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Transpower IPP 2020 – Issues Paper

This letter sets out Meridian's submissions responding to the Commission invitation for submitters to provide their views on the Commission's consideration of Transpower's RCP3 proposal in deciding on the RCP3 reset.

Submission – Commission must analyse how Transpower has responded to incentives

The Issues Paper frames the reset task as:

> *In assessing Transpower's proposal, we are guided by whether the proposal is consistent with an expenditure outcome which represents the efficient costs of a prudent supplier of electricity transmission services. This concept is consistent with the purpose of Part 4 of the Commerce Act 1986 (Part 4), which is also a required consideration under the capex evaluation criteria in the Transpower Capital Expenditure Input Methodology (Capex IM).*

It is not clear to us that this summary sufficiently captures the reset task at this stage of the regulatory cycle or that a straightforward assessment of whether proposed costs are the "…efficient costs of a prudent supplier of electricity transmission services…" adequately captures the Part 4 purpose. In particular, as we said in our recent submission on the DPP reset for EDBs:

> As we understand it, the purpose of Part IV regulation under the Commerce Act is to promote outcomes "…that are consistent with outcomes produced in competitive markets…". The periodic resetting of prices and quality targets via the DPP Reset is a once-in-five-year opportunity to check whether actual outcomes in the distribution sector are achieving such consistency and, to the extent they are not, to recalibrate those price and quality targets. In particular and from a consumer perspective, it is an opportunity to ensure that any efficiencies achieved by distribution businesses in the previous five years are shared with consumers via lower prices being set for the next 5 years.
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> As the Court remarked in *Wellington International Airport Ltd & Others v Commerce Commission* [2013] NZHC 3289:
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>> *[27] Thus the purpose [of section 52A / Part IV regulation] is to promote the s 52A(1) (a) to (d) outcomes consistent with what would be produced in workably competitive markets. For example, suppliers of regulated goods or services are to have incentives to innovate and invest, but consistent with the manner in which suppliers in workably competitive markets have incentives to innovate and invest.*
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>> *[28] When s 52A speaks of promoting outcomes, the question arises: what actions does the regulator take to promote such outcomes? Part 4, in providing for regulation of the price and quality of goods or services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition, envisages that regulation of price and quality will promote those outcomes.*

[29] A key output of Part 4 regulation is prices, the prices that regulated businesses charge for their services. In workably competitive markets, prices are the manifestation of market outcomes: that is, the outcomes of the process of competitive rivalry and of the interaction between supply and demand. It is prices that provide signals to suppliers to innovate and invest. It is prices that determine profits. In each case, of course, prices interact with demand and expected demand. Markets where there is little or no competition do not produce price outcomes that are consistent with the outcomes to be promoted in the s 52A(1) purpose. It is the difficult role of Part 4 regulation to produce prices that generate the s 52A(1)(a) to (d) outcomes, consistent with the outcomes produced in workably competitive markets. Prices are, therefore, at the heart of Part 4 regulation.

In the light of this and as a general comment Meridian is concerned that the Issues Paper does not place sufficient emphasis on alignment of distribution sector outcomes with those occurring in competitive markets. The Issues Paper states the Commission will balance the section 52A(1)(a) to (d) outcomes and exercise judgment in doing so, but does not appear to acknowledge that each of those outcomes needs to be pursued to a degree consistent with that which occurs in competitive markets. In other words, it is not enough, for example, that distribution businesses have some degree of incentive to pursue efficiency, or that they have some incentive to share efficiencies, or that they face some limitations in their ability to make excessive profits. The Commission's task – a difficult task as the Court observed - is to ensure those incentives and limitations are sufficiently strong that they produce outcomes consistent with what would be observed in competitive markets.

We note the Issues Paper reports:

Importantly, the Verifier was not able to confirm that Transpower's proposed base level opex is cost efficient.

And the Commission also states:

…we have yet to form our view on whether the base year expenditure itself is cost efficient. We seek your views on this, as well as the forecast trend, in the context of how it positions Transpower to meet future challenges.

Thus, the Commission recognises the challenge it faces in deciding whether the proposed expenditure level represents an efficient level of costs to supply the transmission services Transpower provides.

The Issues Paper observes that Transpower argues its proposed base level opex is efficient because it is in line with the average expenditure of some of the preceding years. As the Issues Paper observes, this argument rests on the assumption that Transpower's historical expenditures (i.e. 'revealed costs') are reflective of efficient costs if there is an effective incentive mechanism in place that incentivises a supplier of regulated services to actively pursue efficiency gains. An effective incentive mechanism is however a necessary but not a sufficient condition to establish that Transpower's expenditure proposal, based on historical expenditure levels, is efficient. Further conditions would be needed to establish efficiency, namely:

- the incentives are sufficiently strong that the supplier has actually pursued such gains; and
- the mechanism has been operative for sufficiently long and / or the supplier's pursuit of efficiency gains has been sufficiently successful that there are few efficiency gains left to pursue.

Accordingly, we agree with the Commission that it is not sufficient to simply assume (as Transpower appears to) that the incentives in past periods have been so powerful and comprehensively effective that the historical expenditure levels are therefore efficient. As the Commission notes in para 8.34.1 of the Issues Paper:

…the opex IRIS scheme has only been in place since the start of RCP2, it is unlikely Transpower has yet 'revealed' all potential efficiency gains inherent in its opex.

Meridian agrees. It is therefore surprising that in its 18 December letter to the Commission Transpower asserts:

The Commission doesn't need to make judgments about whether, or the extent to which, regulated suppliers have improved efficiency.

This assertion conflicts with section 53A of the Commerce Act 1986 ("the Act") which requires the Commission to ensure that:

> *…sufficient information is readily available to interested persons to assess whether the purpose of this Part* [Part 4] *is being met*.

That purpose includes ensuring suppliers of regulated goods and services:

> *have incentives to improve efficiency and provide services at a quality that reflects consumer demands*.

Thus, section 53A requires that the Commission ensures interested parties have the information to assess whether Transpower does have incentives to improve efficiency. Accordingly, we submit that the Commission's reasoning, summarised above, requires that its assessment of Transpower's proposal be based on an analysis of if and how Transpower has responded to the incentives the Commission has put in place. Furthermore, section 53A requires that interested parties be provided with this information so they can assess whether the incentives are effective. As far as we can tell, nothing in the materials so far available to submitters as part of the 2020 – 2025 Transpower IPP reset contains such information.

For opex, the incentive scheme the Commission has put in place is IRIS, the incremental rolling incentive scheme. Absent IRIS, if Transpower holds expenditure below the Commission's forecast through an efficiency improvement in any year other than the last year of a regulatory period, Transpower's rate of return would be increased only for the rest of the regulatory period[1]. Consequently, the incentive for efficiency improvements would be lower the shorter the time to the end of the current period. IRIS avoids the fall in incentive by adjusting Transpower's maximum allowable revenue, MAR, in the next period, with the result being that Transpower enjoys the benefit to its rate of return in effect for six years (the initial savings in the year the gain is made and then 5 years after that through IRIS), independent of the year of the regulatory period in which the efficiency improvement was achieved.

In summary, as a result of IRIS, a permanent efficiency increase will result (all else being equal) in Transpower earning a higher rate of return than the Commission's 67th percentile WACC estimate both in the period during which the efficiencies were achieved and for some or all of the subsequent period. The Commission estimates the effect of the IRIS mechanism is that Transpower's shareholders obtain around 34% of the present value of any permanent efficiency gains. Consumers and other interested parties cannot however disentangle whether, when Transpower achieves rates of return higher than the Commission's 67th percentile WACC estimate, that reflects efficiency gains being passed to Transpower's shareholders by IRIS as opposed to other factors.

In order for consumers and other interested parties to be able to understand and contribute to the RCP3 reset, the Commission needs to provide an analysis of the efficiency changes indicated by Transpower's expenditure results and specifically what permanent efficiency gains have been achieved and how the corresponding IRIS adjustments have, and/or will be, translated into rate of return increases[2]. The analysis then needs to

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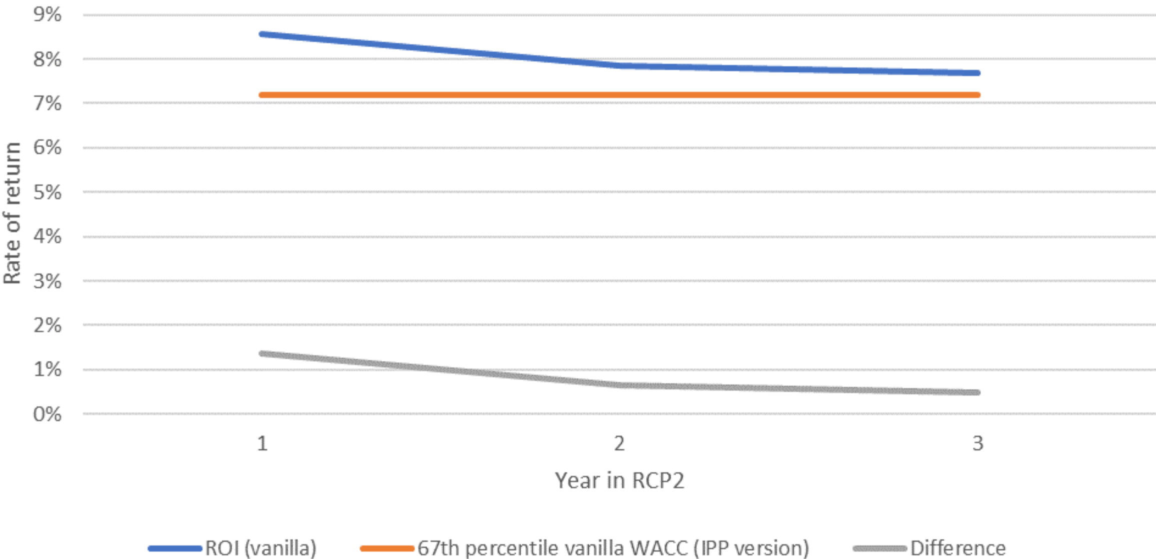
[1] The MAR set by the Commission at the beginning of each regulatory period would result in a rate of return equal to the Commission's estimate of the 67th percentile of WACC if all forecasts applied in setting the MAR were realised. If efficiencies are achieved through lower expenditure then the rate of return will be higher than the Commission's 67th percentile WACC estimate for the rest of the regulatory period. At the beginning of the next regulatory period, the resetting of the opex allowance, taking account of the efficiencies revealed, would reduce the rate of return back to the Commission's 67th percentile WACC estimate, absent the operation of IRIS.

[2] Transpower discloses the IRIS process adjustments on its website but because the detail of the calculations involved are not accessible, it is very difficult for interested parties to identify the efficiency gains. While in the ID Disclosures, Transpower lists the areas where there were savings or overspends compared to the forecast and explains why there were savings or overspends, it is not possible for interested parties to tell from this information which of these savings are permanent efficiency gains that are captured by IRIS and which are just temporary gains. For example, in 2017-2018, we can see from the ID disclosures that Transpower saved $3.9m in opex on its tower portfolio with savings coming from: a lower number of attachments points being replaced, fall arrest systems not installed due to a flaw in design and a review of

demonstrate how the efficiency gain will be reflected in a reduction in MAR. The Commission needs to develop this analysis so that (consistent with section 53A of the Act) consumers and other interested parties can themselves simply and accurately assess the extent to which Transpower's higher rate of return is explained by efficiency gains compared to other factors.

The decision on the RCP3 MAR and quality provisions will largely determine if and how much any efficiency gains are shared with consumers[3]. The background is that the Electricity Price Review's First Report at Figure 21 seems to indicate that in every year to which it has been subject to the current regulatory regime Transpower has consistently outperformed its regulated return. Chart 1 below compares the Commission's 67th percentile estimate of (vanilla) WACC used in setting Transpower's RCP2 MAR ("the IPP WACC") with the actual (vanilla rate of return) result reported by Transpower and is consistent with Figure 21 in the Electricity Price Review's First Report.

Chart 1: Transpower's ROI compared to the estimated return (67th percentile WACC)



The excess return compared to the IPP WACC appears to have been the result of expenditure being below the allowance the Commission built into the RCP2 MAR but it is not clear how interested parties can use the annual Transpower disclosures to determine what permanent efficiency gains have been achieved. Consequently, it seems to us that interested parties do not in practice have access to the information they would require to respond to the Issues Paper question regarding expected trends in Transpower's expenditure.

If we have understood Transpower's RCP3 proposal correctly, acceptance of the proposal would result in a 2.9% increase in opex and a 7% increase in base capex compared to RCP2. As discussed, the information required to assess whether these levels of expenditure would result in any efficiency gains being passed to consumers is not accessible to interested parties. The omission of any information in Transpower's RCP3 proposal as to the passing on of efficiency gains presumably reflects Transpower's assertion that the Commission doesn't need to make judgments about whether, or the extent to which, regulated suppliers have improved efficiency. As already indicated we do not see how this can be consistent with the Act's requirement that interested parties are provided with the information needed to assess whether efficiency gains have been achieved and whether they are being passed on.

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the EPR mitigation programme. The first two seem temporary savings and the last may be a permanent saving but there is no way for us to know this for certain and there is no way for us to know how much of the $3.9m is attributable to each of these factors

[3] See https://comcom.govt.nz/__data/assets/pdf_file/0021/62382/Input-methodologies-review-final-decision-Transpower-Incremental-Rolling-Incentive-Scheme-29-June-2017.pdf

The Issues Paper advises that:

> *…to help us set the opex allowances for RCP3 under the base-step-trend approach, we have requested Strata Energy Consulting (Strata) to work with us to establish that there is evidence that in the base level of opex Transpower has achieved efficiency from its past efficiency initiatives and that it has an ongoing process for identifying and capturing further efficiencies in the future*"(p 28 Issues paper).

The Issues Paper asks:

> *Is there any further analysis you suggest could be carried out to assess whether the proposed base level opex is efficient?*

As discussed above, our response to this question is that a systematic analysis of the way IRIS has operated and the effect of IRIS on Transpower's rate of return would assist the Commission and interested parties to understand and comment on the extent of opex efficiency gains achieved by Transpower.

The above quote from the Issues paper refers to Strata working with the Commission and by implication with Transpower. We suggest that this be expanded to Strata working with interested parties, for example in a workshop chaired by the Commission with participation from interested parties, including consumer groups. We believe this is warranted given the importance of assessing what efficiencies Transpower has achieved and whether, and if so to what extent, the benefits have been or will be shared with consumers[4].

Submission – verifier should be contracted by Commission

As a wider matter, we submit that, in general as well as this specific case, the verifier should be contracted by the Commission with a separate contract to cover any necessary agreement (e.g. regarding provision of information and confidentiality) between the verifier and the regulated supplier. We recognise that the concept of a verifier had, as one of its origins, situations where the Commission was required to respond within tight deadlines, such as with CPP applications. We surmise that this type of situation resulted in the verifier's role being conceived as assisting the applicant to produce a proposal that conformed to the requirements of the CPP IM. That concept in turn suggested that the verifier should be contracted by the applicant. It is now apparent that the Commission will put considerable reliance on the verifier in decisions and we submit it is much more appropriate that verifiers are contracted by the Commission than by the regulated supplier.

Related to this we note that the copy of the verification deed that we have seen seems to contemplate that the detailed opex and capex reviews would not be carried out by Synergies Economic Consulting Pty Ltd, the verifier named in the deed, but by a subcontractor to Synergies, namely GHD Pty Ltd. Further the conflict of interest provisions in the General Services Agreement appended to the deed contemplate that other GHD Pty Ltd personnel might be working on other Transpower projects at the same time that the GHD Pty Ltd staff named in the verification deed were carrying out the verification exercise (page 4 of General Services Agreement). We also understand that GHD Pty Ltd has completed engineering development work for Transpower in the past. As a result, and while we freely admit we may have missed or misunderstood something in all of this, it's not clear to us that the potential for conflicts of interest arising has been successfully managed through this process, particularly if GHD Pty Ltd is a regular contractor to Transpower and will potentially bid to carry out some of the proposed work the subject of the verification exercise.

Submissions on other points raised in Issues Paper

- Meridian questions the value of revenue-linked performance measures. At the level of revenue that Transpower and the Commission are prepared to put at risk we doubt they provide a strong incentive to improve performance. On the other hand, depriving Transpower of the relevant revenue will impact its ability to deliver on the work it proposes in a timely manner and this may be to the detriment of consumers

[4] We note that ideally information from the exercise Strata is to undertake would have been available during Transpower's consultation with interested parties during the preparation of the RCP3 proposal.

of transmission services. We suggest the only quality standards imposed on Transpower with financial consequences should be the prescribed quality standards in the IPP. If necessary additional performance measures linked not to revenue but a requirement to publicly and prominently report on performance (eg a large section on the front page of Transpower's website) could be instituted.

- In relation to the issues in Chapters 4 – 10 of the Commission's Issues Paper, Meridian comments as follows:

    - Customer Consultation - We agree with many of the observations made by the Verifier and by the Commission in this chapter. In our submissions on the Commission's process, framework and approach paper we said the Commission should seek to explain and the quantify the link between RCP3 decisions and the Part 4 purpose. The Commission's response (page 24) is that this will happen in its draft decision paper. We query whether this is early enough in the Commission's process. Our request that the Commission should make clear the impact of Transpower's proposal on prices ultimately paid by customers is, if we have understood page 24 of the Issues Paper correctly, responded to by the Commission saying that it will have this information. It's not clear to us whether the Commission intends to make sure this is available at later stages of the consultation. If so then we are grateful. If not, we suggest that the quality of the RCP3 process and decision-making would be significantly improved if it was made available. Meridian supports the additional disclosure requirements referenced at 4.30 ad 4.31.

    - Quality standards and grid output measures – As noted above Meridian supports quality standards. We question the value of financial quality incentives. In relation to non-financial quality incentives we suggest constant and prominent publication of current performance is preferable to additional reporting.

    - Asset management – Meridian agreed with points made by MEUG that it's important for Transpower to improve its asset health and criticality modelling asap and no later than end of RCP3. We agree with the Commission's suggestion at 6.32 that progress should be assessed by independent verification.

    - At paragraph 7.35.2 the Commission states: "Transpower has signalled that in the HVDC and Reactive Assets – HVDC assets capex program there are uncertainties in accessing accurate cost estimates and resource availability which may result in deferral of works into RCP4. Should this capex program, which is largely focussed on Pole 2 life-extension works, be considered as a listed project and, if so, why?" Meridian believes it should be considered as a listed project as this would potentially enable the uncertainties around costs estimates to be resolved ahead of the project proceeding. Meridian pays for roughly 70% of HVDC costs and we would appreciate the opportunity to have further input via the listed project mechanism.

Please contact me if you have any questions.

Yours sincerely

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