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UNISON SUBMISSION – TRANSMISSION PRICING METHODOLOGY SECOND ISSUES PAPER: SUPPLEMENTATRY CONSULTATION

Introduction

Unison Networks Limited (Unison) welcomes the opportunity to submit on the Electricity Authority's (Authority's) consultation paper: *Transmission Pricing Methodology (TPM) Second Issues Paper – Supplementary Consultation*. This submission represents the views of both Unison and Centralines electricity distribution companies.

Unison acknowledges the resource and time that the Authority has put into considering previous submissions on the Second Issues Paper. We note that several of our suggested changes have been taken into consideration for the revised TPM (e.g. widening the criteria for AoB assets and excluding inefficient exit situations from the criteria for the Prudent Discount Policy). The modelling provided in the Supplementary Consultation paper is also interesting to review, however we believe that this can only be an indication of the impact of the proposed TPM. This is due the large amount of discretion that Transpower has in determining the allocation methodologies for the charges. This point will be discussed in further detail below.

Unison notes that the Authority has signalled that a final decision on the TPM amendments will be made in April 2017. We welcome this conclusion to the review process, as the cost of the work programme in this area to date has been considerable, both in terms of time and resource to the Authority and the wider industry to review and submit on changes. Unison accepts that there are still components of the TPM where we have concerns with the Authority's proposed approach taken (e.g. the removal of RCPD as an allocation methodology, which is discussed further below). However, it is now imperative that a final decision is taken to regain regulatory certainty in this area.

We wish to record, however, that we remain unpersuaded that there will be material efficiency benefits arising from the proposed revised TPM. Our assessment is that the proposals will result in a significant reallocation of sunk transmission costs, with consumers in aggregate becoming liable for a much higher share of the costs of transmission services as a result of relieving South Island generators of the costs of the HVDC (in excess of the modelled ~$200 million efficiency benefits from the proposals).

It appears that it has become an article of faith on the part of the Authority that the proposed TPM will result in greater economic efficiency. In our view, at best, the reallocation of Transpower's revenue requirement, could be argued to improve fairness, particularly as parties such as Centralines and Unison are relieved of obligations to pay for recent large transmission investments which appear to have benefited other parts of the country. But we struggle to comprehend that reallocations of sunk costs can improve economic efficiency, or that changes in parts of the existing TPM could not achieve similar outcomes (e.g., change the recovery of the inter-connection charge to a different allocation mechanism as has been proposed for the residual charge).

Despite these reservations, the key points Unison wishes the Authority to consider before making a final decision on the TPM include:

- Level of Prescription of the TPM Guidelines
- WACC Reduction and the Cap on Price Increases
- Wealth Transfer and Historically Increasing Transpower Charges, and
- TPM and DGPPs – Aligning the Timing.

Each of these points are discussed in more detail below.

1. Level of Prescription of the TPM Guidelines – AoB, Residual Charge and the LRMC

AoB / Residual Charge

The Supplementary Consultation paper sets out a revised set of TPM Guidelines which Transpower would use to implement the proposed TPM. While refinements to the sections of the Guidelines are welcome (e.g. clause 32(f) on the method for calculating the residual charge), Unison remains concerned that the Guidelines leave Transpower with too much discretion in terms of allocation methodologies and insufficient guiding criteria in exercising such discretion. For example, the allocation methodology for the residual charge has changed from "physical capacity of load customer's connections", to "historical anytime maximum demand **or another method**" (emphasis added). The move to historical AMD is positive, however the allocation methodology appears to now be completely at Transpower's discretion. The residual charge allocation method also may impact on the allocation of the AoB charge as seen below in the new Guidelines:

> ***Area of benefit allocation (clause 16):***
> *The standard method must—*
> *(a) to the extent practicable, provide for charges to be allocated to designated transmission customers in an area-of-benefit so that each customer is allocated the proportion of the charges that corresponds to the proportion of the aggregate positive net private benefits the customer is expected to receive from the eligible investment in that area-of-benefit; and*
> *(b) to the extent that the method in paragraph (a) is not practicable, provide for—*
>> *(i) charges to be allocated to each load designated transmission customer in the area-of-benefit u****sing the same method as is used to allocate the residual charge***
>
> ***Residual charge allocation:***
> *The method for calculating the residual charge must be one of the following—*

(a) historical anytime maximum demand:
(b) another method.

The concern Unison has with Transpower having the ability to effectively chose the residual charge allocation method is that it opens Transpower up to objections and lobbying to apply a particular approach that may benefit certain parties, but with little power to discriminate between different alternatives. We think the EA should consider adding criteria to the guidelines that assist Transpower in making judgment calls.

Ultimately, Unison would prefer the Authority retain the RCPD (albeit it could be modified to a gross basis to address the Authority's concerns with ACOT payments), as an allocation methodology for the residual charge as it useful in providing a base price signal for reducing peak demands. We remain concerned that there is a large, but unobserved demand response built on the RCPD approach which may be undermined by its removal. We are concerned that sole reliance on nodal prices to encourage continued demand responses during peak periods may not be as effective as a durable RCPD-based signal. However, we understand that the Authority has retained its view that the residual charge should be as unavoidable as possible, and therefore historical AMD based on gross loads has been signalled as the preferred charge allocation method. Unison therefore recommends that the Authority amend the TPM Guidelines to state that historical AMD is the preferred allocation method to be used for the residual charge, unless this is an inadequate measure and the LRMC needs to be used to send a stronger price signal.

LRMC

The Authority signalled in the Supplementary Consultation that they plan to retain the Long-Run Marginal Cost (LRMC) to be used as an optional addition to the TPM components. Unison supports the addition of the LRMC charge, particularly given the Authority's reluctance to retain an RCPD allocator for the residual charge. However, Unison notes that the LRMC is still intended to be used at Transpower's discretion. In the absence of an RCPD allocation methodology for the residual charge, Unison submits that the Authority should allow Transpower some discretion to transition from an RCPD signal to a more fixed residual allocation approach. This will help to avoid unintended consequences of a wholesale removal of the RCPD allocation.

2. WACC Reduction and the Cap on Price Increases

WACC Reduction Modelling

The Authority has introduced another TPM modelling variable in the Supplementary Consultation paper: a potential decrease in Transpower's WACC from 7.19% to 5.32%. Although this optically shows a better overall impact on consumers, Unison believes this detracts from the true impact of the proposed changes and is misleading. Furthermore, as the interest rate period is cyclical, it is possible that the rate may have increased again by the time the proposed TPM is implemented in 2020. Unison therefore strongly urges the Authority to model based on the impact of the TPM change alone and not external factors that can make the proposal seem more palatable. The potential WACC decrease for Transpower should not be a discussion point in the consultation paper.

3.5% Cap on Price Increases

The Authority has proposed in the Supplementary Consultation paper a 3.5% cap on transmission price increases, with the following rationale:

> *The proposal would reduce uncertainty for consumers by capping increases in transmission charges to distributors and major industrial customers. This cap would mean that distributors and retailers could limit the flow-on impact to households to no more than 3.5% of their total electricity bill.*
>
> *One of the reasons for introducing the cap is to address fears that some distributors have created by over-stating the likely impact of the proposed changes. Although we're proposing the 3.5% cap to assure consumers the impacts are moderate, our modelling shows the cap is unlikely to be needed for any distributor.*[1]

The Authority has modelled the 3.5% cap in combination with the WACC reduction. In this scenario, there are no distributors who would receive a 3.5% cap on transmission charges. Even when the WACC decrease is excluded from any modelling, the number of distribution companies that the cap would apply to would be five[2]. Unison is unconvinced any cap is necessary for a number of reasons:

- the difference in capped versus non-capped prices is not significant in most cases
- the cap provides a limitation on the redistribution of asset costs to deemed beneficiaries that then have to be paid for by non-beneficiaries. The Authority should recognise that some of the parties adversely impacted by a cap have very high lines charges driven by factors such as low customer density and thus would suffer in the transition.
- the cost to administer the scheme is likely to be high relative to the short-term benefits.

Unison submits that the Authority consider removing the proposed cap on price increases, as we consider that the administrative costs are likely to outweigh the short-term benefits to consumers.

3. Wealth Transfer and Historically Increasing Transpower Charges

Unison notes that the Authority's previous consultation paper on the proposed TPM[3] attracted a number of submissions criticising the proposals for the impacts on their end-consumers. One of the points that was noted in their submission was that the TPM proposals will result in a significant wealth transfer from, in particular, residential consumers in the Auckland/Northland regions to other areas, such as the Hawke's Bay, where transmission charges will decrease. This is largely still the case for the proposed TPM in the Supplementary Consultation paper. Some of those parties identified that there would be significant benefits to South Island generators who would have reduced responsibility for paying to transport their product to market.

While, in general, we would support the argument that wealth transfers should not be influential in making a decision when it is between consumers in different areas of the country, as we note above, consumers in aggregate will become liable for $100's of millions of additional transmission

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[1] Electricity Authority (December 2016). Webpage on TPM Supplementary Consultation: http://www.ea.govt.nz/development/work-programme/pricing-cost-allocation/transmission-pricing-review/consultations/#c16277

[2] Electricity Ashburton, Horizon, Northpower, Vector and Westpower.

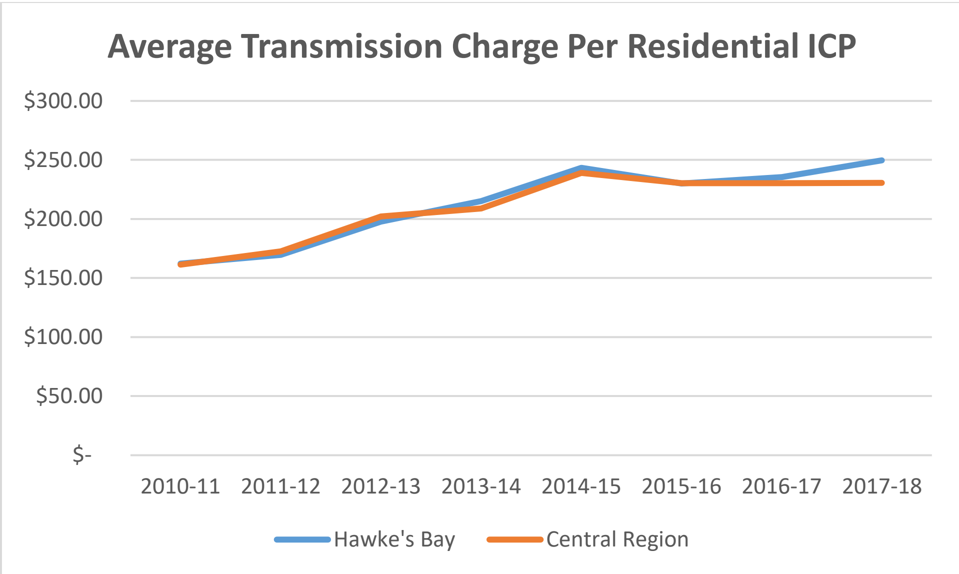
[3] Electricity Authority (17 May 2016). Transmission Pricing Methodology: Issues and Proposal.

asset costs (HVDC), in order to benefit from modelled efficiency gains of around $200 million. Notably, Unison is extremely dubious about the real extent of the efficiency gains. We request that in the final decision the Authority explain how the long-term interests of consumers are met when they are required to meet a significant increase in the overall costs of transmission, for a much smaller magnitude of efficiency benefits. Historically, the Commerce Commission (e.g. the gas network price control inquiry) has found that it should sacrifice economic efficiency in order to achieve a wealth transfer outcome that would benefit consumers by imposing price control. The Authority's proposals would appear to be in the opposite direction where aggregate consumer welfare is to be sacrificed to achieve an efficiency benefit.

While we are concerned that the change in liability for the HVDC will cause an aggregate loss to consumers, we do support the change in approach for allocating the costs of inter-connection assets under the AoB, as Unison and Centralines' customers have experienced substantial increases in transmission charges with no discernible additional services.

To illustrate this point, we have calculated the annual average transmission charge per residential ICP on Unison's network since 2010-11. The graph below shows the following increase in transmission across the Unison network:

- Hawke's Bay: $162 in 2010-11 to $249 in 2017-18, an overall increase of 54%.
- Central Region (Rotorua/Taupo): $161 in 2010-11 to $230 in 2017-18, an overall increase of 43%.



4. TPM and DGPPs – aligning the timing of the Code changes

Unison's final submission point relates to the interaction and timing of the TPM changes and the amendments to Part 6 of the Code – Distributed Generation.

Background to DGPP Changes

Prior the release of the TPM Supplementary Consultation paper, the Authority announced its final decisions on the review of the Distributed Generation Pricing Principles (DGPPs)[4]. The Authority decided that it would not remove the DGPPs from the Code as originally intended. Instead, the Code would be amended to ensure that DG that does not efficiently defer or avoid transmission costs will no longer receive ACOT payments under the regulated terms of Part 6. Under the new Code, Transpower will instead assess which existing DG operators in each region are required to meet the grid reliability standards. The Authority will make final determinations, based on Transpower's advice, which DG should receive ACOT payments under the regulated terms. Transpower can contract with new distributed generation where this would provide additional grid support, and it should only do so when it is the lowest cost option for meeting grid reliability standards. Distributors will no longer make ACOT payments to new distributed generation, however, ACOT payments may continue to be made to existing DG owners. Transpower's assessment of existing DG for the lower North Island is due to the Authority by 30 August 2017. The implementation period relevant to Unison (e.g. for the lower North Island) will be from 1 October 2018.

Interaction with Proposed TPM and Financial Implications for Unison and Other Distributors

In Unison's submission to the Authority on the proposed DGPP amendments[5], we expressed strong concern about distributors potentially being exposed to significant financial risk should payments to embedded generators be contractually required, but non-exempt distributors being unable to recover these costs. The risk of these payments still being contractually required remains with the new Code, and the Authority noted this in its DGPP decisions paper. However, the Supplementary Consultation TPM Paper sets out principles under which the residual charge payments should be made. Unison considers that the contractually-required ACOT payments issue would be resolved under the principle (b) below which, Unison believes, should resolve the contractual payments issue:

> *3.123 The Authority considers that the principles of an efficient residual (and, if need be, AoB) allocator are that:*
>
> > *(a) to the extent that it can be economically achieved, it is designed to ensure that the quantum of residual charge that load is charged cannot change either as a consequence of its own actions or the actions of any other party (except Transpower), so that it does not create incentives or opportunities for designated transmission customers to inefficiently avoid the residual charge*
> >
> > ***(b) it is designed so that any DG that is paid or credited for transmission charges avoided by the relevant distributor would not receive such payment or credit in respect of the residual charge component of the relevant distributor's transmission charges (for example, by adding back a value representing the load supplied by the DG for the purpose of calculating the residual charge)***

[4] Electricity Authority (6 December 2016). Review of Distributed Generation Pricing Principles: Decisions and Reasons.
[5] Unison (26 July 2016). Unison Submission on Review of Distributed Generation Pricing Principles.

(c) it is related to the size of the load of the transmission customer, so that its allocation is durable (d) it results in broadly equivalent charges to customers that are in broadly equivalent circumstances[6].

However, Unison is concerned that there is an 18-month delay between the changes to DGPP section of the Code (1 October 2018 for the lower North Island) and the proposed implementation date of any TPM amendments (1 April 2020), providing the TPM proposals go ahead. The Authority needs to be aware that potentially some distributors will be liable for avoided transmission payments during this interim period. This is manifestly unfair.

The DGPPs have required that distributors pass on avoided transmission costs, which from the perspective of the distributor, is a payment to Transpower that has been avoided. Distributors have entered into contracts with embedded generators on this basis with a reasonable expectation that these payments would be passed on to consumers, which has been enabled by the DPP regime. At the time contracts were entered into, it was Government policy that required distributors to make such payments, as well as be placed in a position where they are the contractual counter-party to Transpower, as opposed to retailers for whom the energy is delivered. Further, it is the long-standing TPM and allocation methodology that has created the current extent of liability for distributors to embedded generators for avoided cost of transmission. The mismatch between the hasty changes to the DGPP rules and the changes to the TPM would potentially leave many distributors (and their consumer owners) materially financially disadvantaged by the regulatory change, which is likely to have implications for funding available for business operations for the duration of the mismatch period. Additionally, if the mismatch in timing of TPM changes and DGPP changes is not addressed, there would be significant harm to confidence in the regulatory system that parties acting in good faith and compliance with regulatory policies would not be subsequently disadvantaged.

In the absence of regulatory certainty and alignment of DGPP changes with TPM changes, there is also the very real prospect of disputes relating payment of ACOT. Given the materiality of these costs, parties are likely to be prepared to incur significant costs in this process including costly litigation. We note that the Authority did not consult on these material design issues in its DGPP Code changes and does not appear to have considered the full ramifications of this timing mismatch.

Unison therefore recommends that the Authority implement a Code change to Part 6 (Distributed Generation) to amend the implementation timing of changes affecting ACOT payments to align with the timing of implementation of the TPM proposals. Alternatively, the Authority should bring forward the date of implementing changes to the TPM (or aspects of the change, e.g., change to gross RCPD) if the Authority is concerned about consumers' liability for ACOT payments. We understand that the Electricity Network's Association (ENA) has also advocated for this in their submission, and Unison would support a future Code change proposal led by the ENA.

Concluding Comments

The key submission points Unison strongly urges the Authority to consider before finalising the proposed TPM are:

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[6] Page 31 of the Supplementary Consultation TPM Paper. These points are also set out in Clause 32 of the TPM Guidelines for Development of the Transmission Pricing Methodology.

- Tighten up the prescriptive nature of the allocation methodologies in the TPM, rather than leave this up to Transpower's sole discretion. Specifically, amend the TPM Guidelines to state that historical AMD is the preferred allocation method to be used for the residual charge, unless this is an inadequate measure and the LRMC needs to be used to send a stronger price signal.
- In the absence of an RCPD allocation methodology for the residual charge, the Authority should allow Transpower some discretion to transition from an RCPD signal to a more fixed residual allocation approach. This will help to avoid unintended consequences of a wholesale removal of the RCPD allocation.
- The Authority only model TPM proposals based on the impact of the regulatory change alone and not external market factors that can make the proposal seem more palatable (such as the WACC reduction). The potential WACC decrease for Transpower should not be a discussion point in the consultation paper.
- The Authority consider removing the proposed cap on price increases, as the administrative costs and the redistribution of asset costs to non-beneficiaries are likely to outweigh the short-term benefits to consumers.
- Implement a Code change to Part 6 (Distributed Generation) to line up the implementation of changes affecting ACOT payments to the timing of implementing the TPM proposals. Unison would support a future Code change proposal led by the ENA.

Finally, Unison supports the ENA's proposal that the Authority allow for a cross submission process on the TPM proposals. Cross submissions would allow submitters to consider the submission by Transpower in particular, as they will ultimately determine the development and implementation of the proposed TPM.

For any questions on the points raised in this submission, please contact Roanna Vining Regulatory Affairs Analyst, by phone (06) 873 9329 or email Roanna.Vining@unison.co.nz.

Yours sincerely

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