

Major Electricity Users Group
PO Box 8085
Wellington

Attention: Ralph Matthes



12th February 2009

Dear Ralph

Re: Transpower's proposed New Investment Agreement

Thank you for your instructions for Strata Energy Consulting (Strata) to review and provide advice on Transpower's proposed New Investment Agreement (agreement) released for discussion in December 2008. The following table provides Strata's advice and main comments on the agreement. Minor points and typographical errors have been provided in a separate table.

2.1	<p>The Definition of Good Engineering Practice in the agreement is not consistent with the definition of good electricity industry practice in Part A of the Rules. One difference is that the Part A definition includes "economic management" whereas the Transpower definition does not. The Part A definition is provided below.</p> <p><i>"good electricity industry practice" in relation to transmission, means the exercise of that degree of skill, diligence, prudence, foresight and economic management, as determined by reference to good international practice, which would reasonably be expected from a skilled and experienced asset owner engaged in the management of a transmission network under conditions comparable to those applicable to the grid consistent with applicable law, safety and environmental protection. The determination is to take into account factors such as the relative size, duty, age and technological status of the relevant transmission network and the applicable law;</i></p> <p>It would be desirable for the definitions to be consistent and it is suggested that the Part A definition of Good Electricity Industry Practice should replace the definition of Good Engineering Practice in the Agreement.</p>
3	<p>The Provision of Plant clauses provide no real definition of the ongoing service required by the customer. The definition of service in this Agreement is input rather than output based. This means that it is based on the provision of assets rather than a service (e.g. Transpower installs and maintains assets – customer pays for them). The agreement for new investment is an opportunity to establish more meaningful service definitions that would bring the contractual relationship closer to normal commercial arrangements.</p> <p>Examples of more meaningful service definitions are:</p> <ol style="list-style-type: none">1. Assets will remain connected to the transmission network2. Assets will be capable of delivering XXMW capacity <p>These types of service measures would be subject to reasonable endeavors and maintenance outage requirements.</p>

	<p>The Transport Working Group (TWG) under the EGEN initiative produced a document that defined output based service measures and levels for transmission services. A review of the TWG work may provide some ideas on appropriate output based service measures that could be used in the new investment agreement.</p> <p>The intention may be that service measures in the Transmission Agreements will also cover connection to and use of grid. If this is the case this link should be more clearly stated in the Agreement.</p>
<p>3.1 (g) and 3.7</p>	<p>These clauses allow Transpower to connect another party to the assets that are subject to the Agreement. Clause 3.7 sets out how the payments received from the new connection will be subtracted from the charges made under the Agreement. It is understood that Transpower considers this arrangement is needed to protect open access arrangements required under the Commerce Act. However, we understand that there has been and remains doubt within industry as to whether there are Commerce Act issues.</p> <p>A potential problem arises with this arrangement for customers. If, for example, a customer wished to future proof transmission capacity to their connection point they may be prepared to sign a new investment agreement for (and pay for) more capacity than was currently required. At a point in the future Transpower may connect another party and fully load the assets meaning that the original customer has lost the benefit of future proofing that they paid for. If the original customer then wished to increase demand they would be required to sign a new agreement for more assets which may be at a higher cost than the original.</p> <p>This problem could be resolved by including a MW capacity as a service definition in the contract. Transpower would not be prohibited from connecting a new customer but would still be required to make the full contracted capacity available to the original customer. This would place the onus on Transpower and the new customer to either secure an agreement for relinquishment of the contracted capacity with the original customer or establish a new agreement with the new customer for the construction of additional capacity.</p>
<p>3.2</p>	<p>The customer has a choice between a fixed price where Transpower takes the risk of any project cost overruns and a New Investment Charge option where the customer takes the project cost risk. It should be possible to have additional types of risk sharing arrangement under the New Investment Charge option.</p> <p>One option would be for the customer to take the project cost risk within say a 5% band and Transpower take the risk on any cost overruns outside that band. Transpower could also retain any saving in excess of 5% providing an incentive to obtain savings.</p>

	<p>However, as Transpower establishes the original project cost estimates providing them with an incentive to make cost savings is problematical. This is because it provides Transpower with an incentive to inflate the original price. This is also an issue for the fixed price option.</p> <p>The Agreement only allows the customer who opts for a New Investment Charge to terminate if costs are 5% or greater than budget. However, there may be other reasons why the customer would seek to abandon the project prior to the completion of the works. Provision should be made to enable this to occur and have the charges adjusted in accordance with the Early Expiration Charge provisions.</p>
<p>3.2 (b) and 3.3</p>	<p>In a commercial bilateral arrangement such as the proposed Agreement, liabilities and penalties for items such as late delivery should be negotiable. Clause 3.2 (a) requires Transpower to use reasonable endeavours to commission the plant by due date and ensure that there are no material differences to specification.</p> <p>Clause 3.3 applies if clause 3.2 (b) does not. However it is not certain how the liquidated damages, which will be specified in Appendix 3, are to be calculated. The Agreement should require Transpower to establish liquidated damages on reasonable commercial terms with the customer. In this way the customer can judge the level of risk taken against the premium being charged.</p> <p>It is not clear how the decision to include clause 3.2 (b) or 3.3 will be made. It would be appropriate for this to be up to the customer to decide.</p>
<p>3.7</p>	<p>Clause 3.7 discusses the conditions that must be met if Transpower is to connect another customer to the assets covered in the Agreement. It says that quality and security must not be adversely affected yet these are not defined terms in the Agreement, Transmission Terms or the Rules. It would be appropriate to set out how Transpower will decide if quality and security are affected and what criteria will be applied.</p>
<p>3.7</p>	<p>With regard to reduction of contract charges, it is possible that the Electricity Commission, or some future regulator, may change the Transmission Pricing Methodology and in particular the concept or boundaries of connection and interconnection assets. Provision should be made for a review of the agreement and the calculation of charges if a material change to the calculation of interconnection and connection charges occurs.</p>
<p>4.3 (a) (ii)</p>	<p>Part (ii) for clause 4.3 (a) provides for the payment of late invoices to be made within 5 days of receipt. However, the wording of this clause can be taken to mean that early invoices arriving before the end of a month have to be paid within 5 days and not on the 20th of the following month. It should be made clear that 4.3 (a) (ii) applies to late invoices only.</p>

8.3, 8.4,
8.5

Important terms of the agreement are deferred to the prevailing Transmission Terms (Default Transmission Agreement or Connection Contract). The provisions covered in the Transmission Terms are credit, force majeure, liability, confidentiality, dispute resolution, assignment, notices and general legal terms. The application of clauses from existing contracts raises some issues for consideration.

Where a customer is on a Default Transmission Agreement the terms of that Agreement can be reviewed and amended by the Electricity Commission. Therefore the terms of the New Investment Agreement will also be amended. This brings a level of uncertainty and risk to some aspects of the Agreement.

Where a customer is on a negotiated Connection Contract the terms of that agreement are fixed for the term of the Connection Contract. Therefore the application of the Connection Contract terms to the New Investment Agreement will be fixed for the period of the Connection Contract. If a new Connection Contract or Default Transmission Agreement replaces the original Connection Contract, the terms of the replacement will apply to the New Investment Agreement. Under this type of arrangement any beneficial amendments made to the Default Transmission Agreement could not be secured by the customer unless the Connection Contract is terminated and they move to the Default Transmission Agreement.

The main benefit of the proposed application of transmission terms is that key terms of the Agreement are the same as those for in the customer's primary transmission agreement.

The main disadvantage if the customer is on a Default Transmission Agreement is that amendments made by the Electricity Commission will change the terms of the bilateral agreement for the new investment.

The main disadvantage if the customer is on a Connection Contract is that the terms are fixed and the customer would not have access to beneficial changes made to the Default Transmission Agreement.

The application of the Transmission Terms is considered to be an appropriate method of reducing the complexity of transmission contracts for Transpower and its customers. However, if a customer wishes, there should be provision for them to fix the Default Transmission Agreement terms that apply at the time of signing the contract for the duration of the contract.

Whilst it is unlikely that a customer on a Connection Contract would prefer the Default Transmission Agreement, the opportunity to have a new investment agreement with applied provisions from the Default Transmission Agreement could be made available.

<p>Schedule 3A 2.1</p>	<p>Deals with replacement of assets when they reach the end of their useful life. It is implied that Transpower will monitor this and will determine when the end of asset life has been reached. The criteria used by Transpower may be more conservative than a customer would apply. For example an industrial customer may be comfortable running older assets than Transpower would use on the Grid. It is suggested that this clause provides for the ability of the customer to require an extension of asset life where this does not compromise safety or affect the transmission service to others.</p>
<p>Schedule 3B</p>	<p>WACC is used in the Agreement to replace risk free rate in the current NIA. In the past Transpower called the NIA the "Risk Free New Investment Agreement" meaning that it was risk free to Transpower (as it was the customer and not Transpower that had the stranding risk). The risk free rate was used in these contracts as the risk to Transpower was less than that covered Transpower's average WACC. So what has changed for the average WACC to be applied to future contracts for new investment?</p> <p>The Commerce Commission has made a similar observation in their 13 May 2008 'Decision and Reasons for Not Declaring Control of Transpower New Zealand Limited'. The Commission's view, set out in paragraph 364, includes the following:</p> <p><i>".....in the GIT there is also the capacity for the Electricity Commission to determine that other rates should be used in investment appraisals. WACC, as used by the Commerce Commission, is applied to all the assets of the monopoly whereas the discount rate in the GIT is applied only to an investment in a single project – to an increment in capital. The former should relate to the risk of the enterprise on average and the latter to the risk of the proposed incremental investment. There is no reason why these rates should be the same."</i></p> <p>The question is the risk of the incremental investment under a new investment agreement different to the average risk faced by Transpower across its asset base?</p> <p>The assumption that NIC WACC = Average WACC needs to be tested and proved. Whilst Transpower could provide their position on this issue it would be appropriate (as this is a bilateral agreement) to refer the issue to an arbitrator (e.g. Professor Martin Lally of Victoria University) that Transpower and its customers mutually agreed to appoint.</p> <p>In addition, there needs to be a method for resolving disputes of any future changes to the NIC WACC. This will require information being provided on the calculation of WACC and reasons for future changes. Resolution via an arbitrator should also be provided in the Agreement.</p>

Table of small points and typographical errors

2.3 (a)	"Other Definitions" wording seems to be incomplete (i.e. " <i>have the meanings ascribed to them by paragraph 1.1 of a schedule</i> ")
3.3	Various references to clauses in 3.3 are incorrect (i.e. clause 3.3 (b) refers to 3.3.1 but this should be 3.3 (a).
3.7	Incorrect reference to clause 0
Schedule 3B	Incorrect reference to paragraph 6(b) in definition of "Fixed Component", should be paragraph 7(b)

Strata considers that it would be advisable for MEUG to be provided with a revised version of the agreement for review and comment prior to it progressing to the Transpower Board for approval.

Please contact me if you wish to discuss any of the above comments.

Yours sincerely

W.A. Heaps
Managing Director
Strata Energy Consulting Limited