



19 November 2013

Submissions
Electricity Authority
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Transmission Pricing Methodology: Sunk cost Working Paper

Meridian commends the Electricity Authority (*the Authority*) for developing and releasing the Transmission pricing methodology: Sunk costs Working paper (*the Working Paper*). The Working Paper usefully clarifies some key concepts in the discussion of sunk costs and efficient transmission pricing, and Meridian appreciates the opportunity to respond.

Summary

In overview, Meridian agrees:

- that for Transpower pricing decisions the relevant distinction is between fixed costs and variable costs. For present purposes the question of whether a cost is sunk is not relevant to the pricing decision – it is accepted that under the current regulatory regime Transpower should recover its sunk costs, and the issue is how to do this while minimising distortions to decision-making
- that infra-marginal prices must recover fixed costs as well as variable costs
- the degree to which fixed costs should be recovered by variable infra-marginal prices can only be determined by considering the total economic efficiency effects (static and dynamic) of a particular pricing proposal in its fact-specific context. There is no universal economic rule.

Relevant question is fixed cost, not sunk cost

Meridian agrees with the central theme in the Working Paper that the question of whether a cost is sunk is relevant to production decisions, but not to pricing decisions for present purposes.

For the reasons given in the Working paper, Meridian agrees that:

- in relation to the marginal price, it is the distinction between fixed and variable costs that is relevant, not the question of whether a cost is sunk or not.
- allocative efficiency is promoted where the marginal price is set equal to variable cost and does not seek to recover fixed costs
- however when it comes to infra-marginal prices, the prices overall must recover the total of fixed and variable costs.

Meridian agrees with the conclusions in the Working Paper that for this transmission pricing process:¹

Categorising costs as sunk or otherwise has few if any implications for efficient pricing. Fixed costs are ignored in setting efficient prices for the marginal unit of service not because they are sunk, but because they need not be altered to alter production levels. Hence, the important distinction for static efficiency considerations is between variable and fixed costs.

However, the static efficiency requirement, that the price for the marginal unit equate marginal willingness to pay and marginal cost, does not mean that every unit of the good or service be sold at marginal cost. This static efficiency criterion only applies to the marginal unit.

Economics does not provide the same definitive test 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...

The approach to efficient prices

In its Overview Paper the Authority states:²

... The Authority concludes that it should consider the total economic efficiency effects (static and dynamic) of a particular pricing proposal, and not just one aspect or one set of prices. A pricing methodology needs to be assessed on its merits.

Accordingly, the Authority is of the view that it may change the methodology for determining transmission prices, irrespective of the existence of sunk costs, if the change promotes overall efficiency in the electricity industry.

Meridian agrees with that approach. As noted above, the real question is how to recover the sum of fixed and variable costs in the most efficient way, regardless of whether the fixed costs are sunk. This will be a context specific analysis. In particular, there is no hard and fast economic rule against recovering fixed costs through variable non-marginal prices. Meridian agrees with the statement in the Working Paper that:³

Economic theory does not support the claim in submissions that "there can be no dynamic efficiency benefits" from adjusting prices to incorporate the cost of sunk assets. Nor is there an economic efficiency reason to argue that recovering fixed costs through variable non-marginal prices would necessarily be allocatively inefficient.

The Working Paper states:⁴

... 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 is made, that is lower than the full economic cost of the service.

¹ Working Paper, paragraphs 9.4 to 9.6

² Transmission pricing methodology: Sunk costs Overview paper, paragraphs 5.17 and 5.18

³ Working paper, paragraph 9.7

⁴ Working paper, paragraph 9.6

Meridian agrees that the current demand for a service should face the economic cost of the service, up to a party's level of benefits. A similar stance is taken in Australia. The Australian Energy Market Commission (AEMC) recently determined that when applying a regional beneficiary pays approach it is not feasible or appropriate to do a one-off identification of beneficiaries at the time the transmission investment is made. The modelling would be significantly uncertain, and:⁵

...there would be a substantial risk for long-lived transmission assets that costs of a long lived asset will become misallocated over time, given the likelihood that beneficiaries will change over time.

As a result, the AEMC came to the same decision that the Authority has come to, which is that the pricing methodology must regularly update the view on beneficiaries. This approach:⁶

...does not change the total amount of revenue allowed to be recovered by transmission network service providers. However, it would result in an ongoing redistribution of transmission charges.

A concern raised in previous submissions was that a beneficiary pays approach resulted in sunk costs being "reallocated", in a way that offended economic efficiency or retrospectivity. Meridian disagrees. In any pricing year the residual value of the sunk assets are not being "reallocated". Rather, a year's portion of the residual value is being allocated for the first time, and once only. This is simply a function of Transpower recovering the cost of an asset over more than one year.

We agree with the Authority's initiative in clearing away the clutter of sunk cost debates, and with the Authority's focus on beneficiary pays as a better framework for identifying efficient transmission pricing. We also observe that a further strong reason for applying a beneficiary pays charge to major assets in the current grid is that it improves the credibility of the pricing methodology with stakeholders and therefore its durability. Where costs and benefits become significantly misaligned, the pressure for regulatory change builds. The sums of money that industry participants are asked to contribute each year are simply too large for any stakeholder to tolerate a serious discrepancy between cost and benefit. Conversely, a transmission pricing methodology that keeps benefits and costs lined up will be durable, and avoid the significant disruption of regular regulatory change.

New Zealand has learned this lesson. Our transmission pricing methodology has been seriously unstable precisely because the very large HVDC costs were imposed on a subset of beneficiaries in a way that far outstripped the benefits they received. Further instability results from the way the costs of Transpower's North Island investment programme are allocated to South Island stakeholders. This is not a trivial issue and the Authority is right to give this consideration weight.

The AEMC has taken a similar view:⁷

⁵ National Electricity Amendment (Inter-regional transmission charging) Rule 2013 (28 February 2013), page 24

⁶ National Electricity Amendment (Inter-regional transmission charging) Rule 2013 (28 February 2013), page 9

Stakeholders may be more likely to support regulatory arrangements that link costs with benefits relative to those that do not. It is likely new costs or a reallocation of costs will achieve greater acceptance by consumers and stakeholders if they perceive a commensurate level of benefits associated with the cost being incurred.

In summary, Meridian agrees that proposals to improve the efficiency of transmission pricing should be assessed on their merits. As the Authority is aware, Meridian has highlighted the high degree of consensus that the single change of dropping the HVDC charge and recovering the costs of HVDC assets through the interconnection charge will significantly improve the efficiency of transmission pricing.

On the question as to whether further changes to the transmission pricing methodology can be identified that generate further efficiency benefits, Meridian has raised a number of constructive changes to the Authority's October 2012 proposal that might serve to meet the concerns of some stakeholders while preserving the dynamic efficiency benefits the Authority is targeting. We look forward to engaging on these matters when the Authority releases its second Issues Paper.

If you have any questions please contact me.

Yours sincerely



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