PACIFIC **ALUMINIUM**

27 June 2014

Regulation Branch
Commerce Commission
PO Box 2351
Wellington

By email to: regulation.branch@comcom.govt.nz

SUBMISSION ON THE DRAFT DECISION ON SETTING TRANSPOWER'S INDIVIDUAL PRICE QUALITY PATH FOR 2015 - 2020

Introduction

1. This submission is made by Pacific Aluminium on behalf of Rio Tinto Alcan (New Zealand) Limited ("RTANZ") and New Zealand Aluminium Smelters Limited (NZAS). It is made in response to the Commission's paper on the draft decision on setting Transpower's individual price quality path for 2015 - 2020 (the paper) of 16 May 2014. Thank you for the opportunity to provide this feedback and nothing in this submission is confidential.

2. We wish to raise the following points:

   a) Transmission costs are a significant operating cost for the smelter and those costs have increased at an alarming rate in recent years, for no discernible change in service. Business in New Zealand needs an efficient and cost effective transmission service.

   b) While Transpower's proposal speaks of seeking greater efficiencies,

Level 6
109 Featherston Street
Wellington 6011
New Zealand
PO Box 1665
Wellington 6140
New Zealand
T +64 (0) 4 471.1527
F +64 (0) 4 472.8041
www.pacificaluminium.com.au

we consider the allocation of significant expenditure for new offices and other non-essential projects at this time indicates otherwise.

c) Transpower's demand forecasting methodology appears to be outdated, probably leading to excessive budget forecasts and over investment.

d) We support the findings of the Commission and its decision to reduce Transpower's opex and capex allowances. However, we believe there is room for further improvement.

Our detailed comments are provided as follows.

Impact of transmission costs on NZAS

3. NZAS operates the aluminium smelter at Tiwai Point on behalf of its owners Rio Tinto Alcan (New Zealand) Limited, a business of Pacific Aluminium, and Sumitomo Chemical Company. NZAS is a tolling entity and supplies aluminium to its owners, which they market around the world, with more than half NZAS' production sold in Japan.

4. NZAS continues to face a difficult market environment, with a sustained low price of aluminium in the global market and a very high New Zealand dollar. Earlier this week, RTANZ posted an underlying financial loss for the year ending December 2013; the second year in a row.

5. NZAS is continuing to do everything within its control to ensure the smelter's future competitiveness, and has made significant inroads into reducing its operating costs. However, one expense NZAS has not been able to have any impact on is the cost of transmission, which increased by over 45% per tonne of aluminium between 2010 and 2013. Given that an aluminium smelter uses a significant amount of electricity, this unprecedented rise in NZAS' transmission costs is placing a serious burden on the business. Based on Transpower's current forecasts, the cumulative *increase* in total transmission costs to NZAS between 2010 and 2016 will approach $100 million.

General assessment of Transpower's proposal

6. It is recognised that many of New Zealand's industrial consumers are facing significant competitive challenges from depressed global commodity prices and the high New Zealand dollar, and that all customers are feeling the pressure of increased transmission costs. Remaining competitive necessitates a relentless pursuit of efficiency improvements and cost reduction. It is important to the competitiveness of New Zealand that Transpower has a similar focus on its operating and capital expenditure. Whilst acknowledging that progress has been made, it is clear that there is still much to do and Transpower must increase its focus on minimising future capital and operating expenditure.

7. While Transpower's submission speaks of greater use of variable line rating, static VAR compensation and demand-side participation, we also observe significant expenditure proposals related to the relocation of substations indoors, greater undergrounding and construction of new corporate offices. Allowed returns that are a premium to the cost of capital drives incentives to invest, even where alternative ways to meet customer needs without investment may be possible. Transpower is well aware of the relationship between the allowed rates of return and its profitability and, in its 2012/13 APR has quantified the relationship as 10 basis points difference in the WACC translating into $4m change in Net Profit After Tax.

8. We appreciate that a separate Commerce Commission process is reviewing the WACC input methodology. Nonetheless, it is important to view the regulation of Transpower's revenue requirements as a whole rather than focus on fragmented elements in isolation as one element impacts on another. Deficiencies in one area of regulation can have negative effects in other areas. For instance, a WACC that is too high and creates an incentive to over-invest puts additional pressure on the Commerce Commission and its consultants to scrutinise and challenge Transpower's detailed expenditure proposals.

9. Pacific Aluminium is encouraged by the Commerce Commission's draft decision to set opex and capex allowances that are 6.5% and 12.3% respectively lower than proposed by Transpower. However Pacific Aluminium is also concerned that excessive allowances for rates of return are incentivising excessive expenditure claims. External reviews of detailed expenditure plans by regulators will tend to be conservative due to information asymmetry and concern about the consequences of cutting

too deep, so driving the right behaviour initially is likely to lead to more effective outcomes.

Demand Forecasting

10. Transpower's demand forecasting methodology merits further consideration by the Commerce Commission. It is noted that Strata identifies in its report that Transpower acknowledges deficiencies in its forecasting methodology and a perusal of the limited data available in Transpower's 2013 APR indicates that network expansion expenditure remains excessive.

11. New Zealand is experiencing flat to declining electricity demand. It is one of several economies[1] experiencing an unprecedented change in the pattern of demand, and has the hallmarks of a structural shift.

12. On a dollar per GWh generated basis, Transpower has proposed opex expenditure that, having increased by around 11% between 2009/10 and 2013/14, would fall back to just 2% above 2009/10 by 2019/20. However, if electricity demand were to remain flat through the forecast period, expenditure per GWh generated would show little to no improvement through the period. If the demand forecast is systematically high this will further encourage over expenditure and over-investment. The forecasting methodology should be reviewed and consideration given to whether expenditure allowances require further adjustment.

Economic Value Adjustments

13. Pacific Aluminium does not agree with the Commission's previous decision to clear the legacy 2011 EV account balances by the end of RCP2. These balances represent a significant over-recovery of transmission charges from consumers and under- recovery of HVDC charges from generators.

[1] United Kingdom, USA and Australia have been experiencing flattening or falling electricity demand over several years.

14. The balance of these accounts in Transpower's 2012/2013 financial statements[2] stand at:

- -$25.6m for the HVAC assets
- +$26.7m for the HVDC assets

This means that consumers and those paying for connection assets are owed $25.6m by Transpower, whilst South Island generators owe Transpower $26.7m.

15. In October 2012 the Electricity Authority proposed a revised transmission pricing methodology that is undergoing consultation. If implemented, it will change the way that costs for the transmission system are recovered and in particular from which parties they are recovered. It would be inequitable if a change in methodology resulted in any rebate of HVAC charges associated with interconnection assets was given to generators as they had not contributed to the build-up of this surplus. It would be similarly inequitable if a changed methodology resulted in Transpower recovering greater costs from consumers and North Island generators for the previous shortfall in cost recovery for the HVDC from South Island generators.

16. For these reasons, Pacific Aluminium urges the Commission to revisit this decision with a view to shortening the period within which these balances are to be cleared. Our suggestion is that these balances are cleared at least within the next two pricing years so that they are gone by the start of the 2017/18 pricing year; which we consider to be the earliest a significantly revised methodology could take effect. Our preference would be to see them cleared sooner rather than later as, while these balances remain outstanding, transmission customers are effectively extending credit at a time when they are already burdened with very high increases in transmission costs.

17. An early clearance of these balances would be consistent with the Commission's earlier position[3] that maintaining these balances as close to zero is desirable, especially in relation to the allocative efficiency impacts and the objectives of ss 52A(1)(c) and (d) of the Commerce Act. The Commission also noted the potential of an amended TPM to

[2] Note 2, Operating Revenue, page 41 of Transpower's 2012/2013 financial statements.
[3] Paragraph 3.10.22 of Individual Price Quality Path (Transpower), Commerce Commission, December 2010.

reallocate the distribution and recovery of these outstanding balances in a way that was not desirable[4].

Base Capital Expenditure

18. Transpower proposed base capex of $1188.6m (in 2012/13 constant prices) over the RCP2 period. The Commission's draft decision is to reduce this amount by $133.3m to $1055.3m a total reduction of 12.3%. Pacific Aluminium notes that the threshold for base capex has been increased from $5m to $20m This means that base capex in RCP2 captures more projects that would have been classed as major capex (with its separate approval process) in RCP1. Therefore, it is not clear to us to what extent the increase in base capex is due to the change in definition and making it difficult to assess the reasonableness of the RCP2 base capex proposal.

Grid Enhancement and Development Capex

19. It is encouraging to note that where Strata did find issues arising from initial samples of enhancement and development capex it extended its enquiries in order to test the robustness of Transpower's remaining proposed E&D capex. This has resulted in the Commission's draft decision to reduce Transpower's proposed E&D capex from $123.8m to $56.7m – a reduction of $67.1m or 54%.

20. Pacific Aluminium supports this reduction, but considers that it raises concerns about the robustness of Transpower's planning and cost estimation processes in this area. Strata identified[5] concerns with demand forecasting, needs identification and options analysis.

21. With demand likely to be static over RCP2 and little further investment in generation likely in the period, we would have expected Transpower's E&D expenditure to be minimal over RCP2. Further, we would want Transpower to have a very sharp focus on minimising this expenditure and getting the most use out of its existing assets, especially in light of the recent very large building programme.

[4] Ibid, paragraph 3.10.23
[5] Technical Advisor Report on the Transpower New Zealand Ltd IPP Proposal for RCP2, page 71, paragraph 295. Strata Energy Consulting Limited and Energy Market Consulting Associates. 16 May 2014.

22. It is also concerning that Transpower has not adequately justified the need for all of these investments or adequately considered other options.

Metal Prices

23. The Draft Decision asks for views on the forecast price of metals used in the adjustment from constant current allowances for capex and opex to nominal allowances. Our concern is that the methodology that the Commission has used is requiring it to take views on these.

24. Transpower does not, for the most part, procure steel, aluminium, copper or other commodities. It procures manufactured products of which these metals are part. The price of these manufactured products, being set in markets with their own dynamics, often have poor correlation to the price of their component commodities. Indexing the cost of manufactured products based on a hypothetical break down of their input commodities – as Transpower has proposed and the Commission largely accepted – creates an asymmetric error. Specifically, it seems inconceivable to us that the Commission will be able to meaningfully challenge Transpower's proposals on indexation – can the Commission ever be expected to have an informed view on the future price of copper and the amount of it that will be in Transpower's various assets?

25. For these reasons we suggest that the Commission seeks another way to convert its proposed opex and capex allowances in constant terms into nominal dollars. Perhaps the use of a broader index, such as a producer price index adjusted for expected national productivity improvement may be an alternative that the Commission might consider.

Operating Expenditure

26. Pacific Aluminium supports the Commission's draft decision to reduce Transpower's proposed opex for RCP2. We note Strata's view[6] that Transpower's proposed Grid opex forecast is likely to represent efficient costs that will reasonably be required to maintain the network in an appropriate condition, though we do not think this conclusion is supported by the evidence. We also note Strata's criticisms of aspects of non-grid opex.

---

[6] Ibid, paragraph 550.

27. Pacific Aluminium agrees with the sentiment expressed by Strata[7] that

"…in respect of the price pressures experienced by electricity consumers, we would expect Transpower to be aggressively seeking to reduce costs in all areas of its business, but particularly in the non-network category."

28. In this regard we are concerned by Strata's conclusions[8] concerning corporate opex and in particular the proposed funding of a corporate office relocation that is not supported by a robust business case. In this regard, Pacific Aluminium agrees with Strata[9]

"…that an organisation focused on cost restraint so as to minimise its cost burden on consumers would require a high hurdle rate for an office relocation, as it is discretionary expenditure."

Proposed Grid Output Measures and Quality Standards

29. We agree broadly with the Transpower's proposals (and the Commission's acceptance) of incentives to improve service standards. We do not have sufficient information to critique the parameters that have been specified or the incentive design, but we would like to stress the importance of ensuring that the incentive scheme is revenue neutral – i.e. that the parameters are set so that the expected value of the incentive payment is zero. The Commission refers to the Australian experience in justifying an incentive payment of $10m, about 1% of annual income. This is not unreasonable, but the experience in Australia is that the service incentives have delivered windfall gains for the service providers as a result of targets that have been insufficiently demanding. We would like to encourage the Commission to consider this in the targets that it ultimately decides.

30. We also consider that the additional performance measure proposed by Strata Energy[10] - a network health measure – would be a useful addition to the Commission's proposed measures. We consider that such a measure would improve the efficiency of capital and operational expenditure. Transpower needs to focus on getting the maximum value

[7] Ibid, paragraph 557.
[8] Ibid, paragraph 591.
[9] Ibid, paragraph 576.
[10] Ibid, Section 9, page 151.

for its customers out of its existing assets and this measure should assist in achieving this.

Concluding Comments

31. Pacific Aluminium is encouraged by the Commission's draft decisions to reduce Transpower's allowed capital and operating expenditure for RCP2. However, we have noted Strata's concerns in a number of areas and this clearly indicates there is significant room for improvement.

32. Likely static demand and minimal commissioning of new generation over RCP2 would suggest little or no further investment in transmission is required, yet Transpower continues to use demand forecasts that suggest otherwise. Transpower also needs to focus on greater efficiencies that extract more value from its existing assets and reduces operating expenditure, especially in non-grid areas.

33. We consider that Strata's proposed network health measure could assist in minimising sustaining grid opex and capex, and support the adoption of incentives to improve performance, provided they apply symmetrically.

34. Our one area of significant disagreement concerns the treatment of the current EV balances for HVDC and HVAC assets. Pacific Aluminium considers these should be cleared as soon as possible and at least over the next two pricing years, before a significantly new transmission pricing methodology is introduced which changes the allocation of costs for these assets.

35. We are happy to discuss our submission in more detail with the Commission and its advisors, so please contact me in Wellington on 916-1493 if this is desired.

RG Deacon

Ray Deacon
Manager Regulatory and Government Affairs