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5 December 2007

David Smol
Deputy Secretary, Energy and Communications
Ministry of Economic Development
33 Bowen Street
PO Box 1473

Dear David,

Review of Parts 4 and 4A of the Commerce Act

1. Introduction

Transpower comments below on the proposals arising from the Review of Parts 4 and 4A of the Commerce Act, in the context of the proposed framework for the regulation of transmission services.

2. Detailed Comments

2.1. Proposals for a default price-quality path (or revenue path)

The Cabinet Paper¹ proposes that the Commerce Commission should set a default price path for a regulatory period (likely to be between three and five years) for all of the larger Electricity Lines Businesses (ELBs), including Transpower, based on factors such as productivity trends and comparative benchmarking.

It is not clear whether the Cabinet Paper envisages Transpower fitting into the benchmarking regime applying to the electricity distribution businesses. In Transpower's view this would be inappropriate given the different characteristics of transmission compared to distribution. This should be clarified in the final proposals.

2.2. Proposals for a customised price-quality path (or revenue path)

Transpower welcomes the formalisation of an option whereby businesses can request a customised price (revenue)/quality path. Transpower believes that the initial price thresholds set for Transpower under Part 4A of the Commerce Act were inappropriate and that it was inevitable that it would breach these thresholds as it

¹ Review of Parts 4 and 4A of the Commerce Act.

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commenced a major investment programme. The administrative settlement process has enabled the development of more appropriate “thresholds”, based on ex ante consideration of individual inputs to the setting of Transpower’s revenue requirements. Transpower considers that a customised revenue path, in effect formalising the settlement approach, is likely to improve the transparency of the revenue setting process, and provide Transpower and its customers with improved certainty but only if certain additional steps are taken (refer section 3 below).

Transpower's approach to revenue setting (including the adoption of the EC’s transmission pricing methodology) means that a revenue path is more appropriate for Transpower than a price path. The Cabinet Paper does not refer to the option of a default or a customised revenue path. It is possible that the generic term 'price-quality path' may encompass both revenue and price paths, but Transpower recommends clarification that this is indeed the case.

2.3. Input methodologies

Transpower considers that there will be benefits arising from the proposals in relation to input methodologies. Transpower agrees that the development of input methodologies by the Commission, in advance of their use, will provide increased certainty for regulated businesses.

Transpower notes that the ex ante review of operating and capital expenditure is an integral part of determining a customised revenue path. Therefore, in addition to the development of input methodologies, Transpower recommends that the Commission set out its approach to determining allowed operating and capital expenditures. This is particularly relevant to Transpower, given that a major component of its revenue is determined by the Electricity Commission (via investment approvals). The process by which Transpower’s operating and capital expenditures will be considered by both Commissions, and how the respective decisions of the two regulators will be integrated into any revenue path determination, should be codified as a separate “transmission” input methodology, rather than managed through the Memorandum of Understanding between the two Commissions.

2.4. Quality

The treatment of quality has been an unsatisfactory aspect of the thresholds regime to date. While Transpower (in common with other lines businesses) acknowledges that regulation of service quality is essential, the way in which the quality threshold has been defined to date has meant that businesses will almost inevitably breach the quality thresholds at some point.

While the Cabinet Paper refers to a price-quality path, it is not clear to Transpower what this might involve in practice. Transpower is aware that, as part of its draft decision not to declare control of Transpower, the Commission is consulting on whether Transpower’s current quality threshold is appropriate. Notwithstanding this consultation, greater clarity as to the approach likely to be applied to quality, including the penalties for breaching the thresholds, is recommended.

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2.5. Merits review

Transpower welcomes the proposal that the Commission's development of input methodologies should be subject to merits review. Transpower agrees that this will help ensure that potential errors in the proposed approach can be corrected, and will promote increased confidence in regulatory decision making.

The proposals do not extend the application of a merits review to Commission decisions relating to specific matters. Transpower disagrees with this approach. There is significant potential for decisions outside of the input methodologies where the Commission's approach may be inconsistent or inappropriate in particular instances and which could have very significant impacts on individual businesses. Without the opportunity for an independent merits review in these circumstances, there is a significant risk that wrong decisions may be imposed on businesses with no prospect of correction.

3. Further regulatory reforms

Transpower's submission to the MED's review observed that the regulatory regime applying to Transpower could be substantially improved by the following:

- i. Applying a conventional revenue path control to Transpower and codifying the processes and input parameters for this form of control in rules and/or regulations;
- ii. Clarifying Transpower's accountability for investment by removing the Electricity Commission's (EC's) ability to substitute its judgments on investment for those of Transpower;
- iii. Having a single economic regulator that is responsible for setting the allowed revenue requirement and separating rule setting from rule implementation. Transpower's preferred option would have the CC setting the rules and the EC implementing them;
- iv. Allowing merits review of the decisions of both Commissions.

The recommendations made in the Cabinet Paper address issues (i) and (iv) to some degree, but do not progress the issues identified in (ii) and (iii). Transpower is disappointed with the decision not to consolidate the regulation of transmission services to the jurisdiction of a single economic regulator and that the review did not take the opportunity to make improvements to the wider regulatory framework applying to transmission. Nonetheless, Transpower believes that the proposals in the Cabinet Paper can represent a step towards a more effective and enduring regime for the regulation of transmission services. A more conventional form of revenue (and service quality) regulation, as applied in a number of comparable jurisdictions, including Australia and the United Kingdom, can still be achieved provided the following further key steps are implemented, in addition to the Cabinet Paper's proposals:

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1. Revise the Memorandum of Understanding (MoU) and associated transmission protocol. Given the regulatory roles of both Commissions in respect of transmission are to be retained, it is imperative that meaningful steps are taken to clearly define respective roles and ensure coordinated decision-making. In particular a revised protocol must:
 - a) reflect the interim regulatory arrangements contained in Transpower's settlement proposal;
 - b) clearly define how the activities of the two Commission will be integrated under the framework described by the Cabinet Proposals; and
 - c) in areas of overlap (such as investment approvals), identify where the decisions of one Commission will bind the actions of the other.
2. Implement Part F rule changes to remove the current ambiguity as to the respective accountabilities of Transpower (as grid planner) and the EC (as reviewer and approver) and remove the EC's ability to substitute its judgments on investment for those of Transpower²;
3. Establish pragmatic Part F processes to enable the EC to consider and approve an aggregated programme of all "investment in the grid" for a five year period, as contemplated by the GPS³, and consistent with a customised revenue path.
4. Establish a timetable and roadmap for implementation of a five year customised revenue path (including ex ante investment approvals by the EC) to take effect from 1 July 2011 (i.e. from the end of the proposed administrative settlement).

We will seek further engagement with Officials and both Commissions on these further proposals. In the meantime, if you have any questions please do not hesitate to contact me.

Yours sincerely



Howard Cattermole
General Manager Corporate Services

cc Mervyn English (EC), Michael Clark (EC)

² Transpower is currently engaging with the EC on the issue of Part F rule changes in this regard.

³ Refer para 87A of the GPS 2007... "It will also enable consideration and approval of investment proposals for the grid as a whole over an appropriate timeframe (for example, five years) within a longer term framework."