

MAJOR ELECTRICITY USERS' GROUP

17 January 2014

Matt Lewer
Chief adviser, Regulation
Commerce Commission

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

Dear Matt


Submission on NIGU Project Amendment issues paper

1. This is a submission by the Major Electricity Users' Group on the Commerce Commission issues paper¹ "Amending Transpower's allowance and outputs for the North Island Grid Upgrade Project" (NIGUP) dated 29th November 2013. Members of MEUG have been consulted in the preparation of this submission. This submission is not confidential.
2. MEUG is an interested party representing major power users' that will pay a share of higher transmission interconnection charges should the Commission approve the proposal resulting in an increase in recoverable charges of \$52m.
3. This submission responds to the Commission paper to² "seek your views on the areas we may analyse further to assess whether Transpower planned and delivered the NIGU Project efficiently". MEUG is also using this review to consider improvements to the Capex Input Methodology (IM) and other Transpower IM to better meet the purpose of Part 4 of the Commerce Act.
4. NIGUP was the largest approved project in the recent \$2.5 billion suite of grid investments, was and still is the most controversial, and is now the subject of the largest request for approval of a cost overrun. If the \$52m requested is approved it will flow through to the power bills of consumers and create a drag on the spending power of households and profitability and investment plans of businesses throughout New Zealand. That drag on the economy is an important detriment to be considered by the Commission.

¹ Refer <http://www.comcom.govt.nz/dmsdocument/11325> found at <http://www.comcom.govt.nz/regulated-industries/electricity/electricity-transmission/transpower-major-capital-proposal/amending-the-allowance-and-outputs-for-the-north-island-grid-upgrade-project/>

² Ibid paragraph 1.2

5. Transpower can expect to recover efficient costs. However the scale of the cost overrun and the impression from the Commission paper that certain usual governance and management practices for large projects were not in place leads us to an initial view that there will be material avoidable costs uncovered. The Commission must apply appropriate resources to ensure any approved cost overrun can be clearly identified as being efficient.
6. In workably competitive markets inefficient costs can be thought of as those costs for which no party is prepared to pay the actual cost because that exceeds the benefits to those potential purchasers. In that case the supplier must write off the actual cost to the point at which buyers are prepared to pay for the service. The Electricity Authority as part of their Transmission Pricing Methodology issues and proposal paper dated 10th October 2012 proposed an approach that identified beneficiaries and estimated benefits relative to costs for discrete transmission investments. For NIGUP the expected benefits over the next few years were expected to be far less than the level of transmission charges as summarised in the snap shot of the following EA slide³.

<div style="text-align: right;"> ELECTRICITY AUTHORITY <small>TE MANA HIKO</small>  </div>							
SPD charge may not cover all costs (projections for 2015 based on 2010-12 data)							
\$ million	Pole 3	NIGUP	WRK Ring	Islington-Kikiwa	Woodville-Masterton	Pole 2	NAaN
Expected cost	101.12	116.93	20.01	4.50	2.47	70.00	58.89
Revenue from SPD charge	37.40	15.78	8.96	1.40	0.70	64.26	5.54
Residual	63.71	101.14	11.05	3.10	1.77	5.74	53.35
Percent covered by SPD charge	36.99%	13.50%	44.78%	31.11%	28.34%	91.80%	9.41%

7. The Electricity Authority estimated that for 2015 the benefit to supply and demand side users' of NIGUP would be \$15.78m compared to regulated charges payable by consumers of \$116.93m. The benefit to NIGUP users' in 2015 was expected to equal 13.5% of charges.
8. On the basis of the above analysis by the Electricity Authority, any approved higher cost that flows through in charges will have zero incremental benefit over the next few years. We think this should be part of the wider consideration of factors considered by the Commission.

³ Electricity Authority, TPM Issues and Proposal, Discussion Forum, 19th October 2012, slide 3, document URL <http://www.ea.govt.nz/dmsdocument/13855> found at <http://www.ea.govt.nz/our-work/consultations/priority-projects/tpm-issues-oct12/>

Review approach and basis of decision making

9. We concur that the decision making criteria is prescribed in the Capex IM⁴.
10. The Commission acknowledges uncertainty on whether the Commission can lower an allowance below what was originally approved⁵. It would be a travesty if the Commission excluded consideration of lowering the allowance below the original approved budget when in fact that option is allowed. Rather than consider that option in a separate⁶ and later process; MEUG recommends the Commission must urgently clarify if that option applies to NIGUP and in the meantime assume that option is available.
11. MEUG suggests use of Good Electricity Industry Practice (GEIP) is a useful minimum standard for considering build practices but may not necessarily be equal to that expected of an efficient business. The criteria for approving expenditure above the original approved level should be that observed in workably competitive markets. We therefore disagree with the statement in the paper⁷:

“We consider GEIP is appropriate, as benchmarking Transpower’s performance to a standard such as best or frontier performance may have negative effects on incentives to invest.”

12. In workably competitive markets businesses that have cost overruns on projects bear that cost. There should be no room when considering cost overruns for a regulated entity to apply any generosities or lesser standard than best or frontier performance.

Areas for further investigation

13. Transpower has fortuitously benefited from the actual direction in change of FX and actual rate of change in CPI compared to the original budget. The value of that fortuitous value gain is⁸ \$70m. MEUG suggests the Commission consider if there are any grounds to limit any fortuitous FX and CPI value gains to Transpower in assessing whether Transpower planned and delivered the NIGU Project efficiently.
14. As an aside we note that in other major transmission projects where actual costs have been less than the original approved budget, that outcome may also be a result of fortuitous movements in FX and CPI rather than efficient implementation.
15. We have no comment on the questions in the paper⁹ regarding the key factors identified by Transpower in its application other than to note the scope of inquiry set out by the Commission in section 4 of the paper is both more comprehensive and more appropriate.
16. The proposed approach to areas that will not be analysed is pragmatic¹⁰.

⁴ Commerce Commission NIGUP issues paper, 29th November 2013, paragraph 2.4

⁵ Ibid paragraph 2.5

⁶ Ibid paragraph 2.8

⁷ Ibid footnote 22

⁸ Ibid paragraph 1.18

⁹ Ibid paragraph 3.7

¹⁰ Ibid refer question in paragraph 4.13

17. In response to the questions in the paper on project governance¹¹, project management¹², contract procurement process¹³, property strategy and implementation¹⁴, and Alliance delivery of overhead lines subproject¹⁵, MEUG note:

- Anecdotal feedback from MEUG members indicates having a high level governance group, including people not on the project implementation team and often external advisors, is standard practice for large capital works.
- A common feature for large capital projects implemented by MEUG members is close continuous scrutiny of expenditure to date against budget and forecast costs. As soon as the project team believes forecast costs will exceed budget remedial action is taken immediately to re-scope work to stay within budget or if that is not possible, approval sought immediately for approval for a new budget.

We are interested to know if Transpower considered seeking a revised approval from the regulator when it first became aware the expected cost would exceed the approved cost and if the project governance arrangement comprehended such a process.

- Usually large projects are contracted out. It is common practice to have very tight provisions for cost variations for contracted out projects. Transpower seems to have had such an arrangement with Siemens for new HVDC Pole 3 and Pole 2 upgrade work.

Other comments and request for information

18. We are still unsure why Transpower sought approval for \$70m with a promise to only charge \$52m when it could have sought approval for only \$52m.
19. MEUG suggests the Commission publish the information listed in paragraph A12 once received from Transpower. If the Commission does not propose to publish the information then MEUG requests a copy of the information as received.

Yours sincerely



Ralph Matthes
Executive Director

¹¹ Ibid paragraph 4.27

¹² Ibid paragraph 4.31

¹³ Ibid paragraph 4.36

¹⁴ Ibid paragraph 4.42

¹⁵ Ibid paragraph 4.44