

12 September 2019

Alison Andrew  
Chief Executive  
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Dear Alison

**Transpower New Zealand Limited — warning for contraventions of the Individual Price-Quality Path Determination 2015 quality standards for the 2015/16 and 2016/17 disclosure years**

***Purpose***

1. The purpose of this letter is to advise Transpower of our enforcement decision on contraventions by Transpower New Zealand Limited (***Transpower***) of quality standards in the Transpower Individual Price-Quality Path Determination 2015 (***Determination***) for the 2015/6 and 2016/17 disclosure periods.

***Warning for contravening quality standards***

2. The Determination sets out the price path and quality standards for Transpower for its second regulatory period, running from 2015 to 2020 (known as ***RCP2***). Transpower is obliged under clause 5.1.2 of the Determination to comply with the quality standards in Part 4 of the Determination. Those quality standards are the grid output targets for each 'revenue-linked grid output measure' (per clause 13 of the Determination).
3. Of the revenue-linked grid output measures, there are:
  - 3.1 fifteen annual measures of grid performance;
  - 3.2 two annual asset performance measures; and
  - 3.3 three annual asset health grid output measures.

In addition, there are three periodic asset health grid output measures, where compliance is assessed over the entire 5 years of the regulatory control period.

4. Compliance with the quality standards requires Transpower to meet the 'target' level for the 'revenue-linked grid output measures'. The 'cap' and 'collar' levels for each of the revenue-linked output measures formally relate only to the calculation of the 'grid output adjustment' (i.e. a revenue adjustment for performance against the quality standards).
5. Ahead of time, we exercised our enforcement discretion to only pursue contraventions that involved exceedance of the collar level of the quality measures.<sup>1</sup>
6. On this basis Transpower exceeded the collar level on five of the 20 quality measures in the 2015/16 disclosure period, and eight of the 20 quality measures in the 2016/17 disclosure period, resulting in a contravention of quality standards in both periods (**Contraventions**). Transpower has admitted the Contraventions.
7. Instead of bringing proceedings under s 87 of the Commerce Act 1986 (**Act**) seeking the imposition of civil pecuniary penalties, we have decided to issue a warning letter to Transpower for the Contraventions. Several key factors were instrumental in our deciding this course of action over any other, and those factors are explained in a later section of this letter.

#### ***Our core concerns with Transpower's conduct***

8. Informed by the review conducted by Strata Energy Consulting Limited (**Strata**) of the Contraventions and Transpower's conduct in connection with them, our view is that the Contraventions occurred in part because Transpower failed to:
  - ensure a new transformer had robust commissioning procedures,<sup>2</sup> resulting in a material outage;
  - conduct a risk assessment to consider the impact a key decision would have on non-compliance with quality standards, or the consequences this decision would have on the overall risk profile at the time the decision was taken;<sup>3</sup>
  - propose objective and realistic quality standard targets in some areas, instead proposing some that were more aspirational in nature (for example, the HVAC measures);<sup>4</sup> and
  - undertake sufficient analysis of historical asset failure data to determine whether issues or trends existed.

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<sup>1</sup> In the final reasons paper for the Determination, the Commission stated that (paragraph 4.40): "*We will not take any such enforcement action for performance below the quality standard but better than the collar that is set for the grid output measure.*"

<sup>2</sup> 2015 Ohakune outage – 1456 minutes outage for Powerco, and 141 minutes outage for TLC

<sup>3</sup> Grillage refurbishment performance against quality standards for 2016/17

<sup>4</sup> AP2 – HVAC average availability 2006 to 2013 as a basis for the target in the Determination. The nature of HVAC assets means a longer period would be a better basis for target setting

9. Strata concluded that Transpower failed to meet good industry practice for an electricity transmission operator in four respects:
- by failing to undertake continuous monitoring and analysis to determine if its level of performance was changing;
  - by proposing grillage expenditure forecasts based on the unit cost of grillage works that had easy access and were less complex, as this was poor forecasting practice and produced forecasts that were very likely to be exceeded;
  - by failing to conduct and document a risk assessment of decisions to reduce grillage volumes below the collar level, report that assessment to the Capital Governance Team (**CGT**), and seek approval of the decision from the CGT, so as to ensure that safety and reliability risks were not outside the CGT's tolerance level; and
  - by failing to advise the Commission of the potential overestimation of insulator replacement requirements prior to the final establishment of the targets, caps and collars.

***The setting and role of quality standards for RCP2***

10. In setting the quality measures and quality standards in the Determination for RCP2, the Commission engaged with Transpower and other parties. In accordance with the Capital Expenditure Input Methodology, Transpower proposed to the Commission what it has called 'aspirational' revenue-linked grid output measures, comprising a much larger number of measures than applied under the first regulatory control period. The Commission decided to adopt the proposed measures as quality standards in the Determination.
11. In light of Transpower's performance against the quality standards so far in RCP2, it appears that Transpower was overly optimistic in proposing those quality measures and did not always take into account the historic impact of planned works or events outside its control. For example, Transpower has stated to the Commission that "we underestimated the degree to which planned work would impact on circuit availability."
12. Furthermore, the fact that there were 20 different measures in the Determination increased the probability of Transpower exceeding the target level of at least one of them in any disclosure period, which would result in a breach of a quality standard under the Determination. We have reflected on this implication of the design of the quality standards when setting the price-quality path for the forthcoming regulatory control period beginning in April 2020, as set out at the end of this letter. We have also reflected and will be ensuring a greater emphasis is placed on normalisation for major events in the forthcoming regulatory control period.

13. Transpower has admitted to the Commission that it had not appreciated until recently the possibility that breaches of quality standards could lead to proceedings and the possibility of the imposition of civil pecuniary penalties under s 87 of the Act (or, indeed, criminal penalties under s 87B of the Act). The Commission has found this lack of understanding about a fundamental aspect of the operation of the regulatory regime under Part 4 of the Act, from as large and well-resourced a regulated entity as Transpower, to be perplexing and profoundly disappointing.

***Our decision to issue a warning rather than commence proceedings under s 87 of the Act***

14. As noted above, where Transpower has contravened a quality standard in the Determination, s 87 of the Act provides that we may issue proceedings and seek civil pecuniary penalties. If the Court imposes penalties, then the Commission or affected persons may separately apply to the Court for compensation under s 87A in respect of the loss or damage resulting from the contravention.
15. We analysed the Contraventions using our enforcement criteria:<sup>5</sup>
- 15.1 seriousness of conduct;
  - 15.2 extent of detriment; and
  - 15.3 public interest.
16. We have also analysed the mitigating factors in this case.

*Seriousness of conduct*

17. We have concluded that Transpower acted largely in accordance with good electricity industry practice, and overall, we considered Strata's review of Transpower's asset management practices was generally positive.
18. We have found that the Contraventions were caused, at least in part, by:
- a lack of emphasis by Transpower on the quality standards when making broader risk-based decisions;
  - a failure of Transpower to explicitly appreciate the impact planned or unplanned outages would have had on either customers or compliance with the quality standards;
  - a substandard commissioning process on a major asset; and

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<sup>5</sup> <https://comcom.govt.nz/about-us/our-policies-and-guidelines/investigations-and-enforcement/enforcement-criteria>

- some quality measure targets for RCP2 being proposed by Transpower at levels that were ‘aspirational’, and as such unrealistic (e.g. HVAC).<sup>6</sup>

19. We recognise that some external factors beyond Transpower’s control also played a part in the Contraventions and have regard to these below.

#### *Extent of detriment*

20. The absolute number of quality standards contravened during the relevant disclosure periods is high, and because of the large number of standards set, some breaches were inevitable.
21. In our view, Transpower was fortunate that the detriment to consumers was not more significant in some areas (e.g. the 2015 Ohakune outage, in which a new transformer was tripped due to defective commissioning procedures). However, we recognise that in many instances, Transpower put in place post-incident reviews, and ensured corrective actions were completed in accordance with good electricity industry practice.
22. There is no evidence that Transpower put its shareholder’s interests (e.g. dividends) above the needs of its capital programmes (e.g. asset renewal). However, we do have some concern that unexpected costs were a key influence on decisions to cease some works (grillage refurbishment or replacement) before the risks of doing so were fully appreciated.
23. Several EDBs were affected by Transpower’s decisions, and these impacts were a key consideration in the Commission’s enforcement decision. We note Transpower’s efforts to work with some EDBs when events occurred; the 2015 Ohakune event being one example. Had we identified a greater number of affected EDBs, or had the effect of the Contraventions on EDBs been greater, then a stronger enforcement response may have been more likely.

#### *Public interest*

24. We have concluded that bringing civil proceedings would have been disproportionate to the level of harm, particularly as there is no evidence that Transpower fell materially short of good electricity industry practice or diverted investment away from network performance or asset renewal.

#### *Mitigating factors*

25. There are several mitigating factors which also counted against a stronger enforcement response, including the following:

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<sup>6</sup> This should be resolved in RCP3, where different and more meaningful measures are to be imposed.

- 25.1 The aspirational levels of the RCP2 quality standards, and the number of different standards, meant there was a higher likelihood of a contravention (see 10).
- 25.2 Transpower responded to some events effectively. For example, after the 2015 Ohakune event, Transpower initiated an immediate post-event review which identified the cause of the transformer trip. Our investigation showed that every action point Transpower set in place as a result of the review was addressed and completed, and that during the event, Transpower provided information to affected EDBs to assist with their continuation of service.
- 25.3 Some outages which contributed to the collar levels for some quality measures being exceeded were directly attributable to natural disasters (Cyclone Cook and the earthquake at Culverden being two examples of this).
- 25.4 Since the launch of our investigation into the Contraventions, Transpower has been more proactive in communicating with the Commission regarding key decisions being taken (for example, explaining to the Commission in advance the planned works proposed for April 2019, and outlining to the Commission in August 2019 Transpower's intended work on HVDC for early 2020). Transpower also commissioned Synergies and GHD Advisory to evaluate Transpower's historic data for RCP3.
- 25.5 Transpower has also told the Commission that it has put in place more structured strategy and risk frameworks since 2017 which includes better linking its strategy to decision making and an improved risk and assurance management policy.

### ***Other matters***

- 26. To assist in our overall determination of the appropriate enforcement response, we engaged Strata to review Transpower's quality performance. We also considered Synergies and GHD Advisory's<sup>7</sup> comments on Strata's report, as well as Strata's response to those comments from Synergies and GHD Advisory. Strata's final report, which has considered all the feedback from key parties, will be published on our website alongside this letter. We also intend to issue a media release about our decision.
- 27. We were recently made aware that Transpower has also contravened quality standards in the Determination for the 2017/18 disclosure period. Our initial understanding, based on early discussions with Transpower, is that the causes of these additional contraventions are largely similar to those in the prior two years.
- 28. Given our finding that the nature of the quality standards in RCP2 increased the likelihood of contravention (see [10] - [13]), our future evaluation of quality standard

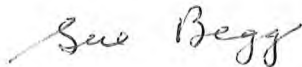
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<sup>7</sup> Synergies and GHD were engaged by Transpower to review Strata's report and provide opinion.

contraventions in RCP2 will focus on whether those contraventions have been caused by poor conduct on the part of Transpower or have resulted in material detriment to consumers. In these respects, the contents of this letter will be used to inform future enforcement decisions.

29. As referenced earlier, our decisions on Transpower's quality standards for the regulatory control period from 2020-2025 aim to address the potential deficiencies of the RCP2 quality standards through the introduction of normalisation to account for events outside Transpower's control, and pooling and dead-bands. This should ensure that the quality standards are more in line with consumer expectations and that contraventions are more effective in signalling potentially deficient conduct on the part of Transpower. Our final determination, expected to be published on 14 November 2019, will provide more detail.
30. Please contact Stephen Bass on (04) 924 3749 or by email at [stephen.bass@comcom.govt.nz](mailto:stephen.bass@comcom.govt.nz) if you have any questions about this letter.

Yours sincerely



Sue Begg  
Deputy Chair