

## ELECTRICITY COMMISSION

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**Before** : Commissioners 'Atiola, Vaihū and Kitekei'aho :

**Assisted by** : Mr. Morris Pita of Messrs Shea Pita & Associates  
(Reset Independent Expert Advisor to the Commission):

Mr. Tavake B. Afeaki  
(Reset Legal Advisor to the Commission): and

Rt. Hon. Lord Dalgety Q.C.:  
(Chief Executive of the Commission):

**Clerk** : Miss Meleseini V. Folau  
(Secretary to the Commission):

**In Re** : **ELECTRICITY RESET 2015**

**Decision Date** : 31<sup>st</sup> August 2015

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**DECISION NUMBER 4**

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## INTRODUCTION TO THE SECOND ELECTRICITY CONCESSION CONTRACT FOR RESET PERIOD 2

- 1: The Instrument which enables the Electricity Commission to carry out its duties as regulator of the electricity sector of the Kingdom of Tonga is called the Electricity Concession Contract. The first such Contract was imposed upon the Regulator by the Minister of Finance<sup>1</sup> in July 2008 and applied throughout the whole of the first regulatory (or reset) period (25 July 2008 to 31<sup>st</sup> August 2015). Reset Period 2 commences 1<sup>st</sup> September 2015 and ends 30<sup>th</sup> June 2020.
- 2: For the second, and subsequent, regulatory periods Section 2(1) of the Electricity Act 2007 (“the Act”) enables the Commission to enter into an Electricity Concession Contract permitting Tonga Power Limited as Concessionaire to generate, distribute and supply electricity in the Kingdom. For the same regulatory periods Section 20(2) of the Act provides that the Minister of Finance on behalf of the Kingdom of Tonga may be a party to the second (and subsequent) electricity concession contracts but **only to the extent that the contract confers rights or imposes obligations upon the Kingdom.**
- 3: With these statutory provisions in mind the Commission has re-structured the Second Concession Contract into two parts, each part contained in a separate document.
- 4: First, there is a document entitled the **Agreement** which incorporates *inter alia* all the matters encompassed by Section 20(2) of the Act and which, in all material respects, repeats the relevant provisions of the first concession contract of 2008 insofar as they confer rights or impose obligations upon the Kingdom. At the request of the Kingdom it also includes at **Clause 5.4** a provision enabling this concession contract to be terminated with the consent of all the parties to the Agreement, that is the Kingdom, the Commission and the Concessionaire.
- 5: Secondly, there is a separate document entitled the **Regulatory Addendum** which encompasses all the regulatory arrangements entered into between the Commission and the Concessionaire in respect of the Second Reset Period.

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<sup>1</sup> See paragraph 2 of Reset Decision Number 1 dated 29<sup>th</sup> June 2015.

## RESET OBSERVATIONS BY THE KINGDOM OF TONGA

- 6:** On 2<sup>nd</sup> June 2015 the Commission received from the Minister of Finance, on behalf of the Kingdom of Tonga, the Kingdom's Observations on the 2015 Electricity Reset Process<sup>2</sup>. We have already remarked thereon in our Reset Decision 1 dated 29<sup>th</sup> June 2015<sup>3</sup>.
- 7:** Many (but not all) of the suggestions contained in these Observations dovetailed with the thinking of the Commission as to what was required in the Second Electricity Concession Contract for Reset Period 2 (2015-2020). As with the views expressed by Tonga Power Limited in respect of the present Reset<sup>4</sup>, the Commission's Independent Expert<sup>5</sup>, and the Tonga Mission Report by SPC Petroleum Advisory Service<sup>6</sup>, full consideration was given by the Commission to the Observations of the Kingdom. It was considered not unhelpful if at this juncture the Commission set forth their thinking thereon.
- 8: **Reset Period**** : The Commission agrees that the Second Reset Period should be for five and not seven years as more fully explained in Reset Decision Number 1<sup>7</sup>.
- 9: **Rate of Return**** : This issue was canvassed at length in Reset Decision 1<sup>8</sup>. All the information requested by the Kingdom from Tonga Power they have provided<sup>9</sup>, but for the reasons given in Reset Decision 1, based on advice from the Commission's independent expert<sup>10</sup>, the Commission determined that for regulatory purposes the allowed rate of return during the Second Reset Period should be 8.50% post-tax real. It must be stressed that this figure is "for regulatory purposes" only being an essential factor in determining the Concessionaire's permitted Capital Expenditure (CAPEX) for

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<sup>2</sup> Reset Document CON-2

<sup>3</sup> Reset Documents EC-100 at paragraphs 23 and 24

<sup>4</sup> Reset Documents TPL-1 to 36

<sup>5</sup> Reset Document EX-1 to 3

<sup>6</sup> Reset Document CON-1

<sup>7</sup> Reset Document EC-100 at paragraph 26

<sup>8</sup> Reset Document EC-100 at paragraph 28

<sup>9</sup> Reset Document TPL-33

<sup>10</sup> Reset Documents EC-1 and 3

Reset Period 2 and in settling the new non-fuel component of the regulated tariff, all as required by the Reset Rules<sup>11</sup>. It is not to be confused with any internal rates of return which Tonga Power might set itself as a management tool to measure their performance, or any return demanded of it by their shareholder, the Kingdom of Tonga.

**10: Extraordinary Adjustment** : The Commission have never been satisfied with the extraordinary adjustment rules imposed upon them by the 2008 Electricity Concession Contract which gave Tonga Power the exclusive power to seek such adjustments. The Commission had no power to seek an extraordinary adjustment. That crucial defect has now been rectified by the new Clause 4.1 of the Regulatory Addendum which provides that :-

- “4.1 (a) If an Extraordinary Event has occurred, and if **either the Concessionaire or Commission** considers that the Extraordinary Event may create grounds for an Extraordinary Tariff Adjustment, then, subject to Clause 4.1(b), that party may submit to the other party a notice (Extraordinary Event Notice) requesting an Extraordinary Tariff Adjustment.
- (b) An Extraordinary Event Notice may not be given within (a) twelve months immediately before a Reset; or (b) within twelve months after an Extraordinary Tariff Adjustment.
- (c) The provisions of Schedule 8 shall apply if an Extraordinary Event Notice is given in accordance with this Clause 4.”

**11:** What therefore is an “Extraordinary Event”? Some adjustment, in the interests of clarity, is required to the existing definition<sup>12</sup>, but a degree of flexibility is required to permit of a judgment call, according to the circumstances of each case, of what can be regarded as a “material change.” Accordingly, the Commission are of the opinion that

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<sup>11</sup> See Schedule 11 of the 2008 Electricity Concession Contract at paragraphs 16-18

<sup>12</sup> Clause 7.2 of the 2008 Electricity Concession Contract

an appropriate definition in Clause 4.2 of the Regulatory Addendum for “Extraordinary Event” for Reset Period 2 should be : -

- “ (a) a material change in the definition of any of the indices **contained in this Regulatory Addendum** used in adjusting the non-fuel component of the Regulated Tariff;
- (b) in any one calendar year, where the difference between actual growth in total kWh of electricity billed and the forecast growth in total kWh of electricity billed for that year as determined at the most recent Reset exceeds three percentage points.
- (c) any Force Majeure Event;
- (d) any discriminatory treatment by the Government of the Kingdom of Tonga **or any instrumentality of the Government which materially** [i] reduces the revenues of the Concessionaire over any 12 month period or [ii] increases the Cost of Service to the Concessionaire over any 12 month period;
- (e) any change in the tax rate applicable to the Electricity Business of the Concessionaire greater than three percentage points;
- (f) any increase or decrease (or combination of increases or decreases) in an existing fee or charge, or introduction of a new fee or charge, **that changes the Regulatory Revenues of the Concessionaire over any 12 month period by in excess of three percentage points;**
- (g) any cancellation or postponement of approved CAPEX projects; or any aid funding for such a project becoming available;**
- (h) any other event, that materially changes the revenues of the Concessionaire or the non-fuel cost of service over any 12 month period; and**

- (i) otherwise as the Commission and the Concessionaire may agree upon in writing.”

The provisions in red ink are the changes to be made to the requirements of the 2008 Electricity Concession Contract.

- 12: CAPEX – Gifted Assets :** As with Reset Period 1, for Reset Period 2 assets gifted from any entity are not taken into account by the Commission in determining the Regulatory Asset Value (R.A.V.) of the Concessionaire : and accordingly, no depreciation in respect of these assets is permitted in the calculation of the depreciation element of the permitted OPEX for Reset Period 2. There have been discussions between the Commission and the Concessionaire about arrangements for the replacement of donated assets at the end of their useful life and in this regard the Commission has proposed to the Concessionaire that from the commencement of Reset Period 3 in July 2020 the Concessionaire must put aside each year into a sinking fund a sum of money so that in due course they have an asset replacement reserve to fund a significant portion of the donated assets replacement costs. The Reset discussions in 2020 will require to result in an asset replacement value being determined and the annual “contribution” (a percentage thereof) to the Asset Replacement Reserve adjudicated upon by the Commission. In principle these proposals have been accepted by the Concessionaire.
- 13:** It goes without saying really that the R.A.V. must (and in fact does at present) exclude assets owned by a third party such as electricity customers as part of their distributed generation system. The Commission most certainly would follow this same approach in the event of an independent power producer owning assets he used to supply electrical power to the Concessionaire for transmission, distribution and sale by them to their electricity customers.
- 14: Non-diesel Generation :** This is a matter covered by Reset Decision Number 2<sup>13</sup> and the Regulatory Addendum now includes a formula which transparently assures electricity

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<sup>13</sup> Reset Document **EC-101** in particular at paragraphs 3 and 12

customers that fuel savings from renewable generation are used to reduce the fuel tariff.

This is now included within Schedule 6 of the Regulatory Addendum.

- 15: Fuel Tariff Adjustment Period** : This matter was resolved in Rest Decision Number 1<sup>14</sup> and the Commission consider that their decision recorded at the end of Paragraph 32 of that Reset document introduces adequate flexibility to meet any significant variation in the cost of diesel fuel purchased by the Concessionaire for the purpose of electricity generation. That Decision is augmented by the wording of Paragraph 2.2 of Schedule 6 of the Regulatory Addendum which states that : -

“ 2.2 The **Fuel Component** of the Regulated Tariff ordinary shall be adjusted during the Reset Period on a quarterly basis (on 1 July, 1 October, 1 January and 1 April) in accordance with the provisions of paragraphs 6 to 16 of this Schedule but the Commission in their absolute discretion may consent to an *ad hoc* request from the Concessionaire to an adjustment within each quarter where there is an upward “spike” in the landed cost of diesel at Nuku’alofa OR may require an adjustment within each quarter where there is a significant reduction in the landed cost of diesel at Nuku’alofa.”

- 16: Other Tariffs** : The Commission are able to reassure the Kingdom that the Regulatory Addendum provides that nothing other than the Regulated Tariff may be charged to consumers without the prior approval of a written decision of the Commission. As noted later in this Decision any application by the Concessionaire to introduce a tariff (other than the Regulated Tariff) would require to be served upon the Kingdom and the Commission would consider their observations thereon before making a decision. There is nothing in the Regulatory Addendum which would prevent the Commission and the Concessionaire considering any alternative tariff ideas laid before them by the Kingdom.

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<sup>14</sup> Reset Document **EC-100** at paragraph 32

- 17: Hedging** : In Reset Decision Number 1<sup>15</sup> the Commission decided that the Concessionaire “shall not undertake any hedging activity in respect of the Price of Oil except with the prior written consent of the Regulator and in accordance with the Hedging Provisions<sup>16</sup> of the Reset Addendum.”
- 18: Power Purchase Agreements** : Any such Agreement could not come into force without the prior written consent of the Commission. The Commission intends to develop a Protocol for consideration of such PPA proposals, including assessment of the benefits of any such arrangement to Tonga’s electricity consumers, all in consultation with the Concessionaire and the Kingdom. Specific provision therefor is made in Clause 2.16 of the Regulatory Addendum.”
- 19: Reporting** : The Regulatory Addendum is quite specific about the nature and extent of the reporting requirements of the Concessionaire to the Commission. Both parties understand precisely what is required. Henceforth the Commission has proposed that all Reports and Applications by the Concessionaire to the Commission (together with all supporting papers) and all Decisions by the Commission or Requests by them to the Concessionaire for further information be recorded electronically at a internet site available to all. The Concessionaire has assented to this proposal. The Commission considers that such transparency is a regulatory imperative.
- 20: Consultation with the Kingdom** : The Regulatory Addendum at Clause 2.14 includes a provision in the following terms : -

**“ Kingdom of Tonga**

2.14 The parties hereto recognise the legitimate interest of the Government of the Kingdom of Tonga as political guardians of the general public interest and for that reason undertake to consult said Government in respect of any proposal to amend the provisions of this Addendum; to review, reset or alter in any manner

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<sup>15</sup> Reset Document **EC-100** at paragraph 33

<sup>16</sup> Clause 2.15 of the Regulatory Addendum

of way the electricity tariff; to review, reset or alter Non-Tariff Charges; and otherwise as expressly provided for in the Addendum.”

#### **EXECUTION OF THE SECOND ELECTRICITY CONCESSION CONTRACT**

- 21:** There is distributed to the Concessionaire and the Kingdom along with this Decision the terms of the Second Electricity Concession Contract as approved by the Commission and the Concessionaire. The Chief Executive of the Commission was authorised to execute on behalf of the Commission both parts of that Contract, namely the Agreement and the Regulatory Addendum: the Chairman of Tonga Power Limited had similar authority from the Concessionaire.

#### **OUTSTANDING ISSUES**

- 22:** It has not proved possible during the present reset to finalise a policy on **Power Purchase Agreements** but arrangements to complete this at an early date are set forth in Paragraph 18 of this Decision.
- 23:** The Concessionaire requested the Commission to defer until a later date the whole question of **Non-Tariff Charges**, being charges, apart from the Tariff, which they could charge to consumers, as also the amount of any such charge. The Commission assented but indicated that this issue must be resolved at an early date. The Commission require that this be resolved within six months of the commencement of Reset Period 2 on 1<sup>st</sup> September 2015. They intend that the Concessionaire’s proposals in this regard be published for comment by consumers and the Kingdom and that the results of such public consultation form an integral part of the Commission’s consideration and determination on this important matter.
- 24:** The whole question of an **Outages** Policy is a matter of continuing consideration by both the Commission and the Concessionaire. What standards are appropriate? What penalties (if any) are necessary to punish failure to meet the required standards – in this

regard the penalty would take the form of a credit to the account of affected customers. This issue the Commission considers must be resolved within six months of the commencement of Reset Period 2 on 1<sup>st</sup> September 2015. As with Non-Tariff Charges there would require to be full public consultation on this matter.

- 25:** The **Fuel Tariff** can be adjusted downwards by a substantial amount once the new Fuel Supply Chain referred to in paragraph 16 of Reset Decision Number 2<sup>17</sup> is implemented. When this can take place is in the hands of the Kingdom.
- 26:** The Commission is considering ways in which the **Non-Fuel Tariff** can be recast in a way which brings a substantial benefit to all consumers, but especially domestic consumers with modest electricity usage, without imposing a financial burden on the Concessionaire. It was requested by the Concessionaire that this matter be considered outwith the Reset. The Commission agreed provided always that this issue was dealt with urgently by them in the three month period ending 30<sup>th</sup> November 2015: it is the Commission's intention that the benefits of this exercise should be received by consumers in December 2015!

### **RESET DECISION 3**

- 27:** There is a minor typographic error on page 14 of the Commission's Reset Decision Number 3 (Document: **EC.102**). The first line on that page should read "Eua Genset / Submarine Cables" and **not** "Eua Genset." The figures shown on that page are correct.

### **BACKDATING TARIFF**

- 28:** Reset Period 2 commences on the 1<sup>st</sup> September 2015 and that is the date when the new tariff for that period comes into effect. It cannot be backdated to 1<sup>st</sup> July 2015 as asked for by the Concessionaire. In any event Tongan Law abhors retroactive decisions which place people in a worse position than otherwise they would have been. It should

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<sup>17</sup> See Reset Document EC-101

not be overlooked that the only reason the Reset was not completed by 30<sup>th</sup> June was the late entry of the Kingdom into the Reset Process and the resulting impossibility of adhering to the target date of 30<sup>th</sup> June if due process was to be accorded to the Kingdom's Observations (Document: **CON-2**).

**BY ORDER OF THE COMMISSION**