BusinessNZ
The voice of business

Lumley House
3-11 Hunter Street
PO Box 1925
Wellington 6001
New Zealand

Tel: 04 496-6555
Fax: 04 496-6550
www.businessnz.org.nz

26 July 2016

Submissions
Electricity Authority
PO Box 10041
WELLINGTON 6143

via e-mail: submissions@ea.govt.nz

Transmission Pricing Methodology – Issues and Proposal (Second Issues Paper)

BusinessNZ is pleased to have the opportunity to provide a submission to the Electricity Authority on its consultation paper entitled 'Transmission Pricing Methodology – Issues and Proposal (Second Issues Paper)' dated 17 May 2016.[1]

Introduction

BusinessNZ continues to welcome, as it did for the first issues paper, the effort evident in the consultation paper released by the Electricity Authority. It is clear that the Electricity Authority has continued to progress its work on a revised transmission pricing methodology (the 'TPM') in a thoughtful manner. The case has now been long, and consistently made that an outcome better than the status quo can be reached. BusinessNZ agrees and believes the work of the Electricity Authority is heading in the right direction.

However, with all complex regulatory issues and processes, some issues of detail remain to be ironed out. To achieve this, the Electricity Authority needs to continue to be receptive to proposals from submitters that will improve the proposal in ways that meet its efficiency objectives and enable those who pay (particularly businesses of all sizes) to have a much better chance of understanding the changes and managing their implications.

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

Comments

BusinessNZ has not responded to the specific consultation questions, leaving these to be addressed by those of its members who have a particular interest in the specific detail of the matters raised. However, BusinessNZ has a number of issues it considers might warrant additional attention prior to the Electricity Authority proceeding with the proposal it has laid out in the issues paper. These issues are set out below.

But before doing this, BusinessNZ considers it worthwhile to restate BusinessNZ's approach to the issue of transmission pricing that it outlined in its submission on the first issues paper. This approach informs the selection of issues which BusinessNZ considers warrants additional consideration by the Electricity Authority.

> "BusinessNZ's Approach to Transmission Pricing
>
> For transmission investments, the key economic characteristics that must, in BusinessNZ's 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 BusinessNZ's 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
>   b. where not possible, allocate the costs of connection assets as fixed charges amongst the connected parties.[2]

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

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."[3]

BusinessNZ is pleased to note that the framework outlined in the issues paper is broadly consistent with this approach. This gives BusinessNZ comfort with the overall direction of travel.

Managing the Impact

The proposal will have substantial implications (positive and negative) for consumers and the business sector, especially major industrials including those who have invested in response to transmission pricing signals and to smooth peak loads. In simple terms businesses and customers in the upper North Island will see transmission costs rise whereas those in the rest of the country will see them fall.

This is a multi-dimensional issue. BusinessNZ understands that the Electricity Authority has a clear efficiency objective in its empowering Act, and that the pursuit of this objective can result in some parties facing higher costs while others face lower costs. Higher costs – so long as they are efficient – are not inappropriate. However, by the same token, the Electricity Authority will hopefully appreciate that it is cold comfort to be advised that while your costs are to rise substantially, this is the best response because doing so will put downward pressure on *future* electricity prices, or that it is to remove the subsidy enjoyed at the expense of other regions and businesses. The global and domestic economic conditions in which the business sector currently operates is fragile and cost increases are unwelcome and in some cases, may be unsustainable.

But neither is higher reliability and greater energy security costless, nor is it appropriate to shield businesses or consumers from the true cost of the services provided from which they benefit. New Zealand has a poor history in this regard and we should learn from it.[4] Facing prices below the full marginal cost of production encourages businesses and households to use more than they should with consequential inefficiency implications for the transmission system.

So the Electricity Authority – in acting in the long term benefit of all consumers – faces a complex balancing act across the entire country within which there will be winners and losers. That is the very nature of regulatory

[3] BusinessNZ submission to the Electricity Authority entitled 'Transmission Pricing Methodology Review – Issues and Proposal' dated 1 March, 2013, page 5.

[4] One need only to think of the 'Think Big' projects by which all New Zealand taxpayers subsidised fuel and energy costs in an effort to make businesses more competitive but which in reality had the opposite effect of shielding them from the reality of international competitiveness when the subsidies could no longer be sustained.

change. But this should not – subject to a rigorous cost-benefit analysis and evidence of a net positive public benefit – cause paralysis and no change - just that the change has to be carefully outlined, understood and robust in its assumed outcomes.

Specific Issues

There are a number of specific issues on which BusinessNZ wishes to comment. These are outlined below (in no particular order):

- some of the detail of the guidance to be given to Transpower is confusing, for example:

    i. the area-of-benefit (AoB) is defined as an area in which at least one designated transmission customer is expected to receive a benefit. BusinessNZ had thought that were there only a single customer then that customer would face a connection charge rather than an AoB charge, and that the AoB charge would be for those situations where there are two or more designated transmission customers amongst whom the AoB could be allocated;

    ii. the distinction between the standard and simplified methods of allocating charges under the AoB is not as clear cut as implied by the issues paper. For example, BusinessNZ considers that it is unhelpful to state that the simplified method should be simple (para 7.38 (a)) or that it be simple for the party paying to understand (para 7.38 (b)) or that it be phased in over as short a timeframe as possible. These are *all* features that should be generic to the calculation of the AoB charge per se, not just to the so-called simplified method;

    iii. the somewhat arbitrary $5million threshold. In order to simplify the overall approach, BusinessNZ suggests that subject to overarching requirements across the calculation of all of the AoB to minimise transaction costs, understandability etc that Transpower should be required to allocate *all* costs on the basis of the set standard method unless it cannot reasonably do so. Only at that point should Transpower use a 'simplified' method;

- the optimisation process. The Electricity Authority guidelines allow for optimisation of assets after construction but it does not appear that Transpower is required to invoke the optimisation process if asset utilisation falls below expected levels;

- the Electricity Authority makes some significant play on the desire to achieve an outcome that is durable. It considers that its proposed approach will deliver a more durable outcome than the status quo. We understand the driver of the removal of the Regional Coincident Peak Demand (RCPD) signal but wish to observe the following:

i. on the basis of the information provided in the issues paper by the Electricity Authority it is hard to justify, on overall efficiency grounds, the investments made to avoid transmission charges, in terms of the overall development and configuration of the grid. However, having said that, such investments were made in good faith to avoid an economic signal. The fact that businesses invested accordingly should not somehow now be seen as simply "bad luck" or "their fault" or a product of misinformed decision making - quite the contrary. As noted above, there will always be 'winners' and 'losers' of regulatory changes but some of the these impacts are dramatic and the Electricity Authority needs to be confident of the efficacy of its proposal;[5] and

ii. removing a locational price signal such as RCPD could potentially remove the signal to avoid transmission services and cause an unintended spike in demand that had hitherto been suppressed, bringing on investment that is inefficient. The proposed guidelines provide for Transpower to consider the introduction of an LRMC charge as one of the additional components. We consider that such a charge could be relatively easy to implement alongside the anytime maximum demand (AMD) measure but would need to be removed from the AoB charge post investment in order to avoid consumers paying for the transmission upgrade twice;

- the Prudent Discount Policy (PDP). We agree that a PDP is appropriate and are not uncomfortable with an expanded form of PDP, but think that the Electricity Authority's proposed changes – while well intentioned - might miss the mark for the following reasons:

  i. the issues paper outlines that the PDP will be for the life of the relevant asset unless a shorter period is agreed. This is intended to provide the party applying for the discount with a degree of certainty. Yet it is also anticipated that the discount will be linked to commodity prices and able to be reduced or suspended. This possibility, while understandable, would undermine the opportunity to take advantage of the discount. It would also require those who administer the PDP to essentially become commodity price experts, if not experts in the business that is requesting a PDP. The implications of this will either exacerbate the risk of asymmetric information or magnify administration costs;

[5] There are numerous legal decisions on this point, but we note here the judgment of MacKenzie J in *Contact Energy Limited and Meridian Energy Limited v Electricity Commission and Transpower New Zealand Limited*, High Court, Wellington, CIV-2005-485-624, 29 August 2005, where he noted – albeit in the context of the HVDC - that were the Electricity Commission to consider that certainty and regulatory stability are relevant, the Commission should take into account (inter alia) whether there have been investment decisions made in circumstances where the investors might reasonably have expected that the current method of charging would remain in place. In our view, application of this principle means that the Electricity Authority must give due weight to ensuring that participants can have confidence that their returns will not be inappropriately diminished.

ii. it is unclear if, in its application whether the risk intended to be managed via the use of the expanded PDP applies to:

   - an entire business - for example, if the Electricity Authority anticipates that the PDP will only apply to single site businesses, like New Zealand Steel or Pacific Aluminium; *or*
   - a particular site – for example, whether the PDP applies to businesses who have a sizable but locationally distributed presence, such as Fonterra or Steel and Tube; *or*
   - a new business who would otherwise enter the market but can demonstrate that it won't due to transmission charges.

   At a minimum, it is important that the application of the PDP not discriminate against, or act to the detriment of, those who are not single site businesses but who nonetheless have substantial regional site presences; and

iii. it is unclear whether Transpower should administer an expanded scope PDP. Putting aside for the moment that the expanded PDP is likely to be more costly to administer, the incentive structures created – in light of the risks of major industrial closures if a PDP request is declined – are highly uncertain. It is, therefore, our preference that the Electricity Authority either keep the PDP as it is and remain administered by Transpower, or have it improved and administered by the Electricity Authority;

- for reasons that are understandable, the cost-benefit analysis (CBA) is hypothetical, or at best only broadly indicative. In particular, we note that the Electricity Authority freely acknowledges that the modelled charges in the paper will vary from actual charges.[6] This makes it hard to give unqualified support for the proposals until the final nature of what will be implemented is known with greater certainty. This implies that at some point in the process from here that there must be a CBA that compares the current guidelines with the likely new guidelines and we would look to both Transpower and the Electricity Authority developing revised CBAs as the proposals firm up. The Courts have recognised the importance of quantifying CBAs as part of the operation of regulatory bodies' decision-making processes.[7] In particular, some

[6] Electricity Authority consultation paper, entitled Transmission Pricing Methodology: Issues and proposal, second issues paper dated 17 May, 2016, executive summary, page xxxi, paragraphs 149 and 150.

[7] For example, Richardson J observed, in the case of Telecom v Commerce Commission (Telecom Corporation of New Zealand Limited v Commerce Commission [1992] 3 NZLR 429 at 447):

> "… the desirability of quantifying benefits and detriments where and to the extent that it is feasible to do so…there is in my view a responsibility on the regulatory body to attempt so far as possible to quantify detriments and benefits rather than rely on a purely intuitive judgment to justify a conclusion that detriments in fact exceed quantified benefits."

of the issues that the Electricity Authority may wish to assure itself of are:

i. the extent, if any, to which the AoB charge may have wholesale market efficiency implications in terms of the location of new generation; and

ii. the quantification of efficiency losses and benefits as much as possible, for example, the greater incentive for customers to reveal their willingness to pay for the services provided by Transpower during the regulatory process, and the robustness of the AoB charge relative to the deeper connection charge.

- the extent to which Transpower is given discretion. We can completely understand the desire, once settled, to have Transpower exercise as little discretion as possible in doing what it needs to do under the new guidelines. But this is different from getting the balance right between the Electricity Authority and Transpower as to who is best placed to exercise judgement in the development of the guidelines. In our view, the Electricity Authority should focus on the 'headline' approaches it wishes to see Transpower develop up, but leave Transpower to then determine the operational detail in consultation with sector stakeholders.

Some Process Issues

It would appear that the work being undertaken – by both the Electricity Authority and other stakeholders – is collectively pointing us towards a point of equilibrium whereby pricing theory meets practical day-to-day business realities.

But further work – particularly by Transpower and the Electricity Authority- needs to be undertaken. Given the nature of the issues at stake, we urge that the implementation process be developed in consultation with sector stakeholders. While it is proposed that Transpower adopt a consultation process in its development of the TPM and decide on the extent and form of its process (para 12.4), sector input should be sought by Transpower in the development of its approach.

We note that the Electricity Authority suggests that once Transpower has submitted its TPM the Electricity Authority will "allow at least 6 weeks" for consultation. We would suggest that 6 weeks should be the absolute minimum, and that the Electricity Authority remind itself of the test set out in in Air New Zealand and Others v Wellington International Airport Limited and Others which stated inter alia that:

> "Consultation must allow sufficient time, and a genuine effort must be made."[8]

[8] McGechan J in Air New Zealand and others v Wellington International Airport Limited and others, HC, Wellington, CP 403-91, Jan 6, 1992

Finally, we note that it is disappointing that the two relevant regulators (the Electricity Authority and the Commerce Commission) could not better co-ordinate the timing of their respective workstreams. In a sector that is resource constrained, the coincidence of these two extremely resource-intensive issues is frankly bewildering. This coincidence (not to mention the Ministry of Business, Innovation and Employment consultation also currently underway on the energy efficiency strategy refresh) has required those who wish to participate in the consultation processes to make resource trade-offs that they would otherwise have been able to avoid, and has potentially given rise to legal risk.

Summary

The current transmission pricing methodology is unsustainable, and has been now for some time. Reform is well overdue. Every year reform is delayed contributes to an on-going misalignment between those who benefit and those who do not, and entrenches inefficiencies in the provision and use of transmission infrastructure.

While highlighting the need to bring this issue to a conclusion as quickly as possible, we also acknowledge that there remains some on-going effort to do so. We have sought to use this submission to highlight some of those areas on which the Electricity Authority could assure itself in order to strengthen the quality of the eventual outcome.

Yours sincerely

John A Carnegie
Manager, Energy, Environment and Infrastructure
BusinessNZ

APPENDIX ONE: ABOUT BUSINESSNZ

BusinessNZ is New Zealand's largest business advocacy body, representing:

- Regional business groups EMA, Business Central, Canterbury Employers' Chamber of Commerce, and Employers Otago Southland
- Major Companies Group of New Zealand's largest businesses
- Gold Group of medium sized businesses
- Affiliated Industries Group of national industry associations
- ExportNZ representing New Zealand exporting enterprises
- ManufacturingNZ representing New Zealand manufacturing enterprises
- Sustainable Business Council of enterprises leading sustainable business practice
- BusinessNZ Energy Council of enterprises leading sustainable energy production and use
- Buy NZ Made representing producers, retailers and consumers of New Zealand-made goods

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 and services for enterprise, BusinessNZ contributes to Government, tripartite working parties and international bodies including the International Labour Organisation (ILO), the International Organisation of Employers (IOE) and the Business and Industry Advisory Council (BIAC) to the Organisation for Economic Cooperation and Development (OECD).

The BusinessNZ family

www.businessnz.org.nz