



25 August 2010

Karen Murray
Chief Adviser
Regulation Branch
Commerce Commission
P.O. Box 2351

Wellington

By e-mail

Dear Karen

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

Introduction

- 1 Meridian Energy Limited (*Meridian*) welcomes the opportunity to make a cross submission on the Commerce Commission's (*Commission's*) Individual Price-Quality Path and Input Methodologies Draft Reasons Papers for Transpower.

- 2 In this cross submission Meridian addresses the following matters:
 - 2.1 the Commission's proposed capital expenditure framework for Transpower;
 - 2.2 the Commission's draft decisions in relation to quality measures; and
 - 2.3 other specific matters raised in submissions by other parties.

- 3 Meridian's contact person for this submission is:

Neal Barclay
General Manager Markets and Production
04 3811226
neal.barclay@meridianenergy.co.nz

Capital expenditure framework

- 4 A core focus of Transpower's submission on Input Methodologies and Individual Price-Quality Path is the extent to which the Commission's proposed regulation of transmission services will disincentivise necessary investment in transmission assets. While Meridian is not in a position to measure the overall impact of the proposed regulatory regime to apply to Transpower, we do share a concern that Transpower efficiently invests in the grid. In some respects, the proposed capex framework settings risk discouraging efficient investment.
- 5 Meridian is concerned that the Commission's draft decision will negatively impact Transpower's current grid investment momentum. At a broad level, Meridian supports Transpower's views on the need to continue along a path of strong investment in the national grid. As a national retailer in electricity, Meridian regularly experiences the difficulties of a constrained grid and has long advocated for improvements to the grid.
- 6 Meridian submits that, while it is important to ensure robust economic scrutiny of Transpower's proposals, it is crucial that transmission investment be considered in the appropriate context – which is long run, with multiple sources of quantifiable and strategic benefits, and large downsides to under-investment.
- 7 Meridian submits the following features are important aspects of the context in which the Commission will be evaluating transmission investment proposals:
 - 7.1 Grid investment decisions call for strategic judgement and deep appreciation of public and national interests.
 - 7.2 it is important to consider the wider qualitative analysis of transmission investments, recognising the strategic value of developing the grid to maintain future options for transmission and generation
 - 7.3 the higher cost of having new investment coming on line slightly "too early" is minor compared to the high costs of delayed transmission investment. Meridian submits that the Commission needs to be cognisant of this while designing its transmission investment and input methodologies framework
 - 7.4 a "just in time" approach to investment is likely to have the unintended effect of increasing security of supply risks and incrementally dismantling the national market in favour of more regionalised electricity generation and supply. This may risk, in turn, the closure of optimal generation options at each step
- 8 With this in mind, Meridian addresses the following key issues in relation to the capex framework:
 - 8.1 the major capex threshold;
 - 8.2 the timing of recovery of major capex; and
 - 8.3 the determination and recovery of project amounts.

Major Capex Threshold

- 9 Meridian agrees with Transpower's submission that the major capex threshold is too low. We agree that the threshold should be set at \$20m.
- 10 Meridian notes that increasing the major capex threshold amount is consistent with the Government's views on this issue, as expressed in the 2009 GPS. Meridian notes that there was widespread industry agreement and support for the \$20m threshold during consultation of the GPS.
- 11 Ultimately, Meridian is concerned that the proposed \$5m threshold sends the wrong investment signal to Transpower and is likely to have a detrimental impact on the integrity, and therefore ability, of the grid to deliver strong national competition benefits. Meridian endorses Transpower's summary of policy intent, outlined in Transpower's "*Key points summary*".¹
- 12 While supporting a \$20m threshold for major capex, Meridian is concerned to ensure that a significant level of transparency is maintained for investments under the \$20 m threshold. Meridian therefore submits that Transpower ought to be required to undertake its robust net benefit analysis and consultation for investments between \$5m and \$20m.
- 13 In addition, Meridian supports Transpower's proposal to introduce a new category of minor capex to enable Transpower to opportunistically buy land.

Timing of recovery of major capex

- 14 Meridian supports the Commission's draft decision on the recovery of major capex, particularly in relation to RCP1. Meridian notes that it is difficult to forecast our own prices when we are exposed to the transmission cost uncertainty that flows from an unexpected MAR reset.
- 15 Meridian disagrees with Transpower's submission that it faces more significant risk than its Australian counterparts. In particular, Meridian does not agree that Transpower faces any significant extraordinary risks as a result of the Commission's draft decision. Meridian submits that it is important that Transpower is exposed to some degree of risk in order to promote efficient decisions.
- 16 It is apparent that several of Transpower's submissions on the capex framework stem from a concern over upfront cashflow. If there is any basis to this concern, we would expect to see the Commission address the concern on a global assessment rather than by incremental adjustments to the regulatory framework as suggested by Transpower.

¹ Transpower New Zealand Ltd. Key Points Summary. Submission to the Commerce Commission on Input Methodologies: Transpower. August 2010.

Determination and recovery of project amounts

- 17 Meridian supports the Commission's draft decision on the approval and recovery of major capital expenditure. Meridian submits, however, that the Commission needs to take care to ensure that this does not incentivise Transpower to over-forecast the cost of its major capital expenditure.

Quality measures

- 18 As Meridian signalled in its submission of 9 August 2010, Meridian broadly agrees with the introduction of quality measures.
- 19 Meridian submits the inclusion of other measures, such as availability measures as well as forced unavailability will provide good incentives for driving efficiency. Meridian agrees with Genesis that measures related to economic outcomes need to be developed.
- 20 Meridian acknowledges the difficulties the Commission faces in perfecting the quality measures, and therefore submits that these measures ought to evolve and improve over time. Meridian would therefore like to see the Commission continue to develop and consult on these measures.
- 21 Meridian further submits that a lack of any quality measures on the HVDC is unacceptable to Meridian.

System minute interruption measure

- 22 Meridian notes that Transpower disagrees with the Commission's draft decision to include a system minute interruption measure. The reasons that Transpower gives for excluding this standard from the quality measures have largely been addressed by the Commission in its Draft Reasons paper and Meridian fully supports the reasoning of the Commission.
- 23 In Meridian's view, the inclusion of a system minutes interruption measure is necessary for a robust and meaningful quality regime, and is one of the more positive features of the current administrative settlement. Meridian notes that the system minute measure is the most robust and effective measure for addressing customer needs.

Revenue at risk

- 24 Meridian agrees with the following submission of Genesis on the question of revenue at risk for RCP1:²

² Genesis Energy submission to the Commerce Commission on Input Methodologies and Individual Price-Quality Price Path: Transpower. August 2010.

Genesis Energy understands the rationale for not introducing revenue at risk and reward at the commencement of the new regulatory regime, but queries whether the Commission is being too cautious. The Commission could place a small proportion of income at risk or reward for the latter years of the first regulatory period (for example, years three and four). This would bring forward the anticipated benefits to consumers of the performance incentive regime.

- 25 By not introducing revenue at risk in RCP1, the Commission is removing the “incentive” part from its performance incentive regime. The requirement to merely report quality performance is not consistent with the imposition of a binding price-*quality* path that the regulation of Transpower under Part 4 contemplates.

Response to other submissions

Timeframe for recovery of EV account balances

- 26 In response to the Commission’s draft decision that the AC EV account balance will be reduced to zero over RCP1, and that the DC EV account balance will be reduced to zero by the end of RCP2, the following submissions were made.

- 27 Transpower submitted that:³

In order to achieve cashflow symmetry, the balance of the HVAC EV account should be returned to customers over the same period that the balance of the HVDC account is recovered from customers, i.e. RCP1 and RCP2.

- 28 MEUG submitted that:⁴

The recovery of the AC EV account balance by the end of RCP1] is too long for the \$109 million to be repaid. Consumers do not see any benefit in being a creditor to Transpower and are annoyed they are being forced to do so. Repayment within two years should be considered.

The recovery of the DC EV account balance by the end of RCP2] is too long for the \$103 million owed to Transpower to remain outstanding. At a minimum the period this debt should be repaid should align with the above timing for Transpower to pay HVAC customers their \$109 million credit.

- 29 As the submissions relate to the recovery of the DC EV account balance, Meridian disagrees with MEUG and supports Transpower.

- 30 The Commission’s draft decision implies an annual positive 20% economic value adjustment (*EV adjustment*) to HVDC prices over the next nine years. MEUG is

³ Transpower New Zealand Ltd. Key Points Summary. Submission to Commerce Commission on Input Methodologies and Price-Quality Path: Transpower. August 2010.

⁴ MEUG. Submission to the Commerce Commission on Input Methodologies and Price-Quality Path: Transpower. August 2010.

essentially requesting that the Commission endorse even greater price shocks for HVDC services than what is currently contemplated by the Commission – in the order of an annual positive 30% EV adjustment.

- 31 Meridian considers that recovery of the DC EV account balance must be at least over a period of two RCPs. This is because:
- 31.1 price shocks of such magnitude as MEUG's submission contemplates are inconsistent with what would be observed in workably competitive markets. Meridian notes that the Commission has emphasised its desire to avoid large price shocks in the electricity distribution and gas pipelines process;
 - 31.2 a decision to require recovery by the end of RCP1 would undermine the concept of regulatory commitment. Consumers of HVDC services have a reasonable expectation that the Commission's decision under the administrative settlement to restrict recovery of the EV account balance to a maximum of 10% forecast revenue would not be completely discarded under a new regulatory regime; and
- 32 Meridian notes that these balances are not "debts" in any legal sense. Meridian notes that these balances have been treated as a regulatory construct and not a debt owed to or by Transpower but an adjustment to be made to future revenue requirements to be paid by future customers. As a consequence of being correctly accounted for in this manner, there are no pools of cash set aside. Meridian submits that the Commission cannot now make decisions on the basis that these balances are something they are not. Meridian therefore reiterates its request that the Commission completes a full and proper audit of the EV account before settling these balances.

Recovery of wash up amounts

- 33 In relation to the proposed framework for wash ups, the Commission has made the following draft decisions.⁵
- 33.1 wash ups will apply to both major and minor capex, pass-through and recoverable costs, and other specified building block components; and
 - 33.2 the recovery of the balance of the EV account accrued in the previous RCP must be fully apportioned equally over each year of the next RCP.
- 34 In response, Transpower submits that:⁶
- under and over recovery of forecast pass-through and recoverable costs should be accounted for by adjustments to the annual MAR in the following year, and annual adjustments permitted for the costs of transmission alternatives and force majeure

⁵ Commerce Commission draft decision on Input Methodologies and Price-Quality Path: Transpower. August 2010.

⁶ Transpower New Zealand Ltd. Key Points Summary. Submission to the Commerce Commission on Input Methodologies and Price-Quality Path: Transpower. August 2010.

events.

Transpower also submits that the annual MAR updates should include adjustments to provide for a return of and on major capital expenditure approved and commissioned during the RCP and added to the RAB during the year. This may be an interim arrangement to apply to RCP1, until a more mature scheme for contingent projects is developed and possibly implemented in RCP2 (as discussed under MAR Updates above).

- 35 Transpower has provided no reason for the difference in treatment for pass-through and recoverable costs, and the costs of transmission alternatives and force majeure events. Without justification, the Commission should not accede to Transpower's request. As we discuss above, if Transpower is concerned about upfront cashflow, a focus on incremental adjustments to the regulatory regime is not the correct (nor principled) way to address the issue.
- 36 Meridian supports the Commission's intent to reduce the magnitude of price shocks resulting from wash ups by smoothing the recovery (or return) of the EV account balance over the full RCP. Transpower's proposal would only serve to undermine that intent.

Treatment of instantaneous reserves charges

- 37 Meridian submits that there are three broad options for the treatment of IR costs. These are:

1) *Full pass through (current proposal)*

IR costs are passed through with strong quality measures on the HVDC. The quality measures provide Transpower with some incentives for good grid management. (However the incentives are unlikely to be economically efficient)

2) *Partial pass through*

Transpower pay for IR when they are not running the HVDC at full capability. This provides incentives for Transpower to manage HVDC availability. In this case, Transpower would pay IR costs when the HVDC is not at its forecast capacity. Some quality measure would still be required to augment this solution however once pole 3 is commissioned this would be a fair and efficient way of allocating risk where it lies.

3) *No pass through*

Transpower pay for 100% of IR costs and event charges with no quality measures being required for the HVDC. This provides Transpower with strong incentives to optimise the operation of the grid.

- 38 Meridian's preference is for Option Three. Longer term, Meridian submits that option two might be a workable comprise. Meridian again notes its offer to help the

Commission develop other workable alternatives to be developed in the longer term, as outlined in our submission.⁷

- 39 In relation to the Commission's proposed treatment of instantaneous reserves charges (*IR Costs*), Transpower submits that it:⁸

disagrees strongly with the proposed fourteen day (ten working days) qualification for outages beyond which instantaneous reserves availability costs allocated to Transpower as owner of the HVDC link would not qualify as recoverable costs. This limitation is impractical, unworkable and not adequately justified by the Commission.

- 40 Meridian disagrees with Transpower's submission. In our submission of 6 August 2010, we discussed the Commission's proposed treatment of IR costs and outlined the fundamental flaws in the Commission's approach.⁹ Key to that reasoning was a well-founded concern that Transpower would face little or no incentives to minimise the IR costs it incurred and was permitted to pass through to its HVDC customers.

- 41 While Meridian continues to submit that IR costs should be treated as part of Transpower's opex, we acknowledge that the 14 day outage threshold was the one remaining incentive under the Commission's proposal for Transpower to manage its assets in such a way as to avoid prolonged outages. Transpower is now suggesting that the Commission remove that small remaining incentive and to essentially give Transpower permission to incur any amount of IR costs and pass those costs through to HVDC customers. Ultimately, however, Meridian submits that, on its own, the 14 day measure is woefully inadequate.

- 42 Meridian notes that this situation would simply not arise under a market that was competitive and is precisely the type of result that regulation under Part 4 was intended to prevent.

- 43 Meridian suspects much of the discussion around the treatment of IR costs is driven by the uncertainties surrounding the construction and commissioning of Pole 3. While Meridian has always insisted (and still does) that the Commission's decision-making must be principled, the practical issue of Pole 3 cannot be ignored. At this stage, it remains unclear how IR Costs arising from the construction of Pole 3 will be treated. It would be helpful if the Commission gave some guidance on this issue. Meridian requests that the Commission determine that these costs ought to be treated as CAPEX.

⁷ Meridian Energy Submission to the Commerce Commission in Input Methodologies and Price-Path Quality. August 2010.

⁸ Transpower New Zealand Ltd. Key Points Summary. Submission to Commerce Commission on Input Methodologies and Price-Quality Path: Transpower. August 2010.

⁹ [reference]

Event charges

44 Transpower also submits that:¹⁰

the treatment of Event Charges should be revised. The Commission proposes that Transpower continue to be exposed to the risk of Event Charges, which are only partly controllable by Transpower. However, under-frequency events can also arise from the actions of a third party but Transpower still determined to be the causer of the event. The recent changes to the Electricity Governance Rules regarding event charge causer determination make this outcome more likely in the future.

To address this and to reflect the future outlook for Event Charges based on the current and future operation of the HVDC link, we propose as follows:

- that there be an additional provision included in base operating expenditure for the Transition Year13 (of \$0.8m) for Event Charges; and
- where Event Charges exceed this allowance, as a result of charges for events outside our control, any over expenditure should be fully recoverable.

45 Meridian strongly disagrees with Transpower's assertion that it has no control over reserve charges. In Meridian's view, as Transpower is best placed to manage event risk, the most economically efficient outcome is for Transpower to bear the costs of event charges.

Separate MARs

46 Meridian disagrees with Transpower with regard to separate MARs and refers the Commission to our previous submission.¹¹

47 Meridian also wishes to respond briefly to the following point made by Genesis:¹²

Genesis Energy agrees with the Commission's assessment that this approach would provide an optimal balance between information disclosure and Transpower's ability to reallocate operational expenditure during a regulatory control period.

¹⁰ Transpower New Zealand Ltd. Key Points Summary. Submission to Commerce Commission on Input Methodologies and Price-Quality Path: Transpower. August 2010.

¹¹ Meridian Energy to the Commerce Commission on Input Methodologies and Price-Quality Path: Transpower. August 2010.

¹² Meridian Energy to the Commerce Commission on Input Methodologies and Price-Quality Path: Transpower. August 2010.

48 Meridian disagrees with Genesis that Transpower should be able to choose how to allocate within a pool of opex. Transpower's ability to allocate opex between the HVDC and HVAC services was the source of over-recovery implicit in the DC EV account that we discussed in our 6 August 2010 submission. Meridian continues to submit that the Commission is required by the purpose of Part 4 to establish separate MARs for HVDC and HVAC, or at least separate opex caps. The alternative is a rerun of the inappropriate opex cost allocation that Transpower engaged in during the period of the settlement.

Other

- 49 At a general level, Meridian supports Genesis' suggestion that the Commission should consult on those costs that the Commission proposes be treated as pass-through costs. Meridian agrees that this step would help industry understand the rationale for pass through costs and therefore help build industry consensus.