Electricity Authority
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3 March 2020

By email to: submissions@ea.govt.nz

SUBMISSION ON THE TRANSMISSION PRICING REVIEW: 2019 ISSUES PAPER

Rio Tinto welcomes the opportunity to provide a submission to the Electricity Authority (Authority) on its consultation paper entitled, “Transmission pricing methodology: 2019 Issues paper, Supplementary consultation, consultations paper” dated 11 February 2020. This submission is made by Rio Tinto on behalf of Pacific Aluminium (New Zealand) Limited and New Zealand Aluminium Smelters Limited (NZAS). Nothing in this submission is confidential.

Should you have any enquiries, please do not hesitate to contact Lesley Silverwood, Director Energy at lesley.silverwood@riotinto.com.

Yours sincerely

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Director External Relations

A submission from
Rio Tinto
to the Electricity Authority on the

Transmission pricing methodology: 2019 issues paper

Supplementary consultation paper

3 March 2020

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Introduction

1. Rio Tinto welcomes the opportunity to make a submission on the Transmission pricing methodology: 2019 Issues Supplementary Consultation Paper, 11 February (Supplementary Consultation Paper).

2. We note the Authority's comment that the content of its Supplementary Consultation Paper "does not preclude further changes or stakeholder engagement".[1] Rio Tinto has prepared this submission in the context of the package of reforms proposed by the Authority in its 2019 Issues Paper and the submissions made by Rio Tinto in regard to that 2019 Issues Paper. Our further submissions here are intended to be supplementary to the points Rio Tinto made in our submission and cross-submission on the 2019 Issues Paper.

3. We may seek to make further submissions, including potentially amending our submissions to date, in response to any further changes proposed by the Authority.

Depreciated historic cost method to be used for setting annual benefit-based charge

4. Rio Tinto agrees with the Authority's amended proposal that the:[2]

> *annual benefit-based charges for post-2019 grid investment be set according to the depreciated historical cost (DHC) method, instead of the indexed historical cost (IHC) approach that was proposed for post-2019 investments in the 2019 Issues paper*

5. We agree for the reasons set out in our submission on the 2019 Issues Paper, paragraphs 70 to 85.[3] The inefficiencies and distortions that would result if the initial proposal to use indexed historical cost (IHC) was retained, would have arisen because that method diverges from the method used by the Commerce Commission to determine Transpower's revenue. Inefficiencies and distortions would likewise arise if the Commerce Commission were to amend its valuation method (to say IHC) and the Authority maintains the use of DHC.

6. To 'future proof' the transmission pricing methodology, the valuation method for setting annual benefit-based charges should be referenced directly to the method specified by the Commerce Commission in its Input Methodologies, and not 'hard coded' in the transmission pricing methodology.

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[1] Electricity Authority, (2020) *Transmission pricing methodology: 2019 Issues Supplementary Consultation Paper, 11 February*, (Supplementary Consultation Paper) page i.
[2] Electricity Authority, *Supplementary Consultation Paper*, ibid, page i.
[3] Rio Tinto, (2019), *A submission from Rio Tinto to the Electricity Authority on the 2019 issues paper Transmission Pricing review: consultation paper*, 1 October.

7. Despite this amendment, inefficiencies and distortions will continue to be significant if the revised TPM does not minimise the residual charge, as otherwise costs associated with the older assets whose value has already been written down substantially will be shared across all customers through the residual charge, rather than being allocated for the benefit of those customers served by them.

Liability for charges could continue for up to 10 years after service ceased

8. The Authority proposes that:[4]

> *if a direct connect or generation customer closes down one of its plants, its liability for associated benefit-based charges would cease ten years after the commissioning of the relevant grid investments, instead of continuing indefinitely as was proposed in the 2019 Issues paper*

9. The Authority reasons that if the transmission charge were to cease immediately upon closure, the incentive for a customer to reveal relevant information during the investment process might be weakened. The Authority suggests a customer might, for example, withhold information concerning a shut-down of a plant that it privately expects to occur within a few years of a new grid investment being commissioned. The transmission customer would do this, the Commission argues, so that it could gain the benefit of the transmission investment in the period prior to plant closure.[5]

10. To address this concern, the Authority proposes that a liability for the benefit-based charges should continue for a customer after it ceases taking the transmission service (for example, because it closes its plant), for a period of ten years following the commissioning of the grid investment. That is, if a customer finds itself in the unfortunate position of having to close a plant, it would be required to pay, in transmission charges, more than the cost of the transmission service it receives for its remaining activities.

11. The Authority views its proposal as equivalent to the risk-sharing arrangements that would likely be part of long-term contracting arrangements in a workably competitive market, comparable to a long-term take-or-pay contract. There are fundamental flaws in the Authority's reasoning, and its proposed solution would be a cause of distortion and economic inefficiency.

12. The scenario postulated by the Authority is commercially unrealistic. Rio Tinto is not aware of any commercial entity that has made a decision to close a plant and then kept that information private for a period of years. Firms can take several

[4] Electricity Authority, *Supplementary Consultation Paper*, op cit, page i.
[5] Electricity Authority, *Supplementary Consultation Paper*, ibid, pages 9 - 10.

years investigating strategies to keep a plant viable that might ultimately not succeed, but that is a very different situation from a firm reaching a decision to close a plant and then keeping that decision secret.

13. The Authority is misguided in its claim that its proposal would reflect the outcome of long-term contracts in workably competitive markets for two reasons. First, as the High Court observed in responding to a similar argument made by the Commerce Commission: markets with long-term contracts are generally characterised by a high proportion of specialised assets and sunk costs, and hence lie at the fringes of what may be considered workably competitive.[6] Furthermore, whereas customers choose to enter into long-term contracts, they do not decide which transmission assets are built and they are required to pay for them regardless of whether they supported or opposed investment in them.

14. Secondly, the Authority would impose obligations equating to a long-term contract only on customers; it does not propose to balance the "take or pay" provisions it would impose on customers with reciprocal obligations on Transpower as a supplier. Worse, these one-sided provisions would be imposed *after* the Commerce Commission has set the method for determining how much customers should pay, taking into account the demand risk borne by Transpower. It is difficult to reconcile this outcome with the Authority's objective to act for the long-term benefit of consumers.

15. The proposal to continue charging customers for services they no longer use inefficiently incentivises total and rapid market exit over partial curtailment or an orderly transition to closure. The better approach is that an obligation to pay for a transmission services should cease for a customer once that customer no longer receives that service. This is the outcome that would most promote economic efficiency and that is consistent with workably competitive markets.

Annual adjustment to residual charge

16. The Authority proposes that:[7]

> *the initial allocation of the residual charge (which is based on historical gross anytime maximum demand) is to be adjusted annually based on changes in the four-year rolling average of gross annual energy usage, lagged by seven years*

17. The Authority views this proposal as balancing two competing objectives:[8]

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[6] High Court, (2013), Wellington International Airport Ltd & Ors v Commerce Commission, NZHC 3289, paragraph 548

[7] Electricity Authority, *Supplementary Consultation Paper*, op cit, page i.

[8] Electricity Authority, *Supplementary Consultation Paper*, ibid, page 13.

- If the allocation of the residual charge is not updated regularly, a customer's charge could become increasingly misaligned with its size and ability to pay.

- Regularly updating the allocation of the residual charge based on changes to AMD would risk creating incentives for a customer to inefficiently change its grid use to reduce its allocation of the residual charge at the next update.

18. The problem of balancing these objectives would dissipate as the size of the residual charge reduces. Rio Tinto considers the best response is therefore to reduce the residual charge by:

    - Allocating the residual charge to generators as well as load customers (see Rio Tinto submission on the 2019 Issues Paper, and earlier submissions).

    - Extending the benefit-based charge to all existing assets (see Rio Tinto submission on the 2019 Issues Paper, and earlier submissions).

19. The Authority proposes to adjust the initial allocation of the residual charge (which would be determined from any time maximum demand) based on changes in each customer's four-year rolling average of gross annual energy usage. The Authority offers no evidence for its assertion that customers have less incentive to reduced their gross annual energy use than their any time maximum demand. That may be the case for some loads, but it is unlikely to be the case for base-load demand (such as the smelter and some other large industrial processes). The Authority should prepared proposals based on evidence, rather than supposition.

20. A lag of seven years appears excessive. It would mean that charges in any current period would be based on demand characteristics from six to ten years previously (given the four year rolling average and seven year lag). In any market with some dynamism, this long delay must mean a high likelihood that the charges for some customers could become increasingly misaligned with its size and ability to pay.

21. Further work is needed by the Authority on proposals for the residual charge.

Prudent discount to apply if transmission charges exceed standalone cost

22. The Authority proposes that:[9]

[9] Electricity Authority, *Supplementary Consultation Paper*, ibid, page i.

a customer may apply for a prudent discount if its transmission charges would exceed the standalone cost of the transmission services it receives.

23. Rio Tinto agrees with this proposal for the reasons set out in our submission on the 2019 Issues Paper at paragraphs 65 to 69.

24. The proposition that no transmission customer should pay no more than the stand-alone cost of the services it receives should be uncontroversial. As the Authority observes, pricing below efficient standalone cost is recognised in the economics literature as consistent with efficient “subsidy-free” prices and pricing above this level is inefficient.[10]

25. Rio Tinto agrees that the transmission pricing methodology would need to include a method for determining standalone cost so that the Authority can assess the method in advance of it being used. The Authority should recognise that Transpower would be conflicted in specifying a method for determining the standalone cost. Transpower is conflicted because a successful application of the prudent discount would require a redistribution of transmission charges over other customers, drawing unfriendly attention to the services provided by Transpower and their costs. Because Transpower is conflicted, the Authority should specify guidelines for a method of determining stand-alone costs. Furthermore the method applied and individual decisions to grant a Prudent Discount should be approved by the Commerce Commission, to ensure that the proposal to provide a prudent discount and recover the discount from other customers is efficient.

26. Rio Tinto’s position is that the specification of these guidelines for determining stand-alone costs should be split-off from the other elements of the transmission pricing methodology and advanced to approval and implementation without delay. There can be no justification for the Authority to continue to allow Transpower to charge some customers more than the stand-alone cost of the services they receive, whether under the current or a revised TPM.

[10] Electricity Authority, *Supplementary Consultation Paper*, ibid, pages 16 to 17.