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TRUSTPOWER SUBMISSION: TPM WORKING PAPER: SUNK COSTS

1 Overview

1.1.1 Trustpower Limited ("Trustpower") welcomes the opportunity to provide a submission to Electricity Authority ("Authority") on its working paper on sunk costs ("the Working Paper").

1.1.2 As we said in our submission to the first working paper in the TPM series, we are very pleased that the Authority has decided to publish a set of working papers and consult on them. We thoroughly support this approach, in comparison to releasing another one-shot Issues Paper analogous to the Authority's October 2012 Consultation Paper ("the 2012 Consultation Paper").

2 Submitters' positions

2.1.1 In the Working Paper, the Authority contends that:

> *"Several submitters argued that the proposed TPM would change the way sunk costs are charged for and doing so would give rise to economic inefficiencies. A strong claim is made that there can be no dynamic efficiency benefits from adjusting prices to incorporate the cost of sunk assets. The contention in several submissions is that a pricing methodology that alters the prices charged for services provided using existing (sunk) investments can produce no efficiency gains, and may result in inefficiency losses. Some submitters also expressed concern that the proposed methodology would convert a fixed or sunk cost to a variable charge and that this would result in allocatively inefficient pricing signals."*

2.1.2 This is not entirely consistent with our understanding. Yes, submitters definitely postulated that the pricing signals proposed in the 2012 Consultation Paper would be allocatively inefficient. However, as we noted in section 2.4 in our submission to the CBA working paper (echoing our submission to the 2012 Consultation Paper):

> *"We agree that charging beneficiaries for new transmission assets should, in theory, have a positive impact on dynamic efficiency, and support such an approach for new assets. However, we also stated that charging for existing assets via beneficiaries-pay cannot, of itself, improve the efficiency of the decisions to invest in those assets.*
>
> *We acknowledge that the way in which charges for existing assets are levied can have a big impact on other investment decisions. One example of this is the reduced incentive to invest in*

South Island generation due to HVDC charges. However, these issues could be solved by changing the existing TPM to a regime other than beneficiaries-pay. "

2.1.3 To clarify, our position was not that changing the charging regime for existing assets cannot have efficiency gains at all (with changes to the HVDC link charging regime a case in point). Instead, we claimed that charging for existing (sunk) assets <u>via beneficiaries-pay</u> cannot have any positive efficiency gains.

2.1.4 Further, implementing the proposal in the 2012 Consultation Paper for existing (sunk) assets would likely be detrimental to both static and dynamic efficiency.

2.1.5 It is important to note that there are many beneficiaries-pay methodologies for new transmission assets that should, in theory, lead to improvements in dynamic efficiency, without necessarily having to impact static efficiency, because they are <u>not based directly on market outcomes.</u> The Authority should be focussing its attention on such methods, rather than pursuing a method that has the potential to impact static efficiency.

3 Review of the Working Paper

3.1.1 Given the technical nature of the Working Paper, we jointly commissioned Castalia to undertake a review of the paper and assess its relevance to transmission pricing in New Zealand in general. Castalia's review is available online at http://www.castalia-advisors.com/news_at_castalia.php&news_id=223.

3.1.2 As Castalia points out, economic theory tells us that the allocation of sunk costs should not influence behaviour on the margin (and hence marginal prices). However, theory does not tell us much with regard to infra-marginal allocation. The Working Paper is not particularly careful about making that distinction, or describing who or what the infra-marginal payers are in this particular context and how their incentives could be affected.

3.1.3 We believe the Castalia review makes a number of useful points of which the Authority should take note, many of which we have made in our earlier submissions, including that:

a) the relevance of the characterisation between sunk and fixed costs for transmission pricing is unclear;

b) it is not clear that simply more scrutiny alone will result in any different outcomes to new transmission investment decisions;

c) the concerns raised by industry participants about potential static efficiency losses remain valid, whether transmission assets are fixed or sunk;

d) to promote efficiency, beneficiaries-pay transmission charges need to have a clear link to the willingness to pay of grid users that are asked to pay those charges; and that

e) the dynamic efficiency benefits of beneficiaries-pay charging should be demonstrated by showing some material failure in the Investment Test process (such as evidence from previous incorrect approvals).

3.1.4 For any questions relating to the material in this submission, please contact me on 07 572 9754.

Regards,

JAMES TIPPING
REGULATORY STRATEGY MANAGER

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