27 June 2019

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

Dear Dane

Transpower IPP 2020 – Draft decisions

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission draft decisions and reasons paper "Transpower's individual price-quality path from 1 April 2020" (draft decision on the "IPP" proposal) published 29th May 2019.[1]

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.

3. The overall draft proposal package is welcomed by MEUG. We support the focus and new features facilitating improvements in the key related areas of asset management and customer engagement. The analysis by the Commission, advisors to the Commission and Verifier have been extensive and thorough. For example, we appreciate the consultations by both Transpower before finalising its proposal and the Commission on the Process paper and Issues paper and the analysis by the Commission in the draft decision of submissions from all parties, including MEUG.

4. The section headers in this submission are listed below.

   a) The future focus on asset management and customer consultation is welcome.

   b) Quality Standards and grid output measures.

   c) Accountability of different roles while leveraging synergies.

   d) ICP assets are critical.

   e) Is there a problem of systemic negative productivity?

   f) Quantifying the value of the WACC uplift "incentive."

   g) We welcome the solutions to overcome our concerns on revenue smoothing.

[1] https://comcom.govt.nz/regulated-industries/electricity-lines/electricity-transmission/transpowers-price-quality-path/setting-transpowers-price-quality-path-from-2020

The future focus on asset management and customer engagement is welcome

5. The Commission media release announcing the draft decision stated:[2]

> "Transpower's forecast spending on its assets and operating costs is relatively flat over the next five years and the quality of services we expect it to deliver is largely unchanged during this period. However, we want to see improvements in its approach to asset management and its engagement with customers on how it chooses to spend its money."

6. The focus for the IPP proposal submitted by Transpower for Regulatory Control Period 3 (RCP3, the 5-years starting 1st April 2020) was:[3]

> "Our proposal is primarily focused on sustaining and maintaining a resilient, reliable and efficient national grid that will set us up for an increasingly electrified economy. While the near-term outlook is for relatively stable demand, we anticipate this will begin to grow strongly nearer to 2025."

7. Transpower's proposed focus for RCP3 assumes from RCP4 onwards there will be rapid electrification of the transport fleet and existing process heat using thermal fuels. There are currently no economic options that would allow electrification of all existing process heat load. Whether there will be economic options in place by RCP4 or later is uncertain. There are a range of forecasts for the electrification of transport.

8. We therefore agree with the Commission's focus in RCP3 to match discovery at a more granular level of consumer needs and price-quality trade-offs with Transpower's asset management processes.[4] This will lead to a more market driven approach to planning the future of the grid beyond RCP3 and away from relying on more centrally planned scenario forecasting approaches such as Transpower's Te Mauri Hiko report.

9. MEUG therefore welcomes the focus and new initiatives in the draft IPP to facilitate over RCP3:

   a) Improvements in asset management; and

   b) Improvements in engagement with customers.

10. MEUG has one suggestion to complement the proposals to improve customer engagement. It would be convenient if Transpower had a web page with a calendar setting out the dates or prospective dates of future engagement so that the information is in one-stop-shop easy to access source rather than dates scattered across multiple web pages. Having timely accurate knowledge of future events will help customers plan their availability and resources to engage effectively.

11. A calendar of events need not be specified in the IPP or Information Disclosure requirements (ID); rather Transpower could voluntarily develop this in consultation with customers and their agents. Details that could be considered include if the calendar should be exclusively for grid-owner reporting and consultation events required by the IPP or ID or if other public engagements are included, e.g. by the system operator and or the grid owner for specific Major Capex or listed project consultations.

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[2] https://comcom.govt.nz/news-and-media/media-releases/2019/commission-releases-draft-decision-on-transpowers-price-path
[3] Transpower Customer Update June 2019.
[4] For example, see draft decision paragraphs [L66] to [L68].

Quality standards and grid output measures

12. MEUG supports in principle the Commission's proposal to limit the revenue at risk to current levels and to reallocate the revenue at risk from Grid Performance Measure #1 (GP1, number of interruptions) to GP2 (duration of interruptions) in line with the practice of overseas regulators. Worked examples of the linkage between the value of lost load (VoLL) for the different types of points of service (POS) and the mix of number and duration of outages would be helpful in advancing the discussion of whether the allocation of revenue at risk between the number and duration of unplanned outages for different POS reflects consumer views of the cost of the outage.

13. Under the proposed incentive rates in Table F9 'Our proposed grid performance measures' (p145) the incentive rates for avoiding an outage seem to be equivalent to the incentive rate for avoiding an outage with a duration:

    - 4.5-minutes for a 'N-1 Security high economic consequence' POS
    - 0.8 minutes for a 'N-1 Security material economic consequence' POS
    - 25.8 minutes for a 'N Security high economic consequence' POS
    - 4.4 minutes for a 'N-1 Security material economic consequence' POS

14. It is not clear from the proposal how these differences in preference for combinations of outage duration and frequency between POS have been linked back to the work on VoLL or differences in the mix of outage duration and frequency.

15. More importantly, MEUG would welcome further explanation from either the Commission or Transpower on how the revenue at risk for unplanned outages (GP1 and GP2) is expected to:

    a) alter Transpower's expenditure or asset management decisions at the margin; and

    b) how these decisions are expected to change the expected frequency of duration of unplanned outages.

16. The research by Transpower on VoLL for different types of POS has been very helpful in identifying the value different types consumers attach to a reliable electricity supply and how these values vary with circumstances (duration, time of day, planned or unexpected, etc) [5]. However, the next step in the consideration of the level of revenue at risk should be to focus on how differences in the revenue at risk encourages Transpower to make decisions that have a net benefit to consumers (reliability is improved and the improvement costs less than the avoided VoLL). This test suggests that it may be easier to assess how changes in revenue at risk for planned outages could produce a net benefit for consumers than to attempt to make this assessment of unplanned outages

[5] The survey instrument in 'Estimating the Value of Lost Load, Transpower New Zealand Limited, March 2018' by PwC distinguish planned and unexpected questions but this distinction does not appear to be made in the analysis of the results. The report is available at https://www.transpower.co.nz/sites/default/files/publications/resources/PWC_Estimating%20the%20Value%20of%20Lost%20Load.pdf

Accountability of different roles while leveraging synergies

17. The draft decision focuses on the incentives and performance of the grid operator leaving the Electricity Authority to manage the system operator regulated services through the System Operator Service Provider Agreement (SOSPA).[6] MEUG is unsure how synergies across the grid owner and system operator roles are disclosed to reveal any arbitraging to book costs and risks under one role and profits in the other.

18. New investment contracts are treated in the draft decision as being on a "willing seller and willing buyer" basis where the party that is contracting with Transpower 'agrees in writing that the terms and conditions are reasonable or reflect workable or effective competition' and therefore need not be considered under the IPP.[7] MEUG is not sure what objective tests an arrangement would need to meet for the contract to be considered 'reasonable' as opposed to 'reflecting workable or effective competition'. We still have concerns on lack of contestability, allocation of costs and risks and rate of return; notwithstanding Transpower posted revised contract terms and conditions in early 2018 after consulting. The development of more granular allocation of costs and risks coupled with consumer preference information over RCP3 will affect regulated and unregulated activities such as new investment contracts. Similarly, we expect terms and conditions for Non-Transmission Services will evolve over RCP3 as improvements are made to asset management and engagement with customers. We don't believe this issue and how it will affect future contract terms and conditions are matters for the IPP; nevertheless, we have noted this issue in case there are.

ICP assets are critical

19. Transpower has never been just a physical conductors and connection assets business. Managing real-time data to optimise use of assets and maintain real-time power is critical. It was therefore concerning to read the critique by EMCa of Transpower's Information and Communications Technology (ICT) capex and opex strategies and proposed delivery.[8]

20. The preparedness of electricity network companies to be agile and innovative in using more granular data on the preferences of customers and the state of network assets is critical to ensure the electricity supply system meets the needs of consumers efficiently and effectively. There is a risk some Electricity Distribution Businesses (EDB) with much smaller resources than Transpower will be unable to meet the challenges of and deliver the benefits of an increasingly digitised business environment.

21. Effective and efficient implementation and co-ordination of asset management and customer engagement information requires best practice ICT management. The ICP asset in this case is the capability of ICP staff.

22. The business of electricity networks may shift significantly towards better management of information to use existing physical assets and non-transmission services to meet differentiated customer preferences instead of building assets. In that future scenario how ICP assets and the capability of staff are accounted for in the price-quality and ID regimes may need further examination.

[6] Draft decision, paragraph [A10].
[7] Draft decision, paragraph [A10], footnote 91.
[8] For example, draft decision, paragraphs [G186] and [G187].

Is there a problem of systemic negative productivity?

23. The New Zealand Productivity Commission recently published a report on productivity.[9] Figure 9 of that report is reproduced on page 6. The Electricity, Gas, Water and Waste Services sectors had both negative labour productivity growth and a declining share of GDP for the 13-years ending 2016. No other sector groups had both negative labour productivity growth and a declining share of GDP. The Productivity Commission's work was focused on macro sector level trends but based on industry level data. It's not clear if "Electricity" refers electricity lines businesses and generators. There may be value in the Commerce Commission checking with the Productivity Commission if their underlying analysis is available to understand historic productivity trends and drivers for Transpower and EDB to assist design solutions to improve productivity for the future.

Quantifying the value of the WACC uplift "incentive"

24. Table F4 in paragraph [F31] summarises incentives that influence Transpower's behaviour. The list includes the WACC uplift. The effect of the uplift as an incentive is reported as being unknown because the actual Weighted Average Cost of Capital (WACC), that is the efficient market WACC, is unknown. The Commission can remove the uncertainty on the incentive effect by asking Transpower how the IPP proposal would have changed had the regulated WACC been at the mid-point.

25. This is important to test the relative incentive effects of the uplift compared to the other seven incentive drivers listed in Table F4. MEUG's thesis is that the uplift would have minimal effect on the asset management plans and investment decisions of either Transpower or EDB.

26. The current uplift at the 67th percentile was set in October 2014. This followed a Commission review initiated by comments in the High Court judgement on the merit review claims on the inaugural Input Methodology (IM) decisions in December 2010 setting a 75th percentile uplift. It still concerns MEUG that the modest almost negligible absolute percentage change in the uplift (though highly material in terms of lower costs to consumers) in October 2014 were based on views rather than evidence or science, e.g. paragraph [X17] of that decision stated, "In our view, it is appropriate to use a WACC <u>significantly</u> above the mid-point …" Since that date the value consumers have paid Transpower and EDB attributable to the uplift would be several tens of millions of dollars if not in excess of a hundred million dollars.

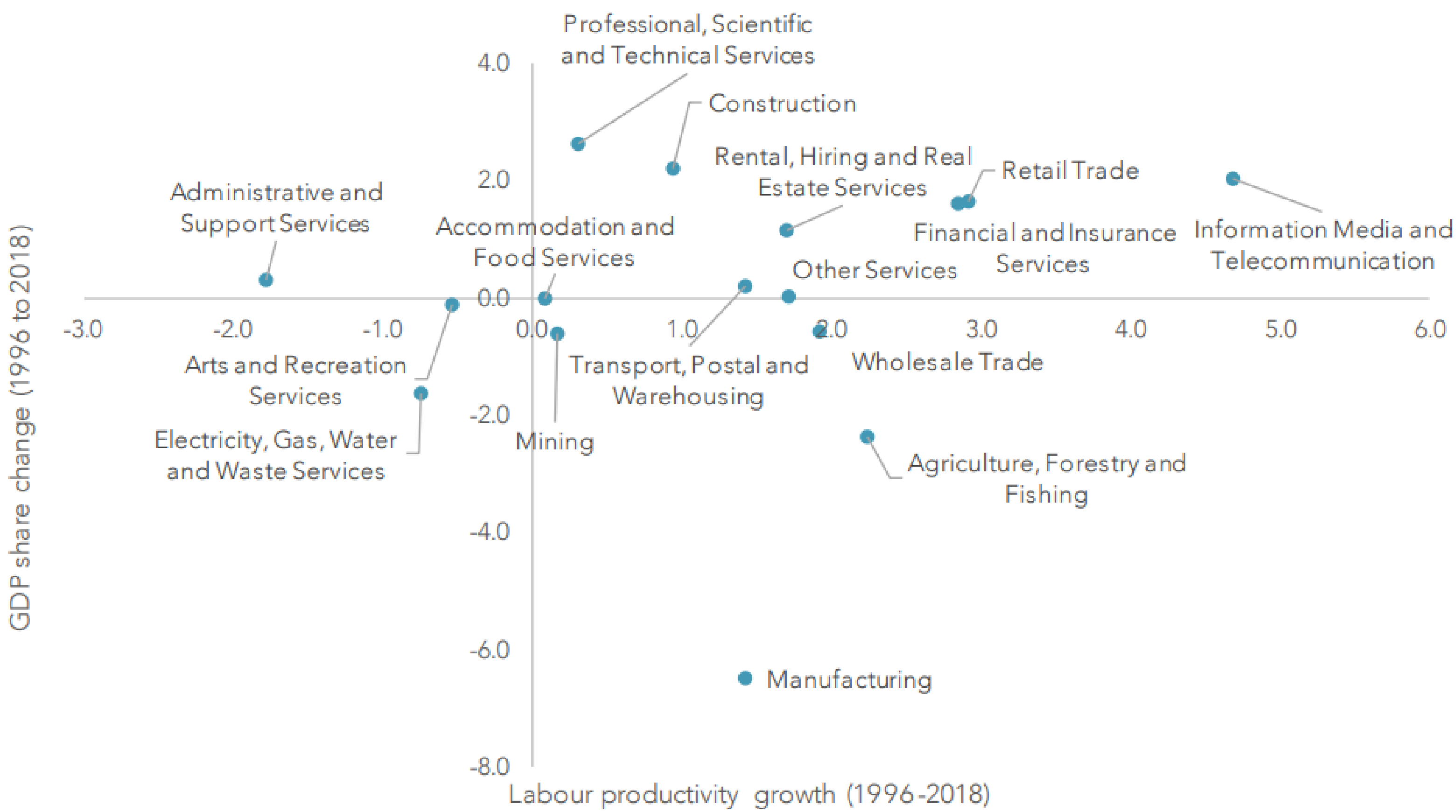
27. A review of the WACC uplift was not considered necessary in the last major IM review that concluded in December 2016 because at that date only 2-years had elapsed since the WACC percentile had been amended and in the view of the Commission no new evidence had been tabled to support a review.[10] The Commission undertook no new analysis in the December 2016 review to validate retaining the <u>significant</u> (as described in the 2014 decision from the preceding paragraph) level of the uplift.

28. At the start of RCP3 it will have been almost 5 ½ years since the current 67th percentile uplift replaced the 75th percentile decision of December 2010. Part way through RCP3 the 7-year mark since the 67th percentile decision was implemented will be reached. The Act requires IM to be reviewed at least every 7-years.

29. Now is an opportunity to test if the uplift does need to be significant to Transpower and EDB or not compared to the other incentive drivers for IPP and DPP.

[9] https://productivity.govt.nz/sites/default/files/Productivity%20by%20the%20Numbers%202019.pdf
[10] Ibid, paragraph [672].

Figure 9 Change in industry share of GDP and labour productivity (1996-2018)



Source: Productivity Commission based on Stats NZ

30. One final point on WACC, not related to the discussion on uplift above, is EMCa's question of why Transpower used an Internal rate of return (IRR) methodology for assessing ICT capex using an 8% discount rate.[11] We do not know if the 8% is real or nominal, before or after tax and how it can be reconciled with the expected much lower regulated WACC to apply for RCP3 from 1st April 2020? We are also unsure why the use of a higher hurdle rate IRR of 15% to account for risker projects was suggested. In our view best practice is to test alternative benefit and cost streams reflecting different outcome probabilities.

We welcome the solutions to overcome our concerns on revenue smoothing

31. The draft decision summarised MEUG submissions in the prior Process paper and Issues paper consultations as MEUG "considered there could be benefit in not smoothing from increased scrutiny of price charges."[12] In submissions to Transpower the draft decision paper summarised MEUG's view as "would want to see clear evidence of consumer benefit" and therefore along with Fonterra did not support a change to revenue smoothing.[13] We agree with this summary of MEUG's views over time.

32. Paragraph [J26] of the draft decision explains two new information requirements that will assist interested parties have an ability to form a view on the performance of Transpower. Those are an annual reconciliation of EV account balances and how that might flow into RCP4 regulated revenue and a post-consultation review of stakeholder engagement on base capex decisions. These two new requirements offset our concerns that annual scrutiny of Transpower might be lost with revenue smoothing. We therefore agree with implementing revenue smoothing.

Yours sincerely

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[11] Draft decision, paragraph [G186.6].
[12] Draft decision, paragraph [J35], Table J1.
[13] Draft decision, paragraph [J37], Table J2.