Status of existing prudent discount agreements and notional embedding contract under new TPM

Consultation Paper

Executive summary

Transpower is party to two existing prudent discount agreements (PDAs) and a notional embedding contract (NEC) which provide various parties with discounts on their transmission charges. The existing PDAs (Waipori and Aniwhenua/Matahina) and NEC (BlackPoint) were agreed under transmission pricing arrangements that are or will soon be obsolete – as the new transmission pricing methodology (TPM) is due to commence in April 2023.

The new TPM also allows for prudent discounts – but only if they can be justified by reference to the settings of the new TPM.

The Electricity Authority (Authority) is considering the status of the existing PDAs and NEC. The Authority is consulting on three options:

1. take no action – allow the regulatory change mechanisms in each contract to operate under the current Electricity Industry Participation Code 2010 (Code) settings
2. an amendment to the Code, so the NEC is no longer an exception to the general rule that Transpower must charge for transmission services in accordance with the TPM[1]
3. an amendment to the Code to ensure that the NEC and existing PDAs end at the commencement of the new TPM.

The Authority considers all three options are viable but currently prefers the balance struck by option 2 as it:

- reduces the likelihood of an outcome inconsistent with the new TPM, acknowledging that a materially different pricing structure will be in place from 1 April 2023
- treats the existing PDAs and the NEC even-handedly
- recognises the pre-existing contractual (regulatory change) mechanisms in the PDAs and NEC, leaving it to the parties to those contracts to consider what, if any, further discussions they should have.

The Authority welcomes feedback from interested parties on this proposed Code amendment.

[1] The Code amendment need not cover the existing PDAs, as they are not an exception to this general rule.

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What this consultation paper is about

1.1 The purpose of this paper is to consult with interested parties on the Authority's proposal to amend the Code so the NEC is no longer an exception to the general rule that Transpower must charge for transmission services only in accordance with the TPM. The problem we are seeking to address is explained further in section 2 of this paper and the proposed Code amendment is discussed in section 3.

1.2 This consultation follows on from the Authority's April 2022 decision to incorporate a new TPM into the Code and its recent consultation (from 28 April-18 May 2022) on three other proposed TPM-related Code amendments.

1.3 Section 39(1)(c) of the Act requires the Authority to consult on any proposed amendment to the Code and corresponding regulatory statement. Section 39(2) provides that the regulatory statement must include a statement of the objectives of the proposed amendment, an evaluation of the costs and benefits of the proposed amendment, and an evaluation of alternative means of achieving the objectives of the proposed amendment. The regulatory statement for this Code change is at section 4 of this paper.

How to make a submission

1.4 The Authority's preference is to receive submissions in electronic format (Microsoft Word) in the format shown in Appendix B. Submissions in electronic form should be emailed to TPM@ea.govt.nz with "Consultation Paper – PDAs/NEC" in the subject line.

1.5 If you cannot send your submission electronically, please contact the Authority (TPM@ea.govt.nz or 04 460 8860) to discuss alternative arrangements.

1.6 Please note the Authority intends to publish all submissions received. If you consider that we should not publish any part of your submission, please:

(a) indicate which part should not be published

(b) explain why you consider the Authority should not publish that part, and

(c) provide a version of your submission that the Authority can publish (if we agree not to publish your full submission).

1.7 If you indicate there is a part of your submission that should not be published, the Authority will discuss with you before deciding whether to publish that material.

1.8 However, please note that all submissions received by the Authority, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means the Authority would be required to release material not published unless good reason existed under the Official Information Act to withhold it. We would normally consult with you before releasing any material that you said should not be published.

When to make a submission

1.9 Please deliver your submission by **5pm** on **Wednesday, 22 June 2022**.

1.10 Authority staff will acknowledge receipt of all submissions electronically. Please contact the Authority (TPM@ea.govt.nz or 04 460 8860) if you do not receive electronic acknowledgement of your submission within two business days.

2 The problem we are seeking to address

Transpower is party to contracts entered under prior settings

2.1 Currently, Transpower is party to certain contracts that were entered into under the settings that exist (or previously existed) before the commencement of the new TPM. In particular, the Authority understands that Transpower is a party to the following three contracts which provide prudent discounts:

(a) an NEC entered into with Network Waitaki and Meridian Energy in 2006 (and ending 31 March 2026)

(b) a PDA entered into with Aurora Energy and Trustpower in 2013 (and ending 23 October 2028)

(c) a PDA entered into with Nova, Trustpower, and Horizon Energy in 2014 (and ending 31 March 2029).[2]

2.2 Broadly, these contracts provide transmission customers with prudent discounts on their transmission charges. The purpose of each was to encourage the relevant parties to remain connected to the transmission grid, rather than bypassing the grid (e.g. connecting generation directly to a distribution network, rather than to the grid) in the context of the then existing TPM (and the financial incentives that created). This is similar to the purpose of the inefficient bypass limb of the prudent discount policy under the new TPM.

The Code treats the existing PDAs and NEC differently

2.3 The Authority considers that the existing wording of the Code (clause 12.95) and the TPM (clause 10(5)) means that any current PDAs will likely cease to have effect at the commencement of the new TPM as the Code requires transmission charging to be in accordance with the TPM (aside from some exceptions listed in clause 12.95). The Authority understands that Transpower shares this view regarding the existing PDAs.[3]

2.4 However, the Authority considers that the status of the NEC is less clear. Clause 12.95 of the Code provides that Transpower must charge for transmission services only in accordance with the approved TPM, subject to certain exceptions. The exceptions include notional embedding contracts, but not prudent discount agreements.[4] The Code defines a notional embedding contract to mean a contract entered into before 1 April 2008 between Transpower and its customer, under which the customer's generation assets are treated as if they were physically connected to load in lieu of their existing connection to the grid. Clause 12.95 may suggest, all other things being equal, the current NEC is to continue under the new TPM.

Pricing outcomes could deviate from the intent of the new TPM

2.5 The new TPM is based on a benefit-based approach to allocating transmission costs, where those who benefit from specific grid investments would pay for them. Charges

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2 We understand from Transpower that Southern Generation Limited partnership now holds Nova's interest in this PDA.

3 See Transpower's December 2021 letter to the Authority on this subject, at Appendix C of this paper.

4 The other exceptions are input connection contracts and new investment agreement contracts.

under the new TPM are intended to promote more efficient grid use and more efficient investments, for the long-term benefit of consumers.

2.6 If the existing NEC continued after 1 April 2023, pricing outcomes for the affected transmission customers may well deviate from the approach intended under the new TPM. For example, parties might pay charges for some benefit-based investments (and possibly connection investments) that do not reflect the benefits they receive from the transmission grid. This outcome might fail to achieve some of the intended benefits of the new TPM, imposing economic costs on other consumers.

The existing PDAs and NEC, if they continued, could lead to prudent discounts that would not be granted under the new TPM

2.7 The Authority understands that the existing PDAs and NEC were entered into with a view to avoiding inefficient bypass of the grid. If these agreements were to continue, however, the risk is that they would provide discounts that are not necessary to prevent inefficient grid bypass under the new TPM.[5] This is because of the substantial differences between the new TPM and the transmission pricing arrangements under which these contracts were entered into,[6] meaning a core part of the bargain these contracts were based on effectively disappears.

2.8 For example, a key component of the existing TPM is an interconnection charge, which is allocated based on grid offtake during periods of regional coincident peak demand. All of the existing contracts involve notionally embedded generation. Under the current TPM, a load customer with embedded generation will have lower grid offtake and so a lower interconnection charge than a similar load customer without embedded generation. This lower charge resulting from embedded generation is a key component of the business case for bypassing the grid that underlies these contracts.

2.9 However, under the new TPM, embedded generation does not reduce a load customer's residual charge allocation in this way (as residual charges are intended to be allocated based on gross energy, which counts energy supplied by embedded generators as well as energy supplied by grid-connected generators). So, it is not clear that the circumstances that gave rise to the existing PDAs and NEC would result in a prudent discount being granted under the new TPM. That is, if discounts continued to be provided under these contracts,[7] such discounts might be unnecessary to prevent inefficient bypass under the new TPM – in which case the agreements would be imposing economic costs on other consumers.

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5 Or at least, the existing PDAs could have this effect but for the existing wording of the Code (clause 12.95) and the TPM (clause 10(5)), which in the Authority's view means that any current PDAs will cease to have effect at the commencement of the new TPM.

6 The current TPM, in the case of the PDAs, and the transmission pricing arrangements preceding the current TPM, in the case of the NEC.

7 For example, if Meridian's generation is treated as if it is embedded at Blackpoint under the new TPM this could lead to Meridian and Network Waitaki being allocated benefit-based charges and/or connection charges that are different to the charges they would be allocated based on the actual connection arrangements. This might result in an effective discount to charges – regardless of whether or not that discount is actually necessary to prevent inefficient bypass of the grid under the new TPM.

Prudent discounts are allowed where necessary to avert inefficient bypass under the new TPM

2.10 The new TPM allows for prudent discounts to be provided to transmission customers in limited circumstances. One of the situations where a prudent discount may be provided is where it is privately beneficial for the customer to undertake a project that would allow it to bypass the existing grid, even though it is not efficient to do so.[8] That is, a deviation from the benefit-based pricing approach (causing economic costs / inefficiency) is allowed only where it is necessary to prevent the greater inefficiency of grid bypass, which would otherwise be likely to occur.

2.11 In order to assess whether a prudent discount is necessary to prevent inefficient bypass occurring under the new TPM, an assessment must be made against the new TPM's transmission pricing arrangements. That is, an application for a prudent discount should be made under the new TPM's prudent discount policy (PDP). The PDP provides that, for an inefficient bypass prudent discount, the customer's charges are discounted by no more than necessary to make it no longer commercially viable for the customer to bypass the grid.[9]

2.12 If the parties to the existing PDAs and NEC consider that a prudent discount is justified under the new TPM, they could make an application under the new TPM. Transpower's assessment of the circumstances according to the prudent discount provisions in the new TPM would determine whether or not a prudent discount is justified – and for the long-term benefit of consumers.[10]

Stakeholders expressed views on existing PDAs in submissions

2.13 In the indicative pricing released with the 2021 Proposed TPM consultation paper, it was assumed that the existing PDAs and NEC would not be carried over to the new TPM.[11] The indicative prices under the proposed TPM therefore did not reflect any discounts. Several submissions in response raised concerns about the treatment of existing prudent discounts under a new TPM.

2.14 In its submission, Horizon Networks suggested the proposed new TPM would compromise the viability of the prudent discount agreement relating to the notional embedding of Southern Generation's Aniwhenua generation and Trustpower's Matahina generation. We agree there are substantial differences between the new TPM and the transmission pricing arrangements under which this contract was entered into, meaning that a core part of the bargain this contract was based on effectively disappears.

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8 The other situation is where a customer's transmission charges would exceed the standalone cost of supply.

9 The PDP also provides that a standalone cost prudent discount applies only when the customer would otherwise pay more than the standalone cost of transmission lines services equivalent to the services they receive from the grid, with the corollary being that the customer's transmission charges are above the incremental cost of transmission lines services equivalent to the services they receive from the grid.

10 The Authority notes that the new TPM enables backdating of any new prudent discounts to the date the new TPM comes into force (1 April 2023) – provided that the prudent discount application is received by Transpower within six months of the publication of prudent discount application requirements and fees. This means that if a customer with an existing PDA or NEC applies for and is granted a PDA under the new TPM, the customer has the option of timing its application so that it could be covered by an appropriate PDA from the commencement of the new TPM (should it be entitled to one under the new TPM).

11 See also Transpower's 2021 Reasons paper, Appendix B: Indicative Prices, page B4.

2.15 Network Waitaki submitted that its largest customer[12] might have decided to bypass the grid rather than enter into a Notional Embedding Agreement in 2006, had the customer anticipated the huge regulatory change and consequential price impact on them from the proposed new TPM. It also submitted that a prudent discount should be allowed to automatically renew unless conditions have materially changed to trigger pre-specified reopeners. Transpower disagreed with the latter statement (in its cross-submission), noting that the best way to determine if *“conditions have materially changed”* is through repeating the prudent discount application process and applying the applicable tests again.

2.16 The Authority does not in principle agree that a prudent discount should automatically renew, given the risk that this would lead to an outcome inconsistent with the new TPM which is a materially different methodology to the one currently in place. The Authority agrees with Transpower that applying the tests for a prudent discount under the new TPM would be the most appropriate way to determine if a prudent discount is required. That said, we are aware that the existing PDAs and NEC have regulatory change provisions within them. These provisions provide a contractual route to considering whether the contracts could appropriately continue under a new TPM.

2.17 Southern Generation Limited Partnership suggested that grandfathering existing prudent discount agreements under a new TPM would dramatically reduce uncertainty for transmission customers and pressure on Transpower in implementing any approved TPM by 1 April 2023. However, the Authority considers that arrangements should not be kept in place that aren’t consistent with the new TPM. In the course of TPM reform the Authority has consistently declined to accept arguments by various stakeholders that have sought to preserve existing positions that are inconsistent with the long-term benefit of consumers.

The status of the existing contracts needs to be resolved

2.18 In the remaining months leading up to the commencement of the new TPM in April 2023, Transpower is involved in a number of tasks related to TPM implementation, including the calculation of transmission prices that will apply for the first year of the new TPM. If any prudent discounts apply for the first year, the amount of the discount must be deducted from the charges of the customer to whom the prudent discount applies and added to other parties’ charges. It is therefore useful to clarify the status of the existing PDAs and NEC before Transpower can complete its calculation of transmission prices that will apply for the first year of the new TPM.

Q1. Has the problem with the existing PDAs and NEC been correctly identified?

12 The North Otago Irrigation Company.

3 The proposed Code amendment

Options

3.1 The Authority is considering three options to address the problem discussed in section 2:

(a) Option 1: take no action

(b) Option 2: an amendment to the Code, so the NEC is no longer an exception to the general rule that Transpower must charge for transmission services only in accordance with the TPM

(c) Option 3: an amendment to the Code to ensure that the NEC and existing PDAs end at the commencement of the new TPM.

3.2 All three are viable options, however the Authority's current preference is for option 2, as we consider that this option best balances the structural change to the TPM that will occur from 1 April 2023 and the pre-existing contractual bargains of the parties, while treating the PDAs and NEC even-handedly.

Analysis

3.3 Under option 1, the parties to the existing PDAs and NEC could determine the status of these contracts via the regulatory change provisions in the contracts. For the reasons discussed in section 2, the Authority's current position is that option 1 should not be adopted. Option 1 is most likely to lead to an outcome inconsistent with the new TPM. This is because, under Option 1, the NEC remains an exception to the general rule that Transpower must charge for transmission services only in accordance with the TPM. Accordingly, the risk is that (at least under the NEC) discounts would be provided that are not necessary to prevent inefficient grid bypass under the new TPM, which would impose economic costs on other consumers.

3.4 The Authority considers that the NEC should no longer be an exception to the rule that Transpower must charge for transmission services in accordance with the TPM. Removing this exception in the Code would reduce the likelihood of an outcome inconsistent with the new TPM (the risk discussed above). It would also place the parties to the NEC in the same position as the parties to the existing PDAs. The Authority is unaware of any logical rationale for preserving one contract but not the other two.

3.5 The discussion in section 2 provides the basis for an argument that the existing PDAs and NEC should not continue under the new TPM. So, the Authority has considered whether to explicitly end all three of these contracts via a Code amendment (option 3). Resolving this issue now would support TPM implementation by allowing Transpower to complete its calculation of prices for the first year of the new TPM in a timely manner.

3.6 However, given that the existing PDAs and NEC have regulatory change provisions within them, it is clear that the parties did contemplate at least considering whether the contracts could appropriately continue if there was a relevant change in the rules (such as a new TPM). The Authority prefers to honour contractual bargains and risk allocations where possible. So, option 3 is not the Authority's currently preferred option.

3.7 Accordingly, the Authority's current preference is option 2, which would allow the contractual regulatory change provisions to take effect. The Authority considers that it is appropriate in principle for the parties to these contracts to at least consider whether they will be able to achieve any form of resolution through the provisions of the respective agreements. Note that, as discussed in section 2, the Authority's view is that the wording of the Code (clause 12.95) and the TPM (clause 10(5)) means that any current PDAs would likely cease to have effect at the commencement of a new TPM and if the Authority decides on option 2, we expect the same would apply to the NEC. Whatever the case, option 2 is likely to result in an outcome consistent with the new TPM.

3.8 In forming this view the Authority has explicitly considered the extent which it is interfering in private contractual arrangements, negotiated and settled in good faith by the parties, that allocate risk and specifically contemplate regulatory change. As noted above, the Authority's preferred option seeks to achieve a balance: to limit that interference in existing contracts as much as possible, while not supporting any ongoing discounting that would be at odds with the new TPM, and which would ultimately be a cost borne by other transmission customers.

The proposed amendment

3.9 The Authority proposes to amend clause 12.95 to remove the reference to "notional embedding contract". This would mean the existing NEC would have the same status as the existing PDAs: it would no longer be an exception to the rule in clause 12.95. The effect would be that Transpower must charge for transmission services only in accordance with the approved TPM.

3.10 The Authority also proposes removing from clause 12.95 the references to:

(a) "input connection contracts", as the Authority understands Transpower is no longer charging under any current input connection contract

(b) "new investment agreement contracts" (pre-April 2008 investment agreements), as these are expressly captured in the new TPM's definition of "investment agreement", meaning the new TPM accommodates the charges under these agreements and so clause 12.95 does not need to.

3.11 Appendix A of this paper contains the proposed Code amendment (Option 2), and also an alternative Code amendment (Option 3).

Q2. What are your views on the Authority's proposal to amend the Code so the NEC is no longer an exception to the general rule that Transpower must charge for transmission services only in accordance with the TPM?

4 Regulatory statement for the proposed amendment

Objectives of the proposed amendment

4.1 The objectives of the proposed Code amendment are described in sections 2 and 3 of this paper.

Q3. Do you agree with the objectives of the proposed amendment? If not, why not?

The proposed amendment

4.2 The Authority proposes to amend Part 12 of the Code as described in section 3 of this paper.

The expected benefits outweigh the expected costs

4.3 The Authority has assessed the benefits and costs of the proposed Code amendment and expects it to deliver a net benefit.

4.4 Relative to the status quo arrangements:

(a) the expected incremental benefits of the proposed amendment include improved efficiency and durability (due to reduction of the risk that unjustified prudent discounts might continue).

(b) the expected incremental cost of the proposed amendment is that if the recipients under the existing NEC choose to apply for a prudent discount under the new TPM, that application might occur earlier than otherwise may be the case, resulting in an increased present value of the costs associated with applying for a prudent discount.[13]

4.5 Table 1 summarises the expected incremental benefits and costs of the proposed amendment relative to the counterfactual of no changes being made to the Code.

[13] As discussed at paragraph 2.3, the Authority is of the view the wording of the Code and the new TPM means that any current PDAs cease to have effect at the commencement of a new TPM. We therefore consider that the focus of the cost assessment should be solely on the NEC, not the PDAs.

Table 1: Summary of the proposed amendment's expected benefits and costs

Benefit / Cost	Magnitude of benefit / cost
The *benefit* from removing the risk that unjustified prudent discounts might continue under the new TPM	Improved efficiency and durability (unquantified)
The *cost* to implement the proposal	Increased transactions costs ($10,000 – $20,000)
The ongoing *cost* for industry participants to operate under the proposal	$0
Net benefit	**Expected to be positive**

The benefits of the proposed amendment

4.6 The Authority expects this proposal to result in improvements in efficiency and in the durability of the new TPM.

4.7 If the Authority did not proceed with this proposal, it is more likely (although not certain) that the existing NEC between Transpower, Network Waitaki and Meridian would continue, and allow some level of discount that is contrary to the intent of the new TPM. In that scenario, a prudent discount might continue to operate and Network Waitaki and Meridian (under the NEC) might pay charges for some benefit-based investments (and possibly connection investments) that did not reflect the benefits they receive from the transmission grid. If this discount was not necessary to avert inefficient bypass of the grid, it would mean unnecessary economic costs were being imposed on other consumers. That is, some of the benefits of the new TPM would fail to be achieved due to the distortion to efficient pricing caused by the discount – and there would be no offsetting efficiency gain from preventing bypass.

4.8 By contrast, the Authority's proposal significantly reduces the likelihood of this outcome by ensuring that the NEC is no longer an exception to the general rule that Transpower must charge for transmission services only in accordance with the TPM. The proposed Code amendment makes it more likely that all contractual parties (Network Waitaki and Meridian, under the NEC) would pay charges for benefit-based investments that reflect the benefits they receive from the transmission grid – unless they are able to secure a prudent discount that is awarded under the prudent discount provisions of the new TPM. The Authority's proposal more likely results in a transmission pricing regime where prudent discounts are consistent with the purpose of the prudent discount policy under the new TPM, which is likely to be more efficient and more durable.

4.9 This outcome is consistent with the intent of the new TPM and would contribute to achieving the efficiencies and the long-term benefits to consumers that the TPM as a whole is designed to achieve.

4.10 These benefits are difficult to quantify, particularly as it is currently unknown whether or not a prudent discount would be justified if the parties applied under the new TPM. However, distortions to efficient pricing can have substantial consequences for consumers, as demonstrated by the CBA for the new TPM,[14] but noting that the efficiency benefits relating to this particular Code amendment proposal are likely to be relatively minor. Further, allowing unjustified prudent discounts to continue under the new TPM risks undermining the durability of the new TPM.[15] As noted above, in the course of TPM reform the Authority has consistently declined to accept arguments by various stakeholders that have sought to preserve existing positions that are inconsistent with the long-term benefit of consumers.

4.11 The specific change in transmission charges paid by transmission customers to cover the cost of any ongoing prudent discount under the NEC (and possibly the PDAs) is ignored for the purposes of assessing the benefits of the proposal, as it represents a wealth transfer.

The costs of the proposed amendment

4.12 If the NEC (and PDA) recipients decide to apply for a prudent discount under the new TPM, they will incur the following incremental costs:

(a) the costs of preparing a prudent discount application under the new TPM

(b) if Transpower approves the application, any costs associated with entering into a PDA.

4.13 Assuming the NEC recipient intends to apply for a prudent discount with effect from 1 April 2023, the incremental cost from the proposed Code amendment is the time value of money associated with applying for a prudent discount sooner than the end of the contract (31 March 2026).[16] We have estimated the incremental cost of bringing forward the timing of the prudent discount application would be approximately $16,000. This estimate reflects the following assumptions:

(a) the NEC recipients intend to apply for a prudent discount with effect from 1 April 2023, i.e. the application is brought forward by three years

(b) the cost of applying for a prudent discount under the new TPM is approximately $100,000[17]

(c) the applicants' weighted average cost of capital (WACC) is 5%.[18]

4.14 For the purposes of the assessment of costs summarised in Table 1, the Authority has used a range of $10,000 – $20,000.

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14 See the 2022 TPM decision paper, chapter 14. The Authority's analysis suggests a central estimate of net benefit to New Zealanders from the new TPM of approximately $1.8 billion over the next 28 years.

15 To be clear, we do not know whether the discount under the existing NEC is unjustified or that it is not necessary to avert inefficient bypass of the grid. However, this risk exists. The best way to determine if a prudent discount is justified is for the parties to apply for a prudent discount under the new TPM.

16 As discussed at para 2.3, the Authority is of the view the wording of the Code and the new TPM means that any current PDAs cease to have effect at the commencement of a new TPM. We therefore consider that the focus of the cost assessment is on the NEC, not the PDAs.

17 The Authority's estimate is that an applicant would incur costs in the range of approximately $65,000 – $125,000.

18 Noting that 4.5% was the 75th percentile vanilla WACC for distributors published by the Commerce Commission in its *Cost of capital determination for disclosure year 2022 for information disclosure* regulation, available at https://comcom.govt.nz/__data/assets/pdf_file/0018/253620/2021-NZCC-4-Cost-of-capital-determination-EDBs-and-WIAL-ID-30-April-2021.pdf.

4.15 Any change in transmission charges paid by existing PDA and NEC recipients is ignored in assessing this proposal's costs, as it represents a wealth transfer.

4.16 While we have not quantified the benefits of this proposal, the Authority expects that the improved efficiency and durability outlined above would be likely to exceed the costs noted here. So, the Authority considers that the CBA supports the proposed option and expects that its proposal would have net long-term benefits for consumers, consistent with its statutory objective. For completeness though, we note that the net benefits of this specific Code amendment proposal are relatively minor, especially in the context of the net benefits we expect to result from the overall TPM reform.

Q4. Do you agree the benefits of the proposed amendment would outweigh its costs?

Alternative means of achieving the proposed amendment's objectives

4.17 The Authority has considered alternatives, but considers they are inferior to its proposal.

4.18 The Authority considered letting the existing PDAs and NEC continue subject to the current Code and their renegotiation provisions (option 1). We concluded that the cost of doing so (i.e. the risk of allowing contracts that were not appropriate under new TPM settings to persist) would not justify any savings that would result from leaving the parties to work through the change provisions in those contracts under the current clause 12.95 of the Code.

4.19 The Authority also considered removing the protection in the Code for the NEC, and also proposing to include an amendment that clearly ends the existing PDAs and NEC from the commencement of the new TPM (that is, option 3: making the proposed amendment to clause 12.95 and also a further proposed amendment that would insert a new clause 12.95A). This option would potentially reduce transactions costs (as contractual negotiations would not need to be undertaken to determine whether existing contracts can or should continue). However, this option would override the contractual bargain agreed between the parties to the NEC. Acknowledging the general value and efficiency of contractual risk allocation,[19] and the risk of regulatory interventions undermining this, the Authority prefers not to take such a course of action unless the long-term benefits to consumers are clear. In this case, option 3 likely only marginally alters the risk of inefficient outcomes (noting the Authority's view that if the proposed amendment to clause 12.95 was made, the existing PDAs and the NEC would cease to have any effect from commencement of the new TPM).

Q5. Do you agree the possible alternatives are inferior to the proposed amendment? If you disagree, please explain your preferred alternative option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.

The proposed amendment complies with section 32(1) of the Act

4.20 The Authority's objective under section 15 of the Act is to promote competition in, reliable supply by, and efficient operation of, the electricity industry for the long-term benefit of consumers.

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19 Especially between substantial parties that have explicitly considered and allocated these risks in a written contract.

4.21 Section 32(1) of the Act says the Code may contain any provisions that are consistent with the Authority's objective and are necessary or desirable to promote one or all of the following:

Table 2: How the proposed amendment complies with section 32(1) of the Act

(a) competition in the electricity industry;	The proposed amendment is not expected to have a material impact on competition in the electricity industry.
(b) the reliable supply of electricity to consumers;	The proposed amendment is not expected to have a material impact on the reliable supply of electricity to consumers.
(c) the efficient operation of the electricity industry;	The proposed amendment improves the efficient operation of the electricity industry by reducing the potential risk of inefficient pricing, unjustified prudent discounts and harm to pricing methodology durability.
(d) the performance by the Authority of its functions;	The proposed amendment will improve the Authority's performance of its statutory functions.
(e) any other matter specifically referred to in this Act as a matter for inclusion in the Code.	The proposed amendment will not materially affect any other matter specifically referred to in the Act for inclusion in the Code.

Q6. Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?

The Authority has given regard to the Code amendment principles

4.22 When considering Code amendments, the Authority is required by our Consultation Charter[20] to have regard to the following Code amendment principles, to the extent we consider them to be applicable. Table 3 describes the Authority's regard for the Code amendment principles in the preparation of the proposed Code amendment.

20 The consultation charter is one of the Authority's foundation documents and is available at: http://www.ea.govt.nz/about-us/documents-publications/foundation-documents/.

Table 3: Regard for Code amendment principles

Principle	Comment
1. Lawful	The proposed amendment is lawful and consistent with the statutory objective (see section 4) and with the empowering provisions of the Act.
2. Provides clearly identified efficiency gains or addresses market or regulatory failure	The efficiency gains are set out in the evaluation of the costs and benefits (section 4).
3. Net benefits are quantified	The extent to which the Authority has been able to estimate the efficiency gains is set out in the evaluation of the costs and benefits (section 4).
4. Preference for small-scale 'trial and error' options	Not applicable. Principles 4 – 8 apply when the CBA of Code amendment options demonstrate a positive net benefit relative to the counterfactual, but is inconclusive about which is the best option. Principles 4 – 8 apply do not apply in this case as the CBA conclusively supports the proposed option.
5. Preference for greater competition	Not applicable. (See principle 4.)
6. Preference for market solutions	Not applicable. (See principle 4.)
7. Preference for flexibility to allow innovation	Not applicable. (See principle 4.)
8. Preference for non-prescriptive options	Not applicable. (See principle 4.)
9. Risk reporting	Not applicable, as the CBA conclusively supports the proposed option.

Appendix A Proposed Code amendment

A.1 Set out below is the proposed Code amendment (option 2).

Application of approved transmission pricing methodology

12.95(1) **Charges to comply with approved transmission methodology**

~~Except for the **input connection contracts, new investment agreement contracts,** and **notional embedding contracts**,~~ **Transpower** must charge for those transmission services affected only in accordance with the ~~approved~~ **transmission pricing methodology**.

Q7. Do you have any comments on the drafting of the proposed Code amendment?

A.2 Set out below is the alternative Code amendment (option 3).

Application of approved transmission pricing methodology

12.95(1) **Charges to comply with approved transmission methodology**

~~Except for the **input connection contracts, new investment agreement contracts,** and **notional embedding contracts**,~~ **Transpower** must charge for those transmission services affected only in accordance with the ~~approved~~ **transmission pricing methodology**.

12.95A **Existing notional embedding contracts and prudent discount agreements to end**

The following agreements end on the commencement date of this clause 12.95A:

(a) **notional embedding contracts**:

(b) prudent discount agreements that applied to a pricing year (as defined in the **transmission pricing methodology**) before the commencement date of this clause 12.95A.

Appendix B Format for submissions

Submitter	

Question		Comment
Q1.	Has the problem with the existing PDAs and NEC been correctly identified?	
Q2.	What are your views on the Authority's proposal to amend the Code so the NEC is no longer an exception to the general rule that Transpower must charge for transmission services only in accordance with the TPM?	
Q3.	Do you agree with the objectives of the proposed amendment? If not, why not?	
Q4.	Do you agree the benefits of the proposed amendment would outweigh its costs?	
Q5.	Do you agree the possible alternatives are inferior to the proposed amendment? If you disagree, please explain your preferred alternative option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.	
Q6.	Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?	
Q7.	Do you have any comments on the drafting of the proposed Code amendment?	

Appendix C Transpower’s December 2021 letter to the Authority

Glossary of abbreviations and terms

Authority	Electricity Authority
Act	Electricity Industry Act 2010
Code	Electricity Industry Participation Code 2010
NEC	notional embedding contract
PDA	prudent discount agreement
PDP	prudent discount policy
TPM	transmission pricing methodology
WACC	weighted average cost of capital