think differently

23 September 2014

Submission
Electricity Authority
PO Box 10041
Wellington 6143

By email: submissions@ea.govt.nz

Dear Sirs

Re: TPM Review – LRMC charges

Thank you for the opportunity to provide feedback on the working paper on the application of a LRMC methodology to the Transmission Pricing Methodology.

The paper refers to workably competitive markets (section 5.5). Nova suggests that the relevance of the economic theories applied in the paper should be considered in the context of a real competitive market; one that has some parallels with the transmission market in terms of high capital investment (LRMC), long term customer commitments, and low short run marginal cost.

The provision of rental space in CBD commercial properties, such as in Wellington and Auckland is such a market. Like transmission investments, office buildings are large, long term investments. New buildings are built when the supply and demand balance leads market rentals to approach LRMC. When a new office block is completed, prices do not drop to the short run marginal cost. This is despite vacant space becoming available.

Unless there is excessive speculative demand for office space, the revenue for the new capacity is contracted ahead before the new capacity being built. Most tenants are locked into longer term rental agreements priced on providing a market return on investment. On the margin, the availability of vacant space leads to some movement in tenancies away from properties where the amenity values are lower. Some space will either remain vacant for a period, or is withdrawn from the market temporarily for renovation or withdrawn permanently. In any case, market rents are not hugely volatile over time unless there is a widespread and rapid change in supply or demand in excess of the market's ability to adjust.

In the market for transmission capacity generators and retailers are locked in to a greater extent than tenants in an office block. As demand in a region approaches capacity, it makes sense that prices approach the LRMC of the next increase in capacity. It also holds that once that capacity is built; there should be a de facto contract that the beneficiaries of that investment will pay for the investment.

In terms of the TPM, the MIC approach mirrors the rentals rising as demand increases to match supply. The beneficiary pays approach is consistent with the ongoing return that the property developer locks in through contract before proceeding to invest in the next major increment to supply. The corollary is that the charges for transmission services should be based on both the LRMC MIC and Beneficiary Pays approaches. For each set of transmission assets the transmission charge should be based on the greater of the LRMC MIC methodology, or Beneficiary Pays.

This would capture the benefits ascribed to recent upgrades such as NIGUP or the HVDC, but also reflects the impending costs associated with projects yet to be completed and provide the appropriate economic signals associated with that. In areas where there are neither recent upgrades to be paid for, nor an expectation of increased investment, the charges should be lowest.

Clearly such a proposal doubles the level of complexity, which has the risk of being totally unwieldy. Nova suggests applying the MIC approach together with the SPD/GIT methodology in their simplest forms may however be workable, as the overall charges will be more equitably spread than they are when applying either method alone. It will also collect a higher level of revenues than either method on its own, and reduce the potential distortion arising from a residual charge.

Please feel free to contact me if you wish to discuss our views further.

Yours sincerely

Paul Baker

Commercial & Regulatory Advisor

pbaker@novaenergy.co.nz

Tel: 04 901 7338