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Dane Gunnell
Manager – Price-quality regulation
Commerce Commission
44 The Terrace
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Dear Dane

Submission
Major Capex Project draft decision: Bombay-Otahuhu Regional Major capital proposal

We welcome the opportunity to submit in response to the Commerce Commission (Commission) draft decision on our Bombay-Otahuhu Regional major capex proposal[1]. We agree with the Commission's intention to approve the project and most of the decision. This submission relates to the Commission's draft decision on Exempt Major Capex.

Capex IM does not permit a symmetric approach to exempt major capex within a Major Capital Proposal

Transpower's Capital Expenditure Input Methodology Determination 2012[2] (Capex IM) includes the concept of Exempt Major Capex (EMC) within a major capital proposal (MCP). However, we do not consider the Capex IM intends EMC being applied as the Commission have in their draft decision.

The purpose of the major capex incentive regime is to incentivise downward pressure on project costs. However, there are some project costs which are outside of Transpower's control. Examples include costs associated with abnormal weather conditions, unexpected sub-ground conditions, lockouts or imposed work restrictions, changes in supply and market forces, and outage constraints due to unplanned system events.

We support the principle of exempting those types of project cost uncertainties from the incentives regime because they are not efficiency related. Exempting costs associated with those events or circumstances from the incentive regime means that Transpower neither benefits (if those costs do not occur), nor is penalised (if those costs do occur). This would be a symmetric approach to dealing with such uncertainties and would be equitable for both Transpower and consumers. The Commission's draft decision describes such an approach in paragraph C47.4. This would help ensure Transpower focuses on those costs it can control, rather than those it can't.

[1] Commerce Commission (2020), Draft decision and reasons on Transpower's Bombay Otahuhu Regional major capex project - 26 November 2020
[2] Transpower Capital Expenditure Input Methodology Determination 2012 (Consolidated 29 January 2020)

Unfortunately the current drafting in the Capex IM does not allow this to occur. As the Commission points out in its draft decision[3]:

> *"While this approach would provide a symmetrical approach in terms of penalty and reward, it is outside the scope of the Capex IM to set the EMC above the MCA [Major Capex Allowance]. This is because the definition of 'exempt major capex' under clause 1.1.4(2) of the Capex IM requires the EMC to be an amount of the MCA."*.

The Commission's draft decision is to implement an approach to EMC as described in paragraph C47.2. In effect the proposed approach exempts a portion of the uncontrollable costs below the MCA. For this project the Commission has chosen "*the midpoint of the lower estimate and the MCA*"[4].[5] This means that Transpower does not benefit if the Commission's estimate of uncontrollable costs that are included in the MCA do not occur. However, because the Commission's approach does not exempt the remaining portion of the uncontrollable costs above the MCA, that Transpower is penalised if they do occur.

In our view, this asymmetric incentive is inconsistent with the intent of the incentive framework that is applicable to Transpower's major capex under Part 4 of the Commerce Act 1986.

Clarify how exempt major capex should be calculated

If the Commission adopts the approach as set out in its draft decision, we request the Commission provides clarification on how to calculate the major capex expenditure and output adjustment, which the Capex IM requires us to do upon final commissioning of an MCP.

Clause B3(1) of the Capex IM requires the calculation of "***capital expenditure*** *for* ***approved major capex projects*** *less* ***exempt major capex***".[6]

To enable Transpower to be able to calculate the major capex expenditure and output adjustment ex-post, we ask that the Commission clarifies:

1. the categories of expenditures that must be included in the actual costs for EMC; and
2. whether the actual EMC must be capped at the level of the Commission's final determination of forecast EMC.

Note, we have been unable to reconcile the Commission's EMC of $2.565 million. Without knowing what the exempt "categories of expenditure" are, we will not be able to administer the calculation[7] of the major capex expenditure and output adjustment.

We propose that the EMC is set to $0 until the Capex IM is amended

While we support the concept of exempting major capex, we consider that implementing it should be deferred and the EMC set to $0 until the Capex IM can be amended to ensure that the incentive mechanism can be applied in line with the intent of the mechanism, i.e. symmetrical application.

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[3] Commerce Commission (2020) – paragraph C47.4
[4] Commerce Commission (2020) – paragraph C47.2.
[5] We note that this differs from the Commission's approach for the Waikato and Upper North Island Voltage Management (WUNIVM) major capex project.
[6] *Capex IM* Schedule B.
[7] As specified in B3(1) of the *Capex IM*`

The Commission has also exempted major capex from the major capex incentive regime for the recently approved Waikato and Upper North Island Voltage Management (WUNIVM) project. We are submitting on this point after further reflection on the application of exempt capex, and its particular application to this project. We will also be seeking further clarification of the above with respect to the WUNIVM project.

We look forward to working with the Commission to clarify this matter.

Yours sincerely

John Clarke
General Manager – Grid Development