



COMMERCE COMMISSION

Regulation of Electricity Lines Businesses
Decision on 2010/11 Non-Part F Capital Expenditure Threshold for
Transpower New Zealand Limited
(4 June 2010)

Purpose

1. The purpose of this paper is to set out the Commerce Commission's (the Commission's) decision that the threshold amount for Transpower New Zealand Limited's (Transpower) non-Part F capital expenditure for the 2010/11 year will be set at \$225.6 million.

Background

2. Under the terms of the administrative settlement between the Commission and Transpower entered into under the Commerce Act 1986 (the Act) in 2008, the Commission is required to set a non-Part F capex threshold for each year of the settlement for Transpower.
3. The threshold provides, for the forthcoming year, an approved level of capital expenditure on assets that Transpower may, upon expenditure and commissioning, enter into its regulatory asset base (non-Part F capex threshold). Details of the types of expenditure that Transpower submits to the Commission for approval under the non-Part F classification, as well as the process the Commission follows in setting its threshold, are provided in more detail in its consultation paper.¹
4. For the 2010/11 financial year, Transpower proposed that its non-Part F capex threshold be set at \$246 million. In accordance with the terms of the settlement, the Commission has reviewed Transpower's proposed level of capital expenditure. The Commission engaged Strata Energy Consulting Limited (Strata) to assist the Commission in its review and to provide its independent opinion on what a reasonable level of non-Part F capital expenditure would be for the 2010/11 assessment period.
5. The review conducted by Strata found that Transpower has, for the most part, complied with the various requirements of the settlement. Strata found that, in terms of implementing process improvements (e.g. targeting least cost efficient interventions), Transpower has made significant progress in the past year. However, Strata advised the Commission that it considered further savings could be achieved. Strata also concluded that, because of the significant difference between the projects planned to be undertaken and those projects actually undertaken in 2009/10 (as at the time of Strata's review), as

¹ Commerce Commission, *Regulation of Electricity Lines Businesses, Invitation for Submissions on 2010/11 Non-Part F Capital Expenditure Threshold for Transpower*, 11 May 2010.

well as Transpower's history of under-spending, it is difficult to rely on Transpower's business plan, and that it would be appropriate for the Commission to adjust Transpower's proposal downwards.

6. In sum, Strata recommended downward adjustments of approximately 15% for replacement and refurbishment expenditure (RRE) and 12.5% for Information Systems and Technology expenditure (IST). This would result in a non-Part F capex threshold of \$210.3 million.²
7. On 11 May 2010 the Commission published its preliminary view, along with Strata's advice to the Commission, as well as comments on Strata's report provided to the Commission by Transpower. The preliminary view was to set Transpower's non-Part F capex threshold for the 2010/11 year at \$225.60 million. Submissions were to be made by Tuesday 25 May 2010.
8. The Commission received four submissions from the following parties:
 - Transpower;
 - Genesis Energy Limited (Genesis);
 - Major Electricity Users Group (MEUG); and
 - Powerco Limited (Powerco).
9. The Commission has responded to these submissions below.

Preliminary view

10. In previous years, Transpower has significantly under-delivered on capital expenditure relative to its business plan and threshold. This has caused concern for both the Commission and interested parties. Information provided by Transpower, however, suggests that Transpower is improving its capability to deliver forecasted expenditure. Transpower also supplied to the Commission its latest year-to-date capital spend and year-end reforecast, which suggests that its capital spend is likely to meet its 2009/10 projection (despite large variances between planned and actual work undertaken).
11. In forming its preliminary view, the Commission considered Transpower's historical performance in delivering to its proposals, as well as the improvements it has recently made to its asset strategies and planning processes, together with Strata's advice, and Transpower's signal of the need for immediate investment.
12. One approach to setting the threshold, considered by the Commission, was to set the 2010/11 threshold based on an average of actual historical expenditures. Although this approach would ease the Commission's concerns regarding Transpower's capacity to achieve its forecast capital expenditure, it would result in a threshold for 2010/11 being less than half Transpower's proposed capital spend of \$246m. Given the current need for investment, and that Transpower has improved its internal processes and asset planning strategies, at least to some degree, the Commission considers this approach would not be optimal. Submissions from Genesis and MEUG agreed that this approach would not set the capital expenditure threshold at an appropriate level.³
13. The Commission noted in its preliminary view, however, that it was not convinced that the full amount proposed by Transpower is reasonable and efficient. Transpower's

² Strata Energy Consulting Limited, *Review of Transpower's 2010/11 Non Part F Capital Expenditure Plans (Asset Replacement, Refurbishment & Enhancement and Information Services & Technology)*, April 2010.

³ Genesis Energy *Submission to the Commission on Transpower's Non- Part F Capital Expenditure Threshold*, 21 May 2010, p.2; MEUG *Submission on 2010/11 Non- Part F Capex for Transpower*, 25 May 2010, p.2, para 5.

improved performance supports a threshold higher than historical average spend, but its history of under-delivering to its business plan and capital forecasts suggests that it would be appropriate to set a lower threshold than Transpower proposes. Any necessary overspend is potentially recoverable by Transpower via the ex-post approval mechanism provided under the settlement. This was supported by Strata's advice to the Commission, as well as submissions by MEUG and Genesis⁴.

14. The Commission's preliminary view was that Transpower's non-Part F capex threshold should take into account any efficiency savings that the Commission considers are achievable during the financial year to which the threshold relates.

Capacity to deliver

15. Although Strata's report questions Transpower's ability to provide the capacity to undertake the full work programme, the Commission's preliminary view was, despite Transpower's poor track record, to allow Transpower the benefit of the doubt. This was because evidence suggests capital spend is necessary⁵, Transpower has improved its internal processes and asset management strategies, and as Transpower seems likely to spend its capital expenditure threshold in the current year. As a result, a new (higher) target may be achievable. In other words, the Commission considered that greater weight should be placed on more recent performance. Further, Transpower has provided its assurance to the Commission that it has improved its capacity to, and will deliver the forecast expenditure. Also, as the risk for consumers of Transpower under-spending is mitigated through the ex-post wash-up, the Commission's preliminary view was not to make Strata's proposed adjustment for capacity concerns.
16. MEUG has, however, challenged the Commission preliminary view, questioning whether the Commission has undertaken sufficient analysis to accurately assess Transpower's capacity to deliver future Non Part F capex, given Transpower's higher expenditure this year results, in part, from re-categorisation of Part F capex, and the purchase of spares for use in future periods.⁶ MEUG argues that the Commission has not provided new analysis that justifies lifting the threshold by \$15 million compared to that recommended by its expert advisor. MEUG also notes that the Commission's preliminary view would equate to providing Transpower a \$36 million increase from the 2009/10 threshold without evidence to support moving away from Strata's advice.⁷
17. The Commission accepts that a significant portion, although the exact amount remains unclear, of Transpower's expenditure this year is due to the purchase of spares and the re-categorisation of Part F capex. This potentially masks Transpower's real increase in capacity to undertake the level of capital expenditure currently proposed. However, Transpower is also forecasting to exceed its threshold by an amount that is greater than the cost of the re-categorisation of Part F capex, and, given that Transpower has assured the Commission that its capacity issues have been resolved, the Commission considers that it is reasonable to provide Transpower the benefit of the doubt, especially when results remain NPV neutral. The Commission will be disappointed should Transpower fail to deliver to its assurances.
18. The Commission will be setting its first pre-approved level of capital expenditure under the new Part 4 framework in November 2010, providing the Commission time to assess whether or not Transpower has delivered against its assurances in the 2009/10 year. This

⁴ MEUG submission, pp 1-2; Genesis Energy submission, pp 1-2.

⁵ Note that it is difficult to ascertain the level of expenditure that will occur in the current year. Re-categorisation of a significant Part F project as non-Part F has increased the level of non-Part F expenditure, as have purchases of spares for use in future periods.

⁶ MEUG submission, para 18.

⁷ MEUG submission, para 20.

matter will be discussed further in the Commission's individual price-quality path draft decision reasons paper in June 2010.

19. MEUG advocated that relying more strongly on the incentives of the ex-post approval process (for approving capital spend in excess of the threshold) may provide an incentive for Transpower to ensure its 'house is in order' prior to submitting capital expenditure forecasts, and ensuring it delivers these. MEUG suggests that adopting this approach would be beneficial to consumers and the economy in both the short and long-term.
20. However, Transpower correctly notes that the intention under the settlement was for the ex-post mechanism to cater for exceptional and unexpected capital expenditure.⁸ While the Commission noted in its preliminary decision that the ex-post option was open to Transpower, it agrees with Transpower that under the settlement, this approach was intended for exceptional circumstances where immediate investment was unforeseen but is necessary. It should be noted also that the ex-post wash up is not a review of the efficiency of Transpower's actual project expenditures, and will, therefore, not make adjustments to project costs. It will, therefore, not ensure least cost outcomes have been achieved as MEUG implies. The Commission considers, therefore, that this mechanism cannot be heavily relied upon to provide the incentives that MEUG is seeking. The Commission is, however, continuing to consider such mechanisms to provide incentives in its development of the framework to apply under the new Part 4 of the Commerce Act.
21. As noted above, should Transpower not deliver to its forecasts in 2009/10, the Commission is likely to constrain the capital expenditure allowed under any individual price-quality path for Transpower, and Transpower may have to rely more heavily on the ex-post facility.
22. Although Transpower has a history of under-delivering to its forecasts, the fact that it seems likely to meet its target expenditure this year gives the Commission confidence that capacity is less of a constraint than in the past. Likewise, as the end result is NPV neutral, the key issue that remains is whether or not the correct level of incentive is provided to improve its planning and delivery of capital expenditure to ensure maximum value for money (as noted by MEUG).⁹ The Commission notes that a generous threshold provides little incentive to maximise project delivery performance, nor any incentive to make efficient deferrals or seek cost savings. Likewise, signals from the Commission that it will not look favourably on a failure to deliver to its forecast, provides a very strong incentive to simply 'spend the budget'. The Commission accepts these are valid concerns.
23. In this instance, however, the Commission is minded to provide Transpower another opportunity to demonstrate it has improved its capabilities. This is a difficult decision given Transpower's past performance. However, the Commission is convinced that the signal from the Commission that Transpower must continue to improve its processes and capability will not go unheeded. Transpower is focusing on making procedural improvements, and all results are currently NPV neutral. This is clearly a judgement call, and the Commission's decision is not to implement the capacity adjustments suggested by Strata.

US Cost forecasting system

24. The Commission's preliminary view was also to provide time for the US Cost forecasting system to be implemented. Streamlined processes and a better understanding

⁸ Transpower submission, pp 4-5.

⁹ MEUG submission, p.4.

of forecast costs will assist Transpower to manage its business and, therefore, the Commission expects cost savings to result in future regulatory periods.

25. While Transpower argues that the US Cost forecasting system will not identify cost savings, and costs may actually increase due to more accurate estimates¹⁰, MEUG supports Strata's report, concluding that it is appropriate to implement an adjustment for future savings that will result from this new tool.¹¹
26. The Commission is of the view that increased accuracy of cost estimates leads to better and more accurate forecasts, better knowledge of where costs are falling, and better allows a business to target efficiency improvements and cost reductions. This may be by way of improved functions downstream, for example, in procurement strategy. In the end, new systems would not be implemented unless they are expected to produce benefits by at least in some way creating efficiency savings. Transpower's argument that costs may actually increase due to more accurate estimates may be correct, but the Commission disagrees that this is a reason not to expect efficiency gains. If that were the case, then it would follow that inaccurate forecasts lead to lower actual cost outcomes. Clearly this is not the case - spending capital on the US Cost forecasting system must be expected to produce a return by way of cost saving through identifiable efficiencies, otherwise the capital would not be spent.
27. The Commission considers that the issue then, relates to the time at which the Commission should require those achievable gains to be recognised. Again, this is a judgement call. In some instances, it would be appropriate to require potential efficiency gains to be taken into account immediately. In other cases, more time may be required before the gains can be implemented and recognised. On balance, the Commission considers that it is appropriate in this case, to provide Transpower time to make the achievable efficiency gains.

Project roll-overs

28. In its preliminary view, the Commission agreed with Strata that it is appropriate to make an adjustment to Transpower's proposed threshold to take account of projects that are likely to be rolled into the subsequent year. Although it is reasonable and efficient to expect some projects to be brought forward and others to be deferred, Transpower's proposed threshold takes into account the value of projects being rolled into the 2010/11 year, but does not make allowance for projects being deferred. For this reason, the Commission considered Strata's recommendation in this regard to be reasonable, and the Commission's preliminary view was to adopt a 5% adjustment for both RRE and IST.
29. Transpower proposes that the rollover adjustment be either removed or reduced because it does not take into account that work from future years may be brought forward.¹² As noted above (paragraph 28) and in Strata's report (section 3.3.2), however, Transpower's proposal takes into account projects being brought forward, but not projects being deferred. The Commission considers that Transpower's argument that rollovers should be considered as re-phasing, or planned substitution, however, is simply a justification for whether or not such movements should occur and has no bearing on how the Commission should treat such movements. The Commission's final decision is, therefore, to adopt a 5% adjustment for both RRE and IST.

¹⁰ Transpower, *Transpower comments on the draft 2010 Strata report*, p.5.

¹¹ MEUG submission, para.9.

¹² Transpower submission, p.3.

Efficiency adjustment on non-approved projects

30. Following Transpower's low level of capital expenditure (relative to the threshold) in 2008/09, the Commission informed Transpower that the Commission would require that, to be included in future thresholds, proposed capital expenditure must fully complete Transpower's internal approval processes. The Commission now considers that, at least initially, it may not be appropriate to require 100% of projects to have been through internal approval processes. The Commission notes that Transpower has increased the level of approvals in the current year, and that Transpower has had two years worth of capital expenditure to consider and approve at relatively short notice.¹³ Likewise, the Commission also accepts Transpower's view that it may, in some cases, be more efficient for Transpower to defer approvals until closer to the time of investment.
31. In this regard, the Commission's preliminary view was not to require 100% of projects to have been through internal approval processes in order for them to be included under the 2010/11 threshold. However, although the Commission accepts there will be an element of unders and overs, in terms of cost and scope changes, it does not accept Transpower's assertion that no overall cost saving will result from Transpower's internal approval process. The Commission's preliminary view was that Strata's 5% efficiency adjustment is reasonable. The Commission recognised that this is a judgement call, but noted that this still provides Transpower with a higher overall threshold than the alternative that was considered (i.e. exclusion of all non-approved expenditure).
32. Both Powerco¹⁴ and Transpower¹⁵ point out that the Commission's rationale for the decision to make a 5% efficiency adjustment to reflect cost saving is unclear and subjective. In contrast, Genesis notes that it is important for the Commission to seek greater efficiencies,¹⁶ and MEUG appears to advocate a threshold closer to that suggested by Strata.¹⁷ As noted above (paragraph 31), the Commission has already recognised in its preliminary view that the level of adjustment would be a judgement call. On balance, considering that the Commission does not accept Transpower's assertion that no cost saving will result from the process, Strata's 5% efficiency adjustment seems reasonable and given the unexpectedly high level of change from Transpower's original business plans to that actually implemented, the 5% adjustment could in fact be considered conservative.

Adjustments for achievable efficiencies

33. Strata proposed a 2% adjustment for achievable efficiencies with respect to reducing and better managing costs for RRE (and 1 % for IST). The Commission's preliminary view was that this appeared reasonable as there is scope for Transpower to improve the way in which it manages, contains, and reduces costs. Although Transpower has made improvements in past years, Transpower also agrees that further improvements are still required.¹⁸
34. While the Commission acknowledges that a level of judgement is required in setting the level of cost savings that it considers are achievable, the Commission remains of the view that 2% is not an unattainable or unreasonable target.

¹³ The Commission is concurrently reviewing capex for the final year of the settlement (this document) and the first year of any individual price-quality path.

¹⁴ Powerco, *Submission on 2010/11 Non Part F Capital Expenditure Threshold for Transpower*, p.2.

¹⁵ Transpower submission, p.3.

¹⁶ Genesis submission, p.2.

¹⁷ MEUG submission, p.4.

¹⁸ Transpower submission, p.1.

Final Decision

35. Taking into account Transpower's previous and current performance, Strata's advice and all submissions, the Commission's final decision is that it is appropriate to set Transpower's Non-Part F Capex threshold for 2010/11 at \$225.6 million. In other words, the Commission confirms its preliminary view that the following adjustments will be made to Transpower's proposal of \$246 million:

Adjustments for RRE:	% Adj	\$ Impact (millions)
Rollovers	5%	\$8.8
Cost Containment Targeting & Monitoring	2%	\$3.5
Efficiency adjustment on non-approved projects	5%	\$2.5
Total	8%	\$14.8

Adjustments for IST:	% Adj	\$ Impact (millions)
Rollovers	5%	\$3.5
Cost Containment Targeting & Monitoring	1%	\$0.7
Efficiency adjustment on non-approved projects	5%	\$1.1
Total	8%	\$5.3

36. The Commission will publish this decision in the New Zealand Gazette.