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Submissions
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Distributed Generation Pricing Principles

BusinessNZ is pleased to have the opportunity to provide a submission to the Electricity Authority on its consultation paper entitled 'Review of Distributed Generation Pricing Principles' dated 17 May 2016.[1]

Introduction

As noted in BusinessNZ's submission on the Electricity Authority's transmission pricing methodology (TPM) second issues paper, it is broadly supportive of initiatives by the Electricity Authority to implement pricing arrangements that are more efficient than the status quo. The Electricity Authority seeks to achieve this in the case of distributed generation, as it does for transmission pricing.

Needless to say, BusinessNZ welcomes the pursuit by the Electricity Authority of its efficiency objectives, especially where its pursuit can result in reduced costs for business as promised by the Electricity Authority. Indeed, the economic logic of the Electricity Authority seems compelling – both in terms of who should be responsible for making avoided cost of transmission (ACOT) payments (Transpower), as well in as the desire to ensure that the pricing signals from both transmission and distribution are efficient and mutually reinforcing. However, there are some implementation details that despite the prospect of lower prices, the Electricity Authority should give greater consideration to before proceeding.

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

Comment

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 by the Electricity Authority. These issues (in no particular order) are set out below:

- the impact of the proposed treatment of existing (or sunk) distributed generation. There are two elements to this:

    i. the Electricity Authority considers that the removal of these payments will have minimal effect on system reliability. We are less sanguine about the impact on system reliability of removing ACOT payments for sunk assets. It is difficult to determine the impact with any degree of certainty and note that the Electricity Authority has presented no firm evidence either way (at best claiming that it is "unlikely that many (if any) distributed generators would shut down"[2]);

    ii. the demonstration effect of the proposal on sunk assets for *future* distributed generation investments. In general we agree with a 'clean' application of any new approach to all *new* assets (for more on how the new rules could be applied see below) but the fact that the Electricity Authority is proposing to essentially remove ACOT payments immediately for all ACOT recipients signals a willingness by the Electricity Authority to disturb what could be thought of as the legitimate expectations of investors. This is similar to the risk that BusinessNZ sees in the case of businesses who have invested in the ability to avoid transmission charges. This has the potential to raise the risk profile of these (and potentially other) investments going forward and in turn raise the cost of capital for future such investments, with a potentially chilling effect;[3]

- the Electricity Authority seems unclear about the extent to which ACOT payments are important, and therefore a source of regulatory risk. On the one hand, the Electricity Authority argues for the code removal because ACOT payments influence investment:

[2] Electricity Authority consultation paper entitled 'Review of Distributed Generation Pricing Principles', 17 May 2016, page J. BusinessNZ notes that the expectation that distributed generation will not shut down seems to be predicated upon the fact that the assets are sunk and that the plant will continue to operate so long as their marginal revenue remains above marginal costs. As such it borders on condoning regulatory opportunism.

[3] 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.

> "[ACOT payments] will encourage inefficient distributed generation investment and/or operation" [page D]

but then later, when considering regulatory risks, argues that ACOT payments are unimportant:

> "Further, the Authority does not expect the proposal to reduce dynamic efficiency by undermining investor confidence in the stability of regulatory arrangements … The level and basis of ACOT payments has not been a 'settled' area of policy. In these circumstances, it is reasonable to expect prospective distributed generation investors to have evaluated their investments based on genuine transmission benefits, rather than relying on windfall transfers (such as ACOT payments)." [page J]

- the cost-benefit analysis (CBA) is problematic, for the following reasons:

  i. the range of net benefits is extremely broad essentially ranging from zero to just under $22 million in net-present value (NPV) terms. This huge variability should, if nothing else, ring alarm bells for the Electricity Authority and the extent to which it can justify an unequivocal course of action based upon it. We specifically note the estimated efficiency loss associated with higher prices for consumers of between $120,000 to $170,000. It is interesting to observe that the Electricity Authority's own Wholesale Advisory Group has in similar such circumstances deliberately suggested less dramatic courses of action for options it considered but which had larger net benefits and narrower differentials between costs and benefits (erring instead on the side of greater transparency or information disclosure in such instances);

  ii. the highly assumption-driven nature of the CBA. The CBA is based on educated guesswork at best. Virtually all of the inputs into the CBA are estimated average values (for example, "a rough approximation to the mean wholesale spot price in regional peak periods") and likely to be highly sensitive; and

  iii. the Electricity Authority seems comfortable drawing regulatory conclusions in the absence of information. For example, the Electricity Authority itself notes that:

  > "It is not possible to assess the benefits of addressing the connection services issue in a quantitative way, because there is not enough information available. Instead the Electricity Authority has made a qualitative assessment."[4]

[4] Electricity Authority consultation paper, *ibid*, page 41, paragraph 4.5.6.

As noted in our submission on the transmission pricing methodology second issues paper, the Courts have recognised the importance of quantified CBA as part of the operation of regulatory bodies' decision-making processes;[5]

- while we agree that Transpower is likely to be the most appropriate counterparty to these contracts, we are unclear if the incentive structure outlined in Appendix C will play out as clearly (or as smoothly) as implied. While we understand that Transpower faces incentives that are aligned with the outcomes anticipated by the Electricity Authority, we note that:

    i. there is likely to be bias (even if unintended) towards solutions that involve transmission solutions, especially in areas where there is load growth, as distributed generation in such areas would only defer investment temporarily;

    ii. devoting resources to the implementation of the new arrangements by Transpower is likely to be seen as a distraction from its core business;

    iii. there is a real risk of 'hold-up' especially in the case of existing distributed generation assets. We note in this context that the Electricity Authority has clearly signalled its expectation by stating that the LSI and LNI are likely to have the least avoided transmission benefit; and

    iv. the Electricity Authority is pursuing this proposal at the same time as it looks to introduce a default use of systems agreement for retailers – for reasons presumably associated with the difficulty associated with negotiating commercial contracts with natural monopoly providers;

    v. we think that the transaction costs associated with the proposal – especially for the small providers of distributed generation - are likely to be larger than anticipated by the Electricity Authority;

- the relationship to the Commerce Commission's input methodologies with respect to the payment of avoided costs of distribution is unclear. In particular, it is unclear the extent to which distribution businesses have the allowable operating expenditure to recover such payments;

[5] 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."

- the Electricity Authority states that it considers a separate set of pricing principles is not required to ensure that pricing for distributed generation connection services is efficient. While we would agree that there seems to be potential for efficiency losses to arise by precluding any common cost recovery from distributed generation owners, in light of the negotiating asymmetries in play removing the code would not seem to be a proportionate response (especially in light of the CBA); and

- the Electricity Authority's proposed implementation pathway is ambitious in light of other work going on. We think that neither Transpower nor the distribution businesses will have the resources to devote to this issue over the coming year and as a matter of priority believe that their focus should be placed on improving the efficiency of their respective pricing methodologies.

A Proposed Way Forward

BusinessNZ thinks that the theoretical case has been well made by the Electricity Authority but considers that the justification for its proposal – insofar as it applies to *both* existing and new distributed generation – is insufficient to support the conclusion reached.

BusinessNZ would support the following transition path:

- that the new rules apply from 1 April 2017 <u>but only to new investments commissioned after October 2012</u> (the date of the first TPM issues paper, which was the first to cast doubt over the future level of ACOT payments). It is clearly arguable (and is argued by the Electricity Authority) that ACOT payments have been substantially uncertain since 2012. On this basis, and in reference to the judgment referred to in footnote 3, it would not have been the case after 2012 that investment decisions could have been made in circumstances where the investors might reasonably have expected the current method would remain in place;[6]

- that the Electricity Authority reconsider its proposed treatment of sunk assets built before 2012 and the risks associated with regulatory opportunism. In this regard, we note the willingness of the Electricity Authority in the TPM second issues paper to differentiate between the treatment of similar sunk transmission assets – treating transmission assets built before 2004 differently from those built after that date, predominantly on durability grounds. While it is acknowledged that there are good reasons for doing so in that case, BusinessNZ thinks that there might be merit – also on durability grounds - in ensuring that the returns to the owners of sunk distributed generation are not

[6] The Electricity Authority's cost-benefit analysis shows that grandfathering will have only a very small impact on the overall effectiveness of the ACOT reform, since the majority of the inefficiencies identified are associated with future, not current, investments.

inappropriately diminished, by treating distributed generators differently according to their commissioning date;

- undertake work to develop the generic approach that would be used by Transpower as a broad framework in its contracting arrangements between distributed generation providers and Transpower. This work should be undertaken in an open and transparent manner in order to ensure that all relevant issues are considered; and

- apply the new approach once the new TPM and Distributed Pricing Principles are finalised.

Summary

It is hard to justify the continuation of ACOT payments under the current rules if they are not providing an efficiency benefit. But BusinessNZ does not believe the proposal to be a suitably proportionate response in light of the quality of the CBA and the implementation issues it has highlighted.

Removing the current ACOT framework should be done in a careful and deliberate manner, not in a precipitate way that could have unintended consequences or send inappropriate signals to all investors. We have sought to use this submission to highlight some of those areas to which the Electricity Authority could give further consideration, as well as an alternative pathway forward which we believe would result in a higher quality regulatory outcome.

Yours sincerely

John 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