Auckland Airport

26 July 2016

Electricity Authority
PO Box 10041
Wellington 6143
by email: submissions@ea.govt.nz

Dear Chair,

Re: Transmission pricing methodology (TPM): issues and proposal, second issues paper

Auckland International Airport Limited (AIAL) welcomes and thanks the Electricity Authority for the opportunity to submit on this consultation, and assist in the shaping of evolving economic regulation within the electricity Market.

Auckland Airport operates an embedded distribution network, and also is a large consumer of electricity. We make our submission in that capacity.

We support the Authority's efforts to move towards a more service-based and cost-reflective transmission pricing methodology, but are concerned about the way in which the Authority has chosen to implement its proposals.

In particular, we believe that the Authority's decision to apply the new TPM retroactively (to significant assets constructed after 2004) is inconsistent with generally recognised principles of good regulatory practice, and will have a number of unintended negative consequences.

Further, we think that retroactivity is inconsistent with the Authority's statutory objective of promoting the efficient operation of the electricity industry for the long term benefit of consumers. As we discuss below, Auckland Airport's view is that the Authority's approach runs counter to its own interpretation of its statutory objective by deterring investment and innovation, and by reducing the efficiency of the electricity market in the long term.

Auckland Airport is also concerned about the expanded prudent discount policy. There is a risk that it could be exploited for commercial gain by large industrial users.

Our response and reasoning is detailed in Appendix 1 below. If you require further information, or wish to discuss this response, our contact person for this submission is Anthony McGivern, Strategic Commercial Manager – Utilities, +64 27 809 3949, anthony.mcgivern@aucklandairport.co.nz.

Signed on behalf of the Auckland International Airport Limited by

Anil Varma
(acting) General Manager Aeronautical Operations

Retroactive regulation is inefficient and inequitable

1. Auckland Airport believes that the Authority's proposal to apply the new TPM retroactively does not have a sound principled or economic justification. As an entity subject to regulation by the Commerce Commission, we would be extremely concerned if the Commission proposed a rule change of this nature in relation to our sunk investments.

2. The Authority has argued that a retroactive application is more durable. It has said that a forward-looking approach would not solve the problems with the existing methodology, which would remain for a very long time.

3. However, as we discuss in greater detail below, our view is that "durability" is best created through regulatory certainty and transparency. A methodology that establishes a precedent of a regulator being willing to materially change rules in relation to sunk investment undermines incentives to invest in new transmission assets, and is not a "durable" methodology. In order to be "durable" the TPM must be consistent with the statutory objective of creating efficiency for the benefits of consumers in the long term. It must promote stability and confidence among potential investors that the regulatory environment is not subject to arbitrary and unpredictable change. It must not be complex and expensive to implement, or subject to a high risk of lengthy challenges and disputes.

The proposed TPM is not "market-like"

4. The Authority wants to create a "market-like" TPM. But retroactivity is not consistent with this objective. In markets, decisions- including about whether or not to invest- are based on price signals at the time the decision is made. Under the Authority's TPM, the opposite happens: price signals are changed after decisions have already been made.

5. Like many other submitters, Auckland Airport's view is that the Authority should focus on encouraging efficient investment planning in the future, and not on reallocating the cost of historical investments. The current regime is not optimal, but it is better not to interfere with a market that has developed "organically" in response to price signals. An efficient market design promotes good investment going forward. Penalising consumers for investment decisions that have already been made does not serve this purpose.

6. A TPM that applies only to new assets may take longer to have an effect, but it will start from a principled and fair beginning, and will be more durable as a result.

Uncertainty and distortion of investment incentives

7. The Authority has described its function as facilitating "investment and innovation". Its job is to foster workably competitive markets, because these can "bring very large benefits to consumers over the long term if they are conducive to entry by innovative suppliers and conducive to efficient investment".[1]

8. Auckland Airport supports this sentiment, but considers that the Authority risks falling short of the objectives it has set itself. In particular, we think that by choosing to apply new rules to historic investments, the Authority is taking an approach that directly deters efficient investment and innovation. Innovation necessarily entails risk, and risk is heightened- potentially to the point where it will not be tolerated- by the threat (perceived or real), that the rules for recovering costs of sunk investments are subject to arbitrary change at some point in the future.

9. Accordingly, it is universally accepted as good regulatory practice that a regulator should avoid materially changing the rules for the cost recovery of long life sunk assets.

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[1] Electricity Authority, "Interpretation of the Authority's statutory objective" (14 February 2011), at para 2.2.1.

Otherwise it risks creating instability and distorting investment incentives. It undermines trust in the regulator- and this can have serious economic consequences. Investment in quality infrastructure relies on providing investors with confidence that they will earn a reasonable return over the life of the assets. Capital providers place a premium on fundamental factors like the stability of regulatory institutions and the quality of regulatory decision-making. A market that is subject to arbitrary regulatory U-turns is not an attractive investment proposition.

10. This is recognised by the Commerce Commission. In its 2010 Input Methodologies Determination, the Commission noted the importance of regulatory continuity where the relationships between suppliers and consumers had been "shaped by regulatory arrangements in the past."[2] The Commission said that it would be "wrong" and not "good regulatory practice" to make material changes to asset valuations where these had been based on an existing regulatory regime and on on-going relationships between suppliers and consumers. This holds true even where the "scope and objectives of regulation have changed".[3]

11. Because of the sunk cost nature of large infrastructure investments, investors ensure they can recover their costs through long term contracts (either on formal terms or terms implicit in ongoing relationships). These are affected by "historical events" and practices, and reflect conditions and expectations at the time at which the relationships were formed.[4] In other words, investors base their decisions on existing regulatory conditions and market relationships in the expectation that those structures will remain constant during the life of the asset. This expectation protects against the risk that suppliers will not be able to earn a return on their investment. By opportunistically revising the historical conditions that led to the investment, the Authority is undermining that protection and deterring investment in the future.

12. In short, if potential investors think that the conditions on which their decisions are based may be changed at a later date, they will be more reluctant to invest, and may simply decide that it is not worth the risk. Or, if they do decide to absorb the higher risk, they will require a higher return as a reward for doing so. The result of this in the long run is that electricity costs will have to rise in order to induce participants to invest in new assets.

The proposed TPM creates an inequitable wealth transfer

13. As well as being dubious in principle, the Authority's proposals will cause serious hardship for some consumers.

14. The new TPM will create serious price shocks for consumers, exacerbated by its retroactive application. The effect will be particularly pronounced in the upper parts of the North Island; that is, in areas with some of the country's most economically challenged communities. Because it operates near some of them, Auckland Airport has direct knowledge of these communities, and considers it unfortunate that the Authority would increase prices the most for those least able to afford them.

15. We accept that it is not the job of the Electricity Authority to make social policy. However, pursuing the principle of efficiency to its ultimate degree will have a social cost. This should not be ignored. The Authority is obliged to consider the interests of consumers when setting the TPM, and many consumers will suffer from being made to pay for historical inefficiencies in the electricity market. The Authority has prioritised efficiency and theoretical purity. It has generated TPM options of great complexity. What it has not done is adequately consider the effect that its theories will have on the lives of end users.

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[2] Commerce Commission, Input Methodologies Reasons Paper (2010), at para 4.3.29
[3] Commerce Commission, Input Methodologies Reasons Paper (2010) at para 4.3.13
[4] Commerce Commission, Input Methodologies Reasons Paper (2010), at para 2.6.25

16. Auckland Airport's view is that the Authority should consider the costs of wealth transfers as part of assessing "the long term benefits of consumers". The Commerce Commission's approach of factoring wealth transfers into its cost benefit analysis was upheld by the Court of Appeal in *Powerco v Commerce Commission*.[5]

17. Further, while we acknowledge the Authority's belief that it is not legally bound to consider wealth transfers (whether as a cost or benefit),[6] we caution the Authority against treating that position as a licence to disregard them altogether- and we certainly hope that it is not the Authority's view that it is required to disregard them. There does not need to be a simple contest between ignoring and considering wealth transfers. Even if the Authority does not take wealth transfers to be a significant factor in its cost benefit analysis, Auckland Airport's view is that it should acknowledge their potentially harmful effects, and include measures in the TPM to mitigate those effects. It should be a relevant consideration that some consumers will be worse off in the long term: there is nothing to stop the Authority making some allowances for this fact.

18. This is particularly true because household electricity consumers are a completely "captive audience". They are unable to influence decisions on sunk investments. Short of leaving the area altogether, consumers will not be able to respond to these price increases by changing their behaviour. All they can do is pay. Prospective implementation of the new TPM would materially mitigate the effects of sudden price shocks for vulnerable consumers.

19. Alternatively, if the Authority insists on retroactively applying its new TPM, Auckland Airport believes strongly that it should do so on a staged basis to give consumers time to adjust to the new higher prices. At the very least, some form of price smoothing mechanism is required to mitigate some of the harmful socioeconomic effects that the new methodology will inevitably cause. A more gradual implementation of the TPM would allow consumers to adapt their behaviour to cope with price increases over time. This is not the ideal scenario, but it is preferable to a sudden and dramatic price rise. As we note below, the Authority has proposed a mechanism to mitigate the effect of its changes on large customers via an expanded prudent discount policy: Auckland Airport believes it should also acknowledge the effect that the TPM will have on ordinary households.

Area of Benefit Implementation

20. The proposed application of the new charges to historic investments will create logistical problems with implementing the area of benefit charge. Transpower will be exposed to extensive lobbying and dispute about which areas have historically benefited from particular transmission assets. As the Authority has noted, this will be less of a problem with future investments. This is because the area that benefits from the investment is something that can be considered and resolved when the investment is being planned: people can be expected, for example, to not lobby against investments that benefit them.

21. Similarly, given the materiality of the wealth transfers, the Authority should not ignore the possibility that some users will choose to litigate the Authority's decisions: this may further delay and complicate the implementation of the TPM.

22. Complexity in implementation creates additional cost, and it is consumers who will have to bear it. A TPM that is unwieldy, complex and expensive will ultimately increase transmission costs. Consumers will be paying the price for administration and logistics that could have been avoided.

[5] *Powerco Ltd v Commerce Commission* [2008] NZCA 289.
[6] Electricity Authority, "Interpretation of the Authority's statutory objective" (14 February 2011), at para 8.

Auckland Airport supports "Grandfathering"

23. To avoid the complications inherent in the retroactive approach, Auckland Airport supports "grandfathering". The recovery of the historical costs of an asset would remain subject to the regime under which the asset was initially developed.

24. This would allow a transition to efficient service-based, cost-reflective pricing, while also avoiding the unintended consequences of reallocating historical costs. There is no principled reason why the new methodology should not be introduced more gradually. This would secure benefits for consumers in the long term, while avoiding price shocks for the most vulnerable groups. It would preserve the credibility of the market regulator. It would be a more certain, stable and durable approach.

25. The Authority has already recognised that there are costs associated with retroactive application. It chose to apply the TPM to significant assets constructed after 2004 in order to avoid the substantial costs of applying it to all assets. Although the costs may have been mitigated by the 2004 cut-off, it is essentially an arbitrary one, and there is no reason why the negative consequences of reallocating historical costs should not be mitigated completely by removing the retroactive element altogether.

Problems with the expanded prudent discount policy

26. The prudent discount policy (PDP) is a necessary feature of the TPM. However, the Authority proposes to expand it. It appears to us that this expansion has only been made necessary by the Authority's retroactive application of the new methodology. Reallocating the costs of historical investments may substantially increase transmission costs for some large consumers, and so the Authority may now have to offer those consumers financial inducements to remain in the country. The PDP, therefore, is the Authority's way of resolving a problem of its own making.

27. We are especially concerned about extending discounts to large customers where there is a "material risk" that those customers will exit the market. A prudent discount policy requires others in the market to subsidise the person receiving the discount. Because a PDP increases transmission costs for other market participants, the Authority should be cautious about extending it too far. There must be robust processes in place to ensure that it is not abused.

Potential for abuse

28. The expanded policy incentivises powerful consumers to "game" the system for lower transmission costs. Multinational companies could use their market power to negotiate discounts by threatening to leave the country, even when they are not seriously considering doing so. This would mean unnecessary discounts that cause unnecessarily high transmission costs for everyone else.

29. The Authority says that a discount would be tied to objective factors, like world commodity prices. We support this. But the Guidelines do not go far enough. There must be more specific rules to ensure that the case for a discount is initially credible- and that it remains credible.

30. The Guidelines are vague. It is not clear how far commodity prices will have to fall before a discount is considered. It is not clear what the threshold is for "material risk". The proposal in its current form is open to interpretation, and exposes whoever is in charge of administering it to aggressive lobbying by sophisticated and motivated commercial parties. The entity in charge of administering discounts should be protected and guided by rigid, specific and objectively verifiable criteria.

31. It is unfortunate that while large (and probably very profitable) corporations are able to apply for relief from higher prices, consumers in Auckland and Northland will not have the same privilege. Households will not be able to apply for a prudent discount, even where there is a material risk that higher prices will mean that they are unable to afford their power bills. There is a wealth transfer not just from North to South, but also from ordinary consumers to large corporations. In our view, this is emblematic of an inequitable and unprincipled TPM.

Length and extent of the discount

32. Even if there is a material risk of a large customer exiting, and a credible case for a discount, it is still possible that the discount will be larger and last for longer than is necessary to avoid that risk, meaning that the policy still allows potential windfalls for large customers.

33. Therefore, the extent of the discount is another aspect that will need to be addressed. The Guidelines say that a discount should not result in the customer paying less than the incremental cost of supplying it with transmission services. In other words, the discount could cause the price that the customer pays for transmission services to be the same as the incremental cost of supplying it with those services. Other than that, there is no detail about how much of the transmission cost can be discounted. It is apparently open for negotiation.

34. The Guidelines provide for the discount to be suspended if the factors it was based on change. Auckland Airport supports this, though it is not clear how it will work in practice. It would presumably require Transpower or the Authority to audit the financial performance of the customer, as well as the international price for its products on a fairly regular basis, and then subjectively assess whether conditions have changed enough to discontinue the discount. In the absence of particular rules about how this will actually occur, it is hard to say whether it will be feasible in practice.

35. Overall, Auckland Airport accepts that bespoke discounts will have to be negotiated on a case by case basis. But not all of the details should be open to negotiation. There must be clear parameters from the outset: restrictions on how large and how long a discount can be. The Guidelines do not currently provide enough detail about how the policy will work. It is vulnerable to manipulation.

The Electricity Authority should administer the PDP.

36. Transpower is not the appropriate entity to administer the PDP for the long term benefit of consumers. This should be done by the market regulator. We consider that the Electricity Authority is better able to preserve the necessary degree of independence and neutrality that will be required to make these potentially delicate assessments (particularly given the inevitable pressure and lobbying about matters that are likely to be in the national interest).

Transpower's Development of the TPM

37. We note that there is considerable discretion for Transpower to develop the TPM in accordance with the Guidelines.

38. We note that Transpower will be required to consult with "interested parties" under the standard process for AoB charges.

39. In our view, Transpower should be given more specific direction as to who it should consult with. In particular, it should be required to consult with major consumers when developing the TPM (and not just when developing areas of benefit). We anticipate that

Transpower will do this in any event, but given that its decision-making has the potential for adverse consequences in all critical infrastructure sectors, we consider that it would be appropriate for the Guidelines to specifically require Transpower to seek advice and input from significant consumers in those sectors.

Conclusion

40. Auckland Airport understands the rationale for overhauling the TPM to make it more service-based and cost-reflective. Our concerns are about how the methodology will be implemented. We do not support the application of the TPM to historical investments: it contradicts good regulatory practice and creates inequitable wealth transfer. Finally, we stress the need for robust specifications and processes to prevent the expanded PDP from being exploited for purely commercial gain.