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28 October 2014

Electricity Authority
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By email: submissions@ea.govt.nz

Transmission pricing methodology: problem definition relating to interconnection and HVDC assets

Introduction

1. Vector welcomes the opportunity to respond to the Electricity Authority's consultation paper "transmission pricing methodology: problem definition relating to interconnection and HVDC assets", dated 16 September 2014. No part of this submission is confidential and we are happy for it to be publicly released.

2. Vector's contact person for this submission is:

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ENA submission

3. Vector has reviewed the ENA's submission and fully supports the reasoning in that submission and the responses to particular questions raised in the Authority's paper.

Material change of circumstances

4. Vector disagrees with the Authority's view that its statutory purpose provides it with a justification to ignore another clear, specific and unambiguous statutory obligation to identify a material change of circumstances. According to the Authority:

the requirement to meet the material change of circumstances threshold for a TPM review does not restrict the Authority to identifying problems that arise only as a result of the identified material change of circumstances. That is because any amendment to the Code must be consistent with the Authority's statutory objective. If the changes proposed to address issues arising from the material change in circumstances do not provide the optimal solution in terms of consistency with the statutory objective, then the Authority is required to consider a broader, optimal solution.[1]

5. Vector does not see any cause for considering the purpose statement or applying a hierarchy to interpretation when there is no ambiguity to the requirement of identifying a material change of circumstances.

6. While the Authority may assert its prerogative to consider all problems with the TPM, it must still discharge the threshold question of a material change of circumstances before it can exercise its power to change the TPM. This step is a pre-condition to be satisfied before the Authority commences any further work as it would minimise the level of uncertainty about the TPM. We note that, at this stage, the Authority has not clearly identified or attempted to identify a real material change in circumstances for the current inquiry.

The problem definition

The Authority's analysis

7. The Authority asserts that "transmission charges do not reflect the cost to each customer" (i.e. there are cross-subsidies) and this is resulting in:

   a) The current HVDC and interconnection charge failing to promote efficient investment in transmission, generation, distribution and load.

   b) The current HVDC and interconnection charges are not durable, creating uncertainty for investors and therefore inefficient investment.

   c) The HVDC and interconnection charges and PDP fail to promote efficient operation of the electricity industry.

[1] Electricity Authority, Transmission Pricing Methodology: Problem definition relating to interconnection and HVDC assets, p. 21

8. We respond to these points below. However, as a first point, the Authority's analysis is based on its view that the TPM has a role to play in investment decision making. We fundamentally disagree with this view: as Vector has outlined in previous submissions, the promotion of efficient investment decisions is the role of nodal pricing (static efficiency for transmission and static and dynamic for generation), while the national net benefit test administered by the Commerce Commission (Commission) ensures continuous investment in the grid (dynamic efficiency for transmission).

9. Once investment is approved by the Commission and the investment is made, Part 4 of the Commerce Act permits Transpower to recover the full cost of that investment (i.e. it becomes a sunk cost). In the context of regulated transmission investment and nodal pricing in the energy market, the role of the TPM is to allocate sunk and fixed costs of transmission in a way that does not distort the dynamic and static efficiency signals created by nodal pricing and the decision making process laid out for the Commission under Part 4 of the Commerce Act.

Insufficient evidence that cross-subsidies are occurring

10. A cross subsidy occurs when the costs of the transmission grid are allocated in a way that one party contributes more than their stand alone cost while another party pays less than their incremental cost. Under these circumstances it could be expected that those paying more than their stand alone cost will, over time, seek to reduce their costs by bypassing the grid. The Authority's case for cross-subsidy is not supported by evidence of users paying less than their incremental cost for interconnection with the grid or of users bypassing the grid because they are paying more than the stand alone cost of interconnection.

11. Vector notes that the TPM has existed in its current form for an extended period of time. Therefore, the Authority's claim that cross-subsidies exist should have been supported with clear evidence of market failure. However, the paper falls short with its supporting evidence.

Inefficient investment

12. The issue of grid investment inefficiency is a matter for the Commission to consider as part of its legislative mandate, under part 4 of the Commerce Act 1986, to set Transpower's allowable revenues and capex expenditure under its individual price path. Under this legislation the Commission approves individual investments (subject to a threshold test) and it must be satisfied that the investments proposed by Transpower will result in a national net-benefit before approving it. As discussed in our previous submission to the TPM: Beneficiaries Pays consultation, the Authority is unnaturally stretching its statutory objective if it considers that it should be responsible for such matters despite the fact that efficient investment clearly falls within the responsibility of the Commission.

13. Vector cannot find any evidence in the Authority's problem definition document to suggest that the current TPM is leading to significant investment inefficiency that is to the long-term detriment of consumers. The Authority's problem definition does not identify any case of systemic inefficient investment.

14. The long-term interests of energy users are best protected by a risk averse investment strategy. As has been demonstrated in the Commission's recent consultation process regarding the regulated Cost of Capital, consensus of expert opinion is that the risks for consumers associated with investment are asymmetric: under-investment will have significantly worse consequences for consumers (increased number and frequency of power outages) than some over-investment (slightly higher prices).

15. Vector also disputes the Authority's view that incentivising parties to make submissions on particular Transpower projects will materially improve Commerce Commission investment approval decisions.

16. Based on the Authority's own analysis in Appendix C of the consultation paper, the majority of affected parties did not submit at all on particular Transpower projects, whether their benefits from a project were more or less than the costs they would incur under the TPM. There were also instances of parties supporting investments despite, according to the Authority's analysis, receiving lower benefits than the changes they would incur to their grid costs.

17. Given this observed behaviour, we are unconvinced that changing the allocation of transmission costs across the industry will necessarily have a large impact in terms of stimulating more submissions on investment proposals than occur currently.

Durability

18. The Authority has suggested that the level of lobbying about the TPM is a measure for durability or lack of durability. Vector notes that any change to a TPM will create "winners" and "losers" and therefore any change will itself give reason for parties to push for further change.

19. Durability is supported by an economically sound methodology consistently applied over time. There are many ways in which transmission charges can be efficiently allocated and there is always an alternative that would result in a lower allocation to any particular party. Therefore some party will always have the incentive to lobby for change. The extent to which the regulator panders to the lobbying creates uncertainty and undermines durability.

20. As such we are unconvinced that amending the TPM as the Authority proposes (or even amending it in a different way) will somehow mean the resulting TPM is more immune from lobbying effort – the "losers" from the change will continue to lobby for "reform".

21. The Authority argues the recent exemption request relating to the commissioning of the NAaN project is an example of the lack of durability. Vector does not support the Authority's conclusion that the NAaN is a strong example of the TPM's lack of durability.

22. Rather, Vector notes the sequence of events that led to Transpower's exemption application – and has triggered an application for a declaratory judgement on the matter – was extremely difficult to foresee and is unlikely to occur again. However, the process that was followed does not demonstrate any fundamental problem with the TPM – an exemption was applied for and a decision was made. A court is shortly due to hear a case on whether the TPM was interpreted correctly, which will provide guidance as to how to handle similar issues in future, if they arise. In our view, this demonstrates the TPM is working and is able to deal with unusual situations as they arise.

23. If the NAaN exemption application has caused any issues of durability, in our view this issues were created by the Authority's interpretation of the NAaN exemption application. This is because the Authority's interpretation of how to apply the TPM in circumstances where commissioning of an interconnection asset is staged will create uncertainty for any future similar grid upgrades.

Inefficient operation of the electricity industry

24. Section 11 of the consultation paper runs through a lengthy list of inefficiencies the Authority believes are created by the current TPM. Even if these issues are real (which is not supported by concrete evidence), in our view they are not justification for the TPM changes being proposed by the Authority.

25. This is because (to the extent they are real):

a) Some issues are best addressed through the Transpower operational review (i.e. issues with RCPD and HAMI charges), including production incentives on direct-connected load including Tiwai.

b) Some issues are able to be addressed through more targeted reforms (e.g. distributed generation pricing principles and the prudent discount policy).

c) One issue (HVDC SI generation investment incentive) is largely theoretical – i.e. we are not aware of supporting evidence of inefficient investment decisions regarding SI generation as a result of the current TPM. Vector also notes the Authority's view that the estimated inefficiency only exists if there is a need for substantial new generation investment over the next few years. As the Authority will be aware there is an observable downward trend for electricity demand and there are few plans for new generation investment in the near term. As such, we assume the Authority will conclude this issue is not material.

d) And the materiality of the remaining issues is very low in the context of the value of the total transmission revenues allocated by the TPM.

26. Thus we are not convinced that the TPM review is the best means of addressing these identified inefficiencies, if in fact they exist.

Conclusion

27. In summary, the Authority has not provided any evidence of a problem with the current TPM that requires significant intervention. It also has not demonstrated a material change required under law to support a change to the TPM. For the reasons outlined in this paper, and in our previous submissions, Vector remains of the view that the Authority's review of the TPM is unjustified in law, is based on misguided economic analysis and no evidence has been put forward that unambiguously demonstrates the current TPM is failing in a material manner.

Yours sincerely,

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