Major Electricity Users Group
PO Box 8085
Wellington

Attention: Ralph Matthes

11th May 2011

Dear Ralph

TRANSPOWER WORKSHOP CAPITAL EXPENDITURE INPUT METHODOLOGY

Thank you for your instructions for Strata Energy Consulting (Strata) to provide advice on the Commerce Commission's (Commission) proposed approach to the Capital Expenditure Input Methodology for electricity transmission. Following the workshop held in Wellington on the 28/29 April and our subsequent discussions I can provide the following advice for your consideration.

In general the Commission's proposed input methodology is a development of the historical approach used in previous years. The proposed methodology can be considered to be generally aligned with regulatory practice in other comparable international jurisdictions such as Australia and the UK. However, there are two key components of the proposal that are considered to be worthy of highlighting to the Commission. These components are:

1. The proposed incentive mechanism; and
2. The materiality level for major expenditure categories

The points that we consider to be important relating to these components are discussed below.

The proposed incentive mechanism

The Commission has proposed a symmetric fixed incentive mechanism rate applying to the allowances for Major capex projects and Minor capex. The intention is to allow Transpower to retain part of any savings or alternatively, to bear some of the risk of poor forecasting and cost overruns. The Commission proposes this should be complemented by the development of required network outputs in the Capex IM. These output measures are to be developed by Transpower for assessment by the Commission.

The development of output measures is considered to be a positive one particularly when, due to changes in the regulatory structure (e.g. removal of ODV and the introduction of the GIT based approval of capital projects), risks have been passed from Transpower to consumers. In this regard the Commission is effectively representing the interests of consumers.

However significant concerns are held over the proposal to implement the incentive regime in November 2011 because the risks to consumers of providing Transpower with incentives needs to be carefully considered prior to implementation.

Concerns over how the risks would be managed include the following:

a. Risk of inflated expenditure forecasts

The current regime already provides incentives for Transpower to conservatively estimate capex costs (i.e.over-estimate). This is because an overrun of the Allowance (or threshold) is not recoverable without the Commission's agreement. While it is not an intended outcome, the proposed incentive regime will nevertheless increase the incentives for Transpower to over-estimate costs. This is because setting a 'soft' target will maximise the potential for gains under the incentive regime. This risk was effectively acknowledged in the Workshop by Transpower's Chief Executive, Dr Patrick Strange, when he noted that if the incentive level was set at 100% it would:

> "put a lot of incentive on us [Transpower] to get that forecast as high as we possibly can".[1]

b. Risk of over aggressive review

An aggressive review process by the Commission will be required to counteract the risk of highly conservative cost forecasts being submitted by Transpower. However, it will be challenging to strike the right balance because of the high level of uncertainty inherent in forecasting expenditure out over five years. There is a risk that in seeking to avoid a 'soft' Allowance that the Commission constrains costs to the point where essential capex is not permitted.

While the principle of an incentive regime is supported, it is recommended a staged approach is required because:

- the regime as proposed will (inadvertently) incentivise Transpower to prepare conservative capex forecasts which will diminish the discipline on Transpower and present it with a soft target to make gains under the incentive regime;
- while incentive regimes have been (and are being) implemented our understanding from the Workshop is that none have yet achieved demonstrable success; and
- the time available in which to implement the regime is extremely tight and there is a significant risk that developing a regime in haste will establish a regime which has unintended and undesirable consequences.

It is suggested that:

a. The output measures are established and tested first. Transpower should develop and propose these measures for the Commission to consider and consult on. The Commission should reserve the right to set alternatives. Transpower's suggestion at the Workshop that the key output measure should be the extent to which the 'lights go out' is not considered adequate because it is not forward-looking and is not the only basis on which expenditure projects and programmes are justified.
b. Monitor and be informed by the performance of incentive schemes operating in other jurisdictions.

[1] p90 lines 24-25 Transcript of the Capex Input Methodology Workshop

c. The Commission should move to introduce incentives on the basis of identified efficiency initiatives before moving to a broad incentive scheme in future RCPs. These efficiency initiatives should be agreed with the Commission and involve specific targeted initiatives which have defined outcomes set over a period of time. Consideration could also be given to incentives which penalize both over or under-shoot the Allowance.
d. Further consideration should be given to the level at which an incentive should be set. It appeared from the Workshop that this had not been fully researched and analysed.

The materiality level

Several key points appeared to be missed at the Workshop in relation to:

- the dollar amount at which projects were determined as being Major or Minor
- how the Minor projects were to be treated.

a. Substitution

The main issue covered by the materiality level is the risk in allowing Transpower a high degree of freedom to substitute Minor Capex projects across years and across asset categories. While retaining flexibility to provide Transpower with some degree of substitution is considered desirable, unrestricted substitution will mean project overspends can be readily be masked by deferring other projects. It also means that a range of projects which have not been subject to any regulatory scrutiny can be carried out.

Given Minor Capex may well exceed $100m per annum, this means a significant part of the capex programme will be subject to a minimal level of control and scrutiny. Also the Minor Project capex forecast on which the Allowance was based may bear very little relation to the programme that is actually implemented. This would raise the question about whether a forecast was an appropriate basis for setting an allowance for Minor Projects.

b. Materiality Level

Irrespective of whether the Major / Minor Projects limit is set at $5m, $20m or $40m the number and value of projects included in the Minor Project category is expected to be very significant because the vast majority of projects are well below the $5m level contemplated. Therefore, irrespective of where the materiality level is set, controls on substitution are required given the issues raised above.

c. Substitution Limits are necessary

Limits are required on the extent to which substitution can occur between years and across asset categories for Minor Projects. These limits should be adequate to ensure regulatory scrutiny and controls at a level appropriate to a sizeable body of capex and provide adequate assurance the projects are necessary, appropriate and at least-cost. It is important that sight is not lost of the importance of doing process reviews. At a time when significant increases in spending are arising occurring close scrutiny is highly important.

d. Documentation not an Issue

Comment has been made that setting a low Minor Projects limit will place an unnecessary burden on resources. This is not considered to be a major issue because the Commission would simply review all or a sample of documentation Transpower had already prepared for its own internal purposes. It is noted that there is a requirement for Transpower to ensure an appropriate level of analysis is undertaken on all projects and programmes, commensurate with the size and value of those projects and programmes. A lower materiality level would not change or add to this requirement.

Also the Commission specifically asked for your perspective on whether the Commission should reserve the right to conduct a merits review of major Grid Upgrades or limit reviews to process only. Our view is that the Commission should not conduct a merits review as a matter of course but it must retain the right to do so should it choose to.

Please contact me if you wish to discuss any of the above comments.

Yours sincerely

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