

# Proposed Code Amendment - Regulatory Framework for the Transmission Pricing Methodology

Summary of submissions and Authority response

**Prepared by the Electricity Authority**

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## Executive summary

This paper provides a summary of submissions received in response to the Electricity Authority's (Authority) *Proposed Code Amendment: Regulatory Framework for the Transmission Pricing Methodology* consultation paper (Consultation Paper). Eight parties provided submissions.

This paper firstly sets out the background for the consultation and its purpose. The paper then provides a summary by issue, generally following the structure of the Consultation Paper with submitters' responses to the questions posted by the Consultation Paper attached as an appendix. The paper concludes with the Authority's assessment of the submissions, its response to relevant points raised by submitters and its decision with respect to the Code amendment proposal.

Most submitters supported the Authority's proposal to remove the pricing principles (and associated interpretation provision) from the Code and agreed with the analysis underlying the proposal.

There were two exceptions. Vector submitted that any review of, and any resulting change to, the pricing principles at this stage would undermine the work undertaken to date under the Transmission Pricing review (the Review). The Authority's response is that there has been no consideration of the effect of the pricing principles in the stage 1 and 2 analysis to date on the basis that such analysis was to occur at stage 3 of the Review – being the current stage. Accordingly the Authority's view is that now, in the context of the wider Review, is an appropriate time to review the pricing principles.

Transpower submitted that the Authority's alternative option to include revised pricing principles was preferable, because substituting improved, simplified pricing principles gives more direction to the industry, and would achieve the objective of strengthening investor confidence more effectively than removal of the pricing principles completely. The Authority's view is that the revised pricing principles proposed or any substitutes, whilst they can be made to be consistent with the Authority's narrower statutory objective, will give rise to duplication and unnecessary regulation. The Authority is of the view that Option 1, where the pricing guidelines (guidelines) and the transmission pricing methodology are assessed against the statutory objective, will provide the desired regulatory certainty and stability to ensure dynamic efficiency. This view is underpinned by the Authority placing considerable emphasis on regulatory certainty and stability in its interpretation of the statutory objective.

After consideration of submissions the Authority has concluded that its quantitative and qualitative assessment (which includes considerations about regulatory certainty and stability) of the options remains valid. This assessment encompasses compliance with the Code amendment principles and the objectives of the Code amendment. Therefore, there are good reasons to proceed with its proposal to remove the pricing principles from the Code and to assess the consistency of any proposals relating to the guidelines and the Transmission Pricing Methodology against the Authority's statutory objective.

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# **1. Introduction and purpose of this report**

## **1.1 Introduction**

1.1.1 The Consultation Paper described the Authority's proposed removal of the pricing principles, set out in clause 12.79 of the Electricity Industry Participation Code (Code) and the related interpretation clause (clause 12.80 of the Code).

1.1.2 This proposal stems (the reasons are explained in more detail in paragraph 1.2.1(e)) from the changes to the decision framework for the transmission pricing methodology (TPM) brought about by the Electricity Industry Act 2010 (the Act) and in particular, the establishment of the Authority with a new statutory objective.

## **1.2 Overview of Consultation Paper**

1.2.1 The Consultation Paper set out the following:

- (a) The background to, and status of, the current Review, explaining that the Authority is now at stage 3 of the Review, which involves identification and detailed evaluation of a preferred option for the allocation of transmission costs. If evaluation suggests a change to the existing allocation, an Issues Paper<sup>1</sup> will be published setting out the process and guidelines Transpower must follow in developing the TPM;
- (b) The decision making framework for the development of the guidelines and the TPM consists of relevant provisions in the Act, specific provisions of the Code (including the pricing principles) and potentially statements of government policy;
- (c) The history of the pricing principles – they have been transferred from the Electricity Governance Rules 2003 and are closely aligned with the pricing principles that were set out in the Government Policy Statement on Electricity Governance October 2004;
- (d) The new statutory objective of the Authority and the Authority's recently published interpretation of the statutory objective; and
- (e) The rationale for the Authority's decision to consult on a proposal to amend the Code, namely that:
  - (i) the regulatory environment had changed since a review of the pricing principles were last considered;
  - (ii) it was good regulatory practice to review the decision framework for the TPM in light of the Authority's new and narrower statutory objective;

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<sup>1</sup> As prescribed by 12.81 of the Code.

- (iii) Submitters to previous consultations considered that a review of the pricing principles was warranted because there was a clearly identified efficiency gain from amending the pricing principles and/or regulatory failure from the inconsistency of them and difficulties with respect to their application; and
- (iv) the pricing principles created additional criteria against which to assess any proposed changes to the guidelines and the TPM and they are internally inconsistent.

1.2.2 The Consultation Paper set out its proposed amendment to the Code – to remove the pricing principles from the Code and assess the consistency of any proposed guidelines and TPM against the Authority’s statutory objective. This is described in the Consultation Paper and in this paper as **Option 1**.

1.2.3 In the Consultation Paper the Authority set out the objectives of its proposal (Option 1) to amend the Code in order to:

- (a) Simplify the decision framework for developing and evaluating the guidelines and the TPM;
- (b) Reduce transaction costs for the Authority and interested parties in formulating the guidelines and the TPM;
- (c) Remove superfluous regulation and simplify the Code; and
- (d) Recognise and reflect the Authority’s narrower statutory objective.

1.2.4 The Authority put forward two alternative means of achieving these objectives:

- (a) **Option 2** – the status quo, being the continuation of the existing pricing principles<sup>2</sup>; and
- (b) **Option 3** – introduce new pricing principles<sup>3</sup> to reflect the new statutory objective, which would replace the existing principles. The Authority set out its proposed new principles.

## 1.3 Purpose of this paper

1.3.1 This purpose of this paper is to summarise the submissions received and where appropriate provide a response to those points made by submitters that were not in favour of the proposed Code Amendment. This paper sets out the conclusions of the Authority with respect to the consultation and its final decision to proceed with the proposed Code Amendment set out in the Consultation Paper. An attached appendix sets out submitters’ answers to each of the questions in the Consultation Paper.

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<sup>2</sup> Existing pricing principles are provided in Appendix 2 for ease of reference.

<sup>3</sup> The proposed new pricing principles are provided in Appendix 2 for ease of reference.

## 1.4 Submissions received

1.4.1 Eight parties provided submissions. Copies of all submissions are available at: <http://www.ea.govt.nz/our-work/consultations/priority-projects/regulatory-framework-tpm/submissions/>. The parties that made submissions are listed in Table 1.

**Table 1: Submitters**

<b>Generator/retailer</b>	<b>Users</b>	<b>Distributor</b>	<b>Other</b>
Contact Energy Limited (Contact)	Major Electricity Users' Group (MEUG)	Vector Limited (Vector)	Transpower New Zealand Limited (Transpower)
Genesis Power Limited (Genesis)	Rio Tinto Alcan New Zealand Limited (RTANZ)		
Meridian Energy Limited (Meridian)			
Mighty River Power Limited (MRP)			

## 2. Summary of submissions by issue

### 2.1 Structure and overview

- 2.1.1 This summary of submissions by issue largely follows the structure of the Consultation Paper, except for responses on the assessment of each Option, which are grouped together to avoid duplication.
- 2.1.2 At the start of each section, a shaded box provides a high level summary of the submitters' views on the Authority's proposal generally, and then on each of the questions asked by the Authority.

### 2.2 Code Amendment proposal – General view

All but two submitters were supportive of the Authority's proposal to remove the pricing principles (and the associated interpretation provision) from the Code. Vector's view was that a review of the pricing principles is inappropriate at this stage of the Review and the status quo should remain. Transpower's view was that Option 3 applies the interpretation of the statutory objective to transmission pricing and therefore provides greater regulatory certainty than Option 1.

### 2.3 Sufficient reason for review?

- 2.3.1 The Authority asked whether there is sufficient reason to review the regulatory framework and if not, why not.

All but one submitter agreed that there was sufficient reason to review the regulatory framework. Vector queried the Authority's position that the existing pricing principles have led to regulatory failure.

- 2.3.2 The table below sets out submitters' views.

Contact	Yes.
MEUG	Yes. MEUG's view was that there has been, and will continue to be, a significant conflict between the TPM pricing principles and the over-arching statutory objective of the regulator. MEUG viewed the Code amendment proposal as timely – on the basis (i) it will allow the industry to realise improvements anticipated from the new regulatory regime that took effect on 1 November 2010; and (ii) it will establish a sound basis for considering options as part of the TPM Review.
Meridian	Meridian agreed with the Authority's analysis that the <i>'interface between the statutory objective, the guidelines and the pricing principles is complex, unwieldy and combined with the ongoing lack of consensus around the</i>

	<i>pricing principles is a demonstrable regulatory failure.'</i>
Vector	<p>Vector generally supported the Authority's willingness to review long standing issues and reconsider whether previous decisions remain optimal in the new regulatory climate.</p> <p>However, Vector submitted that the existing transmission pricing approach is now long-standing and well understood within the industry.</p> <p>Vector did not agree with the Authority's position that the current pricing principles represent a "demonstrable regulatory failure" and requested the Authority to provide supporting information for this position before the Authority progresses the proposal further.</p>
MRP	Yes.
RTANZ	Yes. RTANZ believed section 2.5 of the Consultation Paper summarised the justification well.
Genesis	Genesis did not answer the specific questions but its submission supports the Authority's proposal.
Transpower	Yes. Transpower's view is that current principles have caused substantial unnecessary additional costs and administrative problems in the past. They are internally inconsistent and create unrealistic expectations of what can be achieved through a TPM.

## 2.4 Objectives – are they appropriate and should there be others?

- 2.4.1 The Authority asked whether stakeholders agreed with the objectives of the Code amendment proposal (as referenced in section 1.2.3 above) and if not, why not, and whether there are other objectives that should be included in the Authority's assessment.

The majority (Contact, MEUG, Meridian, RTANZ, MRP) considered the objectives set out by the Authority were appropriate and did not propose others for inclusion. Transpower suggested an additional objective. Vector did not believe a Code amendment to the pricing principles was necessary at this time.

- 2.4.2 The table below sets out submitters' views.

Contact	Agreed with the objectives.
MEUG	Agreed with the objectives.
Meridian	Agreed with the objectives.
Vector	Supported the Authority's willingness to review long standing issues and support an approach to reduce regulation and shorten the Code but did not support a review of the pricing principles at this time.

MRP	Agreed with the objectives and considered them sufficiently broad not to require additional objectives.
RTANZ	Agreed with the objectives and noted that when compared with the alternatives, the proposal will clearly simplify the decision framework, simplify the Code and better reflect the Authority's narrower statutory objective. It is also likely to reduce transaction costs.
Genesis	Did not answer the specific question but its submission supports the Authority's proposal.
Transpower	Agreed with the objectives with the addition of one further objective – <i>(e) Promote greater regulatory certainty and stability with respect to transmission pricing</i> . It is sufficiently important to be an objective, rather than only a consideration to be taken into account in the Authority's analysis.

## 2.5 Qualitative Assessment of each Option (1, 2 and 3)

2.5.1 The Authority asked whether stakeholders agreed with the Authority's qualitative assessment of each of Option 1, 2 and 3, and if not, why not (including for Option 3, any suggestions for more appropriate principles).

Contact, MEUG, Meridian, MRP, Genesis and RTANZ largely agreed with the Authority's assessment of each of Option 1, 2 and 3. Vector and Transpower did not.

2.5.2 The table below sets out submitters' views.

Contact	Agreed with the Authority's assessment of each of Option 1, 2 and 3, noting that, while Option 3 would be an improvement on the current situation, it would involve higher transactions costs for implementation, as opposed to Option 1.
MEUG	Agreed that the Authority had put forward an appropriate set of options as means to achieve the objectives.  It submitted that the Authority's conclusion, based on the qualitative analysis of the options against the four Code Amendment Principles and the objectives, that Option 1 is better than or equal to the alternative options, was reasonable.
Meridian	Supported the Authority's assessment of each option. In respect of Option 1, it noted that removal of the principles should facilitate greater regulatory certainty and thereby promote investment. In respect of Option 3, it agreed that there would be efficiency gains from revising the pricing principles but its view is that these gains could be achieved by relying on the statutory objective alone.
Vector	Did not support the Authority's assessment of the options. Its preference is that the status quo is retained – Option 2.

	<p>It submitted that any change to the pricing principles may give rise to extensive re-litigation of old issues. Any subsequent change to the pricing principles is likely to require Transpower's TPM to be reviewed to ensure it is consistent with any such new principles. Any resulting change to the pricing methodology is likely to lead to confusion and resentment (possibly leading to litigation) all the while there is no clear benefit of efficiency in the market overall.</p> <p>It submitted that Option 1 provides limited guidance to Transpower. Its view was that the greater degree of prescription in the current pricing principles may be more useful to Transpower and its customers than the Authority's objective on its own.</p>
MRP	<p>It agreed with the Authority's assessment of Option 1 and stated it did not agree with Options 2 and 3. Option 2 has provided inaccurate signals and is unpredictable and that a new agreed method is preferred.</p>
RTANZ	<p>It agreed with the Authority's assessment of Option 1 and noted that when compared with the alternatives, Option 1 will clearly simplify the decision framework, simplify the Code and better reflect the Authority's narrower statutory objective. It is also likely to reduce transaction costs.</p> <p>It also agreed with the Authority's assessment of each of Option 2 (stating it was comprehensive) and Option 3 (stating that it reflects the Authority's statutory objective).</p>
Genesis	<p>It did not answer the specific question but its submission supports the Authority's proposal.</p>

Transpower	<p><u>Option 1</u> - did not agree with the Authority's assessment of Option 1 on the basis that removal of the pricing principles will mean the Authority must go through the process of explaining how its interpretation of the statutory objective applies to transmission pricing. Its view was that the evaluation criteria to be applied would be clearer with Option 3 than Option 1.</p> <p><u>Option 2</u> - largely agreed with the Authority's assessment of Option 2 with the exception of the following statements:</p> <ul style="list-style-type: none"> <li>(a) Removing the pricing principles may strengthen investor confidence; and</li> <li>(b) The pricing principles create additional criteria to assess any proposed changes to the guidelines and TPM against. Complexity of decision making is increased without corresponding efficiency gains.</li> </ul> <p>It suggested that substituting improved and simplified pricing principles would achieve the objective of strengthening investor confidence more effectively.</p> <p><u>Option 3</u> - did not agree with the Authority's assessment of Option 3. Provided the pricing principles are designed to be fully consistent with the Authority's statutory objective (as the proposed revised principles are), they should not create additional criteria against which to assess proposed changes to the guidelines and the TPM and should achieve incremental efficiency gains by increasing regulatory certainty and stability.</p> <p>One minor amendment is proposed to principle (d)(ii) <i>where practicable providing locational signalling of long run <u>marginal</u> transmission investment costs, to the extent that these are not already signalled by nodal prices, the regulatory investment test and connection charges.</i></p>
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## **3. Authority's Response**

### **3.1 Introduction**

- 3.1.1 The submissions were largely in favour of the proposed Code amendment to remove the pricing principles from the Code. MEUG, Contact, Mighty River Power, Meridian, Genesis and RTANZ all supported the Code amendment proposal and generally supported the Authority's analysis.
- 3.1.2 Vector and Transpower both disagreed with the Code amendment proposal and contend that the Authority's analysis is flawed. Vector recommended the current pricing principles be retained whereas Transpower recommended the revised pricing principles be adopted, with one additional principle, to address regulatory certainty and stability. Genesis made some additional recommendations, which are discussed below.
- 3.1.3 This section sets out the Authority's consideration of: (i) those submissions that were not in favour of the proposed Code Amendment; and (ii) matters that were raised but were not the subject of the Consultation Paper. Particular consideration is given to commentary on the Authority's quantitative cost benefit analysis (CBA).

### **3.2 Quantitative and qualitative cost benefit analysis**

- 3.2.1 Vector and Transpower both challenged the Authority's assessment of the costs and benefits of the options. Both parties were concerned that the analysis only addresses transaction and administrative costs, whereas in their view it should also address the costs and benefits that may arise from increased regulatory certainty and stability. Their analysis did however lead them to different preferred options.
- 3.2.2 The Authority acknowledges the points raised but contends that it would be extremely difficult to attempt to quantify costs and benefits to the wider New Zealand economy. However, the qualitative assessment against the Code amendment principles (which are fundamentally concerned with efficiency) in table 3 of the Consultation Paper sought to demonstrate these benefits.
- 3.2.3 The administrative and transaction costs that the Authority did identify are objectively more measurable and as such the CBA can give a snapshot of the alternative situations with some degree of objectivity. However as noted in the Consultation Paper:
15. A quantitative cost benefit analysis was undertaken and the results support the above qualitative analysis. Dynamic efficiency costs (attributable to less efficient and/or delayed investment and reduced robustness of the system) were not estimated but could be many times greater than the costs associated with the more measurable variables calculated. However, as the dynamic efficiency gains result from reducing the complexity of the Code, estimating these gains

would increase the net benefit of the proposal against the alternatives.

- 3.2.4 The Authority acknowledged the dynamic efficiency costs and benefits would be far greater than those costs and benefits identified in the quantitative CBA analysis, but given the qualitative analytical results in table 3, any estimation of quantitative net benefits, including these hard to measure efficiency gains, would be fundamentally pointing the analysis in the same direction (i.e a preference for option 1) as the CBA analysis was when applying the more measurable administration and transaction costs.
- 3.2.5 Both parties also raised concerns about some of the assumptions underpinning the CBA, in particular the likelihood of judicial review proceedings being brought.
- 3.2.6 Transpower did not agree with the assessment made of the judicial review risk and made the point that judicial review can be brought on a number of grounds and therefore possible for any of the proposed options. Transpower's view is that there is no good reason to assume that one or other of the proposed options would be more or less likely to attract a judicial review or that the risk should be any particular percentage.
- 3.2.7 The Authority accepts Transpower's analysis of the judicial review risk to the extent that judicial review can be brought on a number of grounds and that there is a judicial review risk for all of the options. The assessment of the judicial review risk in the Consultation Paper relates to the Authority's assessment of the profile of judicial review risk between the options. The risk profile reflects the percentage of risk over and above the base risk associated with each of the options.
- 3.2.8 Although the Authority agrees with Transpower that the focus for judicial review may differ depending on the option adopted, the Authority does not agree with Transpower's assessment of how this may play out.
- 3.2.9 The Authority's assessment was based on its experience that pricing principles "create additional criteria to assess" changes against which are then open to challenge. On this basis the Authority has formed the view that there would be an increased likelihood of judicial review if the Code contains pricing principles.
- 3.2.10 The Authority acknowledges the difficulty of developing a CBA to support decisions such as this one, and that the CBA presented in the Consultation Paper was based on qualitative, but informed assessments. On balance, the Authority considers that although some of the assumptions that form the basis of the CBA could be reworked it remains a possible representation of circumstances that could arise. The sensitivity analysis undertaken tested the boundaries of the assumptions used and did not alter the outcomes presented.
- 3.2.11 Transpower notes that the Authority has made arithmetic errors in its quantitative CBA analysis in the sensitivity analysis (no arithmetic error in the base case). Transpower is correct. However, the error does not affect the conclusion i.e. the

proposal has a higher net benefit relative to the status quo (option 2) or revising the principles (option 3).

- 3.2.12 Submissions received represent a broad range of perspectives on the CBA. The Authority notes that the majority of the submitters agreed with the Authority's analysis and that the outcome of the CBA was in line with the qualitative analysis undertaken.

### **3.3 Vector**

- 3.3.1 Vector has raised concerns that a move away from the current pricing principles removes one of the core building blocks of the TPM and that changing the principles at this stage may mean that the Review would need to re-start from the beginning.
- 3.3.2 The Authority considers these concerns can be addressed. As has been outlined in a paper to the Transmission Pricing Advisory Group: *Impact of Regulatory Change on Review Analysis to Date*<sup>4</sup> there had been no consideration of the effect of the pricing principles in the stage 1 and 2 analysis to date on the basis that such analysis was to occur at stage 3 of the Review – being the current stage. Accordingly the Authority's view is that now, in the context of the wider Review, is an appropriate time to review the pricing principles.
- 3.3.3 Vector suggested that any change to the pricing principles is likely to trigger a review of the TPM to ensure it is consistent with any revised framework. The Authority's view is that regardless of whether the principles are changed, the existing TPM (the status quo) and any new arrangements will need to be assessed against regulatory settings. This assessment will be undertaken as part of the current Review.

### **3.4 Transpower**

- 3.4.1 Transpower recommends the Authority implement Option 3.
- 3.4.2 Transpower's view is that Option 1 will require the Authority to apply its formal interpretation of its statutory objective to transmission pricing – and as such, exactly how its application will be undertaken is unclear and gives the Authority greater discretion. Transpower's view is that this leads to less regulatory certainty and stability, which could have negative consequences for investment incentives. In contrast, it submitted that the revised pricing principles (Option 3) set out how the statutory objective will be applied and that application is codified and so is certain and clear. Transpower submits that Option 3 is more consistent with the Authority's objective to provide greater clarity in the evaluation criteria for developing the guidelines and the TPM, than Option 1.

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<sup>4</sup> This document is available on the Authority website at: <http://www.ea.govt.nz/document/13322/download/our-work/advisory-working-groups/tpag/tpag-meeting-28-march-2011/>

- 3.4.3 The Authority's view is that setting out the revised pricing principles, whilst consistent with the Authority's narrower statutory objective, will give rise to duplication and unnecessary regulation. While it is true that each application of the statutory objective to a particular decision will give rise to new "evaluation criteria" required to apply the statutory objective, this process becomes much more involved where there are three existing layers (statutory objective, pricing principles and guidelines) and where all these existing criteria have to be internally consistent. Parties may look at the interpretation of the pricing principles against the statutory objective, the guidelines and the TPM and direct effort and cost in lobbying for a certain interpretation that stretches the intention or meaning of a pricing principle and the necessary criteria required to apply the pricing principle. The Authority does not believe this would promote regulatory certainty or stability. This has been the experience with the current pricing principles. The argument that the addition of principles provides greater clarity does not have wide application in the Code with the detail and prescription in the transmission pricing part an exception.
- 3.4.4 The Authority is of the view that Option 1, where the guidelines and the TPM are assessed against the statutory objective, will provide the desired regulatory certainty and stability. If greater regulatory certainty and stability is required the Authority believes this should be pursued by amending or adding to the Code amendment principles. However this may not be necessary at this stage given that the Authority has placed considerable emphasis on regulatory certainty and stability in its interpretation of the statutory objective. This decision could be revisited if it came clear over time that the application of the interpretation was not providing sufficient emphasis on regulatory certainty and stability.
- 3.4.5 Transpower noted that the Authority's view is that it would also need to demonstrate how past decisions with respect to the application of the principles remain valid or need to be altered if new pricing principles were adopted (Option 3). Transpower's view is that, while it would be useful, it is not something that the Authority would inevitably be required to do, and therefore it was not correct for Option 3 to be assessed as "worse" than Option 1 for reducing transaction costs. However, the Authority considers that it would be following good regulatory practice to do so and this is sufficient reason.
- 3.4.6 Transpower, like Vector, did not agree with the Authority's CBA on the basis that it did not take into account the benefits arising from the creation of regulatory stability and certainty. Please refer to paragraphs 3.2.1 to 3.2.4 for the Authority's consideration.

## **3.5 Genesis**

- 3.5.1 Genesis recommended that the Authority consider a number of additional changes in the course of the Code amendment. Their recommendations were to:
- (a) include the guidelines as a new schedule to Part 12;

- (b) revise the guideline amendment process to provide that at a minimum, the normal Code change requirements will apply to any change to the guidelines; and
- (c) clarify the respective roles of the Authority and Transpower i.e. The Authority may review the TPM but it may not amend the TPM.

3.5.2 The Authority considers that the suggestion to codify the guidelines is a possibility but this was not the subject of the Consultation Paper. An appropriate time to consider this proposal may be if the Authority publishes an Issues Paper containing draft guidelines. At that point the Authority could consult all interested parties as to whether they believe it appropriate to include the guidelines as part of the Code.

3.5.3 The Authority's view is that other changes suggested by Genesis are more substantive and cannot be considered as part of the Review. The clarification sought by Genesis as to the respective roles of the Authority and Transpower differs from the Authority's understanding of each party's roles. In particular, the Code is clear that the Authority is required to determine Transpower's TPM – it may refer Transpower's proposed TPM back to Transpower for further consideration and can amend a re-submitted TPM itself under clause 12.91 of the Code.

## **3.6 Decision on the proposal**

3.6.1 The majority of the submissions were in favour of the proposal and the supporting analysis, with a minority presenting reasons why the Authority should either not proceed with removing the pricing principles from the Code (Vector) or suggesting replacing them with an alternative set of pricing principles (Transpower). Essentially, both parties argued that the proposal would lead to greater regulatory uncertainty and instability than their suggestions. However, the Authority was not persuaded by the qualitative assessment they provided. They also did not present quantitative analysis to dispute the qualitative analysis presented in the Consultation Paper with respect to the benefits provided by removing the pricing principles. The Authority's analysis suggested removing the pricing principles would lead to greater regulatory certainty or stability.

3.6.2 After consideration of all submissions, the Authority has concluded that there are good reasons to proceed with its proposal to remove the pricing principles from the Code and to assess the consistency of any proposals relating to the guidelines and the Transmission Pricing Methodology against the Authority's statutory objective. This assessment encompasses compliance with the Code Amendment principles and the objectives of the Code amendment.

## Appendix A Submitter responses to questions

This table contains submitter responses to the questions posted in the Consultation Paper.

	Submitter views.	Authority response
<b>Do you agree there is sufficient reason to review the regulatory framework? If not, why not?</b>		
Contact	Yes.	Noted.
MEUG	<p>Yes. This is a long standing problem. NZIER summarised the policy issue in a report for MEUG in October 2009<sup>5</sup>, commenting on the work by NERA for the CEO's Forum:</p> <p><i>"In the Report NERA does not pay much explicit attention to the pricing principles in the Rules or the related guidance."</i></p> <p><i>"To pay limited attention to the pricing principles in the Rules is arguably a sound approach because they are not easy to understand and some industry participants have argued that they are not internally consistent and are difficult or impossible to apply consistently in practice."</i></p>	Noted.
Meridian	<p>Meridian agreed with the Authority's analysis that <i>'the interface between the statutory objective, the guidelines and the pricing principles is complex, unwieldy and combined with the ongoing lack of consensus around the pricing principles is a demonstrable regulatory failure'</i>.</p> <p>Meridian supported the Authority's proposal that the pricing principles and related interpretation clauses (clauses 12.79 and 12.80) are removed from the Code.</p>	Noted.

<sup>5</sup> NZIER, report for MEUG, Alternative Options for Transmission Pricing – Suggestions for Review by the CEOs Forum, 8 October 2009. Refer to <http://www.ea.govt.nz/our-work/consultations/transmission/tpr/submissions/>

<p>Vector</p>	<p>Vector welcomed the Authority’s willingness to review long-standing issues and reconsider whether previous decisions remain optimal in the new regulatory climate. It also welcomed the approach of reducing regulation and making the Code shorter.</p> <p>However, Vector was concerned about the timing and implications of the proposal to remove the pricing principles from the Code. As a result, its view was that no change should be made to the principles at this time.</p> <p>Had this step been taken at the start of the transmission pricing review, it may have been useful. However, the review is now well underway and has already reached some broad conclusions. Vector would be concerned that this step changes one of the core building blocks of the transmission pricing methodology and that changing it may mean the transmission pricing review would need to re-start from the beginning.</p> <p>More broadly, the existing transmission pricing approach is now long-standing and well understood within the industry. It has been reviewed three times and, broadly, found to be sound because it is based on generally good pricing principles and in line with international best practice. To review the principles now will risk extensive re-litigation of old issues. In Vector’s view this would be inefficient and undesirable – the current approach is generally satisfactory and it would be a retrograde step to re-open previous debates. It is preferable to place effort and resources into improvements in other areas.</p> <p>The current approach is allocation-based assignment of charges to beneficiaries (where identifiable) through connection charges and HVDC charges, with the remainder assigned through a postage stamp. It is not clear to Vector that the current approach is failing, in a material way, to deliver efficient outcomes or that any alternative approach would produce a material improvement in efficiency. As a result, Vector suggested that the Authority provides further supporting information for its claim that the current pricing principles represent a “demonstrable regulatory failure” before progressing this issue further.</p>	<p>Noted.</p> <p>Noted.</p> <p>Noted.</p> <p>The Authority considers that removing the pricing principles at this stage (prior to any consideration in stage 3 of the Review) will enhance regulatory stability and certainty.</p> <p>There is ample evidence to support the contention of “demonstrable regulatory failure”, including responses to earlier consultation on the need to review the pricing principles and the ongoing debate with respect to the TPM.</p>
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Genesis	No response.	Noted that its submission supports the Authority's proposal.
RTANZ	Yes – Section 2.5 of the paper summarises the justification well.	Noted.
MRP	Yes.	Noted.
Transpower	Yes. The interpretation and application of the current pricing principles have caused substantial unnecessary additional costs and administration problems in the past. However, Transpower noted that it is the internal inconsistency of the current principles and the fact that they are not realistic with respect to what transmission pricing can reasonably achieve that has been the source of the problems, not the presence of separate pricing principles per se.	Noted.
<b>Do you agree with the objectives? If not, why not? Are there any other objectives that should be included in the assessment?</b>		
Contact	Yes.	Noted.
MEUG	Agreed with the objectives as set out in paragraph 3.2.1 to overcome the policy issues listed in paragraph 2.5.1.	Noted.
Meridian	Agreed with the Authority's objectives for the Code Amendment Proposal.	Noted.
Vector	Vector did not answer this specific question.	
Genesis	No response.	Noted that its submission supports the Authority's proposal.
RTANZ	Yes. When compared with the alternatives, the proposal will clearly simplify the decision framework, simplify the Code and better reflect the Authority's narrower statutory objective. It is also likely to reduce transaction costs.	Noted.

MRP	Yes.  No, the objectives are sufficiently broad.	Noted.
Transpower	It agreed with the proposed objectives, but recommended that the following objective be added:  (e) Promote greater regulatory certainty and stability with respect to transmission pricing.	Not necessary as this objective is integral to the analysis of the proposal and the alternatives set out in the qualitative assessment of consistency with the limbs of the statutory objective. In addition, the Authority's Interpretation of its statutory objective places significant weight on regulatory credibility and predictability
<b>Do you agree with the assessment of Option 1? If not, why not?</b>		
Contact	Yes.	Noted.
MEUG	Agreed these options are an appropriate set of alternative means to achieve the objectives in paragraph 3.2.1.  The result of the qualitative analysis summarised in table 3 that for the four Code Amendment Principles and four Code Amendment objectives considered the proposal (option 1) is better than or equal to the alternatives is reasonable.	Noted.
Meridian	Meridian supported the Authority's assessment of option 1, particularly noting that submitters in previous consultations have found the pricing principles confusing and contradictory. The removal of the principles should facilitate greater regulatory certainty by promoting investment.	Noted.

<p>Vector</p>	<p>No. Specifying that prices must be set in accordance with the Authority's statutory objective provides limited guidance to Transpower as it designs its pricing methodology. The statutory objective can be interpreted in many ways and there is no explicit weighting between the three limbs of the objective. The greater degree of prescription in the current pricing principles may be more useful to Transpower and its customers than the Authority's objectives on their own.</p> <p>Any change to the pricing principles is likely to trigger a review of Transpower's pricing methodology to ensure it is consistent with the new principles. Any resulting change to the pricing methodology is likely to create winners and losers. It is not clear that this will improve overall market efficiency. However, it is likely to create confusion and resentment and possibly lead to litigation.</p> <p>With regard to the cost-benefit analysis, the quantitative analysis presented in the Consultation Paper only considers administrative costs – cost of judicial review, transaction costs, code change costs. A comprehensive cost-benefit analysis should also consider wider benefits and costs to the New Zealand economy as a whole. The uncertainty created by having more general principles and re-opening old debates could well lead to inefficient or delayed investment decisions while investors wait for certainty to be restored. This is likely to have costs for consumers and the New Zealand economy and should be reflected in the cost-benefit analysis.</p> <p>Also, the benefit assigned to a reduced risk of Judicial Review by scrapping the existing principles is not proven. The shift to a new set of principles, with much less prescription, could lead to an increased risk of judicial review simply because inconsistency could arise from the change in principles and how they are interpreted.</p> <p>Vector suggested the cost-benefit analysis is re-done with these points in mind before any final decision is made.</p>	<p>The Authority does not accept the statutory objective can be interpreted in many ways and has published a widely accepted interpretation of it. Authority also provides guidance to Transpower through the guidelines which will be assessed against the above interpretation.</p> <p>Noted, however the TPM is currently being reviewed.</p> <p>See response in paragraphs 3.2.1 to 3.2.4.</p> <p>Noted.</p> <p>Noted.</p>
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Genesis	No response.	Noted that its submission supports the Authority's proposal.
RTANZ	Yes, with the arguments presented under the heading of 'Code Amendment Principle 2' being particularly important.	Noted.
MRP	Yes.	Noted.
Transpower	No. Transpower submitted that it was difficult to see why the removal of the pricing principles "should provide greater clarity in the evaluation criteria for developing the guidelines and the TPM". In its view if the pricing principles were removed completely, the Authority would need to go through the process of explaining how its formal interpretation of the statutory objective applied to transmission pricing. Whereas with Option 3, this action would already be effectively completed and the outcome clearly set out as the new simplified pricing principles.	See response in paragraphs 3.4.3 to 3.4.4.
<b>Do you agree with the assessment of Option 2? If not, why not?</b>		
Contact	Yes.	Noted.
MEUG	Yes, as per above response for Question 3.	Noted.
Meridian	Supported the Authority's assessment of option 2.	Noted.
Vector	The current approach is allocation-based assignment of charges to beneficiaries (where identifiable) through connection charges and HVDC charges, with the remainder assigned through a postage stamp. It is not clear to Vector that the current approach is failing, in a material way, to deliver efficient outcomes or that any alternative approach would produce a material improvement in efficiency. As a result, Vector suggested that the Authority provide some supporting information for its claim that the current pricing principles represent a "demonstrable regulatory failure" before progressing this issue further.	There is ample evidence to support the contention of "demonstrable regulatory failure", including responses to earlier consultations on the need to review the pricing principles and the ongoing debate with respect to the TPM.

Genesis	No response.	Noted that its submission supports the Authority's proposal.
RTANZ	Yes – the assessment is comprehensive.	Noted.
MRP	This option has provided inaccurate signals and is somewhat unpredictable. A new agreed method is preferred.	Noted.
Transpower	<p>Yes, with the exception of the following statements:</p> <ul style="list-style-type: none"> <li>removing the pricing principles may strengthen investor confidence; and</li> <li>the pricing principles create additional criteria to assess any proposed changes to the guidelines and TPM against. Complexity of decision making is increased without corresponding efficiency gains.</li> </ul> <p>Transpower considered that substituting improved, simplified pricing principles would achieve the objective of strengthening investor confidence more effectively.</p> <p>Provided the pricing principles are designed to be fully consistent with the Authority's statutory objective, they should not create additional criteria against which to assess proposed changes to the guidelines and the TPM and should achieve incremental efficiency gains by increasing regulatory certainty and stability.</p>	<p>Noted.</p> <p>Noted.</p> <p>See response in paragraphs 3.4.3 to 3.4.4.</p>
<b>Do you agree with the assessment of Option 3? If not, why not?</b>		
Contact	Yes. While the principles outlined in Option 3 are an improvement on the status quo, Contact submitted that they will likely still result in higher transaction costs than would the proposed option.	Noted.
MEUG	Yes, as per above response for Question 3.	Noted.
Meridian	Yes. Meridian acknowledged that there will be some efficiency gains from the revised pricing principles, but considered that these are likely to be achieved by relying on the statutory objective alone.	Noted.

Vector	The benefit assigned to a reduced risk of Judicial Review by scrapping the existing principles is not proven. The shift to a new set of principles, with much less prescription, could lead to an increased risk of judicial review simply because inconsistency could arise from the change in principles and how they are interpreted.	See response in paragraphs 3.2.5 to 3.2.9.
Genesis	No response.	Noted that its submission supports the Authority's proposal.
RTANZ	Yes. The approach in developing this 'strawman' option is clearly grounded in the consideration of how achieving the Authority's statutory objective should influence a TPM – as it should be. This contrasts strongly with the existing codified pricing principles which are a mixture of economic efficiency objectives (the simultaneous maximisation of each being demonstrably impossible) coupled with a policy desire for FTRs (and other things).	Noted.
MRP	It did not agree with Option 3.	Noted.
Transpower	<p>No. Option 3 is Transpower's preferred option. Its principal reason for supporting Option 3 is that, while both options 1 and 3 require the Authority's formal interpretation of its statutory objective to be applied to transmission pricing with Option 3 this task has already been done, and the outcome is satisfactory and is able to be crystallised in the Code.</p> <p>Transpower recommended one small change to proposed pricing principle (d)(ii) (in bold) and one additional pricing principle (e):</p> <p>(d)(ii) where practicable providing locational signalling of long run <b>marginal</b> transmission investment costs, to the extent that these are not already signalled by nodal prices, the regulatory investment test and connection charges."</p>	See response in paragraphs 3.4.3 to 3.4.4.
<b>Do you agree that Option 1 has a net benefit than the two alternatives? If not, why not?</b>		
Contact	Yes.	Noted.

MEUG	Agreed and noted that option 1 always has a higher net benefit compared to the alternatives under a wide range of feasibility sensitive analysis. Agreed with the comments in paragraph 5.1.7 of the Consultation Paper.	Noted.
Meridian	Yes.	Noted.
Vector	<p>No. Any change to the pricing principles is likely to trigger a review of Transpower's pricing methodology to ensure it is consistent with the new principles. Any resulting change to the pricing methodology is likely to create winners and losers. It is not clear that this will improve overall market efficiency. However, it is likely to create confusion and resentment and possibly lead to litigation.</p> <p>Vector noted that the quantitative analysis considers only administrative costs and recommended the Authority undertake a comprehensive CBA that considers the wider benefits and costs to the New Zealand economy as a whole.</p> <p>In its view the uncertainty created by having more general principles and re-opening old debates could well lead to inefficient or delayed investment decisions while investors wait for certainty to be restored. This is likely to have costs for consumers and should be reflected in the CBA.</p> <p>Further Vector did not agree with the benefit assigned to a reduced risk of judicial review.</p>	<p>Noted.</p> <p>See response in paragraphs 3.2.1 to 3.2.4.</p> <p>See response in paragraphs 3.2.5 to 3.2.9.</p>
Genesis	No response.	Noted that its submission supports the Authority's proposal.
RTANZ	Yes – it almost certainly has the highest net benefit.	Noted.
MRP	Yes.	Noted.

<p>Transpower</p>	<p>No. The Authority's quantitative cost/ benefit analysis is limited to the estimated administrative costs of the different options (either incurred or avoided). While these costs are significant and need to be considered, the principal benefits of a sound regulatory framework for the transmission pricing methodology are the development of an efficient allocation methodology for transmission revenue and greater regulatory stability and certainty. The Authority's quantitative cost/ benefit analysis has not included these benefits.</p> <p>Transpower believed that well designed, simplified pricing principles would promote regulatory stability and certainty, and consequently a regulatory environment more conducive to efficient investment, more effectively than reliance on the Authority's application to transmission pricing of its formal interpretation of its statutory objective.</p> <p>It is difficult to place a precise value on improved stability and regulatory certainty, but the benefit of even a very small consequential incremental improvement to investment efficiency would dwarf the administrative costs of implementing the best regulatory option. A 0.001% per annum increase in GDP would be worth approximately \$18.7million p.a. and the NPV of a sustained benefit of this amount would be approximately \$267million using a 7% per annum discount rate). We believe that well designed simplified pricing principles could achieve a relative stability and certainty benefit within an order of magnitude of this figure, which would justify the adoption of Option 3. See the body of this submission for more discussion in support of this view.</p>	<p>See response in paragraphs 3.2.1 to 3.2.4.</p> <p>Noted.</p> <p>Noted.</p>
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## **Appendix B Existing and proposed new pricing principles**

### **Existing pricing principles**

The pricing principles in the Code are set out in clause 12.79(a) to (f):

- (a) The costs of connection and use of system should as far as possible be allocated on a user pays basis;
- (b) The pricing of new and replacement investments in the grid should provide beneficiaries with strong incentives to identify least cost investment options, including energy efficiency and demand management options;
- (c) Pricing for new generation and load should provide clear locational signals;
- (d) Sunk costs should be allocated in a way that minimises distortions to production/consumption and investment decisions made by grid users;
- (e) The overall pricing structure should include a variable element that reflects the marginal costs of supply in order to provide an incentive to minimise network constraints;
- (f) Transmission pricing for investment in the grid should recognise the linkages with other elements of market pricing (including the design of the financial transmission rights regime under subpart 5, and any revenues from financial transmission rights).

### **Proposed revised pricing principles**

The proposed revised pricing principles are:

- (a) Ensure full recovery of Transpower's economic costs in providing transmission services.
- (b) Promote competition by allocating costs of transmission services in a way that facilitates or encourages competition in the markets for electricity and electricity-related services taking into account long-term opportunities and incentives for efficient entry, exit, investment and innovation in those markets.
- (c) Promote reliability by allocating costs of transmission services in a way that encourages market participants to efficiently

develop and operate the electricity system to manage security and reliability in ways that minimise total cost whilst being robust to adverse events.

- (d) Promote efficient operation which includes:
  - (i) where practicable charging the costs of connection to the connecting party (connection charges); and
  - (ii) where practicable providing locational signalling of long run transmission investment costs, to the extent that these are not already signalled by nodal prices, the regulatory investment test and connection charges;or
  - (iii) where such locational signals are inefficient or only partially recover the balance of Transpower's economic costs not recovered by connection charges, these residual costs should be recovered in the least distortionary manner.
- (e) Be transparent and enduring in a way that is broadly acceptable to stakeholders.