



COMMERCE COMMISSION

**Regulation of Electricity Lines Businesses**  
**Invitation for Submissions on**  
**2010/11 Non-Part F Capital Expenditure Threshold for Transpower**

**Purpose**

1. The purpose of this paper is to invite submissions on the Commerce Commission's (the Commission's) preliminary view that the threshold amount for Transpower's non-Part F capital expenditure for the 2010/11 year be set at \$225.60 million.
2. After considering submissions on this matter, the Commission will publish its final decision in the New Zealand Gazette.

**Background**

3. Under the terms of the administrative settlement between the Commission and Transpower entered into under the Commerce Act 1986 (the Act) in 2008, the Commission is required to set a non-Part F capex threshold for each year of the settlement for Transpower.
4. The threshold provides, for the forthcoming year, an approved level of capital expenditure on assets that Transpower may, upon expenditure and commissioning, enter into its regulatory asset base (non-Part F capex threshold).
5. The types of expenditure that Transpower submits to the Commission for approval under the non-Part F classification are<sup>1</sup>:
  - a) replacement and refurbishment of existing transmission assets;
  - b) minor development and enhancements of transmission assets<sup>2</sup>; and
  - c) operational network information and technology services.
6. The settlement agreement provides that the threshold is to 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 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;

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<sup>1</sup> Part F capital expenditure is currently submitted to the Electricity Commission for approval under Part F of the Electricity Governance Rules 2003.

<sup>2</sup> Financial limits are applied so that only individual asset development and enhancement projects up to \$1.5 million, and enhancement programmes of work up to \$5.0 million are submitted to the Commission under the non-Part F approval process.

- 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>;
- 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 to the Commission, 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 consult on and 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 (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;
- 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;

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<sup>3</sup> The capital expenditure forecasts (and Business Plan) which will set out the forecast non-Part F capex threshold expenditure for the assessment period ending June 2011 will be approved by the Transpower Board in April 2010.

- 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 this [Gazette] notice to state that amount.
7. Transpower proposed that its non-Part F capex threshold for the 2010/11 financial year be set at \$246 million. In accordance with the terms of the settlement, the Commission has reviewed Transpower's proposed level of capital expenditure for the 2010/11 assessment period. The Commission engaged Strata Energy Consulting Ltd (Strata) to assist the Commission in its review and to provide its opinion on what a reasonable level of non-Part F capital expenditure would be for the 2010/11 assessment period.
  8. The review conducted by Strata found that Transpower has, for the most part, complied with the various requirements (outlined at paragraph 6, above). Strata found that, in terms of implementing process improvements (e.g. targeting least cost efficient interventions), Transpower has made significant progress in the past year. However, Strata advised the Commission that it considered further savings could be achieved. Strata also concluded that, because of the significant difference between the projects planned to be undertaken and those projects actually undertaken in 2009/10 (as at the time of Strata's review), as well as Transpower's history of under-spending, it is difficult to rely on Transpower's business plan, and that it would be appropriate for the Commission to adjust Transpower's proposal downwards.
  9. In sum, Strata recommended downward adjustments of approximately 15% for replacement and refurbishment expenditure (RRE) and 12.5% for Information Systems and Technology expenditure (IST). This would result in a non-Part F capex threshold of \$210.3 million.

### **Preliminary view**

10. The Commission's review has followed the process established in the settlement agreement (above). Its preliminary view is that Transpower's non-Part F capex threshold should take into account any efficiency savings that the Commission considers are achievable during the financial year to which the threshold relates.
11. In previous years, Transpower has significantly under-delivered on capital expenditure relative to its business plan and threshold. This has caused concern for both the Commission and interested parties. Information provided by Transpower in accordance with the requirements outlined at paragraph 6, however, suggests that Transpower is improving its capability to deliver forecasted expenditure. Transpower also supplied to the Commission its latest year-to-date capital spend and year-end reforecast, which supports that its capital spend is likely to meet its 2009/10 projection (despite large variances between planned and actual work undertaken).
12. In forming its view, the Commission has considered Transpower's historical performance in delivering to its proposals, together with Strata's advice, and Transpower's strong signal of the need for immediate investment and actual improvements.
13. One approach considered by the Commission was to set the 2010/11 threshold based on an average of actual historical expenditures. Although this approach would ease the Commission's concerns regarding Transpower's capacity to achieve its forecast capital expenditure, this approach would result in a threshold for 2010/11 being less than half Transpower's proposed capital spend of \$246m. 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.

14. The Commission is not, however, convinced that the full amount proposed by Transpower is reasonable and efficient. Transpower's improved performance supports a threshold higher than historical average spend, but its history of under-delivering to its business plan and capital forecasts suggests that it would be appropriate to set a lower threshold than Transpower proposes. Any necessary overspend is potentially recoverable by Transpower via the ex-post approval mechanism provided under the settlement.
15. Although Strata's report questions Transpower's ability to provide the capacity to undertake the full work programme, the Commission's preliminary decision is, despite Transpower's poor track record, to allow Transpower the benefit of the doubt one last time. This is because evidence suggests capital spend is necessary, and as Transpower seems likely to spend its capital expenditure threshold in the current year<sup>4</sup>, a new (higher) target may be achievable. In other words, the Commission considers that greater weight should be placed on more recent performance. Further, Transpower has made strong submissions to the Commission that it has improved its capacity to deliver the forecast expenditure. Also, as risk for consumers is mitigated through the ex-post wash-up mentioned above, the Commission's preliminary decision is not to make Strata's proposed adjustment for capacity concerns.
16. The Commission's preliminary decision is also to provide time for the US Cost forecasting system to be implemented. Streamlined processes and a better understanding of forecast costs will assist Transpower to manage its business and, therefore, the Commission expects cost savings to result in future regulatory periods.
17. However, the Commission agrees with Strata that it is appropriate to make an adjustment to the proposed threshold to take account of projects that are likely to be rolled into the subsequent year. Although it is reasonable and efficient to expect some projects to be brought forward and others to be deferred, Transpower's proposed threshold takes into account the value of projects being rolled into the 2010/11 year, but does not make allowance for projects being deferred. For this reason, the Commission considers Strata's recommendation in this regard to be reasonable, and the Commission's draft decision is to adopt a 5% adjustment for both RRE and IST.
18. Following Transpower's low level of capital expenditure (relative to the threshold) in 2008/09, the Commission informed Transpower that the Commission would require that, to be included in future thresholds, proposed capital expenditure must fully complete Transpower's internal approval processes. The Commission now considers that, at least initially, it may not be appropriate to require 100% of projects to have been through internal approval processes. The Commission notes that Transpower has increased the level of approvals in the current year, and that Transpower has had two years worth of capital expenditure to consider and approve at relatively short notice.<sup>5</sup> Likewise, the Commission also accepts Transpower's view that it may, in some cases, be more efficient for Transpower to defer approvals until closer to the time of investment.
19. In this regard, the Commission's preliminary view is not to require 100% of projects to have been through internal approval processes in order for them to be included under the 2010/11 threshold. However, the Commission does not accept Transpower's assertion that no cost saving will result from the process. The Commission's preliminary view is that Strata's 5% efficiency adjustment is reasonable. The Commission also recognises

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<sup>4</sup> 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.

<sup>5</sup> The Commission is concurrently reviewing capex for the final year of the settlement (this document) and the first year of the new price-quality regulation.

that this is somewhat of a judgement call, but notes that this is a considerably more lenient approach than the alternative that was considered (ie exclusion of all non-approved expenditure).

20. Strata proposed a 2% adjustment for achievable efficiencies with respect to reducing and better managing costs for RRE (and 1 % for IST). The Commission's preliminary view is that this is reasonable as there is scope for Transpower to improve the way in which it manages, contains, and reduces costs
21. It should be noted, however, that the cumulative effect of these adjustments does not mean that Transpower is unable to undertake capital expenditure in excess of the level of ex-ante approval. The settlement provides for an ex-post review by which Transpower can gain approvals for additional capital expenditure and enter approved and commissioned assets into its regulatory asset base. The Commission notes Transpower's concern regarding the uncertainty of this approach<sup>6</sup>, and proposes to set out the process for ex-post approvals in more detail in the near future to alleviate that concern.
22. Taking into account Transpower's performance, Strata's advice, and the information the Commission has reviewed, the Commission's preliminary view is that it is appropriate to set the threshold at \$225.6 million. This is based on the following adjustments being made to Transpower's proposal of \$246 million.

<b>Adjustments for RRE:</b>	<b>% Adj</b>	<b>\$ Impact (millions)</b>
Rollovers	5%	\$8.8
Cost Containment Targeting & Monitoring	2%	\$3.5
Efficiency adjustment on non-approved projects	5%	\$2.5
<b>Total</b>	<b>8%</b>	<b>\$14.8</b>

<b>Adjustments for IST:</b>	<b>% Adj</b>	<b>\$ Impact (millions)</b>
Rollovers	5%	\$3.5
Cost Containment Targeting & Monitoring	1%	\$0.7
Efficiency adjustment on non-approved projects	5%	\$1.1
<b>Total</b>	<b>8%</b>	<b>\$5.3</b>

### **Invitation for Submissions**

23. In accordance with the process set out in paragraph 6, the Commission provided a copy of Strata's advice to the Commission to Transpower for the identification of factual errors. Transpower has not provided feedback on factual accuracy, but rather provided comments on Strata's draft report. Strata's report, as well as Transpower's comments, are available on the Commission's website at:

<http://www.comcom.govt.nz/review-of-transpower-s-proposed-non-part-f-capital-expenditure/>

The Commission invites interested parties to make written submissions on the Commission's preliminary view, including responding to any comments made by Transpower, if relevant, by **5pm Tuesday 25 May 2010**.

<sup>6</sup> Transpower, *Letter to the Commission providing Transpower's comments on the draft 2010 Strata report*, 28 April 2010, p.7.

24. 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 view – it may invite cross submissions.
25. 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 view on the appropriate amount of the non-Part F capex threshold, in light of those submissions.
26. Written submissions should be received by **5pm Tuesday 25 May 2010**.

#### *Confidentiality*

27. 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.
28. 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.
29. 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*

30. 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:

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