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Electricity Authority Sunk Cost Working Paper – Submission

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Confidential	No

1 Paper seems academic in nature

We have some concerns about the nature of the paper. We find the paper perhaps too academic and not sufficiently cognisant of the Electricity Authority's (Authority) role as the industry regulator. Obviously economics is a fundamental part of the regulatory role but economic theory must still be applied within a framework of practical and principled regulation. In particular, we expect the Authority to respect existing property rights unless it meets a suitably high burden of proof that change clearly and significantly meets its Statutory Objective and net public benefits. As we discuss in more detail below, the beneficiaries of Maori development are directly and materially affected by the consequences of transfers of wealth. Arguably economics traditionally dismisses transfers of wealth but good regulatory practice should not treat wealth effects as trivial.

2 Good regulatory practice

One of the key objectives of the paper seems to be to establish that the presence of sunk or fixed costs in transmission does not prevent the Authority from changing the TPM. We generally agree with this position; however, we believe it is important to point out that just because the Authority can change the TPM does not mean the Authority should. In our view the Authority still faces a significant burden of proof that change is clearly warranted.

3 Whole of market application of principle

The Authority has a concise, but broad objective under the Act:

> *The objective of the Authority is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.*

It is clear that the Authority has an obligation to consider the full range of components that constitute the electricity industry and its operation. In considering changes or developments in any one area of the industry, the Authority's objective requires that it consider any consequential effect; that is, the Authority should not consider each component in isolation.

In concluding the summary and main working paper the Authority states:

> *Accordingly, with reference to the Authority's objective, if changing the methodology by which transmission prices are determined promotes overall efficiency in the electricity industry, the Authority may change the methodology, irrespective of the existence of sunk costs.*

The statement indicates that the Authority is seeking to promote the overall efficiency of the electricity industry, but is silent on the primary outcome, being for the long-term benefit of consumers.

While the working paper is necessarily focused on the economics of costs and pricing, there are other aspects that the Authority as the regulator should be considering as it proposes a change in the TPM or any other change. The Authority as regulator should consider items such as:

- The market/investor consequences of the Authority contemplating or implementing regulatory change
- The impact on existing investors and participants who have relied on prior regulatory structures/decisions
- The impact on implied or actual property rights
- The investment horizon/return period required for the majority of electricity infrastructure investments
- The careful utilisation of the guidance economic theory can provide in decision-making and the practicalities of implementation and measurement of benefits/costs etc.

Given the above and the potential implications for many investors and participants from the EA's proposed changes the burden of proof for the Authority for a change should not be an expectation that it will promote an outcome, but it will achieve an outcome. Not only should it achieve a positive outcome, but also, given the uncertainties associated with any forward-looking analysis, the magnitude of benefits should be assessed as significant and beyond doubt before a decision to change is made.

Many of the principles discussed in the Authority's paper could be applied to the entire market and power system. While we are not suggesting that the paper limits the thinking on sunk costs to the transmission network we want to reinforce that most of the electric power system and the market faces the threat of sunk cost. There is little of the electric power system that has genuine alternative use. We wish to reinforce to the Authority that Transpower is not the only investor for who the principle holds that "... there is no obvious economic efficiency reason why that demand should face a price, after that investment has been made, that is lower than the full economic cost of the service." This condition is obviously subject to the risks inherent in a workably competitive electricity market but should not be subject to the imposition by the regulator of unavoidable costs that don't meet the highest standards of good regulatory practice.

4 The real issues

The EA has provided a useful précis of the economic literature on sunk costs and associated marginal and infra-marginal pricing decisions. This will undoubtedly be of use in helping to equalise the use of terminology to the extent that people share the Authority's interpretations. The working paper does not and was not aimed at addressing the real debate around the propose changes to the TPM.

There is no doubt that the electricity industry is dominated by large, expensive and broadly illiquid investments. The characteristics of the bulk of the generation, transmission and distribution assets are similar, in that their alternative uses, once constructed are limited, that the assets are built with expected economic lifespans greater than 20 years and that economic recovery of value through continued ownership is lengthy. To that end much of the definitional discussions in the working paper can apply to esoteric discussions relating to all of these assets.

A key aspect of the discussion relates to the changes to the industry and its operating regime over the last 20 years. The progressive implementation and development of the market structures since the early 1990s and regulatory evolution was aimed at shifting the burden of investment from the government to private investors. The timeframes over which developments can be realised in the industry is long due to the very nature of the assets themselves. Consequently investors require relatively high levels of regulatory stability through time in order to commit the significant sums required.

Although generation investments are not made based on a specific regulatory contract and although the implicit regulatory contract did not guarantee there would be no changes, the expectation is that change will only occur with good reason and with a high burden of proof on the proposer to demonstrate almost with absolute certainty that the assumed benefits will occur.

Milton Friedman wrote in Free to Choose,

> *If it is difficult for private parties to identify who imposes costs or benefits on whom, it is difficult for governments to do so. As a result a government attempt to rectify the situation may very well end up making matters worse rather than better – imposing costs on innocent third parties or conferring benefits on lucky bystanders.*[1]

From our perspective the Authority is assuming a level of forward knowledge and certainty of the benefits of its TPM proposal that exceed the reality of its position and information. In addition, the proposed changes will impose a direct cost and loss on Tauhara North No. 2 Trust (TN2T) and its

[1] Pg 31, Free to Choose: A Personal Statement

beneficiaries, who are innocent third parties in what could well be described as an esoteric game of economics.

The Authority has indicated via its working paper that monetisation of the sunk costs and exit is a valid mechanism to determine that a cost is not sunk. This theoretical perspective ignores the very nature of our relationship with our land and its resources. It ignores the nature of our obligations to our people and generations to come. It ignores that the Authority through its proposed TPM would impose a sunk cost on us, having responded to the incentives provided by successive governments and regulators, only to indulge in a classic bait and switch once our capital is committed.

The Authority appears to have lost sight of its overall objective and the benefits that come from greater competition. TN2T is not a portfolio generator like its competitors, it is not vertically integrated and it does not enjoy a massive balance sheet. As a consequence, the TPM is a direct, unavoidable cost. The Authority does not appear to be conscious of the capital structure implications of its proposal. As a small merchant generator TN2T has a more highly geared balance sheet than the main generators. The proportional effect of a reduction in free cash flow for its equity is significant.

We note that the Authority's working paper clearly identifies that (emphasis added),

> *Economics does not provide the same definitive tests for pricing of infra-marginal decisions as it does for pricing marginal units. The debate is about how best to recover fixed costs (and sunk costs are fixed costs), and not whether a distinction is required between sunk and other costs.* ***If a supplier has invested in assets to meet an expected demand, and if the demand exists for the service, there is no obvious economic efficiency reason why that demand should face a price, after the investment has been made, that is lower than the full economic cost of the service.***

However, the Authority is itself proposing to go against its own observation that the full economic cost should be recoverable, by imposing additional unavoidable costs after the investment has been made. One solution to this effect if the Authority is convinced that it should proceed, is to structure the pricing so that it is recoverable. This would avoid the ex-post imposition of costs and loss of wealth.

Most economists may argue that wealth transfers don't matter or should not be considered, but the Authority is a regulator and needs to be conscious of not only economic efficiency, but also its reputation as a regulator that adheres to good regulatory principles and protection of property rights. Aspects such as these reinforce that the Authority should require a high burden of proof or certainty of benefits before it makes any decision to affect property rights (negatively or positively).

Transmission pricing has been reviewed almost constantly since the electricity market was considered. Although there were initial significant changes when Transpower was established, successive reviews and modifications have been relatively minor. It is valid therefore that as investors we considered the potential for a new cost to be imposed to be relatively low, there was explicit regulatory guidance through prior consideration and industry, working group and regulatory decisions. Had TN2T known that such a change was to be proposed it would have either negotiated a lower entry price or not invested. As a consequence of investing in good faith, TN2T now has unavoidable third party debt that it must repay.

5 Concluding Remarks

The proposed changes to the TPM by the Authority stand to have a substantial impact on the viability of a significant number of renewable energy projects by Maori, for a highly uncertain theoretical gain in economic efficiency. That is, we believe the changes proposed will result in a system that is no more efficient in real terms, but forces out these potential investors.

If any part of this submission requires further explanation, we request that the Authority provide an opportunity for Tauhara North No. 2 Trust to present in person.