



MAJOR ELECTRICITY USERS' GROUP

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Dear Keston

MEUG submission on Transpower capex input methodology review

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission consultation paper "Transpower capex input methodology review – Proposed focus areas for the capex IM review" published 15 May 2017.¹
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. Attached and to be read as part of this submission is advice from Mike Hensen of NZIER "Advice on Transpower Capex Input Methodology" 13 June 2017.
4. In preparing this submission MEUG members, MEUG and advisors to MEUG had the benefit of attending the Commission convened workshop on 24 May and various meetings with Commission and Transpower staff. Those have been very constructive engagements.
5. The consultation paper invites submissions on:²
 - a) What the proposed focus areas for the review should be?
 - b) Specific problems that should be considered within those focus areas
6. The consultation paper suggests 5 focus areas as set out on the left-hand side of the table on the following page. MEUG's abbreviated topic header is on the right-hand side. MEUG also suggests one additional topic, #6, in the last row of the table.
7. Each of the 6 focus areas, including specific problems that should be considered within those focus areas, are discussed in the sections that follow the table overleaf.

¹ Document URL <http://www.comcom.govt.nz/dmsdocument/15418> at <http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/transpower-input-methodologies/capex-input-methodology-review/>,

² Consultation paper, paragraph 109.

Focus area	Consultation paper description ³	MEUG abbreviation
# 1	Given the changing landscape in the energy sector, are there adjustments that could be made to the capex IM to better ensure the right transmission investments are being made, including non-transmission solutions?	Future proofing
# 2	Does the capex IM support a proportionate approach to scrutiny?	Proportionate scrutiny
# 3	Once expenditure has been approved, does the capex IM appropriately deal with changing circumstances?	Ex post adjustments
# 4	Are the incentive mechanisms in the capex IM effective?	Incentive mechanisms
# 5	Are aspects of the capex IM too complex and prescriptive?	Overly complex & prescriptive?
	Focus area proposed by MEUG	
# 6	Given the fundamental problem of information asymmetry, can engagement be improved?	Engagement processes & protocols

Focus area 1: Future proofing

8. MEUG agrees this should be an area of focus.
9. Specific problems and initial views on possible solutions within capex IM to consider:
 - a) There is a risk of never-ending regulatory catch-up. Put another way lagging regulatory changes may hinder efficient price discovery and optimal levels of uptake (not too much or too little, or too early or too late) of new products, services and business models in the retail, ancillary service and wholesale markets, all of which directly or indirectly have prices in those markets affected by regulated transmission costs, prices and quality settings. One way to manage the risk of systematic regulatory catch-up are one-off targeted changes to the relevant IM(s). That has a high transaction cost. An alternative solution is discussed in paragraph 10 a) below.
 - b) Currently, emerging technologies such as battery storage are only on the cusp of being economically viable alternatives for Transpower's major capex proposals depending on the specifics of the project.⁴ For listed projects, that is large reconductoring projects, and base capex, such transmission alternatives are not on the cusp of being viable though over time, and certainly within the say 40-year lifetime of decisions made today for refurbished and replaced assets (R&R), those may become economically viable on a case-by-case basis. MEUG therefore agrees with the consultation paper that there may be a problem whereby there is no requirement in developing base capex programmes to consider transmission alternatives.⁵

An across the board requirement in the Capex IM for Transpower to consider transmission alternatives for RCP3 would be excessive. Transpower could elect to voluntarily develop a screening process to identify candidate base capex programs for further analysis as to the viability of transmission alternatives. Otherwise an

³ Ibid, paragraph 73.

⁴ This submission does not consider the economic viability of emerging technologies such as battery storage for EDB's or by consumers behind their meter; though the economics are likely to be more favourable downstream. This in turn will affect the forecast for demand for future grid services.

⁵ Consultation paper, paragraph 82.4.

amendment to the Capex IM is probably needed provided it minimises unnecessary checking of highly unlikely base capex programs that could be substituted by transmission alternatives.

- c) We think there is a problem in having clarity on the range of future demand for grid services in the long-term given the uncertainties with new technologies and changing economics of emerging technologies and business models. The forecast period used for the Integrated Transmission Plan (ITP) and Asset Management Plan (AMP) to the end of RCP3 is insufficient given R&R base capex investments in RCP3 will have around a 40-year asset lifetime. The drivers for demand for existing and new grid services will be complex including changing economics of transmission alternatives and the effect of possible adjustments to TPM. To illustrate how changes in these drivers may lead to different outcomes MEUG commissioned NZIER for their advice. The advice from Mike Hensen "Advice on Transpower Capex Input Methodology" 13 June 2017 is attached and should be read as part of this submission.

We think more not less quantitative forecasts will be required to cover the range of possible long-term demand scenarios for grid services by GXP. We see no reason why the forecast horizon for detailed ITP analysis should not be extended to 40-years; because the benefit of having an appreciation of the range of quantitative effects of different scenarios will allow Transpower to make better informed decisions and consumers to make informed commentary than relying on story narratives not backed with analysis. We will still need narratives to make the analysis accessible to a range of stakeholders.

- d) In the discussion on focus area 1 the consultation paper asks "Whether improvements could be made to the investment test?"⁶ MEUG has no views at this stage on the investment test in relation to future proofing the capex IM.

We do have a generic comment on the discount rate used in investment tests prescribed in the Capex IM as 7% +/-3% or as otherwise proposed along with justification by Transpower. MEUG suggest the Capex IM be revised to a 6% mid-point rate consistent with The Treasury default rate for cost benefit analysis.⁷ Use of the 7% for Transpower capital investments when the public sector in general has a default rate of 6% would, over the long-term, lead to miss-investment between Transpower and all other public infrastructure unless there are good reasons that should be so.

10. Possible complimentary or alternative solutions outside the Capex IM:

- a) Until there is clarity on the likely direction and pace of adopting new technologies, an option to consider is shortening the next IPP for RCP3 (and following RCP until the uncertainty abates) from 5-years to a 4 or 3-year cycle. Similarly, the Commission could consider aligning the review of IM from no later than 7-years to the same period as IPP so that each IPP has the benefit of refreshed IM that can consider uncertain changes due to technology.

⁶ Ibid, paragraph 82.5.

⁷ Refer www.treasury.govt.nz/publications/guidance/mgmt/planning/costbenefitanalysis/currentdiscountrates , web page published 13 October 2016.

- b) Transpower collaborating with stakeholders on investigations into new technologies as early as possible so that the findings can be socialised and learnings debated. Transpower have commenced this approach already with their investigations into how battery storage might fit into the sector in the future.⁸ A systematic approach and internal protocol by Transpower deciding how and when to publish such material, and how to partner (if appropriate) with selected stakeholders. We pick this point up in MEUG's proposed new focus area 6: Engagement processes & protocols.

Focus area 2: Proportionate scrutiny

11. If there are problems with disproportionate compliance and scrutiny in current areas such as the difference between major and base capex, or prescribed levels of detail required including that for listed projects, then Transpower and the Commission are likely to be most knowledgeable of those.
12. We have another three specific problems in this focus area along with initial views on possible solutions to amend the Capex IM as follows:

- a) The consultation paper asks "Whether the requirements for the ITP are clear and allow stakeholders to gain a transparent picture of Transpower's strategy and expenditure requirements?"⁹ We think the ITP is a work-in-progress. We will be in a better position to comment once this year's ITP is published around October.

An issue to consider is the once a year publication of the ITP which is a very large complex and important document. Large complex listed companies face the same problem in informing shareholders, interested parties (various sector specific regulators) and the public in general (in terms of maintaining a "social licence" to operate effectively) between annual report cycles. Many have voluntarily adopted a half-yearly, and in some case a quarterly, reporting cycle on material changes and key performance metrics in addition to the required continuous disclosure requirements. MEUG suggests Transpower could consider similar half-yearly, if not quarterly, up-date of changes that have affected the last full ITP so that there are no surprises in the next full annual ITP.

Transpower may already do this for their internal management processes. If so the incremental cost of publishing such an update may be modest relative to the benefit to keeping customers abreast of material changes and up to speed to improve engagement on the next annual ITP.

- b) The Commission and Transpower alone discuss and set information templates to be used at each 5-year IPP reset. On the one hand this gives flexibility to the Commission to ensure focus on areas it believes will best improve the long-term benefit of consumers. But there are also downsides. First the risk of regulatory capture. Second the risk the Commission may miss-judge what weighting consumers put on different aspects of Transpower's performance (both quality and price). To mitigate such risks MEUG suggests either or both Transpower and the Commission can discuss all or parts of the proposed information requirements with consumers and interested intermediaries such as retailers. The onus is then on Transpower and the Commission, if in doubt the focus is correct, to engage with consumers and interested intermediaries without overburdening consumers with having to comment on all the proposed information requirements and unnecessarily increasing engagement costs.

⁸ Refer MEUG, Update from the Chair, June 2017, <http://www.meug.co.nz/node/851>

⁹ Consultation paper, paragraph 89.4.

- c) A barrier to consumers effectively engaging with Transpower and the Commission is complexity and information asymmetry. The latter we discuss in paragraph 20 in the introductory paragraph to MEUG's proposed additional focus area 6: Engagement processes and protocols.

Overcoming the barrier of complexity as to how Transpower decides to invest in a base capex programme could be addressed, for example, by the Commission during a RCP randomly choosing a base capex programme and requesting Transpower publish all relevant materials used in finalising the budget and timing for that work relative to the approved cost based on the ITP proposal before the start of the RCP. This transparency of a randomly selected actual base capex programme would help interested parties understand and if appropriate give feedback to Transpower on how it decides on the scope, timing and priority relative to other work programmes.

Focus area 3: Ex post adjustments

13. Suggested issues and options listed in the consultation paper for this focus area were to:
- a) "set and forget";
 - b) Have a "staged approval";
 - c) Allow parties other than Transpower to seek amendment or discontinue a project;
 - d) Have an annual smoothing mechanism for base capex;
 - e) Allow amendments for CPI, FX and other risks outside Transpower's control; and
 - f) Allow "enabling works" in base case ahead of possible major capex.
14. MEUG looks forward to the submissions of other parties to understand the scale of problems in this focus area. In all cases, we will be looking first, for clear evidence that a change from the status quo will lead to measurable improvements for the long-term benefit of consumers. And second, similar ex post contractual adjustments feature in large construction markets. MEUG's concern is that ex post adjustments can shift the balance of risk in such a way that the foundation of ex ante incentive regulation is undermined and consumers bear a disproportionate share of risk.
15. MEUG has one other potential new issue. The present incentives on Transpower to commission works within a regulatory control period may lead to increased (and potentially deferrable) expenditure in the final year of a regulatory control period. It is unclear if the IRIS mechanism completely meets this flexibility. We would therefore like to see, subject to checking the effectiveness of IRIS, some flexibility in Transpower being able to defer commissioning of plant into the following RCP without being penalised for doing so.

Focus area 4: Incentive mechanisms

16. MEUG agrees this should be an area of focus.
17. In addition to the 3 examples of potential topics to consider in paragraph 100 of the consultation paper, MEUG suggests other specific problems as follows along with initial views on possible solutions to amend the Capex IM:
- a) The largest incentive affecting Transpower's decision making for capex and opex is the uplift over the expected WACC, ie the difference between the mid-point WACC and the 67th percentile WACC. MEUG is not aware of any analysis to reconcile the current incentive bonus/penalty payment mechanisms set per the Capex IM do not have a bias, because of the uniform regulated WACC uplift, to favour capex over opex. An investigation should be undertaken to consider if there are distortionary effects. If there are MEUG suggests the solution is to amend the WACC IM, as

discussed in paragraph 18 a) below, as there is no obvious simple mechanism that could be amended in the Capex IM.

- b) In the discussions with the Commerce Commission and Transpower referred to in paragraph 4 of this submission, one key topic for MEUG was the need for as early as possible adoption of a network risk performance measure to replace the current asset health measures (AHM).¹⁰ All parties agree the current AHM are a second-best mechanism compared to a network risk assessment for each asset. The challenge for customers is to have confidence the pace of change is more than measured but has urgency. With the current AHM we will be paying for miss-investment. We don't think this outcome is desired by both consumers or Transpower and there is an opportunity in the spirit of co-operation to implement changes.

We don't think there is a rule in the capex IM we can amend or a new rule we could add to ensure change is at the right pace. Hence we have suggested other non-Capex IM solutions in paragraph 18 b) below.

18. Possible complimentary or alternative solutions outside the capex IM:

- a) Have a targeted review of the percentile assumption in the WACC IM to check there are no distortionary effects when applied in combination with the capex IM. If unintended effects are found; then amend the WACC IM.
- b) There are three non-Capex IM mechanisms that would lift confidence by consumers that the pace of change from AHM to network risk assessment performance measures were being implemented timely:
 - i) Having half-yearly, if not a quarterly, up-date of material changes in the ITP as discussed in paragraph 12, including progress on key topics such as AHM.
 - ii) Having confidence that the Transpower Chief Executive and executive team Remuneration and Performance Incentive Payment Policy and discretionary Performance Incentive Payment (PIPS) Scheme are aligned with the Capex IM and other Part 4 regulatory requirements.¹¹ Complete transparency of these policies and the PIPS scheme would allow interested parties to fully check alignment. An alternative may be Transpower's auditors providing an independent view on alignment as discussed in the next sub-paragraph.

¹⁰ In this submission, the phrase "network risk assessment" refers to a performance measure that uses estimates for an asset of its asset health, risk in the future of failure, and the value of loss load to consumers if supply is disrupted.

¹¹ Refer Financial Statements of the Government of New Zealand for the year ended 30 June 2016, p27, URL <http://www.treasury.govt.nz/government/financialstatements/yearend/jun16/fsgnz-year-jun16.pdf> at <http://www.treasury.govt.nz/government/financialstatements/yearend/jun16/14.htm>

- iii) Auditors have started including in their reports a section titled “Key Audit Matters”. A good example of such a report was by the Controller and Auditor-General for the Financial Statements of the Government of New Zealand for the year ended 30 June 2016.¹² Key Audit Matters, as the Controller and Auditor-General explained:

“Key audit matters are those matters that in my professional judgement, were of most significance in my audit of the financial statements to the Government of the current period. In applying my professional judgement to determining key audit matters, I considered those matters that could be complex, have a high degree of uncertainty, or are important to the public.”

To illustrate, the auditor could, arguably, consider potential long-term asset stranding, or exit of large end users' or power stations from the market, as Key Audit Matters to comment on and how they relate to the Capex IM or Part 4.

Focus area 5: Overly complex & prescriptive?

19. MEUG has no specific problems though, like focus area 2 above (paragraph 11), its likely Transpower in the day-to-day implementation of the Capex IM, will have specific examples for other parties to consider in the cross-submission round.

Focus area 6: Engagement processes and protocols

20. Transpower's engagement with its contractual counterparties, other stakeholders and consumers in general has been continually improving. The following suggestions are therefore about continuing that good work. We think it is useful to remember Transpower is a monopoly and the Commerce Commission, consumers and other parties have and will continue to have an information asymmetry problem across a range of engagements including those relevant to the Capex IM. One part of the solution to the information asymmetry problem is to facilitate transparency of information.
21. Information is both raw data and summary narratives that explain the meaning of that data. Information can also be advising stakeholders of future timelines.
22. Accessibility to consumers for highly technical subjects requires good explanatory narratives. Accessibility can also be achieved by allowing interested parties to build a better understanding of the complexity Transpower manages in day-to-day operations such as choosing between different base capex programmes and modifying a programme compared to the approved RCP budget proposal. Randomly selecting and having full disclosure of how an actual work programme is chosen during an RCP as discussed in paragraph 12 c) is a possible way to improve accessibility.
23. In terms of timelines the Commerce Commission web site is an excellent example where interested parties can select topics and date ranges to check when reports will be published or consultations start and end. It's a one-stop shopping menu for all future Part 4 topic calendars. In comparison, there is no single comprehensive calendar of near term Transpower consultations, publication of reports and other regulatory related events. Having visibility on the overall work programme several months out such as that published by the Commerce Commission allows less resourced parties such as MEUG better plan those resources to improve the quality of engagement.

¹² Refer Transpower 2016 Annual report, p vi, URL <https://www.transpower.co.nz/sites/default/files/news-articles/attachments/Transpower%20Annual%20Report%2015-16%20%28print%20final%29.pdf> at <https://www.transpower.co.nz/keeping-you-connected/investors/2016-annual-report-and-review>.

24. As discussed in paragraph 10 b) of this submission we welcome Transpower collaborating with stakeholders on investigations into new technologies as early as possible so that the findings can be socialised and learnings debated. A systematic approach and internal protocol by Transpower deciding how and when to publish such material, and how to partner (if appropriate) with selected stakeholders may be warranted. Publishing, and updating as needed, a list of project milestones such as when progress reports will be published as suggested in the preceding paragraph will assist Transpower to improve the accuracy of its project management processes and give certainty to all stakeholders on the status and next steps of each project.
25. As discussed in paragraph 12 a) we think there may be a problem with interested parties being unable to come up to speed and be abreast of the complexity of the ITP currently published once a year. Transpower could consider voluntarily publishing half-yearly, if not quarterly, updates published on material changes as they occur so the details of the ITP the next year are not unexpected.

Yours sincerely



Ralph Matthes
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