AUCKLAND CHAMBER OF COMMERCE
Business Vitality

Auckland Chamber of Commerce Submission to Electricity Commission on Transmission Pricing Methodology: issues and proposal

Introduction

1. The Auckland Chamber of Commerce welcomes the opportunity to make a submission on the Electricity Authority's (Authority) consultation paper "Transmission Pricing Methodology: issues and proposal" (TPM Proposal Paper), 19 October 2012.
2. The Chamber's contact person for this submission is: chief executive, Michael Barnett, mbarnett@chamber.co.nz; 0275 631 150.
3. The Auckland Regional Chamber has a corporate membership of more than 6000, including many businesses that expect their views to be forcefully represented in this Submission.
4. The Auckland Chamber is dedicated to the strengthening of the Auckland's status as New Zealand's pre-eminent commercial, industrial and communications region and to assisting the development of the region in creating a desirable environment for its 1.4 million citizens. To this end, the Chamber has sought to establish a partnership relationship with central and local government organisations to help achieve shared delivery of the vision for Auckland.

Electricity Authority TPM Proposal Paper

5. The Electricity Authority (Authority) is reviewing the transmission pricing methodology (TPM), which specifies the method for Transpower New Zealand Limited (Transpower) to recover costs of providing transmission services.
6. The Authority considers that the current TPM can be improved so as to better promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.
7. The Chamber notes that it is generally accepted by participants – generators, major users, retailers - that parts of the current cost allocation process results in some inefficiencies and sub-optimal outcomes for producers and for customers. So change has been expected, particularly in relation to the way in which South island generators (principally Meridian) are required to contribute to the costs of the HVDC (Cook Strait cable) part of the grid.
8. The Authority's industry working group in 2011 produced a majority supported proposal to implement a staged transition over time to address the HVDC issue. However, the Chamber notes that the Authority's proposals go far beyond the scope of that group's recommendations with a fundamental reform of the existing TPM managed by Transpower.
9. Briefly, the current TPM allocates Transpower's annual maximum allowable revenue each year to customers through three charges:
   - A connection charge – to recover costs of connecting customers to the grid;
   - A high voltage direct current (HVDC) charge – to recover the cost of the link between the North and South Island (Cook Strait cable);
   - An interconnection charge – to recover the remaining costs of the grid not covered under connection or HVDC charges.

10. However, the Authority's proposal states that it aims to shift pricing allocation to a principle of 'the party that benefits should pay' involving reform of the current Transpower charging system and requiring:

- A shift to variable monthly pricing from the current stable fixed annual approach
- Updating of Transpower's systems and also those of its customers that support the current TPM to reflect the proposed changes
- A change of the market-led system rules relating to the classification and valuation of assets and introducing a customer disputes process, including
- A reallocation of charges for transmission assets built since 2004 – i.e. back dating by what is in effect a retrospective regulatory intervention.

Chamber's high level interests ......

11. Continuous, cheap, and reliable electricity is of foremost economic importance and, of course, a fundamental platform for running a successful business.

12. The Chamber has reviewed the Authority's proposed TPM reform against a number of basic business-like outcomes and expectations: How it improves the current TPM in terms of:

- Impacts on customers, especially in terms of prices and regulatory, as well as technical/ operational changes that may be required – will the new system bring benefits or costs?
- Simple and transparent – is it easier to understand? Does it strengthen the maintenance of a continuous, affordable and reliable electricity infrastructure network?
- Robust and well-tested – is the proposed TPM based on world-best practice

.... and concerns

13. The Chamber review of the Authority's TPM proposal revealed major omissions in areas of risk that have been examined, leading to a strong recommendation (below) that the Authority undertake a more thorough and robust (and professional) assessment of the long-term impact of the proposals on consumers.

14. While our review was undertaken from the perspective of assessing the potential impacts – benefits and costs – on businesses, it draws on reports of more technical assessments for confirmation or otherwise of our conclusions. Our core concerns:

- The initial TPM Proposal Paper did not assess whether consumers will be better or worse off under its proposals – i.e. no clear benefits to consumers are demonstrated, while technical assessments suggest a flawed approach could result in increased inefficiency and higher costs. Also, a subsequent assessment of pricing impacts undertaken had a number important omissions (discussed below).
- The high level of complexity proposed, reinforces the potential for increased inefficiency, and possibly resulting in, according to at least one assessment of the proposal,[1] imposing a net cost on the market, if it is introduced
- Implications of back-dating the proposal to 2004, including scope for increased disputes and changed price setting 'surprises'.
- The proposed start up date in April 2015 without transition, or assessment of the technical requirements that will need to be made by the market (generators, major users, retailers) for what is clearly a complex and globally untested TPM.

[1] Australian-based Competition Economists Group (CEG) Asia "TPM – Economic Critique" undertaken for Transpower, February, 2013.

- The resulting uncertainty that will be priced into the market, with potential to impact wholesale and retail prices, and the flow on impacts this will have to affect businesses, investors (including offshore) and including, we submit, unintended consequences to economic policy initiatives.

15. We briefly expand on these concerns in the paragraphs below:

No robust assessment of impacts on consumers

16. The Chamber notes that it is not possible to confirm whether introduction of a pricing methodology proposal is to the long-term benefit of consumers without an assessment of the impact (including pricing) of the proposals on consumers. As noted above, the Authority's TPM Proposal Paper did not undertake this, instead limiting its assessment narrowly to efficiency impacts (which may or may not be passed on to consumers). We are greatly concerned at this basic omission.

17. We note that the Authority subsequently prepared a partial assessment of pricing impacts, but we consider that this provides little useful guidance on the potential impacts of the proposal. Amongst other things, the Authority's assessment avoided making judgements on critical matters such as the extent of pass-through of any generator transmission cost change (if South Island generators no longer have to incur full HVDC costs), to all generators. Further, the impact of other potential behaviour changes was not assessed; e.g. if generators review their pricing how will this impact wholesale market pricing and so on.

18. The Cost Benefit Analysis (CBA) appears to be based on an assumption that the proposal would be beneficial, rather than provide a robust quantified assessment of its expected impact. While we acknowledge that assessing dynamic efficiency is difficult it is not an acceptable substitute to undertake a CBA that is entirely divorced from the proposal. Accordingly, the Chamber does not believe the CBA provided can be safely relied on as support for the proposal. We note others have formed a similar view.

19. This failure to demonstrate how customers will be better off under the Authority's proposals immediately generates uncertainty and doubt into the value of proceeding further with the proposal without such basic information. Will consumers be better off under the Authority's proposals, or worse off? What level of price redistribution will be required, e.g. to Auckland customers? Will there be offsetting benefits in terms of service quality?

20. In fact, our review suggests cost increases without any clear evidence of offsetting benefits of improved service quality, maintenance and investment appear inevitable. This is because of the substantial cost to establish the proposed new system coupled with the compliance costs associated with requiring what is now an annual price setting exercise to be completed monthly.

21. As well as no robust analysis by the Authority to demonstrate the impacts on customers, there appears to have been no comparison or modelling undertaken of pricing between the current methodology and the proposed new one.

22. Accordingly, we **strongly recommend** that the Authority undertake a comprehensive business case assessment to:

    - Demonstrate more robustly the impact of its TPM proposal on customers, including to what extent would lower HVDC charges to South Island generators result in lower wholesale electricity prices (if at all)?

    - Compare the impact on pricing between the current methodology managed by Transpower and the proposed new one, including establishment and ongoing operational costs.

Increased risk and complexity

23. A Pricewaterhouse Coopers (PWC) impact assessment[2] of the Authority's proposed change concludes that there will be significant impacts on Transpower's systems, processes and on Transpower's customers.

24. In particular, PWC estimate the Authority's proposal will increase complexity in a number of key areas, and require considerable and expensive redesign of Transpower's systems, including transforming what is currently an annual process to be completed monthly – this will require automation of systems, processes and customer data collection.

25. The cost estimates to establish the new system and implementation timeframes of up to 18 months, as well as the level of uncertainty surrounding the operational efficiency of the changes required as indicated by PWC assessment reinforce the Chamber's concerns and recommendation raised above and suggest the Authority should seriously reconsider the wisdom of rushing its introduction in April 2015, as proposed.

Back-dating to 2004

26. The Authority's proposal to backdate the TPM to reallocate the sunk costs from the approximate $2 billion of investments made since 2004 is likely to, if implemented, result in huge wealth transfers. This in turn has potential to create enormous uncertainty as to how these costs might fall and seek to be recovered from, for example, consumers in Auckland with no benefits indicated that there will be improved service delivery.

27. Indeed, we note that the Authority's cited international precedent supporting the re-pricing of past investments is disputed in the CEG critique (see paragraph 29, p.8), who conclude that 'in fact, the US Court of Appeal judgment cautions against doing so," and add: "More generally, we are not aware of any transmission pricing arrangements that resemble what has been proposed."

28. We further note there is no analysis offered as to why backdating to 2004 has been recommended; 2004 seems to be a randomly selected date.

29. Also, as noted above, the Authority's failure to consider the pricing impacts means that the potential impact of wealth transfers between suppliers and consumers resulting from back-dating has not been analysed.

30. Further, there is already uncertainty apparent in the industry as to how the many inevitable technical and modelling issues of what is regarded as a fundamental, complex change with many unknowns will be resolved by the April 2015 start up date. We note that the majority view of the Transmission Pricing Advisory Group process that concluded in 2011 was that the cost associated with the HVDC should be transitioned over a 10-year lead-in period so that wealth transfer impacts were reduced and the market could dynamically reset incrementally over that time frame.

31. Accordingly, the Chamber **recommends** the Authority abandon back-dating; or, noting the CEG view on back-dating above, a more principled approach is that any changes to the extent they are needed in response to a robust CBA should be implement prospectively rather than retrospectively. This would be more transparent and fairer to all.

Other risk issues generating uncertainty

32. The Chamber urges the Authority to undertake a comprehensive risk assessment that takes into account the assessment by CEG that its TPM proposal is likely to amplify risk throughout the supply chain in a manner that is impossible to hedge against (CEG, paragraph 30, p.9).

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[2] "Transmission Pricing Methodology – Impact Assessment: Understanding the impact on Transpower's systems and processes," Pricewaterhouse Coopers, December 2012.

33. CEG suggest that the reduced certainty surrounding cash-flows is likely to manifest in generators and retailers incorporating additional risk premiums in their prices, regardless of whether they also engage in bidding to avoid sunk costs and/or other behaviours associated with their expectations about the exact amount of additional transmission costs they will face through the application of the 'beneficiaries pay' principle and practice the Authority want to establish.

34. For all the reasons set out above, if these critiques are valid – and we have every confidence that they are - it is very likely that uncertainty will be priced into the market, affecting not only active participants, but also potential participants such as overseas investors and businesses looking to establish here.

35. The Chamber strongly submits that such an outcome would be counterproductive, not just to business but New Zealand Inc.

Concluding comments and overall recommendation

36. Auckland in particular, as well New Zealand, needs a regulatory and pricing framework for electricity that:

- Provides certainty, simplicity and transparency;
- Is robust; and,
- Encourages investment in our infrastructure; which in Auckland is for a population growing at twice the rate of the rest of New Zealand.

37. Our core concern is that we do not believe the Authority has demonstrated the proposal will deliver the above outcomes to the long-term benefit of consumers. Instead, we are deeply concerned that the opposite impacts may be established in the market in respect of electricity – uncertainty, higher costs, more disputes, increased inefficiency – and to the general loss of credibility of New Zealand's brand as a positive and progressive nation to invest and do business.

38. As our submission demonstrates, given the substantive and radical overhaul of transmission pricing the Authority is proposing there is considerable scope for redefining the winners and losers from the TPM. This could be made all the more stark given that the pricing changes would be immediate (1 April 2015 with no phase in period). There is a real possibility of major overnight price changes.

39. Accordingly, the Auckland Chamber does not support the Authority's proposed transmission pricing methodology (TPM). We have substantive concerns about the proposed variable monthly pricing method, which we believe could create substantial and unnecessary risk and uncertainty across all stakeholder groups. We also have substantial concerns about requiring consumers to contribute to the historical cost of generators exporting electricity from one Island to the other through the HVDC link. We consider that the distortionary impact and disputes this would create would far outweigh any practical benefits.

40. Overall, the Chamber questions whether further review of the TPM is required or desirable. We endorse the Authority's view on the importance of a stable and regulatory environment but suggest the ongoing review of the TPM in its current configuration could end up providing the exact opposite – an unstable, uncertain and inefficient environment.

41. If the Authority continues with its review of the TPM, however, the Chamber **recommends** the Authority prepare a further consultation paper which addresses the issues we detail above (and those of other submitters). A consideration is to perhaps prepare a discussion paper around a narrower problem definition such as to just resolve the historical inefficiencies with the HVDC.

42. The Chamber's submission is made in the positive spirit of maintaining the challenge of continuous improvement to Auckland's governance to support and encourage business-friendly innovation and growth.

43. The Auckland Chamber looks forward to continuing to work with the Authority to achieve our shared objective to enable and support a stable, fair and durable electricity market.

Michael Barnett
Chief Executive

27 February 2013