



24 November 2017

Keston Ruxton
Regulation Branch
Commerce Commission
Wellington
By email: regulation.branch@comcom.govt.nz

Dear Keston

Capex IM draft decisions – Table 1 incorrect information comparison

We write to request the Commission corrects information at table 1 on page 24 of the Capex IM draft decisions paper that was published 15 November 2017. The way this information is presented creates a perception that Transpower is going to significantly underspend our RCP2 allowance.

The RCP2 allowance figure calculated by the Commission and presented in the table is incorrect to compare with our current forecast in the 2017 ITP as:

- The figure uses a column reference 'RCP2 allowance in IPP (Commissioned value 2016/17 prices)' when the figures have been based on a starting figure of \$1132.1m (2012/13 constant prices) which is on an expenditure basis not a commissioning basis. This has the effect of overstating the allowance by \$14.7m: in final RCP2 allowances, Base capex (nominal) spend was \$1273m and Base capex commissioned (nominal) was \$1258.3m.¹
- The Commission then applies assumptions used in the RCP2 decision for forecast consumer Price Index (CPI) and real price effects (RPE) to produce an escalator of 1.098 resulting in a final figure of \$1243m ($\$1132.1m \times 1.098 = \$1243m$).

This approach is inconsistent with the calculations that Transpower has used in the 2017 ITP. Our current forecast as published in the 2017 ITP² of **\$1130.4m** is based on commissioned value and is derived from a combination of actual expenditure³, forecast expenditure for 2017/18, 2018/19 and 2019/20 and is presented in 2016/17 dollars.

To do a comparable calculation with Transpower's 2017 ITP using the RCP2 allowance and converting it to 2016/17 dollars on a commissioning basis, the steps should have been:

- Use a starting figure of \$1132.1m and adjust for the timing difference of expenditure and commissioning to get \$1117.4m. ($\$1132.1m - \$14.7m = \$1117.4m$). Then convert to 2016/17 dollars using actual CPI from 2012/13 to June 2017 (escalator 1.0425) to give \$1164.9m.
- Apply the productivity adjustment of negative \$83.3m (see RCP2 final decision), add the real price effect of \$29.5m and FX adjustment of negative \$3.5m to give **\$1107.6m**. ($\$1164.9m - \$83.3m + \$29.5m - \$3.5m = \$1107.6m$).

¹ Final base capex and opex allowances for RCP2 – Microsoft Excel Spreadsheet published 29 August 2014 <http://www.comcom.govt.nz/dmsdocument/12334> (see tab 'Summary Revised Escalator')

² Transpower Integrated Transmission Plan schedules pages 3 - 7

³ Using actual commissioned costs for the years 2015/16 and 2016/17 and a CPI inflator to lift 2015/16 to 2016/17 dollars

This \$1107.6m comparator figure derived from the RCP2 allowance is \$22.8m **lower** than our 2017 ITP forecast. A forecast \$22.8m variance against the total allowance is within 2%. In contrast, the artificially high RCP2 allowance figure in the table implies that Transpower will underspend by \$113m, which is likely to be viewed as material by stakeholders.

We consider the size of the error in the numerical analysis may have influenced the policy direction of the Capex IM draft decisions. The materiality of the difference between the RCP2 allowance figure and our 2017 ITP figure may have been considered evidence that Transpower has overstated the allowance, and support the Commission's views on incentive regulation:

*"...provides Transpower with incentives to overstate the opex and capex allowance it needs to recover at the time we set the IPP. If Transpower is successful at getting us to accept overstated costs, then Transpower is able to earn additional profits without improving its efficiency."*⁴

*"As a result of the incentives to overstate costs, scrutiny of Transpower's proposed expenditure is likely to provide benefits to consumers on an ongoing basis..."*⁵

*"...In particular, Transpower could have an incentive to provide an upwardly-biased cost estimate given the known monetary reward from a higher incentive rate."*⁶

We appreciate that a certain level of scrutiny is appropriate, but are concerned that the analysis error above could encourage bias towards further regulatory intervention than is necessary. This concern is heightened by the number of times the words 'overstate' and 'overforecast' are used in the paper.⁷ The risk to investment and operational outcomes (quality) of understating and underforecasting is not mentioned.

Given the significance of the information variance in Table 1 and the potential implications that other stakeholders may draw from this, we consider it sufficiently important that an erratum be published by the Commission with sufficient time for stakeholders before 8 December 2017. The appendix shows a replacement table. We are available to discuss the calculations described in this letter if required.

Transpower business improvement activities have focussed on obtaining efficiencies, more accurate forecasting and overall governance of capital investment to deliver cost effective transmission services to our customers. We are currently on track to deliver within 2% of the RCP2 allowance.

Yours sincerely



Catherine Jones
Regulatory Affairs and Pricing Manager

Cc Nick Russ
Cc Scott Pearse-Smith
Cc Alex Ball

⁴ X17 Transpower capex input methodology review draft decisions, 15 November 2017

⁵ Ibid X18

⁶ Ibid 113

⁷ A total of 18 times

Appendix

Table 1 Overview of capex value for RCP2

	RCP2 allowance in IPP (commissioned value 2016/17 dollars) (million) (\$)	Current forecast from 2017 ITP (commissioned value 2016/17 dollars) (million) (\$)
Base capex allowance	1107.6	1130.4
Grid R&R	803.9	857.9
Grid E&D	99.1	74.6
ICT and business support	204.6	197.9