MAJOR ELECTRICITY USERS' GROUP

9 November 2012

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By email to regulation.branch@comcom.govt.nz

Dear Andrew

Otahuhu substation diversity project MCA amendment application

1. This is a submission by the Major Electricity Users' Group (MEUG) on the request by Transpower for cost overruns to be approved as set out in the report titled "Otahuhu substation diversity project - application for increase of major capex allowance (MCA)" lodged 27th September 2012[1].

2. The quantum requested for approval is $7.1m. This is a material sum being 7.2% higher than the P90 upper bound cost approval of $99m. This is the first application for cost overruns to be approved in terms of the Transpower Capital Expenditure Input Methodology Determination [2] (the "Capex IM"). Consideration of this request is therefore very important for establishing procedural and analytical precedents for further requests by Transpower to approve cost overruns. We understand those future applications may be in the order of several tens if not hundreds of millions of dollars.

3. An important yardstick for MEUG members in considering the effectiveness of all aspects of Part 4 regulation of monopoly lines businesses is to ask the question, what would happen in non-regulated competitive markets such as those MEUG member companies operate in? In this case the simple answer is that no MEUG member can unilaterally recover the cost of overruns on capital work programmes from end customers. Cost overruns are borne by individual companies not their customers. This creates strong incentives on companies to plan and execute capital investments efficiently. It is against this market comparator outcome that we test requests for ex post approval of cost overruns. It would need to be a very unique set of circumstances where demonstrable benefits could be shown to justify cost overruns being approved.

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[1] http://www.comcom.govt.nz/otahuhu-substation-diversity-project-mca-amendment-application/

[2] i.e. the Transpower Capital Expenditure Input Methodology Determination [2012] NZCC 2, 31st January 2012, found at http://www.comcom.govt.nz/assets/Pan-Industry/Input-Methodologies/Transpower-Capital-Expenditure-IM/Capex-IM-Final-Determination-and-Reasons-Paper/Transpower-Capital-Expenditure-Input-Methodologies-Determination-2012.pdf

4. An analysis of the application against the approval criteria in the Capex IM follows. In each case we conclude the approval falls short of the criteria needed to grant approval:

   a) The risks of cost overruns were reasonably foreseeable and were within Transpower's control[3].

      The Transpower Board when making a final commitment to proceed would have been acutely aware of the scaling up risks they faced as an organisation to plan and manage implementation of a number of large capital works including this project. It was entirely Transpower's choice to decide the timing of the project, method for estimating costs and the contingency margins on P50 estimates to scale up to a P90 estimate.

      There is a sense that immediately following the outage on 12th June 2006 that Transpower wanted to do something quickly and substantial to appease politicians. If true, then decisions to take short-cuts or rush the planning and costing of the project to meet perceived political pressures were decisions by the Transpower Board at the time and any loss subsequently incurred by Transpower should not be to the account of end customers.

      There was always the opportunity to seek a revised approved quantum; subject of course to any revised application passing the appropriate regulatory test. A less aggressive implementation timeline could have been adopted to allow time for more accurate cost estimation. Interim risk mitigation strategies presumably were put in place and would have given time to better plan the project and if necessary seek revised cost approvals. After all the critical failure on 12th June 2006 was due to the poor condition of the connection equipment (shackles) and a failure of maintenance processes to identify risky assets. Immediate short-term mitigation strategies were contemplated by Hon David Parker, Minister of Energy at the time, in his letter to Transpower the day after the 12th June 2006 incident. The Minister said, with emphasis underlined by MEUG:

      "If part of the answer is that the system is unacceptably vulnerable to failure at a single substation – Otahuhu –please provide at least initial thoughts on what might be done to reduce this risk in both the short-term [e.g. via changes to operational and maintenance practices] and in the medium-term [e.g. via additional investment]."

      It was Transpower, not end customers, which decided to proceed with haste and thereby took the risk of cost overruns.

      End customers should not have to pay for Transpower's optimism about implementation or any short-cuts taken in planning and costing of the Otahuhu substation diversity project. In our view the risks of cost overruns were reasonably foreseeable and were within Transpower's control and therefore the application does not meet these criteria.

[3] Capex IM, cl. 6.1.1(5)(a)(i)

b) The net electricity market benefit analysis is not robust[4].

The analysis falls short in at least two areas.

First, not all feasible options have been considered in the application. Two possibilities have not been mentioned. The proposal by Transpower on 11th August 2006 for an upgrade of the existing switchyard at Otahuhu at a cost of $14.1m should have been included. And the option of deferring the start of the upgrade to better plan and cost options as discussed in the section above.

Second, it is unclear how the application treats the change in demand forecasts as those became progressively flatter since 2006. If the much flatter demand forecasts post 2006 have not been considered then the claimed savings in expected unserved energy are therefore expected net market benefit of the actual as built project compared to alternatives will be overstated.

c) The application fails to have a balanced discussion on[5] "why making the proposed amendment would promote the long-term benefit of consumers" and therefore fails to meet the evaluation criteria to[6] "promote the purpose of Part of the Act"

As an approximation[7] if MEUG members collectively use 27% of annual electricity demand then collectively they will need to pay $1.9m of the requested $7.1m cost overrun. Given the choice, we do not see any upside to MEUG members voluntarily agreeing to pay $1.9m for the cost overrun in order to receive a greater longer term benefit. We cannot see any upside for MEUG members to pay their share of this cost overrun or for that matter any benefit for any other end customers.

Approving this application we think has many downsides. It will reduce the incentives on Transpower to continuously improve planning and delivery of capital programmes. The propensity for politicians to influence and the Transpower Board to be influenced by political agenda will not be curtailed if this cost overrun is approved.

On balance MEUG concludes there are no demonstrable benefits and several detriments that will affect end customers if this request is approved.

5. In conclusion MEUG recommend the Commission decline the request by Transpower for approval of $7.1m for cost overruns for the Otahuhu substation diversity project.

Yours sincerely

Ralph Matthes
Executive Director

[4] Capex IM, Schedule H, Division 1, paragraph H6 (5)
[5] Capex IM, paragraph H6 (6)
[6] Capex IM, cl. 6.1.1(2)(b)
[7] This approximation overstates the MEUG member share because they tend to have low load factors.