TRANSPOWER MINOR CAPEX AND OPEX ALLOWANCES, AND QUALITY STANDARDS FOR RCP1

FINAL DECISIONS

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COMMERCE COMMISSION

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Purpose

1. The purpose of this paper is to set out the Commission's decisions relating to allowances for the Remainder Period of RCP1, including:

   a. the operating expenditure allowances;

   b. the Minor capital expenditure allowances; and

   c. the targets, caps and collars that apply to the quality standards.

2. The decisions will form part of the calculation for setting Transpower’s forecast maximum allowable revenue from 2012/13 to 2014/15.

Decision

3. The Commission's decision is to provide a nominal allowance for operating expenditure of $847.3 million. This operating expenditure allowance will be apportioned over each year of the Remainder Period, based on forecast expenditure, for the purposes of setting the forecast maximum allowable revenue (forecast MAR).

4. A nominal allowance of $825.1 million will be provided for Minor capital expenditure. This allowance is based on the forecast commissioning profile of that capital expenditure. This allowance will be apportioned over each year of the Remainder Period, based on forecast commissioning profiles.

5. The Commission's decision regarding quality is to set the targets, caps and collars at the same levels that applied during 2011/12 (Transition Year). The exception is HVAC circuit unavailability which will be set at 0.054, as proposed by Transpower, instead of the Transition Year target of 0.056.

Operating Expenditure

6. The Commission's decision is to accept Transpower’s forecast of operating expenditure expressed in 2010/11 prices. A number of input price adjustments have been applied to convert the operating expenditure allowance from 2010/11 prices into nominal prices. The Commission’s decision for operating expenditure and the associated input price allowance for each year is provided in Table 1.

Table 1 Operating expenditure decision

Operating expenditure allowance	2012/13 ($ millions)	2013/14 ($ millions)	2014/15 ($ millions)
2010/11 prices	264.6	258.8	258.2
Input prices	14.7	21.9	29.2
Nominal	279.3	280.7	287.4

Capital Expenditure

7. The Commission's decision is to accept Transpower’s forecast of Minor capital expenditure expressed in 2010/11 prices. Input price adjustments have been applied to

convert the Minor capital expenditure allowance from 2010/11 prices into nominal prices.

8. In addition to an escalation adjustment for input price changes, an adjustment was required to convert expenditure which had been forecast on an expected spend basis to an expected commissioning profile.

9. The capital expenditure allowance, converted from real to nominal, with the inclusion of the commissioning adjustment, is shown in Table 2.

Table 2 Minor capital expenditure decision

Capital expenditure allowance	2012/13 ($ millions)	2013/14 ($ millions)	2014/15 ($ millions)
2010/11 prices (as spent basis)	269.0	224.4	216.3
Input prices	15.2	22.7	30.2
Commissioning adjustment	17.7	-2.2	31.9
Nominal (as commissioned)	301.9	244.9	278.4

Input Prices

10. The Commission's decision is to accept the CPI forecasts proposed by Transpower. The Commission has considered Transpower's reasons for increases in input costs in excess of CPI and accepted some of Transpower's assumptions (where input prices are forecast to be different to CPI). It has not accepted all assumptions. Where the Commission has not agreed with Transpower, it has applied alternative inputs to generate the overall input price allowance. The Commission has assumed a default position of CPI+0% for input price changes.

11. Details of the assumptions regarding growth relative to CPI are provided in Table 3 and Table 4. The values of the input price adjustments are set out in Table 1 and Table 2.

Table 3 Operating expenditure input price assumptions (growth relative to forecast CPI)

Expenditure Category	Direct FTEs	3rd Party Consultants	3rd Party Contractors	Non Labor/ materials
Departmental	0.75%	1%	0%	0%
IST operations	0.75%	0%	0%	0%
Ancillary services	0.75%	0%	0%	0%
Investigation	0.75%	1%	0%	0%
Insurance	0.75%	0%	0%	0%
Transmission lines	0.75%	0%	1%	0%
AC stations	0.75%	0%	0%	0%

Table 4 Minor capital expenditure input price assumptions (growth relative to forecast CPI)

Expenditure Category	2012/13	2013/14	2014/15
Copper	9.6%	-2.1%	-19.1%
Aluminum	13.5%	19.1%	-15.6%
Steel Fabric	5.9%	1.4%	-1.1%
All Metals	0.0%	0.0%	0.0%
Civils	0.0%	0.0%	0.0%
Labour	0.0%	0.0%	0.0%

Foreign Exchange Forward Rates

12. The Commission's decision is to accept the foreign exchange forward rates and exposures assumed by Transpower.[1] The forward rates are provided in Table 5 and exposures in Table 6.

Table 5 Forward rates assumed by Transpower

Currency	3 Year average forward rate
US Dollar	0.6923
British Pound	0.437
Australian Dollar	0.7977
Japanese Yen	54.34
Euro	0.4988
Canadian Dollar	0.7179
Swedish Krona	4.818
South Korean Won	782

Source: Transpower, *Expenditure Forecasts and Quality Performance: 1 July 2012 to 30 June 2015*, Appendix B, B.3 Assumptions for foreign exchange rates, page 161.

Table 6 Foreign exchange exposures assumed by Transpower

Expenditure Category	USD	GBP	AUSD	YEN	EURO	CAND	KRONA	NZD
Replacement and refurbishment	13.4%	0.0%	0.0%	0.7%	5.9%	0.0%	0.0%	80.0%
Enhancement and development	20.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	80.0%
IT Telecoms & Network (TNP)	5.0%	0.0%	0.0%	0.0%	6.0%	0.0%	0.0%	89.0%
IT Substation automation	4.0%	0.0%	0.0%	0.0%	4.0%	0.0%	0.0%	92.0%
IT SCADA/RTS	25.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	75.0%
Other IST	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	100.0%
Office relocation	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	100.0%
Minor fixed assets	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	100.0%

Note: Transpower's proposal assumes no purchases denominated in Canadian Dollars or Swedish Kronor.

Source: Transpower response to *Q156-01 Escalators and FX edit 3[1]*, FX tab, cells A45:J52.

[1] Transpower developed a forecast of the foreign exchange rate based on the arithmetic mean of the forward exchange rates on 31 December 2012, 2013 and 2014. The Commission compared Transpower's forward exchange rates with the arithmetic mean of the forward exchange rates for 31 December 2012, 2013 and 2014 provided by Bloomberg's professional data service, as of 3 November 2010.

Quality

13. The Commission's decision is to accept Transpower's amended proposal, and to set targets, caps and collars for the Remainder Period at the same level set for the Transition Year. These are provided in Table 7. While this does not require improvements during RCP1, long-term targets will be required of Transpower when setting targets for RCP2. The Commission expects that the targets set for RCP2 will take account of Transpower's own objective to achieve significant improvements in performance.

14. In accordance with the individual price-quality determination that applies to Transpower, revenue will not be subject to the quality incentive mechanism until RCP2.[2]

Table 7 Decision - Quality targets

Measure	Target	Cap	Collar	Weighting
Loss of Supply Event Frequency > 0.05 system minutes	21	10	31	25%
Loss of Supply Event Frequency > 1 system minute	3	1	5	25%
HVAC circuit unavailability (unplanned) - %	0.054	0.029	0.083	25%
Total impact of interruptions (in system minutes)	16.69	4.31	29.07	25%

Business improvement initiative reporting requirements

15. Transpower will be required to report annual progress against the business improvement initiatives outlined in its proposal. This will include summarising the development of its asset management capabilities and the development of a new asset management information system, as well as estimating the benefits delivered.

16. To achieve this, the Commission will require Transpower prior to the start of the Remainder Period to provide the Commission with a consolidated document setting out each business improvement initiative. This will include the objectives and deliverables (including milestones) of each initiative.

Next Steps

17. The Commission must set the forecast MAR for the Remainder Period by 30 November 2011. The allowances set out in this paper will be used in the calculation of the forecast MAR.

18. To give effect to the forecast MAR, an amendment to the Individual Price-Quality Path Determination will be published in November 2011. Transpower will then announce and set prices.

[2] Commission, *Individual Price-Quality Path Determination* , Decision No.718, Part 5, Clause 5.6(2)(a), p.20.

Table 8 Process and next steps

Key Step	Date
Commission issues s 53ZD forecast MAR notice to Transpower.	Completed (15 July 2011)
Consultation on the level of operating expenditure and capital expenditure to apply to Transpower for the Remainder Period.	Completed (5 August 2011)
Commission publishes final decision regarding operating expenditure and capital expenditure allowances.	Completed (this paper)
Commission sets forecast MAR to apply to Remainder Period.	30 November 2011
Transpower announces prices to apply to Remainder Period.	Nov/Dec 2011

Response to Submissions

19. Submissions were received from Transpower and MEUG. MEUG provided the only cross submission.

20. Transpower's submission supported the Commission's decisions. Transpower reinforced that it will be placing utmost priority on delivering improvements to its planning and asset management processes.[3]

21. MEUG observes that the Commission does not intend to link performance and revenue, and suggests that there will not be a financial incentive regime during RCP1.[4]

22. In particular, MEUG observes that revenue will not be subject to the quality incentive mechanism until RCP2, and suggests that the Commission review this decision.

23. This matter was considered by the Commission in detail, and consulted on when setting Transpower's individual price-quality path. The Commission's decision was that Transpower's revenue should not be exposed to its performance against the quality standards during RCP1.[5] In its submission on the Commission's draft decision, MEUG's agreed that Transpower's revenue should not be subject to financial risk/reward during RCP1.[6]

24. Once determined, changes to price-quality paths can only be made in certain circumstances (for example, as a result of an appeal under section 52Z). Accordingly, as the Commission is unable to make changes to Transpower's price-quality path now that it has been set, the percentage of revenue at risk/reward under the incentive mechanism during RCP1 must remain at zero.

25. MEUG concludes that a new incentive framework is required in response to the findings of the operating and capital expenditure review. While the Commission may require Transpower to report its performance on any related matter, substantive

[3] Transpower submission, 22 July 2011, p.1.

[4] MEUG submission, 22 July 2011, p.2., paragraph 7(a).

[5] Commission, *Individual Price-Quality Path (Transpower) Reasons Paper*, 22 December 2010, pp 88-90.

[6] MEUG, *Submission on Transpower Individual Price-Quality Path Draft Reasons Paper*, 9 August 2010, Appendix p.5.

changes to the price-quality path cannot be made during RCP1. However, the Commission does have concerns about Transpower's performance and will be consulting on a number of adjustments to the framework for RCP2. The Commission has already consulted on possible changes to the approach to quality in the context of the Commission's work on the capital expenditure input methodology.

26. It is worth noting that financial incentives do apply during RCP1. The incremental rolling incentive scheme that applies to operating expenditure provides an incentive for Transpower to make efficiency gains and reveal true costs, over time. Likewise, incentives apply to all capital expenditure. Minor capital expenditure is subject to asymmetric incentives, including a wash-up for under spend and full exposure to overspend (unless approved by the Commission).

27. The Commission has recently consulted on a variety of new incentive mechanisms to apply during RCP2. These include incentives around capital expenditure; the linking of Major capital expenditure to the delivery of specified outputs; increased incentives on reliability; and changes to the operating expenditure IRIS mechanism.

28. Finally, in its cross submission, MEUG suggests the Commission should consider applying a glide path that provides lower allowances than those in the draft decision. This would require Transpower to find further efficiency savings in its operating expenditure and capital expenditure. MEUG suggests that 'the Commission find a solution that creates stronger incentives on Transpower to become efficient and to ensure the shareholders of Transpower are not immune to the ongoing inefficiency of the company'.[7]

29. Geoff Brown and Associates Limited (GBA) provided advice to the Commission about the levels of expenditure that could be considered reasonable. GBA's review concluded that in order to achieve the estimated 7.5% savings in operating expenditure, the backlog of investment in the renewal of assets would need to be have been addressed. Likewise, GBA suggests that the implementation of good industry practice asset management would also be required. Given these changes cannot be introduced immediately, Transpower will need time to transition to this more efficient operating level.[8]

30. GBA goes on to state that the transition period will extend through to the end of RCP1 with savings becoming evident and visible during RCP2.[9] Furthermore, GBA's high-level, top-down modelling, which resulted in a level of operating expenditure in excess of that proposed by Transpower, suggests that Transpower's proposal is not unreasonable given its current position and practices.[10]

31. GBA also observes that Transpower's forecast renewal and refurbishment capital expenditure is barely sufficient to offset the natural rate of asset deterioration and

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7 MEUG, cross submission, 5 August 2011, p.1.

8 Geoff Brown & Associates Limited, *Review of Transpower's Forecast Operating and Capital Expenditure for 2012-15*, 15 June 2011, p.45.

9 Ibid, pp 45-46.

10 Ibid, p.45.

maintain the asset average age of the existing asset base at its current level.[11] GBA states that Transpower's proposed capital expenditure allowance is reasonable, and concludes that the capital expenditure allowance should be provided in full.[12]

32. However, GBA observed that the allocation of expenditure across types of asset classes requires better alignment with outputs. While Transpower may be able to better prioritise certain expenditure, GBA recommended that the Commission should not reduce the overall allowance.

33. The Commission considers that constraining operating expenditure and capital expenditure, in this instance, would continue to perpetuate under investment and low levels of maintenance. Setting a lower allowance for operating expenditure (a lower level of earnings) without specific output requirements does not necessarily provide incentives to become more efficient. Transpower may simply avoid the lower returns that would result, by spending less than would otherwise be considered necessary.

34. The Commission is not seeking to apply hindsight to the rights or wrongs of previous management strategies and decisions. It accepts that in this instance, in order to achieve the identified potential future efficiencies, certain increased expenditure will result. Included in this increased expenditure are the business improvement initiatives set out in Transpower's proposal. Given that consumers will bear these costs, the Commission will be closely monitoring Transpower's progress, and information on Transpower's delivery of these initiatives will be made public. Consumers will begin to see the benefits by RCP2.

35. As the potential efficiency gains identified will require time for implementation prior to those gains being achievable, it would not be a reasonable and pragmatic solution to reduce Transpower's allowances prior to those changes being implemented. The implication of this approach would be to reduce Transpower's return to lower than the specified WACC.

36. As noted in its draft decision, the Commission has considered whether it should provide an allowance less than that proposed by Transpower. In this instance, the Commission does not consider it beneficial to make efficiency adjustments prior to those savings having been achieved. In order to move to a more efficient operational state, a large amount of investment is required. At the same time, an increased level of maintenance is required, over and above a business-as-usual amount. Reducing Transpower's operating expenditure during the Remainder Period would likely affect Transpower's ability to implement the process improvements identified in its proposal, at the same time as improving the current performance of the grid and focusing on business-as-usual issues.[13]

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11 Geoff Brown & Associates Limited, *Review of Transpower's Forecast Operating and Capital Expenditure for 2012-15*, 15 June 2011, p.58.

12 Ibid, p.58.

13 Commerce Commission, *Draft decision, Minor Capital Expenditure and Operating Expenditure Allowances, and Quality Standards to apply to Transpower for the Remainder Period of Regulatory Control Period 1*, 27 June 2011, p.2., paragraph X8.