



TRANSPOWER

Keeping the energy flowing

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25 May 2010

Brent Alderton
General Manager Regulation
Commerce Commission
PO Box 2031
Wellington

Dear Brent

Re. 2010/11 Non-Part F Capital Expenditure Threshold

The Commission has invited submissions on its preliminary view on the Non Part F threshold amount that it intends to set for the 2010/11 year.

We have reviewed the Commission's paper and the accompanying Strata Report entitled "Review of Transpower's 2010/11 Non Part F Capital Expenditure Plans – April 2009". We refer the Commission to our earlier comments on the draft 2010 Strata Report, which remain valid¹.

As a general comment, we consider that the Strata report represents a balanced overall view of the company's performance during the current threshold year and, on the whole, comments fairly on the company's capital planning and delivery processes. The report acknowledges that significant improvements have been made to our planning and delivery processes. The report also identifies where certain improvements are still required; we agree with this.

We do, however, continue to have concerns about the proposed level of downward adjustment that both the Commission and Strata consider should be applied to our planned 2010/11 expenditure.

The Commission's preliminary view is that Transpower's budgeted level of capital expenditure for 2010/11 should be reduced by some \$20m to *"take into account [any] efficiency savings that the Commission considers are achievable during the financial year to which the threshold relates"*. Whilst the

¹ Letter from Patrick Strange (Transpower) to Brent Alderton (Commerce Commission entitled "Transpower comments on the Draft 2010 Strata Report – 28 April 2010". Available on the Commerce Commission website at <http://www.comcom.govt.nz/assets/Uploads/Letter-from-Transpower-Comments-on-Draft-2010-Strata-Report-11-May-2010.pdf>

level of reduction is less than that proposed by Strata; we remain of the view that the adjustment has not been justified: nor do we think it will help deliver better outcomes for our customers.

The Commission considers that downward adjustments to our proposed expenditure levels are appropriate to reflect:

	Justification for the proposed adjustment	RRE	IST
1	Efficiency adjustment on non-approved projects	- 5%	- 5%
2	Rollovers	- 5%	- 5%
3	Cost containment targeting and monitoring	- 2%	- 1%

Efficiency adjustment on non-approved projects

We see no basis for applying an efficiency adjustment to projects that have not yet progressed to full business case approval. The Commission's preliminary view is that a 5% downward adjustment be applied to all RRE and IST project expenditure not subject to a full business case approval as at the end of March 2010. The implication is that, as a project passes through the planning process to its final approval, an indicative cost saving of 5% is achievable in all cases. We do not agree with this. The rationale supporting this assumption is absent.

It is equally probable that cost estimates will increase (from an initial estimate) as a project is better defined and approaches final business case approval. Our experience is that this is indeed the case. For example, a common theme in several recent business cases has been an initial under-estimation of the costs of "brownfield" investments where the true costs of working in an existing site are not always recognised fully in the early planning stages. It is the level of cost certainty (accuracy) that will improve during the planning process, not the level of cost per se. In our view this specific adjustment should be removed.

Rollover adjustment

Looked at in isolation, we can appreciate why a rollover adjustment may seem to have some merit. The proposed rollover adjustment assumes that, based on historical outturn, some 5% of the 2010/11 planned expenditure will rollover into 2011/12 – and so therefore the allowed expenditure should be reduced by a similar amount.

It is important to note that in most cases rollovers result from a phasing change within a project – a few months' delay or acceleration to suit the dynamic circumstances involved with running the grid and operating the power system as whole, with variations in the timing of milestones and payments as a result.

Outage constraints, sudden unexpected equipment failures, land access problems, and bad weather can all make plans unachievable and thus lead to

rollovers. Rollovers should more appropriately be considered as examples of re-phasing or planned substitution rather than a separate sub-category of unplanned expenditure. Importantly, rephasing works both ways.

The adjustment does not take into account work that may be brought forward from future years as circumstances and priorities dictate (noting that any work brought forward is required to be justified and approved in the same way as for planned work). Accordingly, a “one-way” adjustment for rollovers is not, in our view, justified.

We propose that the rollover adjustment is reviewed, and either removed or reduced to reflect work brought forward.

Cost containment adjustment

The suggested cost containment (or efficiency) gains are not based on any analysis, but are instead based on a broad and subjective assessment of Transpower's process improvements.

As Strata comments in its report, our processes this year are more effectively targeting least “whole of life” cost outcomes. Consequently, it would seem to follow that, as long as these processes are consistently applied, cost containment will be achieved and will be reflected in work plans. This is not the same as delivering an under spend against budget. However, on balance, in light of the further progress required in our processes, we accept that the adjustment proposed by the Commission represents a pragmatic compromise.

Factual Inaccuracy

There is one factual inaccuracy in the Strata Report on which we would like to comment. On page 25 Strata comments on the ongoing OHK-EDG Grillage Project and in particular states, that “*Transpower may have been expending funds [on this unplanned project] without proper approval*”. This is not the case.

The project was identified to Strata as an unplanned project during the current (2009/10) threshold year. The use of the term unplanned in this context is misleading as it relates only to whether or not a project was included in the business plan prior to the start of the year.

Grillage refurbishment represents a “planned” multiyear programme of asset refurbishment – with the annual volume of work justified and set out in an approved grillage asset strategy. Work in any one year aims to target grillage foundations that are considered to be in the poorest condition. Transpower has in excess of 14,000 steel towers with grillages and, even at a rate of 500-600 tower refurbishments per year, the refurbishment programme could take up to 20 years to complete.

Annual budgets are established based on a forecast (achievable) volume of work to be undertaken on priority assets. The planned work takes into account other transmission line work that is anticipated to occur during the year or years thereafter. An element of rescheduling (substitution) is often required during the year and is to be expected.

The actual projects that are worked on during the year typically depend on such as factors as: access to the lines; local availability of resources; updated condition assessment, and the need to co-ordinate work with other activities on the network.

In the case of the OHK-EDG A line, the grillage refurbishment was brought forward from 2010/11 because of the condition of the structure and the availability of resources to start this work during the 2009 winter. The need for the work was supported by the grillage asset strategy and expenditure approval was undertaken in accordance with Transpower's capital expenditure approval processes – copies of which were supplied to Strata in February 2010. The OHK-EGA A line has 258 towers and the grillages completed in 2009/10 represents only a small proportion of the total number of structures on the line. As part of the rescheduling, the refurbishment of the grillages on other lines was deferred.

In part Strata's observation on this project reflects the problem with reviewing and approving expenditures in isolation for a single year. However it is important that, for the record, the statements in the report are correct.

Currency of data in the Strata Report

Due to timing, some of the data Strata uses to justify its recommendations are misleading. This is in no way a criticism of Strata or their analysis: rather, it reflects the data they had to hand in January / February 2010. As Strata notes in its report, Transpower's performance during the current year, which forms the basis of the proposed adjustments, was reviewed using half-year data and mid year forecast year-end data for 2009/10. The timing of the annual threshold review is such that the use of half-year data to inform Strata's view of our performance against the threshold is unavoidable, but it does mean that much of the information within the Strata Report is now out of date and, in key areas, does not reflect current and forecast year end performance.

For example, by June 30, we will have completed business cases for 87 percent of the upcoming year's RRE work, and we will have invested in excess of 100 percent of our current year's threshold expenditure.

Ex post approval and review process – minimising uncertainty

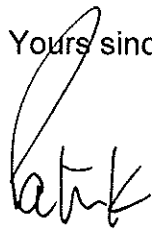
The Commission makes reference to the ex-post review process being a mechanism available to Transpower to seek approval of capital expenditure in excess of the Non Part F capex threshold. When it was put in place in 2006, this ex post review mechanism was expected to cater for exceptional and

unexpected expenditure only. The need for approval of expenditure after it has been incurred (with the possibility of asset stranding) should be minimised: it is at odds with good international regulatory practice internationally, and presents considerable risk to Transpower (and to efficient investment in the grid, as a result). We are concerned that the ex post review process is seen as a risk neutral "safety net" for Transpower, to mitigate against the risk that the threshold was set too low.

Notwithstanding this point, we accept that a small level of ex post review may be inevitable in the near term and will form part the regulatory framework going forward. We welcome the Commission's proposal to set out the process in more detail in the near future.

Thank you for the opportunity to provide this comment on the Commission's preliminary decision, and please don't hesitate to call if you require any further information or clarification.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Patrick Strange', written over the typed name below.

Patrick Strange
Chief Executive