



COMMERCE COMMISSION

Regulation of Electricity Lines Businesses
Invitation for Submissions on
2008/09 Non-Part F capital expenditure threshold for Transpower
(28 May 2008)

Purpose

1. The purpose of this paper is to invite submissions on the Commerce Commission's (the Commission) preliminary view that the threshold amount for Transpower's non-Part F capital expenditure for the 2008/09 year be set at \$202.79 million.
2. The Commission has already consulted on its draft Gazette Notice which will set the thresholds for Transpower as proposed in its Settlement Offer of 11 April 2008 (Revised Offer). The consultation on the draft Gazette Notice was to ensure the Commission's draft Gazette Notice accurately reflected the terms of Transpower's Revised Offer.
3. The purpose of this consultation is to seek views from interested parties on the value that the Commission intends to specify in that Notice for non-Part F capital expenditure for the 2008/09 financial year. The Commission intends to publish its final Gazette Notice once the value of non-Part F capital expenditure for 2008/09 has been decided.

Background

4. As a state-owned enterprise, Transpower is subject to the provisions of the State-Owned Enterprises Act 1986, as well as the regulatory frameworks established in both the Commerce Act 1986 and the Electricity Act 1992. On 22 December 2005, the Commission published in the *New Zealand Gazette (Gazette)* its intention to make a declaration of control under Part 4A of the Commerce Act 1986 (the Act), in respect of transmission services supplied by Transpower (Intention Paper)¹.
5. Subsequent to the Intention Paper being released, Transpower's Board indicated its preference to resolve the post-breach inquiry with an administrative settlement. Transpower provided a formal administrative settlement offer to the Commission on 31 August 2007. This followed a long period of discussion between the Commission and Transpower regarding an appropriate offer. The Commission analysed the offer and summarised its content and implications within the Commission's Draft Decision Paper². The Draft Decision Paper, published on 5 October 2007, set out the Commission's preliminary view to accept Transpower's offer and decide not to declare control, and invited interested parties to submit their views. Having considered the matters raised in

¹ Commerce Commission, Commerce Act (Intention to Declare Control: Transpower New Zealand Limited) Notice 2005, *New Zealand Gazette*, 22 December 2005, Issue 210, p 5382.

² Commerce Commission, *Draft Decisions and Reasons for Not Declaring Control & Draft Decision on Resetting Transpower's Thresholds – Transpower New Zealand Limited*, 5 October 2007.

submissions, the Commission entered into further discussions with Transpower. Transpower provided a Revised Offer to the Commission on 11 April 2008. On 13 May 2008, the Commission announced that it had accepted the Revised Offer from Transpower³ and explained its reasons for not declaring control.

6. Under the terms of that offer, Transpower proposed that it be subject to a threshold which sets, in advance, an approved level of capital expenditure that may enter into its regulatory asset base (non-Part F capex threshold). This is expenditure that, for the time being, will not be submitted to the Electricity Commission for approval under the Electricity Governance Rules.
7. In its Decision Paper⁴, the Commission noted that all grid-related expenditure can be submitted to the Electricity Commission for approval. The term 'non-Part F Capex' was not intended to suggest that these investments cannot be submitted, but rather, that this category of investments are those that will not be provided, at least initially, to the Electricity Commission for approval. This is because, at present, the Electricity Commission does not have an established process for reviewing such capital expenditure, although, it is presently developing such a process.
8. The types of expenditure that have not been submitted to the Electricity Commission include:
 - a) replacement and refurbishment of existing transmission assets;
 - b) minor development and enhancements of transmission assets;
 - c) operation network information and technology services;
 - d) investments which are subject to a bilateral agreement with one or more customers; and
 - e) business support assets.
9. Under the Commission's previous price-path threshold, Transpower was limited in its ability to increase these categories of expenditure. Under Transpower's settlement proposal, however, which replaces the price-path threshold, these categories of capital expenditure would not have been subject to any scrutiny by either commission should the current practices be maintained. Therefore, in recognition of this, Transpower has proposed a threshold relating to this capital expenditure.
10. As part of its consultation on Transpower's settlement offer, 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. The Commission's Decision Paper explained that 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, and considered their appropriateness and effectiveness in achieving the least-cost objective set out in the October 2006 GPS and in Transpower policy documents⁵. Strata did not undertake a full technical review of individual projects.
11. The Commission considered Strata Energy's report, Transpower's comments, and all submissions on that report, and Strata's final recommendations in regard to the non-Part F capex threshold. The Commission's decision was that the level of non-Part F capex in 2007/08 would be set at \$120.7 million.

³ Commerce Commission, *Decision and Reasons for Not Declaring Control of Transpower New Zealand Limited & Decision to Reset Transpower's Thresholds*, 13 May 2008.

⁴ *Ibid*, p.56, paragraphs 261-263.

⁵ Strata Energy Consulting Limited, *Review of Transpower's Capital Expenditure Plans*, May 2007, p 11.

12. Although the Commission noted that its decision required only the minimum of what Strata Energy suggested Transpower could achieve in terms of efficiency gains, in reaching its view, the Commission considered it was appropriate for Transpower to be provided with time to achieve those efficiency gains.
13. The Commission also set out that its preferred approach would be to set the transmission (non-Part F) capital expenditure threshold for a longer period than the one year proposed by Transpower. However, in this instance, the review by Strata Energy indicated that Transpower's capital expenditure forecasting and planning cycles do not, as yet, provide a sufficiently robust forward-looking picture of the level of capital expenditure required⁶.
14. Accordingly, the Commission's decision was that it should set a threshold for non-Part F capital expenditure on an annual basis, following the annual review as proposed in Transpower's Revised Offer.

Non-Part F Capex Threshold

15. In setting the non-Part F capex thresholds for subsequent years (including the 2008/09 financial year), Transpower's offer proposed that the threshold would be established as follows:
 - a) Transpower will record any material changes to its asset management, business planning and capital works policies and/or processes, relating to non-Part F capex, which have occurred during the previous calendar year. These records are to be provided to the Commission in January immediately preceding the start of the financial year;
 - b) in January immediately preceding the start of the financial year, Transpower will make available to the Commission a schedule that shows, for non-Part F capex projects completed in the first half of the financial year, a comparison of actual expenditure (in the first half of the financial year) versus budgeted expenditure (for the first half of the financial year). 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 first six months of the financial year as well as a forecast of similar movements to the financial year end;
 - d) Transpower will prepare its non-Part F capital works plan and business plan forecasts for the forthcoming financial year in accordance with capital works and business planning processes and policies in January/February of each preceding financial year⁷;
 - e) Transpower will ensure contingency sums are adjusted as per the initial threshold 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 capital expenditure, for the forthcoming financial year, together with the project approval status, in final, non-draft form (non-Part F capex plan);

⁶ *ibid* pp 22-23.

⁷ 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, will be approved by the Transpower Board during the month of April.

- g) the Commission (at its discretion) will review (or engage an independent third party to review) the non-Part F capital works plan beginning in February of each year, to provide assurance that:
- the levels of contingency included in the project budgets have been established in accordance with (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 capital works processes around (a) procurement audit, (b) review of open book tendering for replacement and refurbishment (R&R), and (c) project approval document (PAD) templates⁸;
 - If, following consultation with interested parties, the Commission finds that Transpower has complied with and provided for the above then the resulting capital expenditure should be deemed appropriate for the transmission (non-Part F threshold); and
 - prior to the Commission making a determination on the level of the annual transmission (non-Part F capex) threshold Transpower will be provided with a draft copy of the Commission's (or its agent's)⁹ findings and any recommendations from the annual review process, for identification of any factual errors.

16. In accordance with Transpower's Revised Offer, the Commission engaged Strata to assist the Commission in its second review, by providing advice in relation to Transpower's commitments under the Revised Offer and the proposed level of non-Part F capital expenditure for the 2008/09 financial year.

17. The review conducted by Strata found that in the most part, Transpower had complied with the various aspects of its proposal. Strata also found that where Transpower's commitments related to providing processes that, for example, target 'least cost' efficient interventions, Transpower had been making process improvements since the previous review was conducted. Although improvements had been made, Strata advised the Commission that Transpower's processes have yet to yield impact through cost reductions, and that the process was not complete, particularly in respect of replacement and refurbishment expenditure.

18. In sum, Strata recommended to the Commission that Transpower's proposed non-Part F capex threshold should be adjusted downwards to reflect that further efficiency savings were achievable during the 2008/09 financial year. For replacement and refurbishment expenditure, Strata recommended a 5.0% downward adjustment, and for Information Systems and Technology expenditure, a 2.5% downward adjustment. This results in Transpower's proposed threshold level of \$210.5 million being reduced to \$202.79 million. The Commission also notes that Strata considers this to be a conservative adjustment.

⁸ Note that for the threshold reset in February 2008, within the time available, it will not be possible to fully implement all process improvements. Transpower set out the steps it has taken to initiate these process reviews.

⁹ The 'agent' report is to the Commission. The Commission will provide Transpower with this to ensure the Commission bases its final decision on information that is agreed to be correct.

Preliminary view

19. The Commission's review has followed the process set out in Transpower's offer (above). Its preliminary view on this matter is that Transpower's non-Part F capex threshold should take into account any efficiency savings that are achievable during the financial year to which it relates. The Commission agrees with Strata's advice that savings in the order of at least \$7.7 million are readily achievable while still achieving the same output in terms of capital works completed. The Commission is of the preliminary view that it should adjust the proposed threshold from \$210.5 million to be set at \$202.79 million.
20. In a letter to the Commission on 14 May 2008, Transpower provided its acceptance for the threshold to be set at \$202.79 million for 2008/09.

Invitation for Submissions on Replacement Cost Schedules

21. The Commission invites interested parties to make written submissions on the Commission's preliminary view that it should adjust the proposed threshold, and set the 2008/09 threshold at \$202.79 million. The report provided to the Commission by Strata is available on the Commission's website at:
<http://www.comcom.govt.nz/IndustryRegulation/Electricity/ElectricityLinesBusinesses/TargetedControl/transpowerintentiontodeclarecontrol.aspx>
22. At this stage, the Commission is not intending to invite interested parties to make cross submissions. If it considers, however, that matters of substance have been raised in submissions – those that materially alter the preliminary decision – it may invite cross submissions.
23. 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.
24. Written submissions should be received by **5pm Wednesday 11 June 2008**.

Confidentiality

25. 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.
26. 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.
27. 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 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

28. 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:

electricity@comcom.govt.nz; or
Network Performance Branch
Commerce Commission
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Wellington