MAJOR ELECTRICITY USERS' GROUP

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By email to Alex.Sim@comcom.govt.nz

Dear Alex

Submission on 2010/11 Non-Part F Capex for Transpower

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission invitation for submissions on 2010/11 Non-Part F Capital Expenditure Threshold for Transpower[1] published 12th May 2010 (the "invitation for comments paper").

2. Transpower proposed the threshold should be \$246m. The Commission's expert advisor, Strata Energy Consulting Ltd (Strata) following a detailed review recommended the threshold should be \$210.3m. Transpower subsequently provided the Commission further information and made a presentation to Commissioners. Following a request from MEUG, the Commission provided a copy of the presentation material. The Commission then released the invitation for comments paper dated 12th May with a preliminary view the threshold should be \$225.6m. The Commission will after considering comments then decide a final threshold value.

3. There are significant differences between the proposal by Transpower, the view of Strata and the preliminary view of the Commission as summarised in the table below:

Non-Part F capex threshold		Change from Transpower proposal		Change from Strata expert view	
	$m	$m	Percent	$m	Percent
Transpower proposal	246.0				
Strata expert view	210.3	-35.7	-15%		
Commission preliminary view	225.6	-20.4	-8%	+15.3	+7%

4. Two themes can be observed from the above table:

   - First, the Commission agree with Strata that Transpower's proposed threshold is too high and there is scope and a need, in terms of the requirements of the Act, to use a lower and more realistic threshold. Strata recommended decrease of \$35.7m (-15%) and the preliminary view of the Commission is a decrease of \$20.4m (-8%). The cells coloured yellow in the table above highlight this point.

     The Strata report and the invitation for comments paper make sober reading regarding the improving but less than satisfactory processes within Transpower to effectively budget,

[1] Refer http://www.comcom.govt.nz/review-of-transpower-s-proposed-non-part-f-capital-expenditure/

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appropriately approve and then monitor performance against budget. MEUG is disappointed to read that progress has not been as fast as expected given the size of monies involved are not trivial and consumers cannot avoid having to pay once the threshold is set.

Given experience with prior year thresholds and the very detailed analysis by Strata of the proposal this year, MEUG agrees with the general conclusion by the Commission that the proposed $246m threshold by Transpower is not appropriate.

- Second, the Commission's preliminary view is to set a threshold $20.4m (-8%) less than Transpower's proposal but $15.3m higher (+7%) than Strata's expert view. The cells coloured turquoise in the table above highlight this point. It is this aspect of the Commission's preliminary view that we consider further from paragraph 7 onwards.

5. Before focussing on the difference with Strata's advice, MEUG note and agree with the Commission that using an average of actual historical expenditures would be inappropriate[2]. However we do not agree with the Commission's logic for not using this approach, ie:

> "*Given the current need for investment, and that Transpower has improved its internal processes and asset planning strategies, the Commission considers this approach would not be optimal*."

6. In our view the best argument for not using actual average historical expenditures is the conceptually robust and detailed analysis by Strata of the Transpower proposal.

7. The table below summarises the Strata recommendations for adjustments to the proposal by Transpower, the preliminary view by the Commission and the difference between the advice of Strata and the preliminary view. Numbers have been rounded in preparing this table and therefore there may be some rounding differences with the Commission and Strata reports.

	TPNZ Proposal	Strata adjustments		Preliminary view of CC		CC – Strata difference
	$m	$m	percent	$m	percent	$m
RRE Approved projects	126.7					
Capacity, rollovers, unplanned		-17	-10%	-9	-5%	+9
Cost containment Targeting & Monitoring		-3	-2%	-3	-2%	nil
US Cost delays		-3	-2%	0	0%	+3
Non approved projects	49.6	-2	-5%	-2	-5%	nil
IST Approved projects	19.4					
TNP operating leases	27.7					
Capacity, rollovers, unplanned		-7	-10%	-3	-5%	+3
Cost containment Targeting & Monitoring		-1	-1%	-1	-1%	nil
Non approved projects	22.3	-1	-5%	-1	-5%	nil
Total	245.7	-35		-20		+15

8. The above table demonstrates that most of the advice of Strata has been accepted, ie adjustments for non approved projects and cost containment, targeting and monitoring. The two areas where there is a difference between the Strata recommendation and the preliminary view of the Commission are:

   a) A $3m adjustment for US Cost delays as summarised in the row highlighted turquoise in the table above; and

   b) A $12m adjustment for capacity, rollovers and unplanned. The Commission accepted an adjustment should be made with a preliminary view it should be $12m, ie half the amount recommended by Strata. This difference in adjustment applied to RRE and IST capital proposals is summarised in the two rows highlighted yellow in the table above.

[2] Invitation for comments paper, paragraph 13

9. The letter from Transpower dated 28th April 2010 published at the same time as the invitation for comments rebuts Strata's recommendation to adjust US Cost forecasting system by 2%. Transpower argue the US Cost system will provide more accurate forecasts rather than contribute to efficiency gains. The invitation for comments paper agrees with Strata that introducing US Cost systems and other practices will result in future cost savings[3]. The Commission though believe Transpower should be given more time to implement US Cost. MEUG finds it difficult to accept the Commission acknowledges implementing US Cost will create efficiencies and then decides not to create an incentive on Transpower to have it implemented. MEUG supports the recommendation from Strata that a 2% adjustment to approved works for US Cost should be applied because without that adjustment Transpower has no incentive to implement that work in a timely manner. It would be both bizarre and an indictment on the regulatory regime if the US Cost system were implemented after the peak of non-Part F capex had passed. We need the US Costs system now and the threshold should have an incentive for Transpower to implement it.

10. The balance of this submission considers the main point of difference between the preliminary view and Strata regarding the capacity or ability of Transpower to achieve the higher threshold for 2010/11.

11. Paragraph 15 of the invitation for comments paper lists three reasons for the Commission preliminary view being different from the Strata recommendation:

- "… evidence suggests capital spend is necessary"
- "… greater weight should be placed on more recent performance"
- "… risk for consumers is mitigated through the ex-post wash-up"

12. Each of these is considered in turn below.

Capital spend is necessary

13. In discussion with Commission staff it was agreed the use of the word "evidence" in the argument that "… *evidence suggests capital spend is necessary*" did not refer to any new piece of information provided by Transpower to the Commission in support of a less stringent adjustment to the threshold than that proposed by Strata. Instead the reference is more about the overall impression by the Commission that increasing levels of capital investment are likely to be needed and that there may be increasing difficulties in implementing some projects because of problems in finding outage windows.

14. All of this back ground information was presented by Transpower at the Thresholds conference. Strata would have been well aware of this difficult operating environment and the need in terms of maintaining reliability when undertaking their review. In the view of MEUG the first argument by the Commission in deciding not to use Strata's recommendation because "… *evidence suggests capital spend is necessary*" is not new and while it may have been persuasive if the Commission had no hard analysis to work with; it is not relevant given there is a robust piece of evidence in the form of the Strata review.

15. MEUG suggests the invitation for comments paper should have, at the same time making reference to the need for greater expenditure, also noted that with such higher levels of expenditure there was also increased risk of inefficiencies (in both percentage and absolute dollar terms) and therefore greater need for regulatory incentives and scrutiny to achieve least cost and efficient services. In our view the first argument to support the preliminary view to decrease the threshold proposed by Strata by $15m has no substance and lacks balance.

[3] Ibid paragraph 16

Sufficient improvement in Transpower's recent performance to justify increase

16. After following the agreed timetable and provision of data set out in the Settlement and having seen the draft Strata report, Transpower presented more recent forecasts to the Commission arguing their internal processes and future capacity would be capable of achieving the proposed threshold.

17. The claim by Transpower using the more recent forecasts that they will exceed the 2009/10 threshold is complicated by a material error by Transpower in setting the budget for the non-Part F threshold in the first place, ie the need to re-categorise capital works. Footnote 4 of the invitation for comments paper explains:

> "*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*."

18. If the Commission does not know for sure which parts of the actual and forecast 2009/10 non-Part F expenditure can be fairly compared with the 2009/10 threshold; then how can it make any new assessment on an adjustment for capacity other than the analysis by Strata? There is no new analysis by the Commission to justify lifting the threshold by $15m compared to the recommendation by Strata.

19. This is a material issue because the Transpower proposal is for a $56m (+30%) higher threshold for 2010/11 than the $189m threshold approved last year. Achieving such a large lift in additional non-Part F investment levels is challenging given competition for electricity network contractors throughout the world, the complexity of finding outage windows and Transpower concurrently managing building of in excess of $2 billion Part F works already approved. In our view this is not a time to use intangible factors or intuition to give Transpower the benefit of the doubt. Approving a $21m increased threshold for non-Part F capex as proposed by Strata will be challenging enough.

20. The preliminary view to have a $36m[4] increase in the threshold compared to 2009/10 without evidence to support changing from the recommendation by Strata sets a dangerous precedent because it infers lobbying from Transpower, rather than new evidence, was sufficient to materially change the view of the Commission.

Consumers indifferent because of wash-up

21. This argument lacks balance because while we agree consumers will be NPV neutral with cost over or under-runs, the invitation for comments paper fails to discuss the pros and cons of having a stringent threshold and the incentives the wash-up process creates on Transpower. MEUG believes the risk of triggering an ex-post wash-up creates the right disciplines on Transpower to ensure the rapidly growing non-Part F capex is well managed and truly represents least cost and optimal timing. Simply giving Transpower some leeway now will not expedite improvements in Transpower's internal management processes and after the event we and the Commission will be none the wiser as to the efficacy of that expenditure. If Transpower have robustly designed and effectively implemented planning, approval and monitoring processes then an ex post review should be straight forward.

22. Increasing the risk of Transpower breaching the threshold is not a constraint on necessary capex in excess of the threshold being built because the ex-post wash-up process will keep Transpower whole. The only risk Transpower faces is that in an ex-post wash-up process monies spent above the threshold are found not to have been justified. Given the Commission accept Transpower's processes are not efficient, we see little downside to having a stringent threshold and thereby focusing Transpower to put its house in order. This approach will be beneficial to consumers and the economy in both the short and long-term and should have been more thoroughly discussed in the invitation for comments paper.

23. In our view the Commission should give weight to the benefit of improved incentives on Transpower to become more efficient and least cost by having a more stringent threshold and therefore if Transpower do exceed the threshold those costs being reviewed in an ex-post wash-up process.

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[4] Ie the preliminary view of $225m less the threshold for last year of $189m

Concluding comments

24. MEUG agrees with the overall conclusion in the invitation for comments paper that the $246m proposal by Transpower is inappropriate. The question is what adjustments should be made?

25. The Commission have accepted some of the adjustments recommended by Strata resulting in a threshold of $225.6m which is $20m less than the proposal by Transpower.

26. MEUG have considered the $15m of adjustments recommended by Strata but not supported in the preliminary view of the Commission. The $15m difference centres on different views on the ability and capacity of Transpower to achieve a significantly higher level of expenditure. The Commissions arguments to give the benefit of the doubt to Transpower are in our view weak and based on intuition or unexplained intangible factors rather than their own expert advisors analysis. Moreover the invitation for comments paper lacks balance because it fails to consider:

   - With increased expenditure so too should the Commission consider better ways to use regulatory incentives and scrutiny, not simply give Transpower more leeway.
   - Increasing capacity by 30% would be challenging enough in a business-as-usual environment. These are extraordinarily challenging times and a cautious rather than an open cheque book approach should be exercised by the regulator.
   - The longer term cost of the precedent set by Transpower's lobbying, rather than new evidence tabled by Transpower to support their contention they will have capacity to achieve the much higher threshold, seemingly making a significant softening of the adjustments recommended by Strata.
   - The improved incentives on Transpower with the use of a more stringent threshold and therefore the need for Transpower to justify over-expenditure in an ex-post wash-up.
   - The need for the US Cost system to be put in place now and therefore the benefit of applying the 2% adjustment to the threshold to incentivise Transpower to implement it expeditiously.

Yours sincerely

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