



T R A N S P O W E R

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Brent Alderton
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Dear Brent

Re Transpower comments on the Draft 2010 Strata Report

The Commission has requested our comments on the first draft report *Review of Transpower's 2010/11 Non Part F Capital Expenditure Plans, April 2010 (v1.23)*, prepared by Strata Energy Limited.

As a general comment, we are encouraged that the report has acknowledged that significant improvements have been made to our planning and delivery processes over the course of the threshold year. The draft report also identifies where certain improvements are still required – we acknowledge and accept this.

Importantly, the report also reaffirms the importance of investment in the national grid and, specifically, the need for the increased level of expenditure identified in our Plans to replace and refurbish existing transmission assets.

We therefore have a major concern about the proposed adjustment to our 2010/11 capital expenditure plans. The draft report recommends that the budgeted level of capital expenditure for 2010/11 should be reduced by some \$35m. We do not think this is justified: nor do we think it will help deliver a better outcome for our customers.

Proposed Adjustment to Network Expenditure (RRE)

Strata's principal concerns leading to their recommendation are about Transpower's capacity to deliver the planned work, the current status of project approvals, and the level of "unplanned" work and expenditure rollover from last year. We comment later on each of these proposed adjustments but, overall, we believe that no adjustment should be applied to the proposed level of network expenditure (RRE). Constraining the level of allowed expenditure, particularly when it relates to prudent investment on network assets, runs contrary to the generally accepted view that there is a clear need to lift our replacement and refurbishment expenditure levels in order to improve and maintain asset performance.

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While 'excluded' work can be performed by Transpower and approved on an ex post basis, this should always be the exception: it places Transpower at risk, and can lead to essential work being deferred to manage this risk. Further, it is a fundamental move away from the ex ante regime, and a significant ex post review would significantly increase the workload next year on both the Commission and Transpower at the same time as we are processing a major three year ex ante review - for, we submit, little benefit.

Current versus mid year performance

Some of the data Strata uses to justify its recommendation is misleading. This is in no way a criticism of Strata or their analysis: rather, it reflects the data they had to hand. 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 spent in excess of 100 percent of our current year's threshold expenditure.

Comments on Strata's rationale for expenditure adjustments

Strata considers that adjustments to our proposed expenditure levels are appropriate to reflect:

1. the status of project approvals as at March 2010;
2. the scope for future "cost containment" (efficiency adjustment);
3. the anticipated net rollover of expenditure into and out of 2010/11;
4. the level of unplanned expenditure anticipated to be substituted into the 2010/11 plan;
5. Strata's view that Transpower will not have the capacity to implement its plan as proposed.

We provide initial comments on each of the proposed adjustments below.

Adjustments to account for the level of Business Case approvals

Strata has suggested 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 of this is that, as a project passes through the planning process through to its final approval, an indicative cost saving of 5% is achievable in all cases. We do not accept this. The rationale supporting this assumption is unclear and, in the absence of any quantifiable analysis, is assumed to be purely subjective. 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 (and this is our experience). It is the level of cost certainty (accuracy) that will improve during the planning process, not the level of cost.

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Further, the status of approvals presented in the draft report for both RRE and IST understates the current YTD position and the forecast level of project approval which is anticipated to be achieved by the end of the current threshold year. As noted, by the end of June 2010, some 87% of the planned RRE expenditure during the 2010/11 threshold year will have been approved (compared to 72% as at the end of March). This is a significant improvement on last year: further, it is probably as high a number as can be achieved sustainably.

In relation to IST particularly, Strata is concerned about an approach that adopts a simpler estimating model for more distant projects. We believe that our approach is appropriate, especially when the uncertainty is attached to the inputs and when this uncertainty will decrease as the start of the project approaches. More detailed analysis of uncertain inputs does not reduce the uncertainty. This is one of the reasons that leaving project approval until the time when input uncertainties have been reduced makes good business sense. By the start of the 2010/11 threshold we anticipate that some 50% of the planned IST expenditure will be business case approved, which is consistent with the approach noted above.

Adjustment to reflect future cost containment

The proposed 2% for RRE and 1% for IST downward adjustment for “cost containment” is inappropriate. The suggested cost containment (or efficiency) gains do not appear to be based on any analysis, but are instead based on a broad and subjective assessment of Transpower's process improvements. As Strata notes 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. There are no grounds to believe this will, however, result in any under spend against budget.

Strata has acknowledged that there are already processes in place for monitoring costs saved or avoided through effective procurement and cost management strategies. We accept, however, that there is a need for greater transparency and quantification to enable us to show where benefits are being realised through the different stages of the process. This is an area that we are working on.

Adjustment to take into account Rollovers into and out of the 2010/11 plan

The need for clarity around the definition of rollovers and why they occur is important, as it seems to be one of the main drivers for Strata's proposed adjustments to both the RRE and IST expenditures. A rollover, per se, should not be considered to be a negative nor, in the majority of cases, does it represent an unplanned expenditure. As presented, the report implies that rollovers only shift jobs (in total) from one financial year to the next. However, 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.

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The capital expenditure for 2010/11, as set out in our draft Business Plan, includes expected (or planned) rollover of expenditure from this year to the next. Some expenditure which is planned to occur between the time the business plan was prepared, in March, and the start of the financial year on 1 July, will roll over to the 2010/11 financial year. In the context of the threshold, this is called unplanned. In reality, it is planned and the variation results from the work being re-phased.

Outage constraints, sudden unexpected equipment failures, land access problems, bad weather and shortage of resources (often due to unplanned emergency work) can all combine to 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.

Irrespective of the justification for rollovers to occur, it is unclear why reducing the allowed expenditure on the basis that a proportion of planned work is likely to roll into and out of the 12 month plan helps to promote the least cost objective. We suggest there is no basis for this adjustment.

Adjustment to take into account unplanned work / substitution

In the commentary on Transpower's performance, Strata has cited concern about the "very high" level of unplanned projects. We do not share this view.

The number of unplanned projects quoted in the report is somewhat misleading. In the case of RRE, at an aggregate level Strata notes the inclusion of 431 unplanned projects during the current threshold year, with a cumulative value of \$57m. In fact, some \$23m of this total relates to rollover expenditure, of which around \$10m relates to a single project – the Marsden Development Project (which was planned but incorrectly categorised by Transpower as a Part F project). The remaining \$34m can be classed as unplanned expenditure, but only in the sense that the work was not initially phased to occur during the current year at the time the threshold was established. Likewise, some \$11m of the total \$34m of unplanned expenditure relates to a single project – spare transformers.

Large one-off projects aside, unplanned expenditure within a threshold year results mainly from the rescheduling and reprioritising of individual project work as operational circumstances dictate. The fact that the number of "unplanned" projects appears large reflects the level of granularity at which the capital plan is submitted to Strata (down to individual projects with a value less than \$50k). Individual projects in the RRE plan generally form part of longer term programmes of work driven by asset strategies.

As an example, if a planned tower painting project were not able to be progressed as a result of local outage constraints, land owner requirements or local resource availability, and it was decided instead to bring forward another tower painting project in order to meet the target level of annual tower painting (as specified in the asset strategy), the substituted project would currently be classed as unplanned and the deferred project would be flagged, with negative connotations, as a planned project not progressed. (It is questionable whether the regulatory framework should seek to

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monitor project movements at such a high level of granularity and we will, looking forward, group these work packages better to remove this anomaly).

The following table helps to illustrate the above point by showing how substitution of planned work with unplanned work within some of the major asset programmes results in the actual spend being largely in line with the original budget.

Asset Programme	Forecast \$000			Total	Budget \$000 Total
	Planned spend	"Unplanned" New spend	"Unplanned" Rollover spend		
Tower painting	7,978	2,535	4,320	14,833	15,887
Grillage	10,871	2,712	1,904	15,488	11,898
Conductors	10,487	379	155	11,021	12,606
Line protection	1,264	1,893	867	4,025	2,148
Structures and Buswork	2,067	1,807	406	4,283	4,457
Fences and Civil	1,752	2,827	1,252	5,831	5,043
Circuit Breakers	1,983	1,133	474	3,590	4,408
Insulators	4,905	33	(160)	4,778	5,298
Transformer replacement	5,103	1,321	2,989	9,413	5,737

Similarly the overall impact of unplanned expenditure on the total expenditure within the major IST programmes looks less significant when considered at a programme level than it does when looked at from an individual project level.

IST Programme	Forecast \$000			Total	Budget \$000 Total
	Planned spend	"Unplanned" New spend	"Unplanned" Rollover spend		
ISBA	541	---	546	1,087	2,936
MSTA	3,634	3,551	783	7,968	10,508
T&N Tactical	1,190	421	722	2,334	1,316
TNP -	21,562	3,935	4,054	29,551	38,248

We acknowledge we need to improve our processes for tracking and approving unplanned projects, substitutions and planned project deferrals (as Strata suggests). This we will address this year. (However, we do not agree with Strata's suggestion that approval to remove or change a planned project or replace it with a substitute should be approved at a DFA level higher than that required for the original approval. The decision should still be made at that level, providing it follows the correct processes and is appropriately documented).

Adjustments for delays in implementing US Cost forecasting system

Strata has proposed that a downward adjustment of 2% be applied to all RRE projects as a result of "delays in the roll-out of the US Cost forecasting system". This recommendation is based on incorrect logic. Although the roll out of US Cost across other parts of the business may result in some process streamlining (and marginal internal cost savings), the main benefit will come from achieving greater consistency and accuracy in our estimates. The application of US Cost does not, however, lead to cost reduction (and this is our experience in its use to date). In fact, in a market where almost all our input costs are tending to rise (post the financial crisis), the impact of US Cost is likely to result in *higher* estimates because increases in input

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costs will be captured more quickly in the estimating process. The proposed adjustment is, therefore, inappropriate.

The real driver of cost efficiency for Transpower is in procurement and delivery, which is a wider issue than just how we put individual jobs out for tender. Our procurement processes have been improved over recent years and are now more robust and effective. As a result, we are now, we believe, starting to capture gains by better programming of our work (which, in itself, requires more, not less, flexibility in when we actually perform individual scopes).

Adjustments for concerns around Transpower's capacity to deliver

We note that Strata does not suggest that our proposed level of expenditure is inappropriate for the network and in fact the report is supportive of the increased expenditure, especially as it relates to grid assets. It therefore seems counterintuitive to reduce the level of expenditure, below a level which is generally considered prudent, on the grounds that, based on previous years' outturns, Strata considers that we may not have the capacity to implement the work in full during the 2010/11 year.

It is assumed that Strata has formed its view based on the historical levels of under spend against the threshold allowances. This year, our forecast RRE expenditure will exceed the threshold allowance by over \$25m and both the December (Strata's base) and March (Latest) YTD positions (overspend against threshold) would not appear to support Strata's concerns over our capacity to deliver. Taken together with a marginal under spend against the IST threshold components, we forecast a net over spend against the Non Part F threshold of around \$10m by the end of the year.

Proposed Adjustment to IST Expenditure (IST)

The above comments apply principally to RRE, but are also germane to IST. Strata has recommended that similar percentage levels of downward adjustment be applied to the IST capital expenditure plans. We acknowledge that the case for IST capex is somewhat different to that for prudent expenditure on the interconnected grid assets (RRE). A higher proportion of the IST spend is for operational efficiency as opposed to network reliability or security, and the impact of delay is fundamentally different.

However, we believe any adjustment should be significantly less than that proposed by Strata. Over 80% of IST capital expenditure relates to the approved TNP programme, which is mid-way through its delivery – with work scheduled to be completed over the next three years. Much of what Strata's analysis implies is unplanned work (or deferred planned work) on this project is more correctly adjustments in work packages to reflect the dynamic nature of the telecommunications market (particularly with respect to leased fibre or co-build opportunities). The level of the IST adjustment proposed by Strata will inevitably impact significantly on the planned delivery of the TNP programme over the next two years in particular, which would result in planned work needing to be deferred. Deferring this work will require considerable re-planning and will impose additional costs on the overall programme. It would also compromise our ability to secure cost savings through leased deals that currently being offered by the market following an

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extensive competitive tender round. Strata is correct that, in previous periods, planned work was not delivered to schedule on this project. However, as Strata acknowledge, considerable changes have been made over the past year to improve the project management delivery of the TNP which is now on a substantially better footing to meet its target deliverables on time.

Given previous years' IST expenditure performance against the balance (non-TNP) of the IST threshold, we accept that some adjustment may be appropriate but such an adjustment should be coupled with a clearly defined process for conducting an ex post review of actual IST expenditure during the year.

Ex post approval and review process – minimising uncertainty

Should any IST (or RRE) approval be "held back" as proposed, we believe it is very important that there is certainty around the process by which it will be later approved, and request that the Commission provide clarification on this.

Under the current threshold arrangements there is facility for the Commission to approve, ex post, expenditure that falls outside an approved Non Part F threshold. When it was put in place in 2006, this ex post review mechanism was expected to cater for exceptional and unexpected expenditure only, in situations where such expenditure has led to overall expenditure exceeding the threshold cap. Approval of expenditure after it has been incurred (with the possibility of asset stranding) presents considerable risk to Transpower. To reduce its inevitable impact, the approval criteria that the Commission intends to apply need to be clearly defined at the outset.. Uncertainty in this area will increase the disincentive to incur expenditure which otherwise would be considered prudent.

In our view, any ex post review process should focus on simply establishing whether or not expenditure incurred during the year, which was not approved at the start of the year (be it new investment, accelerated planned investment or changes to cost/scope on a planned project), has in fact been planned and approved in accordance with Transpower's internal processes. As Strata notes in its report, our RRE and IST planning and approval processes have been substantially improved and streamlined this year and are being more consistently applied than in previous years.

Considerable effort has been expended to refine our planning processes to ensure that there are clearly documented "stage gates" that each project must pass through to ensure that expenditure is justified in terms of need, that appropriate options and timings are considered, that cost estimates are robust and that least "whole of life" cost delivery outcomes are achieved. As a point of principle, we believe that the quantum of actual expenditure incurred during the year should be less important than whether or not incurred expenditure is justified, efficiently spent and represents the least "whole of life" cost outcome. The ex post review process should place a requirement on Transpower to demonstrate that projects, for which ex post approval is sought, have passed through the required planning process stage gates

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The Commission has asked us to confirm that there are no factual errors in the draft Strata Report. We are currently reviewing the report from this perspective and will write again shortly with any comments.

Thank you for the opportunity to provide this comment on the Strata draft report, and please don't hesitate to call if you require any further information or clarification.

Yours sincerely

Patrick Strange
Chief Executive