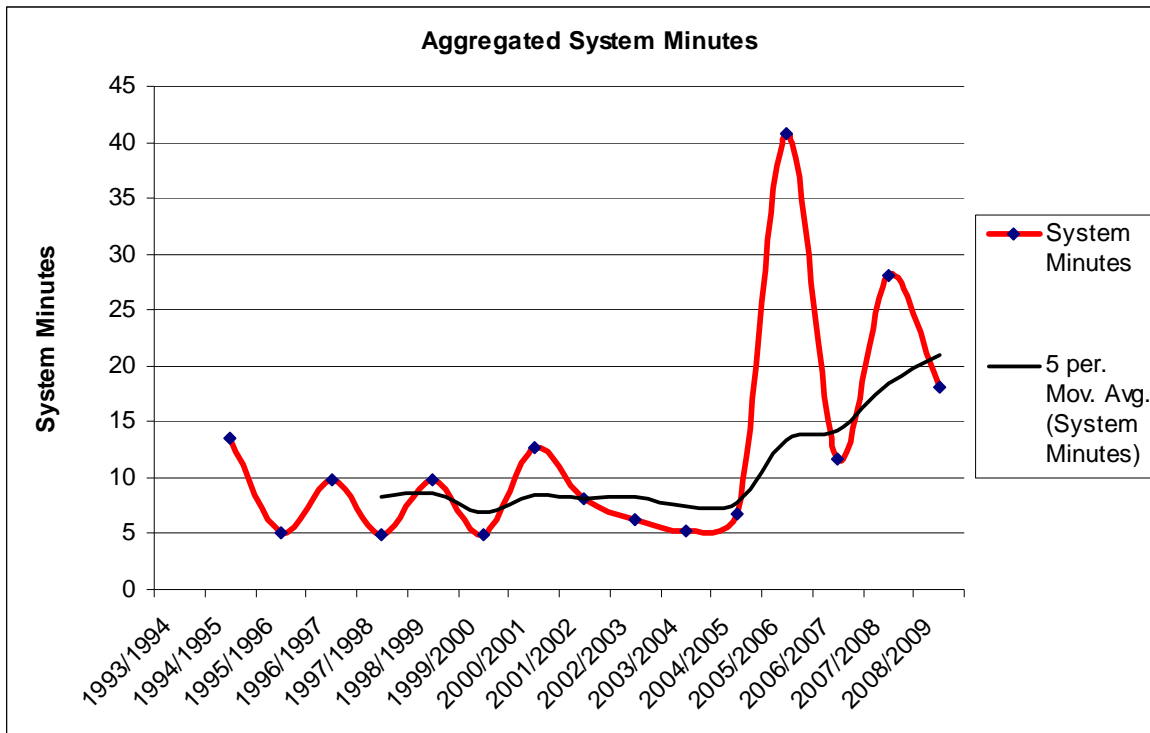
124.2 the draft decision not to set targets, caps and collars for HVDC bi-pole availability in RCP1.

Use of historical data

125 At paragraph 6.5.3 of the Price-Quality Draft Reasons Paper, the Commission states that it "considers that basing the targets, caps and collars on the last five years is likely to provide a reasonable representation of the operating conditions over the first regulatory period".

In Meridian's view, this period is in fact representative of a level of performance which is significantly poorer than Transpower's long run performance. The graph below³³ compares the aggregated system minutes (measuring system interruptions) in each particular financial year against the long run average. This figure x shows the performance as report by Transpower over the last 15 years. The 5 year rolling average shows that depending on which 5 years you use to produce the measure that you will get very different results. And the measure proposed by the Commission based on the last 7 years is not typical of the longer run data.

³³ Transpower's Quality performance Reports 2000-2009



126 The graph demonstrates that on this particular measure of performance, the period from 2004/05 to 2008/09 is not indicative of the performance level that Transpower is capable of (and should be) achieving. Meridian also notes that this is a period in which Transpower has acknowledged that it deferred maintenance of its assets.

127 Meridian therefore questions why the Commission has chosen a period of time on which to base the targets, caps and collars which is clearly reflective of a poorer level of performance than Transpower has historically achieved. The Commission's draft decision will only serve to legitimise that poor performance under the new Part 4 regime. Meridian submits that the Commission should use a historical data set of at least 7 years on which to base the targets, caps and collars and over a period that is dominated by inferior performance.

No targets, caps and collars for HVDC bi-pole availability in RCP1

128 At paragraph 6.7.39 of the Price-Quality Draft Reasons Paper, the Commission states that "its draft decision is to exclude the measure [HVDC bi-pole availability] from the incentive regime for the first regulatory period, primarily due to difficulty in establishing relevant parameters for the measure".

129 Meridian considers that the net effect of this draft decision and the Commission's draft decision to treat IR costs as a Recoverable Cost is that Transpower has no incentives in RCP1 to ensure availability of its HVDC assets nor to minimise its IR costs. Meridian submits that this is directly inconsistent with outcomes that would typically be observed in a workably competitive market. Essentially, the Commission's draft decisions leave Transpower with the ability to incur any sum of IR costs and pass through those costs

- 130 Meridian submits that, notwithstanding the issues of obtaining a suitable data set on which to base the targets, caps and collars, the Commission is obliged to set appropriate performance incentives for the HVDC assets. The alternative situation which we describe above, where Transpower faces no incentives to ensure bi-pole availability or to minimise IR costs is considerably more inconsistent with the purpose of Part 4 than establishing quality standards based on less than perfect information.
- 131 Meridian submits that it is even more important to have availability targets in RCP1. Meridian also submits that Transpower ought to have measures of planned availability. This would ensure greater transparency parties can at least hold Transpower to account.
- 132 Meridian welcomes the opportunity to discuss this submission with the Commission. Meridian's contact person for this submission is:

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Yours sincerely,

Neal Barclay

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