OFFICE OF THE MINISTER FOR
FINANCE & NATIONAL PLANNING

MINISTRY OF FINANCE &
NATIONAL PLANNING
NUKU'ALOFA
TONGA

Reference: 59/40/105

1 June 2015

Lord Dalgety
Chief Commissioner
Electricity Commission

Dear Lord Dalgety,

Re.: Process for Reset of the Electricity Concession Contract

Thank you for the opportunity for the Government of Tonga to participate in the Process for Reset of the Electricity Concession Contract (ECC) between Tonga Power Limited (TPL), the Electricity Commission (EC) and the Government of Tonga.

As you would be aware, Government has specific policy objectives in relation to the electricity sector in Tonga, including:

- Affordability of electricity for citizens, including both minimising the overall cost of electricity generation, and supporting affordability relative to the purchasing power of different customer classes;
- Reliability of electricity generation and distribution;
- Large-scale deployment of renewable electricity generation to ensure that sufficient investment in the Tongan electricity network to support the Government's target of 50% renewable electricity by 2020;
- Transparency of electricity costs and those passed on to and drivers.

Government has also considered the provisions of the Period 1 ECC, together with proposals and analysis provided by TPL, the EC and the independent consultant engaged by the EC. Overall, Government is supportive of the broader framework for the provision of electricity in Tonga, including the continuation of the current concession contract model. However, some areas as part of the Reset that Government wishes to engage further on, and this letter sets out the key topics and issues that Government wishes to bring to the EC's attention, together with suggested alternative approaches and considerations where relevant;

Duration of the Period 2 ECC

- Government notes and support the proposal for the duration of the ECC to be reduced from seven years under Period 1 to five years under Period 2.

Allowable Rate of Return

- The Government notes the significant reduction in the Allowable Rate of Return (AROR) from 12.9% in the Period 1 ECC to a proposed 8.5% under the Period 2 ECC. Further, Government notes that the independent consultants identified some inputs to the AROR that could be refined further. In this respect, through the Commission requests that TPL provide further details on the impact that a lower

AROR would forecast to have on profitability, capital and operational spending, and the non-fuel component of the tariff. As guidance, Government would be particularly interested to understand the impact of a 6.7%, 7.5% and 8.0% AROR on these parameters.

Extraordinary Adjustment

- Government notes that the Period 1 ECC includes an Extraordinary Adjustment provision in relation to the setting of the non-fuel tariff, and that TPL has proposed amendments to this provision to better articulate the circumstances in which this provision would be triggered. Government is broadly supportive of these changes, and suggests the following additional actions:
  - ➢ Clarifying the meaning of "material change" and "indices";
  - ➢ Specifying the units for the proposed inclusion of a 0.25 diesel fuel efficiency target trigger;
  - ➢ Retain the 3% trigger for the difference between forecast and actual electricity demand;
  - ➢ Include an additional trigger relating to a material change in forecast or actual capital spending. A material change in this instance could be (for example) a change in forecast or actual capital spending that would result in a 0.5 seniti or greater change in the non-fuel component of the Regulated Tariff;
  - ➢ and consideration to include petroleum price crisis.

Capital expenditure included in the regulated asset base

- Government notes that the current proposal is for the value of "gifted" or donor-provided assets to be excluded from the Regulatory Asset Value (RAV) for the purpose of calculation of depreciation. Government in consideration of this proposal under the Period 2 ECC would further require additional clarification over the assets excluded from the RAV. In particular:

  - ➢ Exclusion of assets gifted from any entity
  - ➢ Exclusion of assets provided by a third party under a power purchase agreement (or similar)
  - ➢ Exclusion of assets purchased or paid for by customers as part of the installation of distributed generation
  - ➢ and consideration of variation from the asset management plan considered.

Modifying the fuel pass-through component of the regulated tariff to account for non-fuel generation.

Government notes that the current proposal is for electricity generation from gifted assets, principally solar PV generation, is excluded from the calculation of the fuel price pass-through component of the regulated tariff. Government can consider this approach, and recognises that TPL and the EC have entered into a similar approach under the Period 1 ECC. Government further considers that the Period 2 ECC would benefit from additional clarification over the treatment of generation from non-diesel based generators, including:

- Clarifying how the "fuel adjustment" proposed in document TPL-30 is incorporated into the broader fuel price pass-through calculation;
- Clarifying the units for "fuel savings – values" and "kWh billed – values" in the fuel adjustment calculation in document TPL-30;
- Clarifying that electricity arising from distributed generation, or from a PPA, does not contribute to the fuel price passed through to consumers;
- Clarifying that the fuel price impact of other fuel-based renewable energy generation (for example, biofuel-based generation) will be considered separate from diesel-based generation, under an approach agreed with the EC should the need arise;

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- Clarifying how the Government granted concessions to electricity fuel contribute to the reduction/increase in the regulated tariff.

Fuel tariff adjustment period

- Government notes that the Period 1 ECC allows for a quarterly revision of the fuel price component of the Regulated Tariff. Electricity consumers are aware of the broad relationship between international oil price movements and changes in the fuel price component of the Regulated Tariff, and therefore there is an expectation that retail electricity prices will be reflective of price changes in the broader petroleum market. Against this background, Government would like to understand the barriers (if any) to a more frequent revision of the fuel price component of the Regulated Tariff, with a view to moving to a monthly or bi-monthly cycle for revision of the fuel price component of the Regulated Tariff.

Tariffs other than the Regulated Tariff

- Government notes that the Period 1 ECC allows for tariffs other than the Regulated Tariff, and that there is a proposal from TPL for this provision to be retained, and extended, for the Period 2 ECC. Government is broadly supportive of a provision for tariffs other than the Regulated Tariff being included in the Period 2 ECC. However, Government considers that the Period 2 ECC would benefit from greater clarity over this process, including that:
  - ➢ The EC be required to consider, and approve or decline, any application by TPL for a new tariff. In carrying out this function, the EC shall seek and consider the views of the Government before determining the application;
  - ➢ Government may identify to the EC a new tariff type, which the EC shall consider for adoption; and
  - ➢ Consideration is given to explaining or defining the types of alternative tariffs set out in the ECC

Government also recognises that alternate tariff structures have the potential to impact on revenue to TPL, and may therefore necessitate adjustment to other tariff types. It is anticipated that consideration of these impacts would form part of the EC's determination of new tariff proposals. Further, it is expected that this consideration would occur within the current framework of the Regulated Tariff determining total allowable tariff revenue for TPL. In addition, Government is supportive of retaining the current provision allowing to require that a subsidised tariff be implemented by TPL, as long as the cost of the subsidy to TPL is met by Government.

Hedging of fuel prices

- Government understands that current proposals for allowing hedging of fuel prices have been excluded from the Period 2 ECC, with a view to any future hedging activity being subject to discussion between TPL and the EC. Government supports the exclusion of hedging from the Period 2 ECC. Further, Government requests that any future discussions regarding hedging activity be carried out between all parties to the Period 2 ECC including sharing of previous experiences.

Power Purchase Agreements (PPAs)

- Government understands that the Period 2 ECC would allow TPL to purchase electricity from independent power producers (IPPs) via a PPA arrangement. Government supports this flexibility in accessing generation for Tonga, but considers that additional guidance in the Period 2 ECC over the entering into, and treatment of, a PPA be considered, including:

- Allowing entry into PPA's only where the total average cost of electricity delivered by the PPA, including any additional costs imposed by the PPA on TPL, is lower than average cost of generation of electricity by TPL
- Clarifying the allocation of benefit arising from the difference in generation costs between the cost of electricity from the PPA, and the fuel price component of the Regulated Tariff, between TPL and its customers

Reporting

- Government recognises that there is a considerable reporting requirement placed on TPL as part of its requirements under the ECC. At the same time, there is some uncertainty as to the full scope of the reporting requirements, and consequently how well the current reporting requirements meet the Government obligation to ensure the public are satisfied with the level of scrutiny and its efficiency. To address this, Government requests that the EC clarifies the current reporting requirements, including the minimum set of metrics reported, the frequency of reporting, and the mandatory distribution of reports, public notification with a view to determining whether additional requirements regarding both the scope of the reporting activities, and the minimum distribution and disclosure requirements of this reporting, be included in the Period 2 ECC. In requesting this, Government recognises that some information may be commercially sensitive, and therefore requests that any potential changes to the current reporting arrangements are structured in a way that addresses this concern.

Reset Process and Administration

Government requests that the EC consider amendments to the Period 2 ECC that provide:

- An option to terminate the Period 2 ECC at the agreement of all three parties to the ECC;
- This would clarify the circumstances for a mutually agreed termination of the contract;
- Direct inclusion of the Government in the Process for Reset. This could include, for example:
  - An option for the Government to provide a report to the EC at the commencement of the Process for Reset that identifies areas of focus for the Reset
  - A requirement for the EC to circulate to a specified position in the Government, all documentation associated with the Process for Reset within five business days of it being received by the EC (for non EC documents) or published (for EC-generated documents)
  - A requirement for Government to be notified by the EC of discussions between the parties to the ECC in relation to the Process for Reset and public notification obligations.

I appreciate your consideration of the issues raised in this letter, and would welcome the opportunity for the Government of Tonga to participate further in the drafting of the Period 2 ECC. Please do not hesitate to contact me should you have any queries regarding the issues raised in this letter. Further, I look forward to your early response to our request.

Yours sincerely,

MINISTRY FOR FINANCE & NATIONAL PLANNING TONGA

'Aisake Valu Eke

Minister for Finance and National Planning