22 June 2022

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CONSULTATION PAPER – STATUS OF EXISTING PRUDENT DISCOUNT AGREEMENTS AND NOTIONAL EMBEDDING CONTRACT UNDER NEW TPM

1.0 Introduction

Network Waitaki welcomes the opportunity to provide comments to the Authority on the consultation paper titled "*Status of existing prudent discount agreements and notional embedding contract under review*".

Throughout the development of the Transmission Pricing Methodology (TPM), Network Waitaki has actively participated in the consultation process and submitted comments and concerns on numerous occasions to the Authority. At this point we acknowledge that the new TPM will come into effect in 2023 (subject to the outcome of the Trustpower judicial review).

We understand and acknowledge that the new TPM is completely different from the current TPM and the Authority's aim is to have consistent provisions in the Code to achieve pricing outcomes in accordance with the new TPM.

Nonetheless, and as you are aware from our previous submissions and related conversations with Authority staff, Network Waitaki is deeply concerned about the long-term implications of Transmission related costs on our region arising from the change to the TPM. In particular, the impact on the North Otago Irrigation Company (NOIC) who are the sole user of the Black Point GXP, and who are currently the beneficiary of the only remaining Notional Embedding Contract (NEC).

Our submission is in respect of Notional Embedding contracts only.

2.0 Summary of the current NEC

- The current NEC was entered into between Transpower, Network Waitaki and Meridian in 2006 to notionally embed the Black Point load behind Meridian at the Waitaki GXP.
- The Black Point GXP is physically connected via a tee connection to one of the Transpower owned Waitaki-Glenavy 110kV lines.
- The parties entered into an NEC as it was the most efficient solution, commercially and technically, avoiding potential duplication of assets at the time (e.g. NOIC or Network Waitaki building an additional 33kV or 110kV line and inefficiently bypassing the grid).
- Network Waitaki and NOIC had several investment options at the time but chose to accept this arrangement, with commercial and price certainty offered through a 20-year contract.
- Network Waitaki and NOIC, in good faith and trusting the regulatory regime accepted this proposal and entered into a commercial contract with the reasonable expectation that the contractual terms, obligations and charges will be honoured until expiry on 31 March 2026.

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3.0 Scale of the issue raised by the Authority

The Authority goes to great length in the consultation paper to refer to the "cost" that will need to be borne by other transmission customers if this one remaining NEC remains in force until expiry on 31 March 2026.

To put this in perspective, out of Transpower's total Maximum Allowable Revenue (MAR) of about $809m the estimated $385k increase in Transmission charges that will need to be "socialised" in some way if the NEC remains in force will make up 0.05% of total transmission costs for NZ Inc.

This 0.05% should be considered against the impact of a 168% ($385k) increase in Transmission charges[1] for NOIC (who supplies 166 farmers with irrigation services in the Network Waitaki supply area) should the NEC come to an end.

The Authority has regularly acknowledged that there will be 'winners and losers' in the process but except for general discussions on the matter we have not seen concerns of the 'losers' being addressed, especially in smaller supply areas like Network Waitaki. For example, the Authority dismissed Network Waitaki's recommendation to consider a transitional cap for a customer like NOIC, in the same manner as other large direct connect customers.

As we have outlined in previous submissions, had NOIC been a direct connect customer at the Black Point GXP it could have benefited from the transitional cap provisions under the new TPM.

We note that the intent of the transitional cap provisions is to lessen the impact on some customers, up to a maximum of a 3.5% increase in total bill. This arrangement is estimated to cost the industry $2.2m[2] and is a clear **socialisation of transmission costs** which goes against the principles the Authority is suggesting requires the termination of Notional Embedding and Prudent Discount agreements.

It is of great concern to us that the Authority would for the sake of the last remaining NEC (with only three years left to run) risk implementing regulatory change to amend the code to effectively terminate valid commercial contracts when that code had been drafted in such a way as to preserve the status of NECs. There is considerable risk to the Authority in this action by creating an uncertain regulatory environment for commercially contracted parties, putting their own regulatory reputation on the line, and ignoring the huge cost impact on a single regional electricity consumer.

In a time when there is considerable investment to be made in electricity infrastructure, investors need to have regulatory stability and certainty to ensure they can choose appropriate long-term investments, commercial contracts are safe from regulatory interference, and risk can be adequately predicted and managed. Without this, the appetite for investment for the long term could be severely undermined.

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[1] This excludes the New Investment Charge at Blackpoint

[2] Transpower. Indicative Prices (Pricing year 2022/23, p. 12)

4.0 We believe the Authority has not made a clear case for change

We have concern as to whether the Authority has prepared this proposal with sufficient robustness – notably the inconsistent application of principles, nor has it made a clear case for change:

- it indicates the need to end notional embedding and prudent discount agreements as they do not achieve the objectives of the new TPM because it leads to cost socialisation, but yet is quite comfortable with the transitional cap provisions designed into the new TPM which are a clear cost socialisation. This is inconsistent application of the principles of the new TPM.
- the issue is not material for NZ Inc (with 0.05% of costs socialised) but is significant for Network Waitaki and NOIC at Black Point (a 168% increase).
- under section 4.5 of the consultation document, the benefits are stated as "unquantifiable" and the overall net benefit is "Expected to be positive", but this is not substantiated in any way.
- under section 4.22, the test of whether net benefits are quantified refers back to section 4, which relates to the point above, and has not been robustly quantified.

Our view is the Authority has not undertaken sufficient analysis to clearly demonstrate there are net positive benefits, and to prepare a consultation document for a proposed code change on the basis of "unquantifiable" benefits is, in our view, poorly considered regulation.

Network Waitaki strongly disagrees with the proposed code change and rejects the proposed amendment to remove the reference to "notional embedding contract" (NEC) in the Code and is recommending alternative options below.

5.0 Recommendation

We recommend that the Authority consider amending the Code through the following alternative options

- Remove the ability for new NECs to be entered into, however allow the existing NEC to run to its natural expiry date in 2026, and then any new arrangements shall meet the requirements of the applicable TPM at the time, or

- Allow for transitional arrangements to phase out the NEC over the remainder of its term by way of a transitional pricing arrangement to avoid price shocks for the affected parties.

Through these alternative options, the Electricity Authority can achieve its intent of ensuring the Code reflects the intended outcomes of the TPM, by phasing out NECs from the Code over the short term, as well as its overarching statutory objectives through:

  - Commitment to regulatory certainty and stability for long-term investments through honouring the intent of the Code.
  - Respecting valid commercial contracts and allowing parties to negotiate the next terms on expiry as provided for under the applicable TPM of the time.
  - Safeguarding the regulatory reputation of the Authority by ensuring regulatory stability and certainty where significant investment in electricity infrastructure is required to support decarbonisation objectives of government. This action will signal

that commercial contracts involving long term infrastructure investment will not be undermined through regulatory change part way through the contractual term.

- Consistency with distribution pricing guidance as per the Authority's "Pricing Practice Note 2021 (2^{nd} edition) is achieved with phasing of the NEC to pricing under the new TPM rules. This will be aligned with the Authority's expectation of electricity distribution pricing reform, i.e. to smooth customer bill changes over time to an acceptable level of cost-reflectivity.

Appendix 1 contains detailed responses to the questions in the consultation.

For any questions or clarifications on this submission please contact our Regulatory Manager, Cornel van Basten.

Sincerely

[redacted]

Geoff Douch
Chief Executive

Appendix 1

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

Response	The problem has to a certain extent been identified but needs to include the following three aspects as well.

- **Risk of regulatory interference on commercial contracts and the implications on future investment in much needed electricity infrastructure to support government's decarbonisation objectives.**

  Perceived regulatory support for termination of an NEC, through the proposed amendment carries a risk of negatively impacting investors' perception of the stability, dependability, predictability, and reputation of the regulatory regime. The message to an investor such as an EDB or a large customer such as NOIC is that the Authority can influence contractual arrangements and does not trust parties to enter good faith negotiations through the regulatory provisions in contracts when regulatory change occurs.

  It is noted in par. 3.8 that the Authority considered interference in private contractual arrangements but that it seeks to achieve a balance between interference and ongoing discounting at odds with the new TPM. There is one NEC in existence currently. The "cost" of the discount of an estimated 0.05% of Transpower's MAR is negligible against the devastating impact of an increase of 168% ($385k) in current NEC charges for this customer.

  Any socialisation from such a discount will not be inconsistent with the funding of the transitional cap applicable to some direct connects.

- **Impact on affected customers.**

  It is surprising and disappointing that the impact on the customer that will be affected by the proposed amendment is not touched on in the problem discussion. NOIC has been paying the costs associated with the GXP for 16 years. If they bypassed the grid initially, they would have substantially repaid any alternative assets they might have invested in, resulting in lower longer-term costs for them.

  Load customers do not expect large increases in their charges after their capital has been sunk. With long term assets spanning a period of 50 years, it was reasonable to expect that the NEC would be extended at least until its natural expiry date.

- **Consistency with distribution pricing**. The Authority in its recent paper on "*Distribution Pricing Practice Note 2021 (2nd edition)*" acknowledged that the impact on consumers need to be considered by Electricity Distributors and have accepted that moving to cost-reflective pricing requires a transition to soften the impact as per paragraphs 59, 61 and 67 in the Distribution Pricing Practice Note 2021 (2nd edition).

  It is incomprehensible that the Authority would be prepared to go against its own advice given to Electricity Distributors in *Distribution Pricing Practice Note 2021 (2nd edition)* and go as far as a Code change to enable the termination of a negotiated commercial contract, without any consideration of the impact on the customer or consistency with its own distribution pricing advice.

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?

Response	Network Waitaki **strongly oppose** the proposed amendment, as it will create suspicion at investor level of the degree of regulatory stability and to what extent the Authority can be trusted to not make regulatory changes that affects commercial contracts. Regulatory uncertainty can affect investments, i.e. delay or deter it as investors must manage the risk inherent to this uncertainty and have to somehow recover the cost of the risk from somewhere.

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Further comments on the analysis on page 13 of the Consultation paper:

- Par. 3.3 states that *the risk of taking no action in accordance with option 1 will be that discounts will be provided that are not necessary to prevent inefficient grid bypass under the new TPM and thus imposing economic costs on other consumers*

  The cost risk to other consumers amounts to a total of $385k per annum, i.e. 0.05% of Transpower's MAR vs the cost of the regulatory risk created by the Authority overstepping its boundaries into the world of commercial contracts.

- In par. 3.4 the Authority states that *it is unaware of the logical rationale for preserving the NEC but not the other 2 existing PDAs*.

  The logical rationale is that all NECs entered into prior to 1 April 2008 have intentionally been included in the Code (prior to the implementation of the current TPM).

  The intent of the provision is clearly to send a message of regulatory commitment to participants that commercial contracts will be respected for their long-term nature and will be honoured irrespective of regulatory changes in the future.

  Thereby ensuring a stable and certain regulatory regime is maintained conducive to investment and safeguarding the validity of contractual arrangements.

- In par. 3.6 the Authority states that *it prefers to honour contractual bargains and risk allocations where possible and is therefore not in favour of option 3. Option 3 would have amended the Code to ensure the existing NEC and PDAs end at commencement of the new TPM.*

  Network Waitaki agrees that option 3 is unacceptable but argues that through the proposed amendment the Authority enables the same result as option 3.

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

Response

It is not clear what the objectives (as referred to in par. 4.1) are as they are not listed methodically in sections 2 and 3. The following list contains objectives implied in the text according to our reading of these sections and include Network Waitaki's comments on each.

- The Code treats the existing PDAs and NEC differently (Par. 2.3 and 2.4).

  Implied objective: **PDAs and NEC should be treated even-handedly**

  The Code interpretation of an NEC is clear and that the intention of including it is to protect those NECs entered into prior to 1 April 2008 from TPM changes. The current TPM does provide for PDA applications and hence two PDAs were entered into after 2008 in accordance with TPM rules.

  It is thus not a matter of even-handed treatment as that was never the intention. There is one legacy NEC in existence. As per Network Waitaki's recommendation allow the NEC to continue until expiry or put a transition mechanism in place, while not allowing any new NECs.

- Pricing outcomes could deviate from the intent of the new TPM (Par. 2.5 and 2.6)

  Implied objective: **Pricing outcomes must not deviate from the intent of the new TPM**

  The Code explicitly allows for an NEC's (only those entered before 1 April 2008) charges to differ from the approved TPM.

  In the case of the existing NEC the price will deviate from the pricing approach in the new TPM and the cost risk to other consumers amount to $385k. The Authority should allow and trust the affected parties to renegotiate the terms of the NEC rather than easing the way for Transpower to terminate the NEC early and risking future investor confidence through the proposed amendment

- The existing PDAs and NEC, if they continued, could lead to prudent discounts that would not be granted under the new TPM (Par. 2.7 to par. 2.9)

  Implied objective: **Existing PDAs and NEC should not be continued as they could lead to prudent discounts that would not be granted under the new TPM**

There is no disagreement that the existing PDAs and NEC have been granted under different regulatory regimes than the new TPM, hence the provision in the Code to protect NECs entered into prior to 1 April 2008 (clause 12.95(1)).

Clause 7.6 in the NEC contains a process for parties to determine whether the NEC can be amended or not. This is also acknowledged in par. 2.16 in the consultation paper, namely "*These provisions provide a contractual route to considering whether the contracts could appropriately continue under a new TPM.*" It is thus not necessary for the Authority to step into the area of commercial contractual arrangements and risk the stability of the regulatory environment for the sake of one NEC in place with an expiry date as near as 31 March 2026.

Investors in electricity infrastructure require long-term contracts to underpin their investment and manage their risk before committing to large capital outlays.

- Prudent discounts are allowed where necessary to avert inefficient bypass under the new TPM (Par. 2.10 to par. 2.12)

  Implied objective: **Prudent discounts to be allowed where necessary to avert inefficient bypass under the new TPM**

  Network Waitaki understands the provisions of the new TPM and the possibility for NOIC to apply for either a SACPD or IBPD as suggested by the Authority. These options will be considered and investigated to determine whether there is a potential for a successful PDA application in terms of the new TPM.

  Par. 2.17 and 4.10 contains an observation by the Authority on the suggestion from one party that grandfathering of PDAs will reduce uncertainty, that the Authority has *consistently decline to accept arguments by various stakeholders that have sought to preserve existing positions that are inconsistent with the long-term benefit of consumers.*

  Network Waitaki's submission regarding the NEC is not to seek preservation of an existing position but to request the Authority to leave commercial contractual arrangements to the parties involved and not to enable an outcome favoured by one party.

- The status of the existing contracts needs to be resolved (Par. 2.18)

  Implied objective: **The status of the existing NEC and PDAs must be resolved**

  Network Waitaki agrees that it is important to clarify the status of the current NEC. It is not a difficult issue in our view. The NEC has three years left until expiry and is justifiable as it is specifically provided for in the Code. It should now be left to the parties of the NEC to negotiate the terms for the remaining period in accordance with "regulatory change provisions" in the NEC.

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

Response

No, Network Waitaki does not agree that the benefits of the proposed amendment would outweigh its costs.

As per section 4.5 the alleged benefits of improved efficiency and durability of the proposed amendment cannot be quantified. However, what is quantifiable is that the benefits of the proposed amendment will not outweigh the cost for NOIC and the community in Network Waitaki's supply area.

We disagree with par. 4.4(a) that the benefit of improved efficiency and durability will be due to reduction of the risk that unjustified prudent discounts might continue.

- No improved efficiency as the existing NEC is not unjustified. NECs entered into prior to 2008 was specifically provided for in the Code to not have to be aligned to the TPM of the day. Thus, creating an efficient regulatory environment of certainty and stability for long-term commercial contractual arrangements.
- Durability is not supported due to the doubt that will be casted on the value of regulatory commitment. What value is there to regulatory commitment to respect NECs entered into prior to 1 April 2008 if an NEC's existence can be undermined three years prior to expiry? These turnabouts in commitments undermines durability.

NOIC will find it hard to trust entering a commercial contract again in this environment where the rules can change overnight leaving the company with a 168% increase in prices and no consideration by the Authority of the impact.

The cost of the ripple effect of enabling termination of a negotiated commercial contract and the message it sends to potential investors in an uncertain regulatory climate cannot be underestimated.

- The cost impact of this proposal will by far outweigh the benefit through the direct impact on 166 NOIC customers and the flow-on effect in the community supplied by Network Waitaki.

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

Response

Network Waitaki does not agree with either the proposed amendment or option 3 and recommends that the Authority consider amending the Code through the following **alternative options:**

- Remove the ability for new NECs to be entered into, however allow the existing NEC to run to its natural expiry date in 2026, and then any new arrangements shall meet the requirements of the applicable TPM at the time, or
- Allow for transitional arrangements to phase out the NEC over the remainder of its term by way of a transitional pricing arrangement to avoid price shocks for the affected parties.

These alternative options will be consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act:

- The overarching purpose of the Authority is to exercise its functions *for the long-term benefit of electricity consumers*

  First and foremost, the Authority must act for the long-term benefit of electricity consumers. This objective does not allow for discrimination but includes all consumers, including residential, commercial, and industrial companies such as NOIC.

  The Authority's proposed amendment will be to the long-term disbenefit of electricity consumers. Amending the Code to remove a clear intentional provision to safeguard contractual arrangements is a dangerous precedent for a regulator to set in an environment where government's decarbonisation goals will require huge capital investments.

  Investors will require assurance that investments will be safe and through this proposed amendment, changing the business environment of a company almost overnight, will not invoke investor confidence and will shift the risk and cost of that risk somewhere else, which will not be for the long-term benefit of electricity consumers.

  Instead, Network Waitaki's proposed alternative options will send a message:

  - To market participants that the Authority is committed to honouring of contractual arrangements and will not interfere but will let the regulatory change provisions in the contract be negotiated by the parties involved.
  - That regulatory commitments are firm. Reopening of a contract in accordance with the provisions of the contract should occur in the commercial world and the outcome not engineered by the Authority through Code amendments.

- *Limb 1: Promote competition in the electricity industry for the long-term benefit of electricity consumers*

  The proposed amendment by the Authority will not promote competition for the long-term benefit of electricity consumers because efficient investment will not be encouraged in an uncertain regulatory climate.

Any investor discouragement will affect the long-term value gains for consumers in aggregate. What value is there to a commitment if it can be undermined by the regulator on an arbitrary basis?

To promote competition, the Authority must create an investor-conducive environment that reduces risk and is supported by regulatory certainty.

Network Waitaki's proposed alternative options will facilitate a regulatory climate in which participants will have confidence and trust that the Authority will not undermine or interfere unnecessarily in regulatory rules and especially not those rules that impact on commercial agreements.

- *Limb 2: Promote reliable supply by the electricity industry for the long-term benefit of electricity consumers*

  Similarly, to the proposed amendment, the alternative options recommended by Network Waitaki will not be a barrier in the promotion of reliable supply. Instead, it will encourage the parties to the NEC to consider the most appropriate, secure, reliable, and cost-efficient means of supply going forward from 2026.

  The difference with the proposed amendment is that Network Waitaki's alternative options will provide more certainty on the Regulator's reliability to not interfere in commercial arrangements.

- *Limb 3: Efficient operation of the electricity industry for the long-term benefit of electricity consumers*

  The proposed amendment will not support the efficient operation of the electricity industry for the long-term benefit of electricity consumers. Instead, it will:

  - Add significant regulatory transactional and compliance cost to electricity consumers such as NOIC and its customers.
  - Enable termination of the NEC prior to its expiry date and increase the price for Transmission services by 168% for the end-use customer.
  - Enable and strengthen the hand of the monopoly provider of Transmission services to terminate a twenty-year contract entered into in 2006 - seen as the most efficient investment among all the supply options at the time.
  - Create a climate of uncertainty regarding strength of regulatory commitment to stick by the rules.

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

Response	No, Network Waitaki does not agree that the proposed amendment complies with section 32(1) of the Act. Q5 contains comments on competition, reliability supply and efficient operation. relating to clause 32(1)(a), (b) and (c). In terms of the performance by the Authority as per clause 32(1)(d) we do not agree that the proposed amendment will improve the performance of the Authority. Instead, the Authority will enable and strengthen Transpower's monopoly position to force the termination of the only NEC - a valid commercially negotiated contract. This action/amendment will negatively impact investor confidence in the reliability of regulatory commitment to honour commercial contractual arrangements protected in the Code.

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

Response	Yes, Network Waitaki does not agree with the proposed Code amendment and have recommended alternative options for the Authority to consider (in section 5 on page 3) above.