25 March 2014

John Rampton
Electricity Authority
PO Box 10041
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Dear John

Re: Beneficiaries-pay working paper – submission of Contact Energy

Thank you for the opportunity to comment on the Beneficiaries-pay working paper (**working paper**).

1. General comments

Contact is concerned that the approach taken by the Authority to the development of a new Transmission Pricing Methodology (**TPM**) is undermining confidence in the TPM process and exposing the industry to unnecessary costs and uncertainty. Contact's principal concerns are that the:

(i) Authority has failed to address Contact's and other submitter's concerns that the Authority has satisfied its' regulatory threshold before it can review the TPM Guidelines:[1] that there has been a material change of circumstances;

(ii) Authority appears captured by the attraction of using SPD to identify beneficiaries in a Beneficiaries-pay model and has failed to consider alternative options. Even with the simplifications and variations outlined in the working paper, use of the SPD method has significant drawbacks. The Authority's failure to adequately explore alternatives is surprising given the widely stated criticism of using SPD;

(iii) complexity of the proposal and interaction with the market is likely to adversely impact on retail customers' electricity bills. Given the current impetus to disaggregate bills we urge the Authority to consider this issue;

(iv) process to date has lacked transparency and the flow of information, working papers aside, has been one-way. This has resulted in submitters such as Contact being asked to respond to working papers in isolation and without any clarity from the Authority as to how responses to date have been interpreted;

(v) response by Contact to the working paper would have been better informed if Contact had had the benefit of reviewing the residual working paper[2]. Given

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[1] Rule 12.86 'Review by the Authority' Part 12 -Transport of the Electricity Industry Participation Code 2010.

[2] We note that the Authority refused Contact's request for an extension to the deadline for submissions on the Beneficiaries-pay working paper. Contact requested this extension once it

the close link between the application of a Beneficiaries-pay approach and the splitting of the residual charge our comments in this response must be considered qualified by any submission we make on the residual working paper.

Submitters on the working paper are being asked to evaluate options in terms of dynamic efficiency without a valuation framework that has transparency or industry buy-in. In the working paper observations such as ‘demand may disconnect if prices rise’ are made, but without a unified way of balancing these observations submitters are left to comment on details of a proposal without an clear idea whether it is improving or worsening the proposal in totality. It is not clear how the Authority is coming up with, or ruling out, options when there is no obvious lens through which each option is viewed. More rigour and evidence needs to be provided against the unsubstantiated assertions/observations in the working paper.

Finally we note that since the Authority released its first TPM consultation paper in October 2012 there have been some significant changes in the New Zealand market. This includes an increased focus on the retail market, the potential exit of some or all of the load used by the Tiwai Aluminium Smelter in 2017, and the successful establishment of the Financial Transmission Rights market. The electricity market has not remained static and neither should the Authority. In Contact’s view the Authority must reflect on the changes that have occurred in the market since the release of the first consultation paper and take these changes into account when determining whether to proceed with changes to the TPM and the scale of such change.

2. *Contact is unconvinced that the Authority’s Beneficiaries-pay options will deliver the required efficiency gains*

While Contact understands the allure of a Beneficiaries-pay model, having spent 18 months considering its ramifications we believe it is impractical for New Zealand’s electricity industry. A Beneficiaries-pay approach may go some way to addressing the perceived fairness of the transmission system’s cost allocation, sufficient issues have been identified, including the theory behind it, its implementation and its interaction with the wider market that a pause is needed before the Authority carries on with further fine tuning of various SPD based Beneficiaries-pay approaches.

More thought must be given to the incentives created by a Beneficiaries-pay approach. In addition to inevitable changes to generator offer behaviour and the interaction with nodal pricing, there are general credibility issues with prices created through an SPD based approach. So far these issues have had little debate, with the

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was revealed that the residual working paper would no longer be available during the Beneficiaries-pay working paper consultation period.

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Authority proposing more variations of SPD based methods without addressing the growing body of opposition towards each iteration.

The Authority's seemingly unwavering adherence to using SPD is needlessly reducing options and in Contact's view lends itself to challenge. With this Beneficiaries-pay paper we expected to see a suite of Beneficiaries-pay options, not limited to application of SPD. The absence of those alternatives dilutes the value of this consultation.

Contact also believes that SPD based charges (even simplified as proposed in the working paper) are just too complex. Despite the Authority signalling that it believes greater participation in grid investment will lead to greater efficiency, Contact is sceptical. Not only has the consultation process to date showed a lack of interest from identified affected parties such as Northland consumers, but in our view if the methodology can only be understood by a few well-resourced companies it is hard to see this expected increase in participation eventuating.

3. *There are significant credibility issues due to its complexity and interaction with offer behaviour*

The Authority's Statutory Objective notes "dynamic efficiency benefits occur when competition encourages efficient investment in capital goods and innovation, and when it ***provides consumers with confidence that price movements reflect underlying demand and supply movements***". [3] Contact sees a significant risk to confidence in prices, be it nodal pricing, forward price expectations or retail tariffs under the proposed SPD methodology.

This stems from both the complexity of the SPD methodology (even when simplified) and the new incentives the SPD approach will create. The SPD method effectively creates a spot price for transmission that generators must transact at. Generators will need to factor this into their offer strategy, creating a distortion from the current process. How offer behaviour will change has not been explored in any detail during the consultation and Contact is particularly concerned that pricing confidence may be eroded.

Take the following example of a hypothetical generator seeking to avoid SPD charges:

Generators in an exporting region increase infra-marginal offers to minimise their modelled benefits. Generators in importing regions raise their un-cleared offers in an attempt to post higher prices, and cause load to incur higher modelled benefits, in the hypothetical scenario where a key transmission circuit is removed. Two likely impacts would be:

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[3] Interpretation of the Authority's statutory objective. Appendix A, A.23 (b)

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- Higher average prices: For any half-hour period, an unanticipated reduction in demand would now cut the supply curve at higher prices than would otherwise be the case
- Higher peak prices: For any half-hour period, an unanticipated increase in demand would call on generators now at higher offer prices than would otherwise be the case.

The effect of this distortion, which seems largely unavoidable since the key aspect of SPD based methods is the use of actual market offers, is that at times of high demand, or when the grid is close to capacity, there could be significant increases to the spot price as a direct result of the new incentives the Beneficiaries-pay method has introduced.

These prices would almost certainly find their way into forward price expectations and retail tariffs. This can only increase the already ambiguous impact of transmission costs on a customer's bill at a time when retailers are seeking to make related distribution costs more simple and transparent. The Authority proposes to design a TPM which is likely to distort generator offers. This is hard to defend and could undermine the confidence in the prices.[4]

As discussed in previous submissions on the TPM proposal Contact has already observed issues with a generator based charge on offers through the South Island HAMI charge. The effect of this charge has led to Contact's South Island plants running below capacity (resulting in higher priced generation being dispatched), underutilisation of transmission capacity and a skewing of generation investment into the North Island. In Contact's view under the options proposed there is every likelihood this perverse outcome is likely to be repeated.

4. ***Will the proposed TPM make a difference to new investments?***

The Authority states that amendments to the TPM should facilitate "efficient investment in the electricity industry by providing incentives so the right investments occur at the right time, and in the right place". If it were the case that generators were building generation in the middle of nowhere, directly causing the inefficient building of transmission capacity that they could ultimately avoid, then there may be an argument for some generators to bear some of the grid costs, but we don't see this. Of the last four major transmission investments:

- two were built on the grounds of an increase in benefits to New Zealand: Pole 3 and the Wairakei Ring
- two were built on the grounds of security: NAaN and NIGU

Together these projects represent c$210m of the $310m recoverable under the SPD method and yet were approved on the basis of either security for a particular region or benefit to the entire New Zealand electricity system.

[4] While some of the volatility can be addressed through longer charging periods, it does not change the quantum of the charges and so is unlikely to change half-hourly behavior.

From these facts it is difficult to conclude how the proposed efficiency gains to generation or transmission investment will be realised. It is more likely that efficiency will decrease since economies of scale associated with transmission investment inevitably lead to transmission being underutilised for some time once built. However an additional disincentive is created under the SPD method for new generation to build and utilise this spare capacity since it will incur costs associated with this transmission which is already in place.

From a retail customer perspective, if greater efficiency comes from greater participation or even greater awareness of the costs of providing transmission then a prerequisite is that customers understand the process. As discussed earlier Contact believes the SPD method is too complex for the majority of customers to understand and participate in and is better suited to large well resourced companies to participate in.

5. Incremental changes are OK

Contact believes the better approach to a change in the TPM is to make incremental changes to the current TPM. Contact has consistently argued for changing the allocation of costs of the HVDC (subject to a robust CBA so that the change is enduring) from South Island generators to load in order to reduce the historic inefficiencies with the HVDC charging methodology and alleviate the known inefficiencies in the current HAMI based charging method. This option should be included in any proposal that looks at changing from the status quo. With no clear problem definition, or CBA, it is difficult to simply rule this option out since it avoids many of the pitfalls associated with the proposed Beneficiaries-pay approach.

Other benefits associated with incremental changes are that:

- It is stable and simple: All participants, as opposed to ones with specific knowledge or resources, are able to make informed choices. A known, simple system will allow more participation in the investment process than more complex alternatives.
- It will minimise distortions: Generator offer prices remain unchanged, no chance of behavioural change or risk being priced into the forward curve, tariffs or spot price.
- It is more transparent: Transmission components need to be able to be explained to the customer for the long-term credibility of the regime. Under Beneficiaries-pay there is too much scope to charge arbitrarily. For example one retailer could adjust tariffs more regularly than a competitor as their view on estimated SPD costs change. Another retailer could wait and smooth out these charges. Both could correctly state on the bill that a change in tariffs is due to changes in transmission costs, but this is not a recipe for an enduring TPM.

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6. *Feedback on the specifics of the working paper*

Notwithstanding the issues raised above, below we provide comments on the proposals in the working paper. This comment should not be construed as full or partial support for the Authority to continue to pursue a Beneficiaries-pay model using SPD method without considering alternatives.

Of the options presented in the working paper the simplified SPD charge appears the most aligned with what we perceive the Authority is seeking to achieve with change to the current TPM. Our rationale for this conclusion is that:

- SPD generation charges look as though they will be small or largely avoidable through a change to generation offer strategy. The issue for any SPD method then reduces to differences in the treatment of cost recovery of the NaaN and the NIGU.
- With the proposed SPD+GIT and GIT+SPD methodology the difficulty comes from the large allocation of costs to a particular region, in this case the Upper North Island, and the incentives that it will create. An example of what can happen with a large allocation of costs to a region is the allocation of HVDC costs to South Island generators, which curiously is one of the reasons why the current TPM is seen as unstable and being re-thought at present. The South Island HAMI experience, as well as issues highlighted in the Authority's ACOT paper, (inefficient embedding of generation) are likely to repeat under these options.
- The NIGU investment, despite being approved on the grounds of security, has arguably facilitated the liquidity of the ASX market and increased retail competition. These outcomes has benefited New Zealand as a whole but their benefits are not valued in the proposed SPD+GIT and GIT+SPD methodology.

We wish to reiterate the point we made in Contact's submission on the ACOT paper that in designing the TPM embedded generation should be treated no differently from other generators. In Contact's view the embedded generator question is simple: a generator is a generator. SPD charges for a generation scheme greater than 10MW should be calculated on the amount exported from the scheme to the network it connects to. Efficiency issues, assuming there to be any, should be dealt with through an alternative mechanism rather than ad hoc patches.

Contact has no doubt that a simpler solution to the TPM, i.e. one that achieves the efficiency objectives of the Authority but reduces inefficiencies from both anticipated and unintended consequences, could be implemented.

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We would be happy to discuss any of the points raised in this submission with the Authority.

Yours sincerely

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