

19th November 2013  
John Rampton  
Electricity Authority  
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Wellington, 6143

By email: [submissions@ea.govt.nz](mailto:submissions@ea.govt.nz)

Dear John

## Working Paper – Sunk Costs

We appreciate the opportunity to comment on the working paper *Transmission pricing methodology: Sunk costs*, published by the Electricity Authority (The Authority) on 8 October 2013. Our interest in this consultation is as Grid Owner and administrator of the TPM.

### An interesting account of the academic discourse

The sunk costs working paper brought together an interesting collection of observations from the academic discourse on the theoretical distinction between fixed and sunk costs. There is nothing in the sunk costs working paper that we particularly disagree with and several conclusions that we agree with.

At a general level it was not entirely clear to us what the purpose of the sunk costs working paper was in context of the current TPM investigation. Nothing in this working paper triggered a rethink of the views that we or the Competition Economics Group (CEG) have expressed previously (CEG's response is attached to this submission).

The working paper identifies that at times in this process the term 'sunk' has been used to describe what may correctly be termed 'fixed' costs. The working paper explains that sunk costs are also fixed and, in the context of pricing, that:

*"The debate in the economics literature 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 for efficient pricing."*<sup>1</sup>

In this context the discussion in the working paper about the delineation between fixed and sunk costs is moot. While we found aspects of the logic outlined in the sunk costs working paper curious there seems, given the conclusion above, little point commenting in detail at this point. I note, for the record, that we responded to questions from the Authority at the TPM conference<sup>2</sup> about the practical and

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<sup>1</sup> Electricity Authority: TPM sunk costs working paper, paragraph 1.10.

<sup>2</sup> *Response to unanswered questions – Transpower*, available at <http://www.ea.govt.nz/about-us/news-events/events-calendar/transmission-pricing-methodology-conference/>

economic characteristics of specific transmission assets. We remain of the view that most transmission assets are, for all practical purposes, sunk.

### **Any methodology should be assessed on its merits**

We agree with what appears to be the main conclusion of the paper<sup>3</sup> that a pricing methodology needs to be assessed on its merits. We also agree with the statement that the existence of sunk costs does not and should not, of itself, preclude change to the TPM<sup>4</sup>. In the context of that paragraph we observe that the Authority is not quite free to change the TPM at will – it must first establish that there has been a material change in circumstances.

If the Authority establishes that there been a material change in circumstances then it should articulate any specific problems that it identifies with the current TPM, identify options for potential change, and assess each option on its merits. The notion that a policy proposal should be explicitly assessed against the three limbs of the statutory objective<sup>5</sup> for its impacts on *competition in, reliable supply by and efficient operation* of the electricity industry ought not to be controversial.

The assessment should also take into account practical considerations, transaction costs and the desirability of consistency and certainty<sup>6</sup>; as well as the existence of sunk investments and the impact that wealth-shifting rule-changes can have on investment confidence if they are not well justified.

### **CEG comments**

We asked CEG to review the sunk costs working paper and consider whether its content caused CEG to change its previous advice to the primary consultation, post conference, or, in cost benefit analysis working paper. CEG observes that:

*“although there is very little in the paper with which we disagree...nothing in the sunk costs working paper causes us to change our view that there is unlikely to be any material efficiency benefits associated with applying a “beneficiary-pay” approach to reallocating the costs of existing assets in this instance.”*

Please contact me if you would like to discuss any of the points made in this submission. You can reach me on 04 590 7544 or [jeremy.cain@transpower.co.nz](mailto:jeremy.cain@transpower.co.nz).

Yours sincerely



**Jeremy Cain**

**Chief Regulatory Advisor**

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<sup>3</sup> Paragraph 1.13

<sup>4</sup> Paragraph 1.14

<sup>5</sup> To promote competition in, reliable supply by, and the efficient operation of the electricity industry for the long term benefit of consumers

<sup>6</sup> As was required under (revoked) Code 12.80 with the requirement now recognised through the EA's consideration of the 'efficient operation' limb of its Statutory Objective <http://www.ea.govt.nz/our-work/consultations/priority-projects/regulatory-framework-tpm/>