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Submissions
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SUBMISSION ON TPM WORKING PAPER – SUNK COSTS

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to comment on the "Transmission pricing methodology: Sunk costs" working paper (the **paper**) released by the Electricity Authority (Authority) in October 2013.

Introduction

2 The paper indicates that the Authority will release a new issues and proposals document in the future, and we will reserve our position on that until we have the full picture. In addition a number of other working papers are in preparation by the Authority. As such, our submission on this current paper is quite brief.

3 The Electricity Network Association (ENA) has also prepared a submission on the paper. Orion endorses the ENA submission.

Comments

4 We are of the view that the paper fundamentally misses the point that we believe most submitters have been making, which is simply that, once built, long-lived transmission assets have very little value in any alternative use. The costs are, largely, sunk.[1] This is why the new investment decision-making process is so central to efficient investment in the transmission system, and why it is important that this process be changed if in fact poor decisions have been and are being

[1] The paper (for example at para 9.2, page 18) implies that an important element in the definition of sunk costs is that there be "…no demand for the asset in its **current** use." (Emphasis added.) This strikes us as a step beyond the borders of sunk cost. Surely it is the value (via demand) for the asset in the **next** best use that is important for deciding if it is a sunk cost?

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made.[2] This implication of the "beneficiaries-pay" analysis in the TPM proposal, is one we believe the Authority should take a very clear position on.

5 On the other hand, if major transmission investments are not sunk (meaning the assets could be redeployed at low-cost to a use of broadly equal value) there would be no need to be so concerned about past, or future, poor decisions, or decisions to invest that turned out in hindsight to be unnecessary. But by extension if transmission investments are not sunk costs, the dynamic efficiency benefits from improving decisions about them would be much reduced. We do not think this is the position that the paper is trying to support.

6 Regarding static efficiency, this common sense definition of sunk costs is why so many submitters were concerned about any price signals that change the way the existing grid is used, and in particular the pattern of generation. Generation is currently despatched according to what is lowest cost allowing for transmission losses and constraints - the SRMC of transmission. If an alternative approach changes the despatch, by changing generator offers as they seek to recover additional transmission costs at the margin, then by definition that alternative cannot be a lower cost despatch, and it is likely to be higher: an unambiguous economic efficiency loss.

7 In this respect, the distinction in the paper between production decisions and pricing decisions in the context of sunk (or fixed) costs is, in our view, unhelpful. Were New Zealand to have a single agency responsible for provision of generation and transmission, that agency would, for efficiency, dispatch as if the transmission system was sunk, taking into account only the effects of marginal losses and constraints. Separating out the generation and transmission into two agencies, and therefore introducing the need for the parties to agree pricing for services, should not change the efficient production decision. Yet the paper seems to argue that it could, and should.

8 The Executive Summary of the paper, (para 1.14) concludes that: "if changing the [TPM] … promotes overall efficiency…the Authority may change [it] irrespective of the existence of sunk costs." We do not think anyone would disagree with this. But submitters have not, in our view, argued that sunk costs count against changing the TPM *per se*, they argue that sunk costs change the nature and magnitude of the efficiency gains, and in particular the dynamic efficiency gains, available from alternative TPMs, which is a very different point.

9 In the end, we cannot find a clear statement in the paper about whether or not most transmission investment is in fact sunk, and whether or not it is, what if any difference this makes to the case for the proposed TPM. However, we can find an argument that appears to us to be unhelpful, at least to what we take to be

[2] Which is not Orion's position, but what we perceive to be the Authority's position.

the paper's position. This is that Transpower's regulatory environment "…would seem to ensure that expenditure by Transpower on long-lived assets take the economic characteristics of fixed costs rather than sunk costs." (Page 18). We submit that:

- "would seem" is rather equivocal: does it or doesn't it?,
- the regulatory environment does not change the "**economic** characteristics*"* of the investments at all; whether any party has the ability to charge for a sunk cost investment does not change whether it was a good idea for NZ Inc. to make it, and
- arguing that the regulatory environment can make sunk costs into fixed costs from Transpower's financial perspective acknowledges, if accidentally, that fundamentally, and economically, there is indeed a difference between fixed costs and sunk costs, and that transmission costs are indeed sunk costs.

10 On the other hand, the paper's description of Transpower's regulatory arrangements helps explain why changes to the TPM will not, of themselves, deliver any improvement in investment decision-making and therefore dynamic efficiency, since the incentives on regulator and regulated will not change just because the TPM changes. Once again we urge the Authority to take what it clearly considers to be a superior method of assessing transmission investments over to the Commerce Commission with a view to persuading the Commission to change the capital expenditure input methodology that applies to consideration of major new transmission investment proposals.

11 One aspect of the paper that appears to introduce new material is the discussion of 'infra-marginal' decisions. However, we are unsure what the relevance of this material is, partly because it conflates concepts of 'cost', 'price' and 'decision' in ways that we do not understand.

12 One interpretation is that there are a number of ways to recover costs via prices, and prices do not *necessarily* need to reflect marginal costs for efficiency.[3] But the question is, will the alternative pricing arrangement be more efficient than the status quo? We think it is reasonable to presume that the current TPM is reasonably efficient and that the burden of proof, or at least the responsibility to clearly set out the line of argument, lies with the proponents of alternatives.

13 Para 9.5 of the paper seems to imply riding the aggregate demand curve down and pricing each unit at just below the willingness to pay, but above marginal

[3] Indeed we would say that, absent significant practicality considerations, the economic orthodoxy implies having a combination of SRMC and "Ramsey" pricing, which has its objective minimising distortions in use of the sunk (or fixed) cost assets.

cost, until we get to the last unit priced at marginal cost (incidentally capturing all of the consumer surplus – where does it go to?). In principle that would lead to the same economic outcome as the same amount would be consumed and produced: as efficient but with a different distribution of wealth. However, even if such an approach was technically possible, we cannot see that the proposed TPM includes any process for such price differentiation. Rather, if the price diverges from the marginal cost it will do so at all levels of demand, with attendant adverse efficiency effects, or, at best, no gains.

14 Para 9.6 then counters a point that we don't think has been made, namely that advocates of marginal cost pricing do not think it appropriate for providers to recover the "full economic cost of the service." Once again, cost and price are conflated. We think all submitters agree that the full cost will be recovered (some might not be so sure that it *should be*), if only because Transpower's regulatory regime says it will be.

15 With a view to helping out: no matter what the TPM is, various parties will be making these "infra-marginal" decisions. They will have made them in the past, and they will be making them in the future. The question we need to answer is, how would an alternative TPM *improve* those decisions? The paper is silent on this.

16 Finally we note the discussion of price discrimination (paras 7.7 to 7.10, pages 13 and 14). In our view the discussion is unhelpful. The price discrimination described requires the ability to identify the different types of customer preference, price accordingly and then limit trading amongst customers post-sale. We do not see how this relates to the proposed TPM, and no examples have been provided in the paper of how this might be applied to it in a helpful way. To be more specific, we see nothing in the new TPM (as proposed in October 2012) which implies that different users will end up paying different amounts for the transmission of the same unit over the same assets at the same time.

Concluding remarks

17 Thank you for the opportunity to make this submission. Orion does not consider that any part of this submission is confidential. If you have any questions please contact Bruce Rogers (Pricing Manager), DDI 03 363 9870, email bruce.rogers@oriongroup.co.nz.

Yours sincerely

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