24 February 2017

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Mr Carl Hansen
Chief Executive
Electricity Authority
PO Box 10041
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Dear Carl,

Transmission pricing methodology: second issues paper – supplementary consultation

1. This is Vector's submission on the Electricity Authority's (the Authority) *Transmission Pricing Methodology (TPM) Second Issues Paper Supplementary Consultation* (Supplementary Consultation). Attached to this submission is an expert report by Covec titled *Expert review of Expert Reviews of Transmission pricing Methodology Reform Proposals* (the Covec Report).

Executive summary

2. The key matters for Vector discussed in this submission are:

   a. The Authority's latest proposal does not address significant feedback received in submissions and expert reports.

   b. The proposal further concentrates the cost of the grid onto end-users allowing generators to free-ride on essential infrastructure for transporting their product to market.

   c. The cherry-picking of historical assets for the proposed area-of-benefit (AoB) charge unnecessarily creates "winners and losers" based on arbitrary decisions around the timing and sequencing of grid upgrades.

   d. The proposed retail price cap blurs the actual impact (and harm) of the TPM changes on end-users.

Background

3. This Supplementary Consultation follows from the Authority's *TPM Second Issues Paper* consultation released in May 2016. The *TPM Second Issues Paper* followed from the Authority's *TPM Options Working Paper* released in June 2015. Since 2012 the Authority has released multiple proposals related to TPM reform, including, *inter alia*, the definition of "sunk cost", spot-price dispatch modelling and a long-run marginal cost working paper. These TPM consultations have resulted in significant cost being incurred by stakeholders in

responding to the multiple consultations and by the Authority, with the Authority's cost then being levied back to consumers.

4. While the Authority has been active in its consultation on TPM reform we remain concerned the Authority disregards much of the feedback it receives in each consultation.

Stakeholder interest

5. The Authority's *TPM Second Issues Paper* consultation received over 500 submissions, an unprecedented level of interest in electricity industry public policy decision making. The overwhelming majority of these submissions were critical of the Authority's proposal.

6. The number of submissions to the single consultation significantly exceeds community engagement on other high profile contentious economic regulation decisions such as telecommunications access pricing, or setting of input methodologies for businesses regulated under Part 4 of the *Commerce Act 1986*.

7. The level of interest highlights the importance stakeholders have in a workable TPM, including the impact of unreasonable increases to grid costs for the majority of grid end-users. While there has been considerable concern about proposed TPM changes from electricity end-users, of particular note has been the absence of criticism from significant electricity retailers about the impact of these higher costs on their customers.

Weight of expert opinion is critical of the Authority's proposal

8. As discussed at length in the Covec report, the weight of expert opinion on fundamental aspects of the Authority's TPM reform is critical of the design. Table 1 of the Covec report[1] summarises expert views on key aspects of the Authority's reform. In relation to the Authority's proposal for applying its area-of-benefit (AoB) charge to sunk assets Compass Lexicon noted:

   The EA's proposal, however, fails to satisfy fundamental principles for transmission pricing and, therefore, will not promote efficiency. The new proposed deeper connection and area of benefit charges intend to recover sunk costs from the alleged beneficiaries of historical investments. This will negatively impact on dynamic efficiency for three reasons:

   (a) First, whether historical (sunk) costs are recovered from beneficiaries of the existing asset would not promote efficient decisions on new investments;

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[1] Covec (John Small), *Expert review of expert reviews of transmission pricing methodology reform proposals*, February 2017, p. 17

(b) *Second, to the extent that the new charges depend on location, they could create inefficient location decisions, based on the attempt to reduce transmission charges.*

(c) *Third, the beneficial-pay principle applied to new investments is not based on charges proportional to net benefits.*[2]

9. The forecasted impacts of the proposed TPM reform are already affecting location decisions. In Northland concerns about transmission charges were a factor for a proposed pulp plant in Ngawha not proceeding.[3]

10. Even expert reports expressing more enthusiasm for TPM reform have qualified their support for specific aspects of the Authority's proposal. Stephen Littlechild, in his expert report for Meridian Energy, noted:

> *"I accept changing the TPM cannot affect or improve the efficiency of past investments."*[4]

11. Vector considers the Covec Report as pertinent evidence of how robust critiques of the Authority's proposal have been consistently ignored at each consultation. The Covec report totalled 60 expert opinion submissions to different consultations on TPM. Such expert opinions are in addition to submissions provided by grid users, participants in New Zealand's energy sector and members of the public. An overriding observation from the Covec report is the Authority consistently pursuing reform in the direction against the overwhelming weight of expert and public opinion.

12. Given the intensity of interest in the TPM and response to the Authority's consultations, for the Authority to consider only "refinements" to its TPM proposal are needed demonstrates a disregard of expert opinion and community concern with the Authority's approach for TPM reform. The Authority, at a minimum, must address such expert opinions. However, Vector recommends the Authority reaches an agreed problem definition before embarking on ill-conceived reforms to correct a non-defined problem.

Flawed logic for reviewing the TPM

13. The Authority's reasons for reviewing the TPM and reasons for making particular decisions demonstrate a lack of a coherent rationale for undertaking the review and decision making.

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[2] Compass Lexicon (Marcelo A Schoeters and Pablo T Spiller), *Transmission pricing mechanism in New Zealand: An analysis of the Electricity Authority's proposed options*, 11 August 2015, p. 5.

[3] http://www.nzherald.co.nz/the-country/news/article.cfm?c_id=16&objectid=11762408

[4] Stephen Littlechild, *Report on the Electricity Authority's transmission pricing review*, 26 July 2016, para 57

14. Examples of its flawed reasoning include the Authority's basis for determining a *material change of circumstances* – which is required to trigger a TPM review under the *Electricity Industry Participation Code 2010*. The material change of circumstances relied on by the Authority is the level of investment approved for Transpower since 2004. The Authority notes such investments have resulted in Transpower's regulated asset base (RAB) increasing by $2.8 billion since 2004.

15. The Authority suggests the current TPM does not encourage parties to petition against Transpower investment proposals under grid investment test consultations. Nonetheless, the Authority does not conclude whether this increase in Transpower's RAB value was the result of Transpower seeking imprudent investment or the Commerce Commission or Electricity Commission imprudently approving capital investments.

16. We consider the logical conclusion of the Authority's material change of circumstances is the current TPM provides insufficient signals for consumers to curb usage; thereby encouraging Transpower to seek new investment to cater for rising peak electricity demand.

17. At the same time, the Authority's Supplementary Consultation suggests the current interconnection charge for the high-voltage alternating current (HVAC) grid sends too strong a signal for users to curb consumption at peak demand periods – peak demand being the critical driver for new investment by Transpower. These statements are contradictory and drive different reforms.

Significant tinkering at each consultation despite failing to listen to stakeholders

18. While the Authority has resolved the current TPM is not "fit-for-purpose", the Authority's proposals to reform the TPM undergoes radical transformations at each consultation. At the same time each of these radical transformations fails to address fundamental concerns parties have raised with the Authority's proposal, such as making retrospective changes to the pricing of historical assets.

19. The Authority's *TPM Options Working Paper* released in 2015 proposed a "deeper connection charge" as a key reform to the TPM. The *TPM Options Working Paper* also suggested a residual charge will continue to be levied on a regional coincident peak demand basis. The "deeper connection charge" was subsequently removed in the *TPM Second Issues Paper* while the residual charge was changed to an installed capacity at the grid exit point for an off-take customer.

20. Further, the *TPM Second Issues Paper* introduced a broadened prudent discount policy allowing customers to reduce their TPM charge. This could occur where the customer can demonstrate either:

    a. private benefits from investing in generation assets to disconnect their demand from the grid;
    b. a customer's grid charges exceed the standalone costs for delivering electricity to them; or
    c. TPM charges are the reason for closing their plant.

21. However, a proposed refinement in the Supplementary Consultation removes the above proposed changes to the prudent discount policy. We believe the significant tinkering of the proposed new TPM in each consultation risks a high degree of "policy on the fly". The policy changes appear ad-hoc with little coordination, logic and targeting of a single problem definition. More importantly, the changes do not appear to be in response to the issues raised by the majority of submissions to the consultations.

Cherry-picking

22. A key feature of the Authority's TPM is to apply its proposed area-of-benefit (AoB) charge to a select number of historical investments specified in clause 8(b) of the proposed guideline. Extending the AoB to include some existing assets approved since 2004 unnaturally skews the burden of the TPM to regions such as the upper North Island.

23. The cherry-picking of assets commissioned from a particular point in time will not deliver any significant future efficiency gain (as uniformly agreed by all experts asked to opine on the TPM) but does risk compromising the efficient use of these sunk assets. This distortion of historical assets between AoB and the Authority's proposed residual charge merely creates "winners and losers" for the TPM reform based solely on the timing and sequencing of historical grid upgrades.

24. While Vector does not see any significant efficiency benefit from applying a retrospective AoB charge, we do see there being a more fair and principled approach with extending the coverage of the AoB charge to apply more extensively across Transpower's grid assets. For example, extending the coverage of the AoB charge to all historical assets removes the arbitrariness of the AoB charge and reduces the "winners and losers" resulting from the selective application to historical grid assets. To adhere to the Authority's principles of service based pricing – any attempt to adopt an AoB charge should apply to all assets where all assets are valued on a consistent service reflective basis i.e their replacement value.

Generators should not be able to free-ride

25. We continue to believe the Authority's proposed reforms significantly ignores the benefits grid connected generators receive from being able to transport their product across the country. The Authority's proposed TPM results in generators paying even less for the grid than under the current TPM where generators have been deemed the beneficiaries of a single asset – the inter-island Cook Strait link. Currently, generators pay approximately 18 percent of grid charges. The proposed TPM will result in generators collectively paying less than 10 percent for the grid. The windfall to generation will be funded by consumers.

26. The forecast reductions for generators from the Cook Strait link will result in significant windfall gains for generators. This is especially concerning given the high level of dispute and litigation incurred with settling the current Cook Strait link charge.[5] The result of the litigation was that South Island generators were found to be the chief beneficiary of the Cook Strait and so should pay for the costs of that asset. The Authority's proposal effectively sets aside the court's intervention with the settling of the current Cook Strait charge.

Proposed total bill price cap is a flawed consumer safeguard

27. Vector is also disappointed with the Authority's proposed consumer safeguards. The proposed "retail price cap" masks the real impact of the proposed TPM reform. Rather, the Authority's proposed changes for TPM will substantially increase the costs of transmission charges for customers.

28. This is because the Authority is proposing to "anchor" its 3.5 percent price cap to the final year of the current regulatory period for Transpower and electricity lines businesses. This is presumably to capture possible changes to regulated revenues. Indeed, the Authority has even taken the unprecedented step of forecasting the expected weighted average cost of capital (WACC) for the ensuing reset three years in advance of the regulatory period. The Authority's forecast of WACC is concerning given it is providing supposedly "reputable" view on a parameter highly sensitive to the market environment and clearly outside of their statutory scope.

29. Nonetheless, the price cap also highlights a concern where the Authority abdicates its responsibility to consumers by relying on other independent and unrelated decisions. The Authority also appears to be relying on electricity retailers passing through in full any cost savings the Authority has forecasted from regulated services. This is especially concerning given current evidence of retailer pass-through of cost savings has been scarce.

[5] *Contact Energy Ltd and Meridian Energy Ltd v Electricity Commission and Transpower New Zealand Ltd* CIV-2005-485-624

30. The Authority's retail price-cap does not hide the fact the proposed TPM reforms are "robbing Peter to pay Paul". In this instance Peter being ordinary electricity consumers in Northland, Auckland and the Eastern Bay of Plenty to pay highly resourced and profitable South Island generators and the owners of the aluminium smelter.

31. The Authority should take responsibility for the impact of its decision on customers and devise consumer safeguards relevant to the intervention being targeted – in this instance reforms to transmission charges rather than masquerading its changes do not harm consumers by hiding behind possible "retail bill" changes. Ultimately any changes to the TPM should result in all grid users, including generators, paying a fair share of the grid instead of concentrating the costs of the grid onto end-users.

Regards
For and behalf of Vector Limited

Richard Sharp
Head of Regulatory and Pricing