



15 October 2013

Submissions
Electricity Authority
PO Box 10041
Wellington 6143

Via email: submissions@ea.govt.nz

Mighty River Power Limited
Level 14, 23-29 Albert Street
Auckland 1010
PO Box 90399
Auckland Mail Centre
Auckland 1142

Phone: +64 9 308 8200
Fax: +64 9 308 8209
www.mightyriverpower.co.nz

DDI: +64 9 308 8200
Direct Fax: +64 9 308 8209

Transmission Pricing Methodology: Cost Benefit Analysis Working Paper

Mighty River Power welcomes the opportunity to provide feedback to the Electricity Authority's consultation on its revised Cost Benefit Analysis (CBA) framework for the Transmission Pricing Methodology (TPM). No part of the submission is confidential.

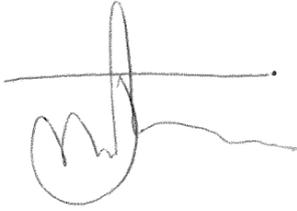
Mighty River Power's detailed submission is provided as an attachment to this letter. In summary our key points are:

- We welcome the Authority's recognition of the material deficiencies with the CBA from the original TPM proposal and the intent to consult on a range of options for reform.
- The working paper represents a first step toward progressing the CBA, but the lack of a robust empirical basis for reform of the TPM is not resolved in the current problem definition and remains the most material issue in the process to date.
- As a priority, the Authority should produce a separate working paper and consult with stakeholders on its problem definition.
- Further stakeholder consultation is also a critical step prior to the application of the CBA to future options. This will be essential to develop the assumptions and inputs into a robust bottom-up assessment and avoid the previous issues with the application of the Authority's economic and decision making framework.
- The CBA must reflect the various static and dynamic impacts raised in the various independent economic consultant reports as well as the impacts raised by geothermal and embedded wind generators.
- Issues related to the over-simplification of the Authority's statutory objective remain in the CBA working paper and need to be resolved.
- A range of alternatives should be assessed in the CBA process, not just variations of the Authority's preferred SPD approach.

- The results of the CBA once applied to options should be subject to independent verification.

Please direct any queries on this submission to myself on nick.wilson@mightyriver.co.nz or 09 580 3623.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Nick Wilson', written over a horizontal line. The signature is stylized with a large 'N' and 'W'.

Nick Wilson

Senior Market Regulatory Advisor

MIGHTY RIVER POWER'S COMMENTS ON THE CBA WORKING PAPER

1 POSITIVE OUTCOMES

Mighty River Power welcomes the Authority's intent to consult on a revised CBA following consistent feedback from stakeholders that there were material deficiencies with the CBA from its original TPM proposal.

The Authority's approach of applying a top-down efficiency factor as the single determinant of potential dynamic efficiency gains was widely criticised on the basis it was "made without justification and was highly subjective"¹.

We support the Authority's intent to supplement the top down approach with a structural bottom-up approach. An example of such an approach which we considered credible was outlined in the report by consultants Reunion² and Covec also provided valuable guidance³.

Other independent economic consultants Castalia (Genesis) and RedPoint (TrustPower) also provided valuable guidance to the Authority on the application of bottom-up assessment which has characterised previous transmission pricing reforms in New Zealand and internationally.

Mighty River Power also supports the recognition that a range of options for reform should be considered and that efficiency benefits should be tested and not just assumed.

2 PROBLEM DEFINITION REQUIRES FURTHER CONSULTATION

Mighty River Power's main concern is that the Authority has still not adequately characterised the problem with the status quo and identified any market failure created by the current TPM.

The problem definition in the paper states that:

"The current TPM can be improved so as to better promote competition in, reliable supply by, and the efficient operation of the electricity industry for the long term interest of consumers. Specifically the inefficiencies in transmission cost recovery under the status quo result in inefficient investment in, and operation of, the electricity industry."

This is insufficient as a problem definition. It offers no clarity as to the size or materiality of the issues the Authority perceives with the TPM status quo and has no basis in empirical fact.

Our main critique of the Authority's original problem definition was that it calculated the inefficiencies of the status quo as the difference between what a theoretical and unspecified beneficiary-pays approach would deliver. This was assumed as an arbitrary percentage reduction in the costs and deferred timing of future investment.

Mighty River Power argued that if it is the Authority's contention that there are material inefficiencies with the current TPM then it should be possible to empirically identify examples of excessive investment and how lobbying by beneficiaries was successful in bringing forward

¹ See Section 4.2.3 of PWC (March 2013) "Review of the Submissions of the Electricity Authority's Transmission Pricing Methodology". Available from <http://www.ea.govt.nz/dmsdocument/14592>

² See Section 3.5.2 of Reunion (Feb 2013) "Proposed Transmission Pricing Methodology: Assessment of the CBA" Available from <http://www.ea.govt.nz/dmsdocument/14469>

³ Covec (March 2013) Review of TPM Proposals <http://www.ea.govt.nz/dmsdocument/14470>

excessive investment and how they stood to benefit to the detriment of others. This analysis has not been undertaken to date.

The theory presented in the paper again does not meaningfully address the inefficiencies the Authority perceives with existing TPM. In essence, the Authority appears to be arguing that efficient transmission charges would provide appropriate long term signals to increase or reduce use of the transmission system, subject to the availability of transmission substitutes. However, it does not examine the extent to which the current TPM (via the RCPD mechanism) may or may not provide such signals and therefore the extent to which reform is warranted.

The Authority may hold the view that its preferred approach would result in material gains in both static and dynamic efficiency but this was not borne out in its own analysis⁴ or the feedback from stakeholders. On the contrary, the clear feedback to the Authority was that there were significant static inefficiencies that could result from its preferred approach, making the status quo or more incremental options more attractive⁵.

Consistent with best regulatory impact assessment practice⁶, the appropriate approach for assessing the TPM should be:

1. Defining the problem and assessing its magnitude;
2. Defining the policy objectives broadly enough to consider all relevant alternative solutions and identify the full range of feasible options;
3. Analyse the options and their impacts (e.g. via CBA and other qualitative methods)
4. Undertake a risk assessment (including impacts on various stakeholders).

The limitation of the process to date is that a number of these steps in were amalgamated in the Authority's earlier TPM Issues and Proposal paper. As such the current process has become highly challenged. Stakeholders are being asked to comment on a CBA framework that will be applied to yet unspecified options based on a problem definition the majority consider unsound.

Mighty River Power therefore recommends the Authority consults as a priority on a revised working paper on problem definition prior to releasing a second issues paper.

3 ITERATIVE DEVELOPMENT OF THE CBA IMPORTANT

While the CBA working paper represents a welcome first step, much of the detail of the approach still remains undefined and opaque. The role of a well-designed CBA should be to clarify and make explicit the main assumptions and reasons underpinning the development of a proposal.

The lack of consultation with stakeholders between the announcement of the Authority's economic and decision making framework and its revised TPM proposal created significant uncertainty. This has led to protracted rounds of consultation and calls for the Authority to explain further and provide additional information on the impacts of its policy.

⁴ Where nearly all the benefits were assumed to be dynamic efficiency benefits.

⁵ See footnote 1, section 2.1.2

⁶ New Zealand Treasury [2013] Regulatory Impact Assessment Handbook

The key learning from this process is that the development of the CBA should be iterative. The Authority should continue to consult with stakeholders as the CBA is developed further. Key areas of uncertainty that Mighty River Power considers require resolution include:

3.1 Use of a top down efficiency factor

Mighty River Power remains highly sceptical of the Authority's use of this approach. The main criticism the Authority received was that the selection of the efficiency factor was effectively arbitrary and could be used to justify any proposal due to the lack of a causal relationship.

We remain concerned that the use of the top-down efficiency factor approach appears only to be proposed in terms of quantifying the benefits of reform. This affords far too much leeway to a parameter that is capable of significant manipulation.

Mighty River Power presented independent economic analysis to the recent TPM conference which illustrated that total factor productivity (TFP) was far lower and in fact actually negative for the electricity and gas sectors than the figure utilised by the Authority⁷. Further, the Authority had applied network TFP to a much larger revenue base.

The Authority therefore should not just rely on the top-down approach for the quantification of efficiency gains but also acknowledge evidence of potential losses. It is essential any top-down assessment is verified against a robust bottom-up assessment and that there is not significant divergence.

3.2 The appropriate application of a bottom-up approach:

The clear feedback to the Authority was that the presence of dynamic efficiency benefits required further assessment. Specifically, this should include analysis of what future transmission investment decisions could reasonably be expected to be influenced by a change in the TPM.

As noted above, several independent consultants' reports have provided guidance on how a structural bottom-up approach could be implemented, yet there is little detail in the working paper on how these recommendations will be operationalized in the CBA.

3.3 The appropriate integration of static and dynamic inefficiencies, including wealth transfer impacts

While the paper accepts the adverse consequences of reform need to be considered, little specific detail is provided.

Mighty River Power does not support the contention in the paper that adverse reform consequences were considered in the Authority's previous proposal. The analysis provided by independent consultants for Mighty River Power suggested that the actual net dynamic impacts of the Authority's proposal were in the range of **negative -\$27.8m to +\$17m**. This was significantly different from the Authority's own sensitivity analysis.

Various alternative economic analyses were provided to the Authority which also attempted to quantify potential dynamic and static inefficiencies. It is incumbent on the Authority to directly address these analyses in any future CBA.

⁷ See Footnote 3, Section 5.3

Mighty River Power also fully supports the Authority's recent comments that:

"Regulators are always able to transfer wealth, but if they do so it has to recognise there will be a cost. The cost will be in the willingness and terms on which parties will invest in generation capacity in the future and in other sectors of the economy."⁸

Significant concerns were raised particularly by a number of wind and geothermal generators on the negative impacts on the Authority's original proposal on their current and future investments. At the recent commissioning ceremony for the Ngatamariki geothermal plant, the Chair of the Tahaura North No. 2 Trust, Ngahihi o te ra Bidois, raised directly the negative economic impacts to his Trust's beneficiaries and to future investment from the Authority's TPM proposal. Such impacts require explicit consideration in any revised CBA process.

3.4 The application of the Authority's statutory objective

Mighty River Power is concerned by the statement in the paper that the Authority intends to attribute a high degree of focus on final consumer prices as a proxy indicator for the achievement of its statutory objective.

While we agree the analysis provided by the Authority on consumer prices outcomes significantly understated the impacts from its proposal, a focus solely on end consumer price reduction should not imply achievement of the Authority's statutory objective.

The correct application of the Authority's statutory objective should include an explicit and transparent assessment of the various limbs. This is consistent with our views put forward in our original submission⁹. Such an approach would balance any potential short term wealth transfer benefits with of the potential impacts in terms of future investment (which could reduce reliability for consumers) and the efficient operation of the system.

These are important elements of the Authority's statutory objective which require proper and separate investigation.

4 FURTHER OPTIONS SHOULD BE CONSIDERED

While we welcome the intent in the paper to consider a wide range of options we are still concerned that the Authority may be inclined to consider variations on its beneficiary pays approach. Other more incremental reforms, such as those proposed in our recent cross-submission¹⁰ and by Contact Energy for the HVDC, should also be considered.

Section 2 of Table 4 on the CBA Framework also indicates that options consider should include: "more emphasis on recovering transmission costs from the competitive sector (i.e. generators and retailers)".

Mighty River Power considers the appropriate decision framework is whether the options advance the Authority's statutory objective and address any issues identified in the problem definition analysis. As indicated above, we consider further work is required on problem definition in consultation with stakeholders.

Consistent with its views in previous submissions, Mighty River Power still advocates that the results of any CBA analysis should be independently verified.

⁸ Paragraph 63 of Electricity Authority (4 June 2013) "The Economics of Electricity"

⁹ See Section 2.3 of Mighty River Power's TPM Submission <http://www.ea.govt.nz/dmsdocument/14461>

¹⁰ See Mighty River Power TPM Cross-submission <http://www.ea.govt.nz/dmsdocument/14593>