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Submissions
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Transmission Pricing Methodology Review: TPM Options Working Paper

BusinessNZ is pleased to have the opportunity to provide a submission to the Electricity Authority on its consultation paper entitled 'Transmission Pricing Methodology Review: TPM Options Working Paper' dated 16 June 2015.[1]

Introduction

BusinessNZ welcomes the effort evident in the consultation paper released by the Electricity Authority. It is clear that the Electricity Authority has endeavoured to progress its work on a revised transmission pricing methodology (the 'TPM') in a methodical, thorough and thoughtful manner. In particular, we support the initiative that the Electricity Authority has shown at continuing to refine its options. This has helped to provide clarity, especially around the link to the problems that the Electricity Authority is seeking to address.

BusinessNZ supports, in principle, the base option with application A. However, this does not obviate the high burden of proof being demonstrated as reflected in a clear and certain net benefit to consumers. Any TPM also needs a high level of market participant and consumer support for it. To achieve this, the Electricity Authority needs to continue to be receptive to ideas from submitters that that will improve the proposals in a way that meets its efficiency objectives and enable those who pay (particularly small to medium enterprises ['SMEs']) to have a much better chance of understanding and managing it.

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[1] Background information on BusinessNZ is attached in Appendix One.

Without these fundamentals, regulatory instability and uncertainty will prevail, undermining investor and consumer confidence at the very time that business confidence in the operation of the electricity market seems to have stabilised. We reiterate our previous observation that if the proposals are genuinely to the long-term benefit of consumers then you would expect a high degree of consumer support.[2]

Comments

Given the importance of this issue, BusinessNZ wishes to reiterate for the Electricity Authority its approach to the issue of transmission pricing (the following two paragraphs are from an earlier TPM submission to the Electricity Authority). This approach informs BusinessNZs subsequent comments.

<u>BusinessNZs Approach to Transmission Pricing</u>

For transmission investments, the key economic characteristics that must, in BusinessNZs view dictate the eventual outcome reached are:

- in adopting a competitive wholesale electricity market, New Zealand has abandoned the full co-optimisation of transmission and generation locations;

- instead, relying as much as possible on market-driven transmission investment will—with nodal pricing—promote the best locational choices for new load and new generation;

- market-driven investment in transmission may be possible for some connection assets. Everything else will be centrally planned; and

- where transmission investments are centrally planned, Transpower's transmission pricing is about cost recovery, not about providing locational signals. By the time the investment is approved, it's too late for signals.

Therefore, the goals (or objectives) that the Electricity Authority should be striving to achieve are, in BusinessNZs view:

1. to optimise the locational choices made by new generation or new load where these choices involve new connection assets. Achieve this by:

    a. relying wherever possible on private contracting with directly affected parties for the provision of, and payment for, new connection assets; and

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[2] BusinessNZ submission to the Electricity Authority entitled 'Transmission Pricing Discussion Paper', dated 14 July, 2011, page 2.

b. where not possible, allocate the costs of connection assets as fixed charges amongst the connected parties.[3]

2. the goal for all other costs—for interconnection assets and the HVDC—is to allocate the sunk costs in such a way as to:

   a. recover the cost of the asset in a non-distortionary way, say based on capacities, not generation; and

   b. efficiently trade-off the fairness of cost-sharing rules and any perverse incentives the rules may create.

We are pleased to see that some of these ideas have been captured by the Electricity Authority. For example, we note that the purposed new deeper connection charge is to enhance the prospects of parties negotiating new deeper connection assets directly with Transpower, and that the emphasis on capacity charging is to minimise avoidance behaviour.

Specific Comments

Based on this framework, BusinessNZ has the following comments (in no particular order) on the options paper:

1. *the base option is preferred*: BusinessNZ considers this for two primary reasons, being:

   a. *that it best delivers on the characteristics outlined above, and the goals to be achieved*: in particular, it appears to strike the right balance between what might be considered as more theoretically correct approaches, and the benefits being sought. For example:

      i. a practical difficulty of LRMC pricing for transmission is that forecasts can be uncertain and volatile. The Electricity Authority appears to hold similar concerns; and

      ii. short-run pricing is not the best way to provide signals for long-run investment decisions. Both theory and New Zealand's own experience point to some disadvantages of SRMC pricing as applied to transmission. The main problem with SRMC prices is precisely that they are short run, but the decisions we want people to make are often long run. Short run prices stay very low when capacity is available, and then spike suddenly and sharply when capacity becomes scarce. A business making a ten year investment decision therefore needs to make a forecast of SRMC prices ten years into the future if they are to make the right investment decision. A generator deciding whether or not to locate in the South Island might

[3] The prospect of allocation should enhance the prospects of negotiated payments.

do this, but a small business deciding whether or not to install energy-efficient appliances will not. Nor, probably, will a light industrial operation deciding whether to expand in Auckland or Christchurch; and

b. *it appears to solve the majority of the problems being addressed*: the Electricity Authority, and most other parties now recognise that the status quo isn't sufficiently adaptive to new circumstances and doesn't incentivise the appropriately efficient response. In light of 1. (i) and (ii) above, the base option appears better suited to addressing the problems identified by the Electricity Authority, while being less complex than the alternatives;

2. *application A is also preferred*: it is preferred as a corollary to 1.(b) above. Application B is more akin to the status quo in effect, and is therefore in BusinessNZs view unlikely to address the problems defined by the Electricity Authority (see below for more on the transitional implications of application A)

3. *a robust cost-benefit analysis will be vital*: for a set of proposals that are so significant, it is critical that the Electricity Authority's calculation of net benefits of its eventual preferred option, in net present value terms, is robust. There are three particular aspects to this that BusinessNZ considers warrants further consideration. These are:

   a. *the implications for small to medium enterprise of the revised allocations*: as a general point, it is unclear what the effect of the three options considered by the Electricity Authority will be on small to medium businesses (SMEs). Much is made (and appropriately so) of the impact of the options on New Zealand's largest businesses. However, it is important to remember that 30% of employees in New Zealand are employed by enterprises with fewer than 20 employees, and 27% of New Zealand's GDP is estimated to be produced by enterprises with fewer than 20 employees. There are 58,480 business units with more than zero but fewer than 100 employees in the Auckland and Northland regions.[4]

      We understand that the Electricity Authority has not undertaken any modelling specifically focussed on SMEs in the TPM work, and this is a gap that needs filling especially given the potential impact of the changes on Auckland and Northland businesses (although BusinessNZ does understand the modelling considers some non-direct connect consumers and generators, though mainly large ones). While we appreciate that the Electricity Authority has taken into account that some SMEs are directly exposed to transmission charges through their distribution charges and respond to these it is – to say the least -

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4 The data can be found on Statistics New Zealand's website at: http://nzdotstat.stats.govt.nz/wbos/Index.aspx?DataSetCode=TABLECODE7602

unclear how the allocations via electricity lines businesses will play out, especially for existing businesses who are unlikely to relocate to avoid such allocations

b. *careful consideration is required of the dynamic efficiency impacts of wealth transfers*: it is evident, as has been the case for previous proposals, that the potential wealth transfers will be substantial in some cases (between generators, consumers, businesses and regions), and that these effects might swamp any assumed efficiency benefits. As a result, a greater emphasis on the efficiency effects that will arise from the wealth transfers is warranted;

4. *transitional arrangements will need to be carefully designed and executed:* what the Electricity Authority does in regard to transitional arrangements, and how well it executes that will be critical to the overall success of the new TPM as much as the new TPM itself. While transitional arrangements will feature almost across every aspect of the eventual implementation of the preferred option, as a corollary to point 3. above, BusinessNZ asks that the Electricity Authority be especially mindful of the issue of transitional features as it models the impact on SMEs.

   BusinessNZ also asks that the Electricity Authority continue to operate in as open and transparent manner as possible to ensure that the trust which it appears to have built in the lead-up to and including the publication of the options paper, is not let dissipate.

5. the presumption of durability: the Electricity Authority seems determined that its proposals will, if implemented, be more durable than the counterfactual. Simply based on the experience over the preceding decade, and the numerous attempts to bring the issue of the TPM to a resolution, BusinessNZ remains sceptical of these claims. Durability is a function of the quality of regulatory actions taken or omitted. It does not occur because someone thinks that it will as a result of reaching a conclusion, rather it occurs because of the underlying quality of the regulatory decisions made (e.g. taking all practicable steps to avoid drawn-out legal action), combined with the clear signal that the issue is not up for renegotiation

   It is arguable that durability with regard to the TPM has been absent from the moment that the then Electricity Commission announced that it was to review the TPM in 2007. If the Electricity Authority is seen to acquiesce to lobbying behaviour it will only serve to encourage further lobbying for change.

   As a general principle, BusinessNZ considers that it is important that participants must have confidence in the Electricity Authority's regulatory decision making processes and that arbitrary and inefficient outcomes will not result. This does not, of course, mean the absence of change. It is inappropriate to see any issue, particularly transmission regulation, as static – regulation must evolve, particularly as circumstances, technology and understanding develop. Rather, the Electricity Authority needs to balance certainty and regulatory stability against the ability for the regulatory framework to evolve over time. In BusinessNZs view, application of the above principle means that the Electricity Authority must give due weight to ensuring that all:

a. of its decisions are coherent and rational given the particular circumstances under consideration; and

b. businesses must have confidence that their returns will not be expropriated by regulatory fiat.

Due regard of these tests will minimise uncertainty and regulatory instability and enable participants to plan investments with confidence. The current options paper gives BusinessNZ greater confidence that these issues are in hand;

6. *the allocation of sunk costs:* it has been traditional in New Zealand to see the HVDC link and interconnection assets as a sunk cost, with the main focus of the debate on how to recover the cost of that asset in a non-distortionary way.[5] If that's the appropriate way to assess it, then any lump-sum charge which does not change behaviour will suffice. In other words, the consideration of the set of options canvassed in the Electricity Authority's options paper need to continually be assessed against the objective of non-distorting cost-recovery. BusinessNZ does not consider that 'efficient' pricing must in all cases be synonymous with a market-driven price or some proxy thereof. Administrative prices (either fixed or variable) can still be efficient. There are a couple of points in this regard that are worthwhile noting, these being:

    a. *private benefits, transmission costs and prices*: when purchasing the bundle of electricity services, consumers will buy electricity up to the point that their private cost equals their private benefits. The issue therefore is not whether the amount paid for the quantity of electricity purchased exceeds the consumers private benefit (it never will), but rather whether the cost of transmission services is greater or less than its price and if so, the extent to which that might distort the amount of electricity purchased (and in turn, the level of private benefit). We remain unpersuaded that half-hourly transmission charges will aid more efficient electricity use or transmission investment decisions. Instead it may simply add a cost to the industry that previously did not exist; and

    b. *the 'retrospective' application of the TPM*: all investments switch from being prospective and optional before the fact, to being sunk afterwards. Before an investment has been committed, it is appropriate to signal to consumers and generators how their decisions will affect the investment. Afterwards, it is too late. The Electricity Authority has

[5] It is generally assumed that nodal prices provide short-run marginal cost efficiency signals.

recognised this in the design of its options. When thinking about a cost recovery scheme that is to be imposed on an identified group of beneficiaries for a particular asset *after* commissioning then an allocation after the fact should reasonably not charge more to any sub-group than they could objectively have been expected to have been willing to pay at the outset. In our view, this would get close to the base option + application A; and

7. *the process going forward*: greater clarity around the future process would be desirable. There are likely to be a range of views submitted to the Electricity Authority (including other variants on the status quo not canvassed in the working paper), and this is the first (and potentially only) time to comment on issues such as deeper connection before the next issues paper. In light of this, a cross-submissions process may be appropriate; and

8. *the allocation of roles between regulators*: finally, BusinessNZ recognises that setting the amount of money needed for the grid or the "size of the pie" is not the Electricity Authority's job and not what we are looking at in the consultation process. However, this process does beg the question about whether it is time to look at combining responsibility for the role of setting the price methodology with the role for determining the level of cost to be allocated.

Summary

BusinessNZ welcomes the efforts made by the Electricity Authority in its search for a durable resolution to the issue of the TPM. It is clear that a 'landing zone' to this long-running and highly contentious issue may be emerging.

Looking forward, businesses – both large and small – wish to be assured that pricing changes are efficient and deliver improved market outcomes. This is needed to assure the business community, on whose behalf BusinessNZ speaks, that in the context of such a substantial proposed change there is clear evidence of demonstrable (and material) net benefits associated with the change. Only this will result in long-term, durable policy settings.

Yours sincerely

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APPENDIX ONE: ABOUT BUSINESSNZ

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Business Central, Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), BusinessNZ is New Zealand's largest business advocacy body. Together with its 80 strong Major Companies Group, and the 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, BusinessNZ contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

BusinessNZs key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.