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Submissions
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CROSS SUBMISSION ON THE ELECTRICITY AUTHORITY'S TRANSMISSION PRICING METHODOLOGY SECOND ISSUES PAPER: SUPPLEMENTARY CONSULTATION

1 Introduction

1.1.1 The Electricity Authority (**Authority**) has recently consulted on the *Transmission Pricing Methodology Second Issues Paper: Supplementary Consultation* (**Supplementary Consultation Paper**). The Supplementary Consultation Paper sought comments on a further 17 refinements to the proposals for replacement Transmission Pricing Methodology (**TPM**) Guidelines, made in the Authority's Second Issues Paper.

1.1.2 The Authority received 202 submissions in response to its Supplementary Consultation Paper. We have read these submissions and sought advice on them from our external advisers.

1.1.3 Some of the submissions raise similar concerns to those covered in our earlier submissions on this topic. Others raise entirely new points, including potential unintended and unconsidered consequences of the Authority's updated proposals.

1.1.4 Indeed the Employers and Manufacturer's Association said that from its perspective:[1]

> *… it is only now that the real issues are beginning to emerge with the industry having been shut out of the process since a working group was wound up in 2012.*

1.1.5 Our impression is that there is still widespread opposition to the Authority's proposals, and perhaps more importantly, a widespread view that the Authority has not yet made the evidential case for a shift from the status quo. In this regard we noted that Pacific Aluminium, a significant 'winner' from the Authority's reforms, has suggested that more empirical work needs to be done to ensure the TPM which results from any replacement guidelines published by the Authority "*produces economically sound pricing*"[2].

1.1.6 The Authority's Cost Benefit Analysis (**CBA**) has also been subject to considerable criticism, including by our experts. Since our initial submission we have filed two further letters detailing significantly material issues with the modelling used to justify a shift away from the existing HVDC charging methodology.

1 EMA Submission on Supplementary Consultation Paper (February 2017), at page 5.
2 Pacific Aluminium Submission on Supplementary Consultation Paper (February 2017), at paragraph 168.

1.1.7 We also noted that across the policy divide were a number of submission which commented on:

a) the quality of the drafting of the TPM;

b) issues regarding implementation timeframes; and

c) the extent to which the Authority's proposals were:

i. internally consistent; and

ii. consistent with the Authority's other reform initiatives.

1.1.8 Against this context, Trustpower was surprised that the Authority only wished to receive cross-submissions on one matter, namely the requirement in clauses 26-30 of the proposed replacement TPM Guidelines to use an indexed historic cost (**IHC**) valuation method for allocating Transpower's costs, or another method which is service-based or cost-reflective.

2 Cross-submission on the valuation issue

2.1.1 We have taken advice on this matter from HoustonKemp. This advice is attached to this cross-submission in a short memo (**HoustonKemp Valuation Memo**). This memo should be read as part of our cross-submission.

2.1.2 Having reviewed both the submissions themselves and the advice on those submissions from HoustonKemp, our views on submissions on this matter are set out in the remainder of this section.

2.2 Why the valuation issue has arisen

2.2.1 In our view, the valuation issue only arises due to specific aspects peculiar to the Authority's proposal, namely:

a) *The decision to apply the new Area of Benefit (**AoB**) charging methodology retroactively*. In other words, the Authority is proposing to set <u>new</u> charges for <u>old</u> assets (e.g. HVDC, NIGU and NAaN). This will consequently lead to significant wealth transfers between those currently paying for those assets (via the existing postage-stamp charge), and those proposed to pay for them in future via the AoB charge.

b) *The prescription for charges to be "service-based"*. As Transpower has submitted consistently throughout the TPM Review, the service provided by transmission assets does not vary materially through time. Service-based charging therefore requires a transition to a "time-neutral" method for asset valuation – which will also lead to significant wealth transfers between charge counterparties.

c) *The prescription for charges to be calculated on an asset-specific basis*. As we have submitted previously, the Authority holds the view that the "services" provided by the grid can be decomposed as services being provided by specific transmission assets. If the Authority were to define services in a different manner, the spotlight would likely shine less brightly on the valuation methodologies for these specific assets.

d) *The Authority's interpretation of its statutory objective*. In interpreting its statutory objective and calculating the costs and benefits of its proposals, the Authority explicitly excludes consideration of the impacts of wealth transfers among current and future charge counterparties, including investors in long-lived, capital-intensive generation assets. It has never once concluded that such wealth transfers will have consequential efficiency impacts, and has demonstrated little sympathy for those whose investments will be rendered less profitable (or even unprofitable) by its recent decisions. The Authority has not deemed there to be sufficient need for appropriate transitions, in such cases.

2.2.2 If the Authority were to amend its proposal to include only new transmission assets in the AoB charge, and/or for the charges to be calculated on a basis that is not asset-specific, the valuation issue would not arise as a conflict between stakeholders to the extent that it has now.

2.2.3 Further, if the Authority were to include the efficiency impacts of wealth transfers in its CBA, it would likely determine that these needed to be managed through appropriate transition mechanisms.

2.3 Our fundamental position

2.3.1 Fundamentally, we do not believe the case has been made to move from the status quo to a new AoB charge, for any transmission assets.

2.3.2 However, if the Authority is to persist with implementing an AoB charge, we believe it should apply to new transmission assets only.

2.3.3 We have considerable sympathy for the view that parties such as Meridian, who have invested on the basis of one set of expectations, should be protected from changes to regulation which significantly disadvantage them, financially. This protection should extend to load customers as well.

2.3.4 However, as noted above, the Authority has consistently demonstrated that it does not consider such changes will lead to efficiency impacts that need to be considered in its CBA.

2.4 Meridian's earlier views on charging for existing and new assets on a different basis

2.4.1 We note that, throughout the recent consultation rounds, Meridian and its experts have argued that existing and new assets should be charged for on a consistent basis.

2.4.2 For example, Professor Littlechild stated that different charging regimes for new and old assets would be:[3]

> *… confusing and burdensome. It would set an undesirable precedent that certain parties – those established at an earlier point in time – could expect to be favoured at the expense of other, later, market participants.*

2.4.3 Meridian stated that different charging methods for old and new assets could provide "*mixed signals*" and create an:[4]

> ***Uneven playing field**: Similarly situated generation or load customers could face dramatically different transmission charges depending on whether particular assets were subject to the new or the old TPM. Such a result would undermine the Authority's "competitive neutrality" principle, and could affect locational decisions. Arbitrary distinctions between new and current assets would also undermine durability.*

2.4.4 We comprehensively refuted these points in our 24 February 2017 submission. We find it interesting that Meridian is now advocating for different asset valuation methods for existing and new assets, despite the fact that this would fall foul of the service-based philosophy. Such differentiation in valuation methods would appear to create all the same issues as those listed in section 31.3 of their July 2016 submission.

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[3] Littlechild, Report on the EA's TPM Review (July 2016), at paragraph 53.
[4] Meridian, Second Issues Paper (July 2016), section 31.3 at page 58.

2.5 The issues are about perceived inequity, rather than efficiency

2.5.1 HoustonKemp conclude that, within the context of the Authority's review and its interpretation of its statutory objective, the issues raised by Meridian and others are concerned primarily with equity, rather than efficiency:[5]

> *The concerns raised by Meridian do not directly go to efficiency – Transpower would continue to recover its regulated revenue allowance, and transmission prices would continue to be set between incremental cost and standalone cost.*

2.5.2 Earlier advice provided to us by Creative Energy Consulting suggests that equity is a difficult concept on which to base regulation: [6]

> *The problem with equity – and possibly one reason why it is not established as a policy objective – is that it is a very slippery concept. Like beauty, equity is often in the eye of the beholder. For example, some may consider that a pricing method in which everybody pays the same price, irrespective of location, is the fairest one. Others may consider it unfair that, under that approach, they appear to be paying for transmission assets that they don't use.*
>
> ***Equity involves the consideration of the relative prices paid by different classes of user. Location is an obvious classification and the one that the Authority tends to focus on. But generational classes (eg current users versus future users) and customer size (ie proportionality) are also relevant to equity considerations. Focusing on one category (eg getting end-users in Auckland to pay for the NIGU) could create inequity in another category (eg current Auckland end-users paying for the costs of oversizing the NIGU, which was done with future users in mind).*** *(emphasis added)*

2.6 Limited engagement with stakeholders on the valuation issue

2.6.1 In our view, throughout its TPM Review process, the Authority has not given sufficient coverage to the potential implications of the different valuation methods on parties' charges. As evidenced by the figures produced by Meridian, which relate to potential charges for HVDC beneficiaries if IHC were to be used instead of depreciated historic cost, the implications are significant.

2.6.2 As a result of the vacuum of information, the issue is likely to have been viewed by the majority of submitters as primarily technical and of little consequence to them. This is likely to have reduced levels of engagement on this highly important topic.

2.7 Next steps

2.7.1 Transpower holds the key information relevant to the discussion on the financial implications of various valuation methods. This information has not yet been surfaced.

2.7.2 As Professor Yarrow advised in support of our 24 February 2017 submission, Transpower's views on this matter are significant, as it is the party with the best information on its assets and its customers' usage of its grid, and the party tasked with designing and implementing the new TPM.

2.7.3 There are a range of time-neutral asset valuation methods that could be considered. This is a key design detail which should therefore be left to Transpower to decide, following considered consultation with its stakeholders.

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[5] HoustonKemp Valuation Memo, at page 6.

[6] Creative Energy Consulting, Review of TPM Options Working paper (August 2015), at paragraph 2.4.2.

2.7.4 Further, given the limited nature of the consultation on this issue that has occurred to date – both in terms of the information provided and the level of meaningful engagement with stakeholders – we believe that it would be premature for the Authority to decide on a particular valuation method at this juncture.

3 Concluding remarks

3.1.1 This cross-submission should be read together with all of our earlier submissions on this topic.

3.1.2 Having read the other submissions and taken advice on them, Trustpower considers that nothing in the responses made in support of the Authority's proposal to replace the current TPM Guidelines (including those by Meridian Energy, Contact Energy and Pacific Aluminium, which appear to support "bright lines" as long as they are in their favour) require a departure from the views set out in our prior submissions.

3.1.3 In particular, we maintain our view that the Authority should not replace the current TPM Guidelines as:

a) to do so would be inconsistent with the Authority's statutory objective;

b) in developing prescriptive replacement guidelines, the Authority is overreaching in terms of its role;

c) the Authority's regulatory impact analysis is insufficient to justify the particular reform it proposes;

d) an overwhelming majority of expert advisers reject the Authority's analysis and proposals; and

e) the Authority has not followed the process required by the legislative framework in advancing this proposal.

3.1.4 We would appreciate the opportunity to further explain these views to the Authority in person prior to final decisions on the TPM Review being made.

Regards,

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