



MAJOR ELECTRICITY USERS' GROUP

24 March 2010

Alex Sim
Chief Adviser
Regulation Branch
Commerce Commission

By email to Regulation.Branch@comcom.govt.nz

Dear Alex

Post-workshop submission in relation to transmission

1. This is a post-workshop submission by the Major Electricity Users' Group (MEUG) in relation to the Commerce Commission workshop held 2nd and 3rd March 2010¹ and the invitation for submissions received by email 10th March 2010. Comments on the two matters identified by the Commission for MEUG follow.

Question 2: Regarding, operating expenditure (opex), MEUG proposed, that efficiency gains actually relate to long-term superior performance: What empirical evidence or benchmarking was MEUG proposing be used?

2. This question relates to the submission by MEUG dated 31st July 2009 on the proposed Input Methodologies. The full text of our comment is repeated below:

“Consideration be given to allowing Transpower to earn a margin representing efficiency gains in operating costs relative to an ex ante forecast. However the Commission must be absolutely sure that giving Transpower a near-term benefit, in effect a higher cost to consumers, will result in superior performance against that of an efficient business in the longer-term. This should be a matter of careful empirical analysis to benchmark Transpower’s current relative performance to that of the most efficient peer business and to track performance over time to ensure there is a payback to consumers.”

3. Introducing a margin for efficiency gains in operating costs requires a measure of how efficient Transpower is compared to similar transmission businesses. The onus should be on Transpower to provide this information with the Commerce Commission assessing if the information is appropriate. If there is no suitable data available to measure the relative operating efficiency of Transpower against similar transmission business then we do not see how a bonus for superior service can be made.
4. It would be insufficient to accept prior Transpower operating performance as the benchmark against which to measure future efficiency gains in operating expenditure if we do not know if Transpower is efficient relative to similar transmission businesses. The scenario we wish to avoid is paying Transpower in the future a margin for efficiency improvements when we have been paying a full WACC to date for a service that has not been efficient.

¹ Refer <http://www.comcom.govt.nz/IndustryRegulation/Part4/DecisionsList.aspx#1346>

5. Every contestable business must have continuous improvement processes in place just to keep their current position in the market. In competitive markets only sustained superior service results in a margin over and above everybody else. Setting an ex ante multi year regulatory operating budget for Transpower needs to assume ongoing efficiency gains equivalent to the best in class of similar transmission businesses as a matter of course. Business as usual should not be the basis for an ex ante regulatory budget. A margin for superior service by Transpower needs to be clearly demonstrated against the performance of similar transmission companies. The incentive should be on Transpower to provide the data to allow such a mechanism to be put in place including the symmetrical risk that Transpower will earn less if they fall short of being efficient.

Question 4: Regarding New Investment Agreements (NIA), Transpower agreed to forward, with its submission, a copy of the new NIA, together with background information, and its view on current and potential barriers to competition in the provision of new grid assets.

6. As mentioned at the workshop we acknowledge that Transpower have made considerable progress in listening to issues raised by interested parties regarding the existing New Investment Contract (NIC). A process of informal consultation was undertaken over late 2008 and early 2009. The last draft we received was on 3rd April 2009 titled "Standard New Investment Contract" (Standard NIC).
7. Since the workshop at the start of this month Transpower has provided a copy of the new Customer Investment Contract (CIC) that will come into affect 1st April 2010. There are some changes compared to the 3rd April 2009 draft. Initial unedited comments from MEUG members and other parties on the CIC are included in the appendix. We have not had an opportunity to discuss these with Transpower.
8. MEUG has previously noted that using the regulatory WACC for Transpower's total regulated business may be inappropriate for each new CIC. For the total Transpower business there might arguably be small risks on regulatory stability or asset stranding. For plant constructed under a CIC there is a single counterparty that must already have meet the stringent credit requirements of the Transmission Agreement and the payments are clearly defined and time limited. It is difficult to see what risk Transpower is taking that will not be covered as a margin in the Fixed Charge option or full cost recovery in the other options; hence why the regulatory WACC should apply. MEUG see the CIC as essentially a cost plus contract using finance provided by Transpower and hence chargeable at Transpower's cost of debt. As counterparty risk is already covered any margin above the cost of debt would only be to cover any incremental costs associated with obtaining that debt.
9. The main policy issue is to find a way for the CIC to further evolve to better reflect construction contracts found in competitive markets. These changes can at present only be set at a pace and on the terms acceptable to Transpower. Progress to date has been positive but far too slow. We agree with the emerging view of the Commerce Commission² to consider an approach similar to the AER oversight of similar arrangements. That would include requiring Transpower to "provide all commercial information to the customer which would assist the customer in its negotiation" and "providing assurance that Transpower has targeted appropriate least cost, efficient objectives when budgeting, procuring and implementing new investment projects, and either comply with its own cost estimation, contracting and tendering policies, etc or negotiate variations against budget".

Yours sincerely



Ralph Matthes
Executive Director

² Refer agenda papers circulated by the Commerce Commission prior to the workshop.

Appendix: Initial comments on CIC

This list has been sourced from MEUG members and other interested parties. It has not been edited or discussed with Transpower.

1. Clause 2.3 (l) Replacement WACC: Issue here is retrospective application of a new WACC as defined by the Commerce Commission. Should customer take on the risk of additional interest cost burden on underpayment to Transpower?
2. Clause 3.1 Transpower's Duties: The definition of service do not relate at all to the requirements of the counterparty which may, for example, be 'increased security of supply'. The customer pays for the assets which are then owned and controlled by Transpower. At no point in this agreement are the needs of the customer recorded or acknowledged. The reasons why the customer entered the contract should be recorded.
3. Clause 3.1 (b) Transpower's Duties: Commissioning: Commissioning should at minimum "use best endeavours".
4. Clause 3.1 (e) Transpower's Duties: Meet the Budget: Transpower should "use best endeavours".
5. Clause 3.2 Change in budget: Compared to the existing NIC the CIC is now more clearly structured as an agreement for construction of assets and nothing more. This can be seen in the change in the definition of 'Good Electricity Industry Practice' to 'Good Engineering Practice' and also in the scope of Transpower's duties which are limited to the provision of plant. If the agreement is intended to be limited to an agreement to construct assets then it should be in a standard form with standard forms of performance incentives and liabilities that would be expected in a typical construction agreement.

Apart from electing the Fixed Charge option, the only protection provision for budget overruns is the ability for the consumer to terminate if Transpower advise the Budget will be exceeded by 5% before Transpower award a contract to a third party for provision of the plant. This provision is not very helpful as it places no performance pressure on Transpower and the consumer is unlikely to have an alternative to continuing at the higher cost. The lack of performance guarantees and alternatives for the consumer suggests that this is not a straightforward commercial arrangement and should be given careful regulatory oversight.
6. Clause 3.2 Change in Budget: Who pays between budget and <5% over? How many times can a budget be increased (e.g. currency volatility)?
7. Clause 3.2 (a) Change in Budget: There should be a maximum time period for notification.
8. Clause 3.2 (d) Change in Budget: counterparty to Pay Costs: Should a customer bear all of these costs?
9. Clause 3.2 (e) Change in Budget: Deemed Acceptance: Unacceptable limitation of rights, delete.
10. Clause 3.3 (c) and (d) Remedies for Delay: Provided a realistic sum is in the schedule then OK, but query whether this will ever be agreed by Transpower.
11. Clause 3.4 Condition Precedent: What happens to money paid etc if consent ultimately not obtained? Can customer claim carry cost against Transpower?
12. Clause 3.7 (b) replacement of Plant: Risk that 10% of life will not be delivered and contract termination if agreement not reached is potentially onerous to customer.
13. Clause 4.3 Date of Commissioning Tests: 10 days is short notice for major event given likely Senior Management attendance. How important is it for customer to attend a commissioning?

14. Clause 5.1 Payment of the charges: Unacceptable limitation of rights.
15. Clause 5.7 Default Interest: If an invoice is disputed then default interest should not apply.
16. Clause 7.1 (a) Circumstances of Early Expiration: non-payment: Draconian clause as covers any sum. Should exclude disputed sums.
17. Clause 7.1 (b) (iii) and (d), and (e) and (f) Circumstances of Early Expiration: Indicated days notice are too short.
18. Clause 7.1 (g): "would not remedy" should read "is unable to remedy".
19. Clause 7.2 Other termination rights: Unacceptable limitation of rights under law.
20. Clause 8.1: "which materially affects a party's" should read "which materially affects either party's".
21. Clause 9.5 (b) Application of Other Provisions: Is the 100% of contract charges adequate?
22. Clause 10 to be added re governing law is NZ law.
23. Clause 11 to be added re signing by fax etc for boilerplate clauses.
24. Schedule 3 New Investment Charge and Schedule 3B Variable Charge, Clauses 1.4: Use of tax gross up on capital costs to Transpower and then depreciation offset in levelised payment; this methodology needs to ensure that the net present value of total project payments is not inconsistent with the counterfactual of the customer paying non-grossed up payments etc.
25. Schedule 3 New Investment Charge and Schedule 3B Variable Charge, Clauses 2.3 and 2.4 respectively: Need to ensure that WACC adjustment is not retrospectively applied across prior payments (unsure of intent of sub clause but note Clause 2.6 in each schedule).
26. Schedule 3 New Investment Charge, clause 3.2 (f): There should be a defined methodology for calculating internal Transpower costs that is auditable and verifiable.
27. No fixed pricing options or milestone definitions so full cost variability risk passes to customer.
28. Schedule 4 Early Expiration Charge: Seems particularly onerous given externalities that could bring rise to early termination (e.g. regulatory risk, legislative risk). Much of the value at risk falls on reliance of Transpower delivering on schedule regardless of customer executing obligations on schedule.
29. Schedule 4 Early Expiration Charge, clause 2.2: Should have a defined time limit for Transpower to refund any negative Early Expiration Charge and also there should be carry charges applied against Transpower for late payment (parity with their charging for late payments).
30. Other: An issue discussed with Transpower last year is what provisions will apply if, at a future date, the assets are used for the benefit of other customers. The CIC is silent on this point. Once commissioned the assets will be owned by Transpower (clause 3.5) and will be part of the Grid (clause 3.6) yet will be paid for by the consumer under the terms of the CIC. As the Grid is 'open access' Transpower may connect other customers to the asset which may reduce the actual service provided to the contract counterparty that is paying for the assets. For example, if the consumer agreed to pay for an additional transformer to provide N-1 capability and subsequent connections reduced this to N. The CIC does not prevent this from happening or provide compensation to the consumer paying for the asset if it does. In the prior draft Standard NIC Transpower removed the clauses giving them the rights to connect others and adjust the payments. However, because the CIC is now silent on this issue, there is a risk that there will be inadequate protection and or compensation to the counterparty from the impacts of future connections. This could be remedied by inserting after clause 3.6:

'Transpower will not permit any person or an additional customer to connect to the Plant (or any associated equipment that utilises the capacity of the Plant) for the duration of this Contract where, in the «CONTRACT_ORG_NAME»'s opinion, connection is likely to adversely affect the quality and security of the flow of Electricity to «CONTRACT_ORG_NAME»'s Assets. If «CONTRACT_ORG_NAME»'s agrees to the connection of an additional customer to the Plant, «CONTRACT_ORG_NAME»'s any payments due under this contract will be renegotiated on the basis of the shared use of the Plant.'