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Karen Smith
Regulation Branch
Commerce Commission
Wellington

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

Dear Karen

Transpower additional information Capex IM review

We welcome the invitation to provide additional information in support of our June 24th submission to the Commerce Commission's focus areas for the Capex IM review. The invitation is unique to Transpower and we appreciate the time extension granted.

We have been asked to propose any specific information requirements that should be added, amended or removed. Our suggestions align with the change criteria "significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose)".[1] At this stage, we have focussed particularly on Schedule F, but anticipate there may be changes to other clauses under the Commission's focus on incentive mechanisms, investment approvals and application of the IMs change criteria. We agree with the Commission's update paper that the incentive mechanisms are an important topic for review.

In this submission, we discuss our approach to the base capex proposal for the RCP3 reset, to underpin the areas we have identified for change. As the Capex IM has impacts across our business, each rule needs to be easily understood for rationale and application. Most of the amendments aim to reduce the depth of regulatory intervention in the current rules and lift the proposal (and evaluation) to a higher-level view that better matches the incentive premise for the regulation and our maturing regulatory journey.

[1] The change criteria are: promote the Part 4 purpose in s 52A more effectively; promote the IM purpose in s 52R more effectively (without detrimentally affecting the promotion of the s 52A purpose); or significantly reduce compliance costs, other regulatory costs or complexity (without detrimentally affecting the promotion of the s 52A purpose).

Refocus base capex proposal to reduce cost or complexity

The existing settings for the Capex IM derive from the Commission's emerging views for the 2011 Capex IM workshop, stakeholder and Commission views expressed at the workshop, and submissions.[2] Several of our views expressed then have been superseded, following practical experience with applying the Capex IM and the development of the incentive framework between RCP1 to RCP2. The table below outlines the main changes in the regulatory framework between the two regulatory periods.

Table 1 Regulatory framework key changes from RCP1 to RCP2

Feature	RCP1	RCP2
Opex incentive	Incremental rolling incentive scheme (IRIS) introduced – asymmetric	IRIS modified to better create a consistent incentive throughout the regulatory cycle and made symmetric
Capex incentive	No incentive arrangement	Introduced continuous incentive, balanced with opex incentive
Reconductoring projects	Base capex unless replacement is an enhancement (reconductoring was the driver for clause 3.2.1 in base capex)	Created 'listed' mechanism for large reconductoring projects with cost benefit analysis "consistent with investment test"
Network performance	System-wide measures, reporting only.	New customer-facing measures, some with financial incentives
Other output incentives	None	Volume targets designed to address deliverability concerns. Pilot asset health measures.
Business processes improvement	Improvement plan agreed with Commission. Focussed on safety, asset management, cost estimation.	Obligation to publish and report on improvement plan.[3] Focus on asset health, cost estimation and service measures.

We propose that some of the regulatory interventions thought necessary when Transpower was a newly regulated entity are less necessary now as we prepare for the third regulatory period under the IPP (Individual Price Path) and under full incentive regulation.[4]

We consider that our proposal for the third regulatory period (due December 2018) should be subject to information requirements and evaluation by the Commission that reflect approval for a funding baseline for the incentive based regime to operate.

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[2] 2011 Capex IM emerging views paper, the workshop transcript, and submissions http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/archive/transpower-capital-expenditure-input-methodology-consultation-archive/

[3] Setting Transpower's individual price-quality path for 2015—2020, 29 August 2014 *[x15] … [6.3] Transpower will be required to publish… [6.3.3] a one-off business improvement and performance measure development initiative plan by 31 July 2015*

[4]The Commission describes incentive based regulation as "the explicit use of rewards and penalties by the regulator to encourage desirable outcomes from the regulated company. Incentive regulation is used to provide a company with a financial incentive to achieve efficiencies in its opex and its capex" [Transpower Capex IM workshop paper 8 April 2011]

Evaluation by the Commission could then test:

a. how efficiencies achieved up to the forecasting base year have been reflected in the expenditure proposal for the next RCP
b. the approach we used to size the funding baseline
c. how we have tested price-quality trade-offs
d. how we will manage uncertainty and constraints (e.g. deliverability).

We think a central component to an effective reset process should demonstrate the approach to the trade-off between price path and quality. Higher quality may be achieved through lower asset failure risk (better reliability or mitigation), earlier or larger grid capacity expansion, or better commercial servicing. (Conversely for lower quality).[5]

In 2016 we published *Transmission Tomorrow* in the context of advancing technology change and have created new strategic priorities and operating plans to position our business for the changing energy landscape. We are also close to releasing the statutory update of our integrated transmission plan (ITP) and updated narrative for the supporting documents[6] (asset management plan, planning report, and performance report). We are keen to ensure these avenues of communication provide our customers with sufficient information to understand our operating context and plans.

Clauses proposed for amendment

In our June 24th submission[7], the areas we identified for change were the ex-ante / ex-post efficiency judgements and the reliance on demonstrating compliance with, and departures from, "policies and processes". We discuss first our reasoning for attention to these two areas, but note we have identified further clauses under the reduce cost / complexity criteria and the role for incentive regulation. (We indicate the broader scope below and by marked up Schedule F in the appendix).

Efficiency (Clause F5)

In our submission, we stated

> *We consider that periodic scrutiny is a poor mechanism for driving efficiency. Interventions such as making ex ante adjustments to allowances for possible future efficiency gains, requiring disclosure of policy and process changes, reconciling plans to delivery, and making ex post assessments of efficiency are administratively demanding and cumbersome. Such intervention is fraught with information challenges and incentive problems. Our view is that better outcomes could be achieved with well-designed incentive arrangements that motivates ingenuity and effort in our workforce, suppliers and service providers to drive towards the best outcomes…An emphasis on*

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[5] Although the possibility for price/quality trade-offs is governed also by rules of Part 12, Electricity Industry Participation Code, Part 12 e.g. the Benchmark Agreement.

[6] Schedule E, Capex IM.

[7] *Capex IM focus areas* Available at https://www.transpower.co.nz/submissions

> *incentives is particularly important given the increasing need for us to be flexible and agile in responding to our strategic environment…*

We emphasise that under the regulatory framework created by the Commission we should be relying on the expenditure incentives to encourage us to search for and reveal efficiencies. The expenditure efficiency arrangements should reinforce an approach where our proposal for the next regulatory period allows for the revealed efficiency i.e. take our efficiency as achieved up to the forecasting base year. As written, the existing Capex IM rules require regulator judgement to be applied to assess what efficiency there could / should be, rather than allowing dynamic discovery under the incentive regime.

Using the reset to set prospective efficiency targets can reduce the effectiveness of within period incentives with the following effects:

- The regulated firm may be discouraged from discovering efficiency opportunities
- efficiency targets can create a short-term focus that may drive long-term costs or quality deterioration
- information challenges for the regulator, and reset evaluation team, are likely to be less effective than a well-motivated firm at finding sustainable costs savings
- The lack of symmetrical treatment of efficiency gains and losses ex ante, does not support experimentation to find a 'right' level of expenditure

There is only limited time and resources able to be deployed through a reset process and those resources are best directed to the higher-value activity of mediating price-quality trade-offs so that services better reflect customer preferences. Based on the above views, we propose removing clause F5 "cost and efficiency" entirely (see appendix).

Policies and processes (Clause F6 (1), and base capex policies/processes adjustment)

In our submission, we stated:

The existing rules contain a level of Commission scrutiny into our business processes that was in response to our commitment in RCP1 to various improvement initiatives… We consider that as the business has matured under the regulatory regime there is less need for emphasis on the scrutiny of policy and processes. We suggest some information requirements could be reduced or removed…

Our business does not stand still. We have recently created a new *grid operating model* for strategies and polices to guide asset planning decisions, and have embarked on a second transformation focussed on driving efficiencies through the business. Policies and strategies that are changed (e.g. by legislative change, or changes to practices or standards) are subject to governance procedure. However, having to track, record, then publicly describe compliance with and departures from our internal policies, serves no incentive purpose under Part 4 and derogates both management and Board responsibility. We consider the base capex adjustment mechanism for compliance with policies and processes is inconsistent with the broader settings for incentive regulation and is a disincentive to incorporating positive change.

Continued scrutiny into the detail of our business risks stifling process innovation and crowds out focus on the things that matter: customer engagement, improving efficiency and providing quality that consumers seek.

We propose removal of the *policies and processes adjustment* e.g. 3.2.2 and Schedule B2, and related clause in the base capex proposal e.g. clause F6 (1).

We also consider clause 3.2.1 “Base capex projects or programmes with forecast cost of greater than $20 million” [8] is no longer relevant. The origin for the clause was that base capex would have reconductoring projects included. These projects were the reason consultation and an economic test consistent with major capex were required. The listed project framework has superseded the role of the clause.

Appendix Schedule F

We identify with strikethrough / insertions the Schedule F provisions that we propose for change under the reduce cost /complexity criteria (and without compromising Part 4 or IMs statutory purposes). Comment boxes provide our rationale. If the Schedule F clauses are amended / removed there could be consequential changes to other parts of the input methodology including the Commission’s evaluation clauses under part A and to some definitions.

Please let me know if you have any questions or would like to discuss the additional information issue raised.

Yours sincerely

Catherine Jones

Regulatory Affairs and Pricing Manager

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[8] In respect of a base capex project or base capex programme involving forecast capital expenditure of greater than $20 million Transpower must, prior to undertaking the project or programme, undertake-
(a) a cost-benefit analysis consistent with determining expected net electricity market benefit; and
(b) consultation with interested persons in accordance with clause 8.1.2