



COMMERCE COMMISSION

**Regulation of Electricity Lines Businesses**  
**Invitation for Submissions on**  
**2009/10 Non-Part F Capital Expenditure Threshold for Transpower**  
**(29 July 2009)**

**Purpose**

1. The Commerce Commission (the Commission) is inviting submissions on its preliminary view that Transpower's non-Part F capital expenditure (non-Part F capex) threshold for the 2009/10 year be set either at \$189.6 million, or at \$185.6 million if the Bunnythorpe-Wanganui B line replacement (BPE-WGN B line replacement) project is found to not comply with the non-Part F capex process as set out in the administrative settlement between Transpower and the Commission.
2. The Commission intends to finalise Transpower's non-Part F capex threshold for 2009/10 by notice in the *Gazette* once it has fully considered submissions on this consultation paper.

**Background**

3. The Commission is required to set a non-Part F capex threshold for 2009/10 for Transpower under the terms of the administrative settlement between the parties, entered into under the Commerce Act 1986 (the Act).
4. The threshold provides an approved level of capital expenditure for the forthcoming year that Transpower may, upon expenditure and commissioning, enter into its regulatory asset base (non-Part F capex threshold).
5. The term 'non-Part F capex' is not intended to suggest that this category of investments cannot be submitted to the Electricity Commission. Rather, these investments are those that are not presented, at least initially, to the Electricity Commission for approval because the Electricity Commission does not have an established process for reviewing such capital expenditure, although, it is presently developing such a process.
6. The types of expenditure that Transpower submits to the Commission for approval under the settlement include:
  - a) replacement and refurbishment of existing transmission assets;
  - b) minor development and enhancements of transmission assets<sup>1</sup>; and
  - c) operation network information and technology services.

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<sup>1</sup> Practical financial limits are applied so that only individual asset development and enhancement projects below \$1.0 - \$1.5 million, and enhancement programmes of work up to \$5.0 million are submitted for approval to the Commission under the non-Part F approval process.

7. As part of its consultation on the administrative settlement, the Commission invited interested parties to submit on the process undertaken to review Transpower's proposed level of capital expenditure for the 2007/08 financial year. In March 2007, Strata Energy Consulting Limited (Strata) completed a review of the policies, processes and practices of Transpower with respect to capital expenditure on asset replacement, refurbishment and enhancement, and IT. Strata considered the appropriateness and effectiveness of those policies and processes in achieving the least-cost objective set out in the October 2006 GPS on electricity governance and in Transpower policy documents.<sup>2</sup> Strata did not undertake a full technical review of individual projects.
8. The Commission considered Strata's report, Transpower's comments, and all submissions on that report. The Commission also took into account Strata's final recommendations in regard to the non-Part F capex threshold, post submissions. The Commission set the non-Part F capex threshold in 2007/08 at \$120.7 million. The following year, the Commission set Transpower's 2008/09 threshold at \$202.8 million. These threshold values set by the Commission were below the levels proposed by Transpower as they incorporated efficiency gains that the Commission considered achievable by Transpower.
9. The Commission is now in the process of setting the value for Transpower's 2009/10 non-Part F capex threshold. Transpower has proposed a threshold of \$209.6 million.

#### **Non-Part F Capex Threshold Process**

10. The administrative settlement outlines the process by which the non-Part F capex threshold for each financial year of the settlement period, including 2009/10, is to be set in advance, as follows:
  - a) Transpower will record any material changes to its asset management, business planning and capital works policies or processes relating to non-Part F capex that have occurred during the calendar year before the commencement of the assessment period. These records are to be provided to the Commission in January immediately preceding the commencement of the assessment period;
  - b) during that January Transpower will make available to the Commission a schedule that shows, for non-Part F capex projects completed in the second half of the calendar year before the commencement of the assessment period, a comparison of actual expenditure in that second half versus budgeted expenditure for that second half. Reasons for variations will be provided for all projects that have exceeded 10% of budgeted cost;
  - c) Transpower will make available to the Commission upon request a schedule which sets out significant movements of non-Part F capex projects into and out of the capital works plan which have occurred during the second half of the calendar year before the commencement of the assessment period as well as a forecast of similar movements for the first half of the following calendar year;
  - d) Transpower will prepare its non-Part F capex plan and business plan forecasts for the assessment period in accordance with capital works and business planning processes and policies in the January/February immediately preceding the commencement of the assessment period<sup>3</sup>;

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<sup>2</sup> Strata Energy Consulting Limited, *Review of Transpower's Capital Expenditure Plans*, May 2007, p 11.

<sup>3</sup> The capital expenditure forecasts (and Business Plan) prepared in January / February of each financial year, which will set out the forecast non-Part F capex threshold expenditure for the subsequent financial year, were to have been approved by the Transpower Board during the month of April.

- e) Transpower will ensure contingency sums are adjusted to no more than 7.5% for IT and 0% for replacement, refurbishment, minor development and enhancement expenditure;
  - f) Transpower will make available upon request project approval documentation, including a final schedule of all projects making up the proposed non-Part F capex, for the assessment period, together with the project approval status, in final, non-draft form (non-Part F capex plan);
  - g) the Commission (at its discretion) will review (or engage an independent third party to review) the non-Part F capex plan beginning in February immediately before the commencement of the assessment period in order, among other things, to provide assurance that:
    - the levels of contingency included in the project budgets have been established in accordance with paragraph (e) above;
    - the expenditure forecasts have been prepared in accordance with Transpower’s capital works and IT planning processes and policies;
    - Transpower’s processes have considered and targeted appropriate least-cost, efficient, interventions;
    - Transpower has proactively pursued and implemented process improvements and delivered on commitments made to review the scope for improvement to its non-Part F capex processes relating to procurement audit, review of open book tendering for replacement and refurbishment , and project approval document templates;
  - h) if, following consultation, the Commission finds that Transpower has complied with and provided for the requirements of paragraphs (a) to (g) then the resulting capital expenditure will be deemed appropriate for the transmission (non-Part F capex) threshold; and
  - i) the Commission will provide Transpower with a draft copy of the Commission’s (or their agent’s) findings and any recommendations from the above review, for identification of any factual errors;
  - j) the Commission will then determine the amount of the total non-Part F capex for the transmission (non-Part F capex) threshold for the assessment period, and will amend the relevant *Gazette* notice to state that amount.
11. The manner in which the threshold has been designed, and the process to set each annual threshold, is intended to provide Transpower a level of discretion and allow it to exercise its role as a ‘prudent’ and dynamic grid planner. The thresholds set, provide an overall level of expenditure amount that Transpower should not exceed. However, Transpower retains discretion to prioritise, defer, bring forward, add or remove projects so long as the total capital expenditure does not exceed the threshold.

### **Interim threshold set**

12. The administrative settlement anticipates that the Commission will set a non-Part F capex threshold for 2009/10 by 1 July 2009. Delays occurred during the review and the Commission was unable to make a final determination by that date. Delays occurred due to various reasons, such as the need to understand the reasons for and implications of:
- Transpower’s significant under-spend against its 2008/09 threshold;
  - the low level of project approvals that had occurred (only 29% for IST capex, and 54% (by value) of replacement and refurbishment projects);
  - an increasing number of rolled over projects; and

- the classification of one the proposed projects, the BPE-WGN B line replacement in the Taranaki region.
13. Combined, these matters raised concerns about the accuracy and reasonableness of Transpower's proposed level of non-Part F capex for 2009/10.
  14. Given delays in completing the 2009/10 non-Part F capex review the Commission published an interim threshold of \$189 million in the Gazette on 25 June 2009, to ensure a threshold remained in place at the expiry of the 2008/09 threshold. This interim threshold took effect on 1 July.

### **Review of Transpower's proposed 2009/10 threshold**

15. The Commission engaged Strata to review Transpower's proposed threshold of \$209.6 million as per the process set out in the settlement. Strata advised the Commission on whether or not Transpower had developed its proposed capex forecast in accordance with the process and requirements as set out in the settlement agreement.
16. One of Strata's key findings is that Transpower's proposed threshold does not fully comply with the obligations and processes set under the settlement.<sup>4</sup> The settlement requires that Transpower 'has proactively pursued and implemented process improvements' targeting least-cost objectives. Although some process improvements have been made by Transpower to strengthen project planning and to target 'least cost' objectives, Strata advised the Commission that Transpower's process improvements have yet to yield significant cost reductions. Strata also noted that the process improvements are not complete, particularly in respect of replacement and refurbishment expenditure.
17. In previous reviews, Strata identified that further efficiency gains could be made if Transpower adopted capex reduction targets, cost analysis of the impact of changes to policies, changes to cost estimation processes, procurement policies, and review of condition assessment and procurement policies. Although Strata acknowledges that Transpower has made a number of improvements to its policies, procedures and processes, Strata considers that further efficiency gains are available and are not reflected in the Transpower business plan. Strata recommends a 2.5% downward adjustment be applied to all projects to reflect efficiency gains achievable from process improvements.
18. A second key finding from Strata's review is in regard to the proportion of projects that have been through Transpower's internal validation and approval processes. These processes are applied by Transpower to ensure that least cost objectives are being met, and that only essential projects are being undertaken. Strata's review of Transpower's capital works indicates that gains of at least 5% can be made when the project validation and approval process is undertaken. However, at the time Transpower proposed its threshold of \$209.6 million, only 29% of projects had been fully reviewed and approved for IST capex, and 54% of (by value) of replacement and refurbishment projects.
19. Although it identifies a possible 5% reduction, Strata recommends that the Commission apply a somewhat more conservative 2.5% downward adjustment to those projects that have not completed the validation and approval process. This is to reflect the minimum cost reductions that are likely to be achievable had Transpower's internal validation and approval processes been completed.
20. A third key finding from Strata's review is in regard to the projects being rolled from one year into the subsequent year's threshold. The review of the 2008/09 and 2009/10 regulatory periods shows that the value of projects being rolled from one year into the

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<sup>4</sup> The Commission will address separately Transpower's non compliance with its settlement obligations to the process of setting the 2009/10 threshold.

next is no longer approximately matched by the value of unplanned projects that are undertaken. The impact of this is to inflate the threshold to a value higher than that actually required, by the value of the projects that, for various reasons, are not undertaken.

21. In response to this, Strata recommends that the Commission reduce the threshold by 6% during the 2009/10 regulatory period to approximately balance the projects rolling in and rolling out. Although the 6% is somewhat subjective, it is the approximate value of projects Strata expects Transpower will not undertake.
22. In sum, Strata recommends to the Commission that Transpower's proposed non-Part F capex threshold should be adjusted downwards to reflect three factors. These (discussed above) include:
  - a 2.5% downward adjustment applied to all projects to reflect efficiency gains achievable from process improvements;
  - a 2.5% downward adjustment applied to projects that have not been through Transpower's approval process, reflecting a minimum level of cost reductions that are likely to be achievable from Transpower's internal validation and approval processes; and
  - a 6% downward adjustment to account for the rolled over projects which are not expected to be undertaken by Transpower during the 2009/10 regulatory period.
23. The combined impact of these three adjustments reduces Transpower's proposed threshold of \$209.6 million down to \$189.6 million, a reduction of 9.5% or \$20 million (\$7.9 million to reflect efficiency savings being readily achievable and \$12.1 million to account for the rolled over projects unlikely to be undertaken in the forthcoming year).
24. In light of Strata's professional judgement regarding potential efficiency improvements available across the range of Transpower's investments, the Commission is of the view that the 2.5% reduction recommended by Strata to be applied to all projects is a conservative downward adjustment.
25. The Commission also considers that, given Strata's advice that projects going through Transpower's complete validation and approval process show, on average, efficiency gains of at least 5%, a 2.5% downward adjustment on those projects that have not been through this process is also reasonable and conservative. Transpower's level of forward planning of projects has been below that which is desirable, particularly in relation to the low proportion of projects subject to Transpower's own validation processes.
26. As noted above, the threshold is intended to provide Transpower a level of discretion and allow it to exercise its role as a prudent and dynamic grid planner. The threshold sets an overall expenditure amount that Transpower should not exceed. Transpower retains discretion to prioritise, defer, bring forward, add or remove projects so long as the total capital expenditure does not exceed the threshold. Transpower has, however, failed to justify the inclusion of projects year after year, which are not undertaken. The Commission is therefore of the preliminary view that the certain projects will not be undertaken in the 2009/10 year, and that the 6% adjustment recommended by Strata for rollovers is somewhat conservative.
27. The Commission accepts that efficiency improvements can be achieved in a variety of ways, and considers that Strata's proposed top down approach is straightforward and pragmatic. The Commission is of the view that these recommendations are fair, reasonable and achievable.

28. The Commission also notes that Transpower has under-spent against all of its three previous capex thresholds. In the 2008/09 year, the under-spend was significant. It should also be noted that Transpower's under-spend, every year, is despite the Commission applying various efficiency factors and downward adjustments to the threshold level proposed by Transpower.
29. It also should be noted that the non-Part F capex threshold value does not in any way constrain Transpower from undertaking capital expenditure. The settlement provides a second approval mechanism - an *ex post* review by which Transpower can seek regulatory approval, after the event, for prudent investments. Another option is that Transpower can simply submit any additional expenditure to the Electricity Commission for review, and if approved, Transpower may recover its costs. As such, Transpower has two options, over and above the non-Part F threshold, to seek regulatory approval of capital expenditure should it find its threshold constraining. Transpower has not, however, utilised its other options to date.

### **Bunnythorpe-Wanganui B line replacement**

30. The Commission is still seeking information from Transpower regarding the BPE-WGN B line replacement project. This project has been included by Transpower in its proposed 2009/10 non-Part F capex threshold as a 'like-for-like' replacement project.
31. Transpower has estimated the BPE-WGN B line replacement project value to be approximately \$14 million, with \$4 million being included in the 2009/10 threshold (the remaining amount is likely to be included in the following year's threshold).
32. The Commission is concerned that the project may not have been appropriately classified. The outcome of the classification affects whether or not it can be approved as a non-Part F project, or whether Transpower must submit the project to the Electricity Commission for approval. Therefore, whether or not this project is a like-for-like replacement or whether it involves augmentation, may change whether or not this project should be included in the non-Part F capex threshold.
33. If the BPE-WGN B line replacement project is found to have been inappropriately classified, the 2009/10 non-Part F capex amount will further be reduced by \$4 million to \$185.6 million.

## **Preliminary view**

34. The Commission's review has followed the process set out in the settlement. The Commission's preliminary view is that Transpower's non-Part F capex threshold should take into account any efficiency savings that are achievable during the relevant financial year.<sup>5</sup> The Commission agrees with Strata's advice that:
- efficiency savings in the order of at least \$7.9 million are readily achievable while still achieving the same output in terms of capital works completed, and
  - approximately \$12.1 million of projects included in Transpower's threshold are unlikely to be undertaken in the forthcoming year.
35. The Commission's preliminary view is that Transpower's non-Part F capex threshold should be reduced to either \$189.6 million, or to \$185.6 million if the Bunnythorpe-Wanganui B line replacement (BPE-WGN B line replacement) project is found to have been inappropriately categorised under the terms of the administrative settlement.

## **Invitation for Submissions on Replacement Cost Schedules**

36. The Commission invites interested parties to make written submissions on the Commission's preliminary view that it should set the 2009/10 threshold at \$189.6 million (or \$185.6m in the circumstance outlined above). The Strata Report is available on the Commission's website at:
- <http://www.comcom.govt.nz/IndustryRegulation/Electricity/ElectricityLinesBusinesses/TargetedControl/transpowerintentiontodeclarecontrol.aspx>
37. The Commission will consider the submissions received, and may, if necessary, engage a consultant to provide advice on various matters raised in submissions. If appropriate, the Commission will revise its preliminary decision on the amount being set for the non-Part F threshold, in light of those submissions.

### *Confidentiality*

38. Parties making submissions may wish to provide confidential or commercially sensitive information to the Commission. Parties can request that the Commission make orders under s 100 of the Commerce Act in respect of information that should not be made public. Any request for an order under s 100 must be made when the relevant information is supplied to the Commission and must identify the reasons why the relevant information should not be made public. The Commission will provide further information on s 100 orders if requested by parties, including the principles that are applied when considering requests for such orders. A key benefit of such orders is to enable confidential information to be shared with specified parties on a restricted basis for the purpose of making submissions.
39. Any s 100 order will apply for the limited time specified in the order. After the expiry of any order, the Commission will follow its usual process in response to any request for the information under the Official Information Act 1982.
40. The Commission discourages requests for confidentiality of submissions, as it is desirable to test all information in a fully public way. It is unlikely to agree to any

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<sup>5</sup> Consistent with the purpose of Part 4 of the Act, as set out in section 52A.

requests that submissions in their entirety remain confidential. However, the Commission recognises there will be cases where interested parties making submissions may wish to provide confidential information to the Commission. If it is necessary to include such material in a submission the information should be clearly marked and preferably included in an appendix to the submission. Interested parties should provide the Commission both confidential and public versions of their submissions in both electronic and hard copy forms. The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

*Receipt of submissions*

41. Written submissions should be received by **5pm Wednesday 12 August 2009**.
42. The Commission intends publishing all submissions on its website. Accordingly, the Commission would prefer receiving submissions in electronic form. If the submission does not contain confidential information, it is not necessary for interested parties to send the Commission hard copies of their submissions, unless it is not possible to do so electronically. Submissions should be sent to:

Philippe Laspeyres  
Network Performance Branch  
Commerce Commission  
P.O. Box 2351  
Level 6, 44-52 The Terrace  
Wellington

or

[electricity@comcom.govt.nz](mailto:electricity@comcom.govt.nz)