From the Electricity Networks Association

Submission on Transmission Pricing Methodology: Connection Charges

24 June 2014

The Electricity Networks Association makes this submission along with the explicit support of its members listed below.

Alpine Energy Ltd
Aurora Energy Ltd
Buller Electricity Ltd
Centralines Ltd
Counties Power Ltd
Eastland Network Ltd
Electra Ltd
Electricity Ashburton Ltd
Electricity Invercargill Ltd
Horizon Energy Distribution Ltd
Mainpower NZ Ltd
Marlborough Lines Ltd
Nelson Electricity Ltd
Network Tasman Ltd
Network Waitaki Ltd
Northpower Ltd
Orion New Zealand Ltd
OtagoNet Joint Venture
Powerco Ltd
Scanpower Ltd
The Lines Company Ltd
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Top Energy Ltd
Unison Networks Ltd
Vector Ltd
Waipa Networks Ltd
WEL Networks Ltd
Wellington Electricity Lines Ltd
Westpower Ltd

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1. Introduction

1. The Electricity Networks Association (ENA) appreciates the opportunity to make a submission on the Electricity Authority's (Authority's) working paper "Transmission Pricing Methodology: Connection Charges" (Connection Charges paper).

2. The ENA represents the 29 electricity network businesses (ENBs) in New Zealand.

1.1 Summary

3. The Authority has released the Connection Charges paper in response to submissions it received on its Transmission Pricing Methodology (TPM) issues paper.[1] The Authority states that it prepared the Connection Charges paper to "better understand whether there are efficiency problems with the existing transmission connection charges".

4. There are three issues covered in the Connection Charges paper:

   (a) Whether connection assets are inefficiently classified as interconnection assets either because parties connect in a transmission loop to minimise their charges, or during staged commissioning processes.

   (b) Whether the pooling of connection charges, or use of averaged depreciation in the charges is efficient.

   (c) Whether the allocation of operating costs to the pool is efficient.

5. The Authority has not shown that there are efficiency problems with the existing connection charges in reality and it is the ENA's view that there are no material problems with the structure of these charges.

6. We provide more detailed comment on these three issues in the body of our submission.

7. The ENA's contact person for this submission is:

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1 Electricity Authority, *Transmission Pricing Methodology: issues and proposal*, 10 October 2012.

2. Comments

8. The ENA considers that the Connection Charges paper was released prematurely. While we respect that consultation processes can be used to improve the Authority's understanding of an issue, the consultation paper does not identify that there are demonstrable, material efficiency problems with the current model. We would expect that the Authority would seek to validate in some way whether theoretical concerns are manifesting in reality before issuing such a consultation paper. In addition, we are concerned that the Authority has not given sufficient consideration to the complexity and cost of the changes proposed.

9. The cost benefit assessment that the Authority has provided lacks rigour and is based on subjective opinion.

10. The ENA remains very concerned that the Authority continues to approach the TPM in a piecemeal fashion. The Authority has stated that it believes that the proposed changes to the connection charge should be considered in the context of the current TPM (para 6.24). The ENA strongly submits that this will not result in the best outcome. Even if the Authority decides to treat its decisions about connection charges as discrete from decisions about the interconnection charge, the Authority should recognise that any decision that it makes about changes to the interconnection charge may have a material bearing on the best choice of connection charge structure.

11. For example, if the Authority continues to believe, despite submissions, that there is a real and material inefficient incentive to connect in a transmission loop, then it must consider whether proposed changes to the interconnection charge are sufficient to eliminate this inefficiency.

12. ENA's overarching view is that the theoretical concerns raised by the Authority are not evident in practice, that the current connection charging regime is relatively efficient and effective, and that the Authority's alternative proposals would not result in material improvements in achieving any of the Authority's key objectives and, more likely would result in net costs to consumers.

2.1 Inefficient classification as interconnection assets

2.1.1 Connecting in a loop

13. In the 2012 Issues Paper, the Authority raised the possibility of parties having the incentive to connect in such a way that connection assets are classified as interconnection assets. The Authority raises this point again in the current paper. While the ENA accepts that this outcome is possible, in all the cases that the Authority has given in both papers either the assets were never built (so we cannot know what the outcome would have been), or the parties have recognised that this shift is unintended and negotiated a contract that reinstates the connection charges.

14. Even if a real example is identified it would be necessary to determine whether the actual connection was the most efficient connection decision or whether it was taken only in response to pricing incentives.

15. It has not been demonstrated that the incentive to connect in a manner that avoids connection charges exists in practice. No instance of inefficient connection in a transmission loop giving rise to reclassification of connection assets has been identified. Where there has been a potential reclassification this has been avoided by the parties through common sense contractual means. Hence there is no loss of efficiency to be remedied.

2.1.2 Staged commissioning

16. The Authority has raised an additional potential inefficiency relating to the classification of assets as connection or interconnection in the Connection Charges paper. This relates to the process of staged commissioning and follows on from the Authority's decision to decline Transpower's application to treat the NAaN interconnection assets consistently through the commissioning process.

17. The scenario that the Authority paints involves bringing forward the construction of a portion of an interconnection asset at the instigation of an ENB in order for that ENB to avoid some other investment in their network. The ENA accepts that it is possible that such a scenario may arise. However, this is likely to be rare.

18. Staged commissioning is a process which may be used by Transpower when parts of a project are physically completed at different times. As Transpower outlined in a letter to the Authority relating to the staged commissioning of the NAaN interconnection assets, commissioning assets when they are ready rather than deferring commissioning until all assets are built has operational, security and market benefits and is of negligible cost to consumers.[2] Staged commissioning is therefore an economically sensible approach to the physical realities of completing an interconnection link. The intermediary stages that may arise due to the nature of the construction process are not driven by and do not give rise to any additional benefit to ENBs through avoiding distribution investments (compared to the completed interconnection asset).

19. The ENA expects that where there is a benefit to an ENB of bringing forward a portion of an interconnection asset by a significant period of time to act as a connection asset this will be identified during the planning phases of the project or at the time the asset is approved by the Commerce Commission. The Commerce Commission process includes consideration of the timing of an investment and the ENA would not expect it to approve an interconnection asset to be built earlier than it would be needed as an interconnection asset.

20. The ENA agrees with the Authority that an ENB should face a charge related to the benefit of bringing forward construction of part of an interconnection asset as a

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2 Transpower letter to Electricity Authority, *NAaN pricing treatment – staged commissioning*, 13 September 2013. Accessed on 9 June 2014 from www.ea.govt.nz/development/work-programme/transmission-distribution/exemption-application-classification-of-naan-assets-under-the-tpm/consultation/#c9262.

substitute for another investment. This could appropriately be dealt with contractually by Transpower and the ENB at the planning stages of a project. Reclassifiying interconnection assets as connection assets during commissioning has no efficiency benefits and is likely to simply result in the elimination of this efficient construction process.

2.2 Connection pool

21. The ENA does not agree with the Authority's assertion that connection asset service levels reduce over time, with assets providing lower service as they age. Maintenance costs may be somewhat higher for an older asset, but assets in the connection pool are required to meet the GRS so the level of service that customers receive from Transpower is relatively constant. There is no real issue about tolerating lower levels of service and the economic value to the consumer of the connection service is generally stable.

22. A constant price for a given level of service is normal in workably competitive markets. The Authority has not provided examples of workably competitive markets where prices exhibit a saw-tooth profile based on the age of plant used to deliver a service, or manufacture a product. As far as we are aware, negotiated connection charges under CICs generally have a flat profile.

23. Kahn's seminal text *The Economics of Regulation* suggests that there are only three sensible ways to recover the gross cost of capital (i.e. including depreciation): a flat charge per unit of time; an equal amount per unit of sales; or in a way that fluctuates with the business cycle. Kahn argues that the second is preferable on the basis that this provides stability for consumers for the long-run investment decisions that are often inherent to users of electricity (and the other options have undesirable features).

24. The dynamic efficiency that the Authority thinks will arise from DRC based charging is illusory. The Authority has provided no evidence, and the ENA is aware of none, that the Commerce Commission is approving inefficient investments. The Authority has noted that Transpower tried the DRC-based charging system that the Authority proposes in the early 1990s and it led to excessive reluctance from customers when assets required replacement. This suggests that DRC-based charging would likely result in inefficiently low levels of investment, or inefficiently costly Commerce Commission approval processes.

25. The Authority has also not considered how any transition from flat-charging to saw-tooth profiles would be managed. For example, connected customers who have paid flat charges to date and are served by assets half-way through their lives, would receive a significant subsidy if there was to be an uncompensated switch to DRC-based charges.

2.3 Allocation of operating costs

26. The Authority has questioned whether it would be more efficient to allocate operating costs to individual assets.

27. The connection pool is a relatively efficient and simple way to price connection services which are part of Transpower's provision of the GRS. As discussed in section 2.1, the

ENA's view is that connection assets are used to deliver a connection service which is of stable economic value to consumers and it is therefore reasonable and efficient to charge a stable price. It is not apparent that there is a marked efficiency benefit to a different allocation of operating costs (including maintenance and overheads), as it is not clear that Transpower's customers generally have the ability to monitor or scrutinise Transpower's maintenance practices.

28. It is also not clear how more precision in cost allocation would affect consumption and investment decisions as for many consumers (other than directly connected customers) the prices are averaged by intermediaries such as ENBs and retailers. This averaging further reduces the potential for any benefit from such pricing, even if it was accepted that benefits were possible.