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## **Consultation paper for cross-submissions on Transpower's submission on final drafting for IPP regulation for RCP2**

**Supplement to 12 September Transpower Individual Price-Quality Path Draft  
Determination 2015**

Date: 14 October 2014

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## Purpose of this paper

1. This paper provides our preliminary views:
  - 1.1 on Transpower's request that we change the revenue-linked grid output measures targets for Transpower's individual price-quality path for the next regulatory period (RCP2) from 1 April 2015 to 31 March 2020; and
  - 1.2 on Transpower's request that we change the revenue-linked grid output measures incentive rates and ICT costs.
2. The revenue-linked grid output measures link an amount of revenue to asset delivery targets, which were proposed by Transpower in its 27 June 2014 submission on our 16 May 2014 draft reasons paper.<sup>1</sup> The target measures were previously set by us in our decision on the expenditure allowances and quality standards for RCP2 and how Transpower's maximum allowable revenue will be calculated for each year of RCP2.<sup>2</sup>
3. In its submission on our draft Individual Price-Quality Path Determination (IPP Determination) Transpower has submitted that some of the target measures it previously submitted are incorrect.<sup>3</sup>
4. Transpower has also asked that we amend the 7.5% productivity adjustment we applied to the revenue-linked grid output measure incentive rates, and that we amend the level of ICT costs allowed by the Commission.
5. We consider that it would appropriate to correct for Transpower's errors in relation to the asset delivery targets for the reasons discussed in paragraphs 12 to 24. We do not consider it appropriate to amend the revenue-linked grid output measures incentives rates and ICT costs.

## How you can provide your views

6. We seek your views on the changes to the asset delivery targets requested by Transpower in its submission on our draft IPP determination.
7. We are not seeking feedback on Transpower's requested changes to the incentive rates and ICT costs, but you may make submissions on these matters if you wish to do so.
8. We request that we receive submissions by **5pm on 21 October 2014**.
9. Please email all submissions to [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz) with the subject line 'Transpower requested changes to IPP submission' and your name.

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<sup>1</sup> Transpower "Response to IPP Draft Decision" (27 June 2014), p39.

<sup>2</sup> Setting *Transpower's Individual Price-Quality Path for 2015-2020*, 29 August 2014.

<sup>3</sup> *Transpower Individual Price-Quality Path Draft Determination 2015*, 12 September 2014.

10. We appreciate this timeframe is tight as a result of the request being included in Transpower's submission on our *Transpower Individual Price-Quality Path Draft Determination 2015* (draft IPP Determination).
11. We intend to issue our final IPP Determination, which gives effect to Transpower's Individual Price-Quality Path, by 28 November 2014.

### **Process for error correction of decisions on base capex allowances and grid output measures under the Capex IM**

12. The Transpower IM contains an express provision for reconsideration of an individual price-quality path in the event of an error which has an impact on the price path of an amount at least equivalent to 1% of the aggregated forecast MARs for the disclosure years of the IPP affected by the incorrect data.<sup>4</sup> We note that Transpower's errors in this instance do not meet this threshold and it would therefore be impermissible for us to correct them after finalising the IPP Determination.
13. In contrast, the Capex IM does not contain a specific provision setting out the circumstances in which we can make corrections to our decisions on base capex allowances and grid output measures prior to the date of our final IPP Determination. This means there is no obvious mechanism for correcting errors identified between the date of our Capex IM decisions (29 August 2014 for RCP2) and the date of our final IPP Determination (28 November 2014 for RCP2).
14. The sole purpose of the August Capex IMs decisions was to set key inputs for the IPP Determination which will be finalised in November. In our view, at this stage of the process, the need for finality does not outweigh the importance of ensuring that these decisions can be corrected, if we are persuaded on the basis of cogent information that this would be appropriate and would not unfairly prejudice anyone.
15. We therefore consider that on balance, the restriction on the correction of errors expressed in the Transpower IM should not be read into the Capex IM, and that we can adjust our August decisions on base capex allowances and grid output measures when finalising the IPP Determination.
16. We seek your views on our position on the correction of errors identified between the date of our Capex IM decisions (29 August 2014 for RCP2) and the date of our final IPP Determination (28 November 2014 for RCP2).

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<sup>4</sup> *Transpower Input Methodologies Determination [2012] NZCC 17, Subpart 7.*

## Asset commissioning – volume target errors

17. We propose correcting errors in Transpower’s revenue-linked grid output measures targets by amending the relevant target numbers in Table 4.1 of the draft IPP Determination.<sup>5</sup>
18. Transpower has identified errors in some of the volume targets that it provided for the asset health grid output measures in its 27 June 2014 submission on our draft decisions on Transpower’s individual price-quality path for RCP2. Transpower argues that 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.
19. Correcting the targets requires consequential adjustments to the cap, collar and incentive rate settings. Without correction, errors in the targets would expose Transpower to \$5.6m of penalties under the grid output adjustment mechanism.
20. According to Transpower, the errors arose because the asset health incentive regime was developed after its proposal was submitted and, in some cases, asset counts were drawn from the wrong sources. Four sources of error are given:

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

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 replacement 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.<sup>6</sup>

21. We have reviewed the reasons for the target errors and the detailed financial data provided by Transpower in response to our information request and we are satisfied that the revised targets proposed by Transpower align the forecast quantity of commissioned assets in the Transpower expenditure proposal with the allowance provided for in our final decision.
22. We consider that it would be appropriate to correct the errors in the Final IPP Determination. We further do not consider that any person will be unfairly disadvantaged if the corrections are made.

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<sup>5</sup> The revised numbers are included in *Transpower submission on legal drafting of revised draft determination*, 26 September 2014, Appendix A.

<sup>6</sup> *Transpower submission on legal drafting of revised draft determination*, 26 September 2014, pp 2-3.

## Incentive rate productivity adjustment

23. We do not agree with Transpower's requested changes to the incentive rates to provide for the application of a 7.5% 'productivity' adjustment.
24. In its RCP2 expenditure proposal<sup>7</sup> Transpower applied a top-down 7.5% 'productivity' adjustment to its aggregate nominal commissioned Grid and ICT Capex forecasts.
25. In correcting the targets (discussed above) Transpower found that it had not applied a 7.5% productivity adjustment to the incentive rates. The incentive rate is the applicable revenue at risk divided by the target number of units to deliver.
26. Transpower has submitted that, together with the requested changes to the volume target errors, these corrections ensure 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.
27. The Commission accepted the incentive rates proposed by Transpower in its 27 June 2014 submission on our 16 May 2014 draft reasons paper. Transpower explained that the total revenue at risk for its asset health incentive mechanism of \$14.3m corresponds to the nominal value of the [Commission's] proposed reduction (being about \$40m) at the asset health regime incentive rate of about 36%.
28. The Commission notes that the setting of incentives is not a science, and the numbers used to derive the incentive rates applied by the Commission to other revenue-linked grid output measures are not mechanistically calculated.
29. Therefore, there does not seem to be any justification for applying a mechanistic adjustment to the amount used as the basis for the rates previously proposed by Transpower for the asset fleets subject to the revenue-linked asset health grid output measures.

## ICT Costs

30. We do not agree with Transpower's request to remove our 2.5% reduction to Transpower's ICT capex expenditure.
31. Transpower submitted that the Commission's decision to reduce ICT capex by 2.5% was based on an error in the advice of the Commission's consultants, Strata, regarding the extent to which Transpower had applied its 7.5% 'productivity' adjustment. Transpower quotes our 16 May draft reasons paper at paragraph 5.111:

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<sup>7</sup> Transpower's proposal can be found on our website at <http://www.comcom.govt.nz/regulated-industries/electricity/electricity-transmission/transpower-individual-price-quality-regulation/transpowers-price-quality-path-from-2015-to-2020/>.

...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."

32. Transpower asserts that in fact, the net adjustment was already 7.5% and was increased (to 9%) due to the further 2.5% reduction. Transpower argues this was not the Commission's intention, based on our reasons given in the 16 May draft reasons paper.
33. In reaching our decision we considered an adjustment of up to 5%, comprising the 2.5% adjustment recommended by Strata plus an additional adjustment of up to 2.5% to take account of the apparent shortfall (of up to 2.5% based on Strata's advice that the productivity adjustment appeared to be as low as 5%).
34. Given, however, that the level of productivity adjustment Transpower had made was unclear, our decision was to apply a 2.5% reduction only, to take into account all of the already implemented strategies, processes and other improvements that will deliver further savings to Transpower's ICT Capex expenditure forecast during RCP2.
35. We consider that a plain reading of the analysis and the findings in the Strata Report and our own reasons does not support Transpower's assertion that our decision to apply a 2.5% adjustment was based on incorrect advice regarding the shortfall between Transpower's proposed 7.5% adjustment and the resultant adjustment after accounting for the late increases in some ICT category elements.