TRANSPOWER

Transpower House, 96 The Terrace,
PO Box 1021, Wellington,
New Zealand
Telephone +64-4-590 7000
www.transpower.co.nz
Jeremy.cain@transpower.co.nz
04 590 7544

26th September 2014

Brett Woods
Senior Analyst
Regulation Branch
Commerce Commission
Wellington

By email: regulation.branch@com.com.govt.nz

Dear Brett

Submission on final drafting for Individual Price Quality (IPP) regulation for RCP2

Thank you for the opportunity to comment on the proposed drafting to the IPP determination for RCP2, which gives effect to policy as described in the Commission's decision document "Setting Transpower's Individual price-quality for 2015 – 2010".

We appreciate the Commission's treatment of the practical and substantive matters raised in our previous submission to IPP draft determination[1]. We note and support the Commission's intent to provide for the new 'listed projects' framework under the Capex IM instead of this IPP.

As requested, this submission focuses on the technical drafting of the IPP. Appendix A contains our detailed drafting suggestions and comments while we use this letter to draw attention to three specific technical points:

1. a minor but important clarification is required to the AP1 grid output measure (HVDC energy availability) to ensure this incentive operates as intended
2. asset commissioning targets for the volumetric incentive need to be adjusted to be on a commissioned asset value basis (rather than an expenditure value basis) and to reflect the 7.5% productivity adjustment
3. including defined terms in the determination (as the Commission does with standard terms determinations under the Telecommunications Act) will make the IPP more user friendly.

In addition we comment on two other important matters that we consider the Commission should address before finalising the IPP:

1. an error in the calculations that led the Commission to reduce the ICT capex allowance
2. the highly prescriptive approach to asset health model development which detracts from the objective and produces a high cost / low value outcome.

[1] Transpower submission, dated 11th July 2014, available at http://www.comcom.govt.nz/regulated-industries/electricity/electricity-transmission/transpower-individual-price-quality-regulation/transpowers-price-quality-path-from-2015-to-2020/

HVDC availability measurement - request clarification of AP1 definition

In our December 2013 RCP2 proposal we proposed availability measures and targets for HVAC circuits and for the HVDC poles 2 and 3. For the HVDC we proposed an energy availability target of 98.5% which was:

> based on reductions below 100% energy availability to account for:
> - approved construction outages during the period[2];
> - preventative maintenance outages required to meet service specifications; and
> - forced outages based on service level agreements for pole 3.
>
> There is no historic performance target associated with Pole 3 (commissioned May 2013), so historic comparison of HVDC performance against the RCP2 target is not meaningful.[3]

All analysis and discussion has been in relation to the weighted average energy availability across HVDC poles 2 and 3. That is, it is the aggregate energy across the two poles that is measured not the energy availability of the individual poles. When commenting on the earlier draft of the IPP determination we, in an attempt to articulate this point, referred to the term **HVDC link** as representing the two poles collectively.

We now consider that the term **HVDC link** introduces further ambiguity and should be removed from the definition of AP1. The ambiguity relates to the definition of HVDC link within the Electricity Industry Participation Code which could be interpreted to include assets other than HVDC poles 2 and 3. Such an interpretation would render the targets approved by the Commission as unachievable – imposing an automatic $5m penalty on Transpower over the period and removing any incentive to achieve or exceed the HVDC energy availability target.

Although such an interpretation would be inconsistent with the derivation of the target approved by the Commission, and be unlikely to withstand scrutiny, we prefer to avoid ambiguity and request that the Commission clarify the AP1 description in the draft IPP.

Asset commissioning - volume target errors and productivity adjustment

We have identified errors in some of the volume targets we provided for the asset health grid output measures. These should be corrected in the final IPP to restore consistency between the targets and the asset volumes used to set the base capex allowance. Correcting the targets requires consequential adjustments to the cap, collar and incentive rate settings. We have reassessed these accordingly and indicate them all in the marked-up IPP determination (the corrected targets are provided in Appendix B). In doing so, we have also determined that the incentive rate should be based on unit rates that incorporate the 7.5% productivity adjustment used to set the base capex allowance.

Collectively, these corrections ensures that the IPP determination gives effect to the Commission's intention (expressed in the decision paper) that the targets should align with the allowances. This ensures that there is not a perverse incentive to reallocate expenditure to assets with revenue-linked targets simply to avoid penalty.

The target errors arose because the asset health incentive regime was developed after our proposal was submitted and, in some cases, we have drawn asset counts from the wrong sources.

- For tower painting the figures we provided are drawn from asset health model. The model is an input to the planning process, so the tower count differs from the plan.

---

[2] No construction outages are currently planned during RCP2. This could change if Stage 3 of the HVDC Upgrade is approved and the construction outages fall within RCP2.

[3] Transpower RCP2 Expenditure Proposal, December 2013. Section 10.4.2

- For grillages and insulators the figures are drawn from tables in the document 'asset management plan' which was not updated to match the final plan included in the allowance.
- For outdoor circuit breakers the figures we provided are counts of the asset replacements in flight (i.e. incurring expenditure) during RCP2, rather than the assets completed (i.e. commissioned) in RCP2
- For outdoor-to-indoor conversions that figures incorrectly counted an investigation project as producing a conversion deliverable.

We have provided the Commission with information to demonstrate that the corrected targets match the assets in the financial models used to calculate the base capex allowance.

IPP should be a standalone document

In our earlier submission on the draft IPP we requested that the Commission define all terms relied upon by the IPP within the IPP. In other words it should be a standalone document – it should not require the reader to reference multiple Commission determinations, the Commerce Act 1986, the Electricity Industry Act 2010 and the Electricity Industry Act Participation Code (Code) to understand and apply the IPP. Extensive use of cross-reference makes that document very difficult to use and reduces accessibility for interested parties.

We note that the Commission has listed in an appendix to the IPP where all terms used in the IPP that are not defined in the IPP can be located. If the Commission does not accept our request to define all relevant terms within the IPP then we request that in places where the location identified takes the user to a definition that in turn references another source, the IPP should indicate the source definition (including the clause). This is particularly important for IMs that then reference other Acts or terms under the Electricity Industry Participation Code. These definitions should be sufficiently stable such that bringing them into the IPP shouldn't be problematic.

ICT costs

In reviewing the Commission's final decision, we have found that the Commission's decision to reduce ICT capex by 2.5% is based on an error by the Commission's consultants. At paragraph 5.111, that Commission states that:

> …it appears that due to late increases in some ICT category elements, the net adjustment to ICT capex is actually below 7.5%, and appears to be as low as 5%. Therefore our final decision to apply a 2.5% reduction is in addition to correcting for the shortfall between Transpower's proposed 7.5% adjustment and the resultant adjustment after accounting for the late increases in some ICT category elements.

In fact, the net adjustment was already 7.5% and is increased (to 9%) due to the further 2.5% reduction. From the reasoning in the decision paper, this was not the Commission's intention.

The decision is based on incorrect advice from the Commission's consultants. Paragraph 188 and footnote 41 of the Strata report (appended to the final decision) refer to extracts from Board papers produced during the proposal preparation process. Strata have compared figures from those papers to RCP2 real expenditure before the 7.5% productivity adjustment and incorrectly concluded that the adjustment was only 5%. We did not receive any request for verification or clarification of this point.

The RCP2 financial models consistently apply the 7.5% productivity adjustment to nominal expenditure at an aggregate level, not a portfolio level. Given that the decision is based on a clear error, we believe it would be appropriate to take the opportunity to correct the error before the determination is finalised to avoid constraining IST investment below the intended level. We advise that it would take only one or two days to re-run base capex allowances to remedy this error.

Over-prescription detracts from asset health model in the IPP

We appreciate the consideration the Commission has given to our comments on the workability of prescribing operational performance measures (such as compliance with outage plans and communication about interruptions) in legislation prior to our development and testing of their scope and effectiveness with our customers. We support the Commission's decision to address future development of performance measures through the agreed Business Initiatives plan (reference clause 27).

We agree with the Commission that it would have been problematic to link asset health measures to revenue during RCP2, particularly at a disaggregated level and with an additional design objective of using the model to back out the base capex incentive. Inclusion of the measures as a reporting-only 'pilot' scheme is a preferable approach, although our concerns remain that this regime could impose a significant compliance burden that draws key resources away from activities that add more value for our business and for consumers.

It is important that the pilot scheme does not impose unnecessarily onerous reporting requirements given the opportunity cost of reporting activities and the likely limited value in detailed reporting. In addition, asset health is an evolving discipline within Transpower, so it is preferable that the reporting obligations are not unnecessarily prescriptive. As drafted, we consider that clause 28 of the IPP is both overly onerous and overly prescriptive. In particular, the clause:

- assumes that the way we measure and understand asset health remains constant such that a meaningful one-to-one comparison is possible between ca. 2014 models and our evolving models. It may be that new models for optimising tower maintenance will not focus on the average remaining life of protective coatings, but will characterise health in some other way
- demands a data and resource intensive reconciliation approach that is unlikely to add value to stakeholder understanding of how and why our plans are evolving, how our capability is evolving, or what this might mean for long-run costs and asset performance
- is likely to make it *harder* for the business to improve its tools and processes, both directly and because key resources will spend considerable time on low value reporting.

While we fully support the role of asset health modelling and are committed to ongoing development of our capability, we recommend that sub-clauses 28.1.3, 28.1.4; and 28.2, 28.3 and 28.4 should be deleted in their entirety. For sub-clause 28.1.2 it would be appropriate to require commentary on overall drivers for the results reported.

We support providing commentary on developments in our asset health modelling approach for the three relevant asset fleets. In addition, the business initiatives mechanism in clause 27 provides a means for tracking and communicating capability development.

We are available to discuss any of the matters raised above or in the appended mark-up of the IPP.

Yours sincerely

Jeremy Cain
Regulatory Affairs Manager

Appendix A – Mark Up of drafting for IPP Final Determination

See separate document

Appendix B – Asset volume target and productivity error amendments

The table below sets out the volumes we initially used to set the volume targets ('initial targets'), and the volumes used to set the base capex allowance ('corrected targets'). The caps and collars and incentive rates for each revised target are indicated in the mark-up.

Grid output measure	Disclosure Year	Initial Targets	Corrected Targets (to set base capex)	Variance
AH1: Number of towers painted	2015/16	451	427	-24
	2016/17	529	523	-6
	2017/18	531	517	-14
	2018/19	553	558	5
	2019/20	564	555	-9
		2628	2580	-48
AH2: Number of grillages commissioned	2015/16	408	339	-69
	2016/17	408	396	-12
	2017/18	408	408	0
	2018/19	409	390	-19
	2019/20	409	377	-32
		2042	1910	-132
AH3: Number of insulators commissioned	2015/16	1526	1532	6
	2016/17	1466	1466	0
	2017/18	1402	1402	0
	2018/19	1315	1315	0
	2019/20	1380	1375	-5
		7089	7090	1
AH4: Number of outdoor circuit breakers commissioned		155	141	-14
AH5: Number of transformers commissioned		26	26	0
AH6: Number of outdoor to indoor conversions commissioned		16	15	-1