15 November 2013

Ralph Matthes
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Sent by email to ralph@meug.co.nz

Dear Ralph

EA Consultation – TPM SUNK COST paper

As requested we have looked at this consultation paper from the Authority and would make the following comments.

1. In the same way as the CBA paper, overall this paper is not controversial and describes the Authority's views on sunk costs using an economic lens. The paper has a particular focus on the various views regarding sunk costs that were aired in submissions to the October 2012 TPM consultation paper. Unlike the CBA paper which was pitched at a high level, this paper takes a reasonably detailed view of sunk costs.
2. The paper very accurately describes the differences between the relevance of sunk costs in production versus pricing decisions, which was one of the sources of confusion in some submissions. The paper also identifies the importance of the nature of the costs of long lived assets – that is, the difference between whether they are sunk or fixed. The third key theme is the importance of the Price-Quality regulation that applies to Transpower when thinking about recovery of Transpowers' costs.
3. The sunk cost paper accords with our (NZIER and MEUG) past observations that, from a pricing view point, transmissions costs are not sunk to consumers and that variable charges can be more efficient than flat tax type charges.
4. There are a number of important messages for consumers in this paper, though the nature of any potential impact will remain unclear until we have visibility around how the Authority will bring its views on sunk costs, and other aspects of its TPM consultation, into the yet-to-be-released final TPM proposal.
5. The first message is that under the Input Methodologies, Transpower can be compensated for halting a project a project that is no longer viable – that is, the costs are sunk in principle because demand is no longer there. Transpower can make investment decisions through to the point of commissioning an asset, after which time the cost to consumers is locked in and demand risks are transferred to consumers.
6. The second message is that the Authority has clearly set out their view that infra-marginal costs are not sunk and they make very clear that all users of the transmission grid should not expect to avoid transmission charges based on a sunk cost argument. With this matter settled, the infra-marginal capacity costs are thereafter subject to a recovery using an "efficient" pricing mechanism (beneficiary pays and residual in the October 2012 paper). We have previously commented regarding the difficulties of identifying beneficiaries and the issues associated with a "residual" charge.

7. A third important message is that regulation enshrines Transpower's right to recover "approved costs" through its MAR setting process which creates a property right to a long lived revenue stream from assets, which can be sold by the Crown. This fact makes the debate around the definition of whether the "approved costs" are fixed or sunk somewhat irrelevant, but should turn the focus of attention onto identifying the most efficient mechanism for cost recovery. This is where the Authority is coming from with the TPM.

8. We need to place on record again past comments to you regarding these subject matter papers and the TPM. As you know the Authority appears to be attending to material matters of principle ahead of releasing the (final?) TPM proposal, with the aim of separating issues of principle from issues of application. We remain concerned that without an appropriately defined and agreed problem definition that is assessed through a fit-for-purpose cost-benefit analysis, the disagreements about the efficiency of the proposed TPM and the potential for unintended outcomes will remain, regardless of the clarity that is gained around these principles.

Yours sincerely

David de Boer