

TRANSPower NEW ZEALAND LIMITED

**Transpower Response to Strata Report (May 2008)**

Review of Transpower's Capital Expenditure Plans  
(Asset Replacement, Refurbishment & Enhancement and Information  
Services & Technology)

*11 June 2008*

**TRANSPower**



# Table of Contents

<b>1</b>	<b>INTRODUCTION</b> .....	<b>1</b>
<b>2</b>	<b>GENERAL COMMENTS</b> .....	<b>1</b>
2.1	COST MINIMISATION OBJECTIVE .....	1
<b>3</b>	<b>REPLACEMENT, REFURBISHMENT AND ENHANCEMENT CAPITAL EXPENDITURE</b> .....	<b>1</b>
3.1	TRANSPOWER COMMENTS ON STRATA'S KEY CONCERNS .....	1
3.2	BENCHMARKING .....	3
3.3	GRID RESTRUCTURE.....	3
3.4	TLM REPORT ON TOWER PAINTING.....	3
3.4.1	<i>Estimated cost savings</i> .....	3
3.4.2	<i>Condition assessment</i> .....	4
3.4.3	<i>Preparation and application of paint</i> .....	4
3.5	COST TRENDS .....	4
3.6	ROLLOVERS .....	5
<b>4</b>	<b>INFORMATION SYSTEMS AND TECHNOLOGY EXPENDITURE</b> .....	<b>5</b>
4.1	FIBRE SWAPS.....	5
4.2	COST ALLOCATION .....	5

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## Transpower's Response to Strata's Report

### 1 INTRODUCTION

The Commerce Commission (Commission) has invited submissions on its preliminary view on the Non Part F threshold amount that it intends to set for the 2008/09 year. As noted by the Commission in its consultation material, Transpower has signalled its acceptance of the proposal that the Non-Part F Capex Threshold be set at \$202.79 million for the 2008/09 year.

Transpower has reviewed the Strata Report entitled “*Review of Transpower's Capital Expenditure Plans (Asset Replacement, Refurbishment & Enhancement and Information Services & Technology)*” and the various observations and comments made by Strata within.

Whilst Transpower concurs with Strata that there is scope for Transpower to make continuous improvements to its processes and practices in order to better target whole of life least cost outcomes, there are certain aspects of the Strata report that Transpower wishes to clarify.

### 2 GENERAL COMMENTS

#### 2.1 Cost minimisation objective

Transpower is concerned that Strata's focus on ensuring that projects are delivered at minimum or least cost does not fully take account of the need to minimise costs over the life cycle of an asset. Transpower notes that it is important to undertake the right capital expenditure projects at the right time, as well as delivering such projects at minimum cost over the asset life cycle.

A focus on whole of life cost minimisation would represent a more balanced viewpoint and would help ensure that short-term cost minimisation was considered within the broader context of whole of life cost outcomes.

### 3 REPLACEMENT, REFURBISHMENT AND ENHANCEMENT CAPITAL EXPENDITURE

#### 3.1 Transpower comments on Strata's key concerns

Strata provides a summary of its concerns with Transpower's progress in relation to the least cost objective on page 10. Given that this lists Strata's key concerns, Transpower has reproduced Strata's observations below and where appropriate has provided comments on the statements.

##### Strata observation

- there are still no specific targets set for reductions in capital expenditure costs on a category by category basis;

*Transpower believes the objective should be to ensure that the right investments are undertaken at the right time, at a minimum whole of life cost to ensure adequate levels of performance of grid assets. This does not mean that lower capital expenditure is desirable per se as might be implied by Strata's statement.*

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*However, Transpower agrees with the intent to ensure costs are incurred as efficiently as possible.*

**Strata observation**

- there is little quantification or analysis of the timing of capture of benefits;

*Transpower notes that its current processes are already driving out efficiency gains, and that these are reflected in its works plans, but accepts that these could be better quantified and reported.*

**Strata observation**

- as yet there is no rigorous and complete process for feeding back cost data into the estimation process (we acknowledge steps are under way to address this);

*Transpower notes that the unit costs used in cost estimations are based on actual costs. Thus, actual cost data are used in the cost estimation process.*

**Strata observation**

- the reliability and quality of condition assessment and post-completion inspection procedures is now in question (at least in relation to tower painting);

*Strata's conclusion appears to be based on the report by TLM, a consultant to Transpower, which itself reflects a misunderstanding of the processes Transpower uses for condition assessment of towers. This issue is discussed in more detail below.*

**Strata observation**

- the processes for assuring compliance with Procurement Policy are inadequate.

*Transpower notes that management control and delegations are used to assure compliance with the Procurement Policy as well as periodic auditing of compliance. Transpower notes that the internal audit of its Procurement Policy application is scheduled for 2009/10 following an update of the Procurement Policy in 2007.*

**Strata observation**

- the lack of appropriate benchmarking still remains an issue;

*This is discussed further below.*

**Strata observation**

- whilst it is accepted there are some limitations on the applicability of open-book contracting, Strata considers that there are still some opportunities to progress different contractual structures and tendering techniques.

*Transpower notes that there are not wholesale opportunities or benefits for changing current contractual approaches. However, there may be some scope to progress different contractual approaches in some circumstances and these will be further investigated.*

## **3.2 Benchmarking**

Strata mentions its concerns with the lack of appropriate benchmarking in several places in the report (e.g. page 10 bottom bullet and page 24). Transpower notes the difficulties inherent in the quantitative benchmarking of capital expenditure performance, given the lack of directly comparable information against which to compare the cost performance of different transmission businesses.

Transpower's approach has been to use the ITOMS study to benchmark its practices and policies against those used by the best performing businesses. Transpower notes that while ITOMS does not provide benchmarks in all relevant areas, it does provide benchmarks for a range of activities that are relevant (eg tower painting, asset age profiles, and routine maintenance cost comparisons). It notes, however, that practically it is difficult to unilaterally introduce new benchmarking measures through ITOMS given the range of international organisations involved.

## **3.3 Grid restructure**

Strata discusses (page 29) Transpower's recently announced restructure of National Grid. The Report comments that there is "a new function referred to as Asset Works Planning". Transpower notes that this is not a new function.

## **3.4 TLM report on tower painting**

Strata discusses the TLM report on tower painting (page 33). Transpower is concerned that some of TLM's comments have been taken out of context and that this may create unrealistic expectations of the scope for improvements and possible cost savings. Conclusions have been drawn from TLM's comments on condition assessment (CA) that are not warranted (eg last paragraph on page 34). Strata also comments on problems arising from inadequate preparation of towers for painting.

### ***3.4.1 Estimated cost savings***

Transpower is concerned that expectations of savings from the tower painting programme may be too high, especially in the early years. The percentages used for the potential savings from changes to tower painting policy appear to be based on comments made in the TLM report conclusions (page 46, section 11.2 of that report).

TLM has rightly concluded that the unit cost of tower painting would reduce if tower painting moved to a preventative maintenance basis on new or near new towers. Transpower concurs with TLM in this regard and indeed has adopted this approach as a policy. However the analysis does not take into account the fact that cost savings expected from the changed approach to tower painting on new or near new towers, will be overshadowed in the early years, because of the backlog of towers in poor condition requiring secondary preparation and some member replacement.

### **3.4.2 Condition assessment**

Strata draws far reaching conclusions from the TLM comments on the CA process for tower painting.

Transpower considers that TLM's comments on the CA data ignore the fact that condition assessment involves a two-stage process. The first is the routine CA for tower painting, which involves a high-level assessment (based on referenced policy standards). This high level CA assists in identifying priority areas of work but is not used to set the scope and budget for tower painting. The second stage involves a more detailed and targeted assessment, which is undertaken by specialist contractors as part of a Special Purpose Condition Assessment (SPCA).

The SPCA provides an accurate measure of the tower surface areas, condition of those areas, identifies replacement steel members, quantifies preparation requirements and recommends appropriate paint product for use. It is only after the SPCA has been conducted that the scope and budget for tower painting is defined and expenditure approved. This important second stage is not referred to by TLM.

### **3.4.3 Preparation and application of paint**

Strata notes (page 34) that the incorrect preparation and application of paint by contractors has resulted in a serious reduction in the life of the paint coating. Previous paint failures have been identified as primarily caused by poor quality preparation.

Transpower accepts that paint failures have occurred as a result of tower painting practices that occurred in the mid 1990's. The preparation standards for steel are now more stringently specified by Transpower with an increased level of supervision / inspection which provides additional independent checking and verification of the quality of contractor work to ensure these standards are being met.

Transpower believes that the incorrect preparation and application of paint is no longer happening, but ongoing checking of contractor performance is required to verify this.

## **3.5 Cost Trends**

Transpower does not consider that the cost trend analysis (page 35) provides a fair representation of probable trends in tower painting costs. The use of generalised averages from one year to the next such as the increase from 2007-08 of \$39,647 to 2008-09 of \$49,830, does not provide a fair representation of probable trends. The costs are influenced by many factors, including size of tower, location, travel distances, levels of secondary preparation, amongst others. The observed change between years is more likely to reflect changes in these influences, rather than in average costs.

### **3.6 Rollovers**

Transpower generally uses the term 'rollover' to refer to work that spans one financial year to the next. In most cases, rollovers result from a phasing change of a few months' delay or acceleration to suit the dynamic circumstances of operating and maintaining a grid. Outage constraints, sudden unexpected equipment failures, bad weather and shortage of resources can all lead to plans having to be revised.

Transpower notes, and Strata acknowledges, that it is essential that Transpower retain sufficient operational flexibility to allow it to respond to changing circumstances.

Transpower supports a move over time to approval of a five-year plan of work, which is allowed for under the proposed Commerce Act reforms. It considers that this would largely overcome the concern that Strata has with rollovers and delayed work, which are inevitable given the short threshold timeframe (e.g. one year).

## **4 INFORMATION SYSTEMS AND TECHNOLOGY EXPENDITURE**

### **4.1 Fibre swaps**

In a number of places Strata uses the term 'fibre swaps'. Transpower notes that this terminology may be misleading as it implies some form of exchange of capacity, when this may not be the case. Transpower suggests that instead the term 'fibre lease options' would have been more appropriate.

### **4.2 Cost Allocation**

In Sections 12.12 and 16 Strata make several critical observations on Transpower's internal processes for determining the correct allocation of costs between the system operator service and the transmission business and notes that there is room for Transpower to exercise discretion in this regard. While there is always an element of judgement in any cost allocation, Transpower believes that the cost allocation methodology applied and the controls that are currently in place are appropriate.

Transpower applies an Avoidable Cost Allocation Methodology (ACAM) to allocate costs between system operation and transmission services. The resultant transmission services costs are used to determine the transmission services revenue requirement. This methodology is specified by the Commerce Commission in the Electricity Information Disclosure Requirements 2004<sup>1</sup>.

The application of ACAM is reviewed periodically. A comprehensive review was undertaken in 2007 and a further refresh review was conducted in 2008. The results of the 2007 ACAM review were reviewed by Ernst and Young (Transpower's external auditors).

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<sup>1</sup> The application of ACAM results in system operation (SO) being allocated those costs that would be avoided by the transmission business were Transpower not providing the SO service. Accordingly, SO costs are the incremental costs of providing the SO service over and above the costs of providing transmission services.

Transpower's regulated information disclosures set out the estimated financial statements and notes for the "lines business" (i.e. transmission services). The lines business' financial statements are calculated using the ACAM methodology to separate the costs (and revenue, assets and liabilities) of SO and other non-lines business activities undertaken by Transpower. The information disclosures are audited statements (by PwC in this case) and are published annually in November.