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Transmission Pricing Methodology Review: TPM Options
Electricity Authority

By email: submissions@ea.govt.nz

NZCID Feedback on the Transmission Pricing Methodology Review: Options Working Paper¹

The New Zealand Council for Infrastructure Development (NZCID) welcomes this opportunity to provide feedback to the Electricity Authority (the Authority) on the transmission pricing options working paper (the Paper).

Introduction

We support the Authority's ongoing efforts to promote an efficient and competitive market for the long term benefit of consumers.

We acknowledge limitations within the existing transmission pricing methodology (TPM), which we agree with the Authority are likely to send inefficient signals to the market regarding the actual costs of electricity transmission.

We consider the options outlined in the Paper to more accurately reflect the true costs of transmission than the status quo.

We therefore consider that shifting to one of the three potential options is likely to promote the long term interest of consumers. However, while we think it likely, we caution against assuming it is necessarily the case.

If the uncertainty created by this review and the precedent it sets for ongoing regulatory intervention results in increased costs to electricity providers, these costs will be passed on to consumers and may not be in their long term interest.

We therefore support a TPM regime which accurately apportions the cost of transmission but results in minimal uncertainty for long term investors.

We hold no specific preference as to which option (base, SPD or LRMC) is adopted, but emphasise the value of simplicity.

We support the introduction of Application B and will support Application A where there is appropriate phasing-in of historic investment charges which recognises the long term nature on infrastructure investment.

¹ This submission represents the views of NZCID as a collective whole, and may not necessarily represent the views of individual member organisations.

The cost of uncertainty must be acknowledged

Electricity infrastructure providers including generators and distributors operate businesses with high capital outlays and lower long term operating costs. That is, business models span two or more decades within which timeframe very large initial sunk costs are recovered over the course of the asset's life.

In order to resource the high costs of constructing electricity infrastructure, large electricity market participants access capital markets, both foreign and domestic.

Capital markets price risk. The terms under which large electricity companies are able to access finance are impacted by regulatory risk, such as changes to the methodology governing national transmission charging.

Higher loan rates for capital intensive infrastructure providers, such as electricity generators and distributors, are passed on to consumers in the form of higher electricity charges.

In addition to a higher cost of debt, risk also increases costs to electricity infrastructure providers, and in turn consumers, by reducing the lifetime value of fixed assets.

Regulatory changes, such as those to the TPM, which impact the spatial allocation of charges to fixed assets, will result in shorter lifespans for those assets negatively impacted by new charges.

Because a high proportion of costs for electricity infrastructure is sunk (i.e. cannot be recovered) through initial construction phases, the ongoing risk of regulatory change impacting the longer term operating lifecycle of investment necessitates that sunk costs are recovered sooner by asset owners.

Spreading the fixed cost of electricity infrastructure over fewer years results in higher annual operating cost projections even if no regulatory or other changes occur through the life of the asset. These costs are passed on to consumers.

It is therefore of the highest importance that the regulatory environment affecting electricity generators and distributors is as stable and predictable as reasonably possible.

Transparency is also important for investors

We note that reducing the uncertainty of regulatory change remains an objective of this TPM review given the generally sub-optimal way the current TPM allocates transmission charges (s. 4.24), but we add that transparency is also important to lowering the costs to electricity infrastructure providers and in turn consumers.

In our view, the complexity of the TPM has now reached such a point as to reduce the transparency of the electricity market.

In order to attract investment, electricity infrastructure operators must be able to outline the risks of investing in the New Zealand electricity market. Risks that cannot be clearly understood and mitigated, are priced accordingly.

We do not consider it likely that investors in the New Zealand electricity market will be in a position to understand their full exposure to changes in the TPM, either now or in the future.

Investors who do not fully understand their risk exposure will either choose not to invest or will add a premium to their expected return on investment.

In either case, the outcome is increased costs to electricity asset owners and a pricing structure which is not in the long term benefit of New Zealand consumers.

We encourage the Authority to note that complexity inhibits transparency and reduce wherever possible the complexity of the TPM.

We support more gradual phasing

Notwithstanding our concerns that risk and complexity may result in lower long term benefits to consumers than anticipated by the Authority, we still consider there to be merit in revising the TPM.

We consider that the three options outlined by the Authority will result in a more efficient allocation of transmission charges.

We hold no particular preference for any of the options, but reinforce that simplicity has a value and that this value must be recognised in the development of the TPM.

Of more immediate concern to us than the actual methodology for allocating transmission costs is the implementation of that methodology.

We note that Application A, under any option, will result in a significant reallocation of the costs of transmission.

We do not oppose the reallocation of costs to those parties who benefit from services.

However, we retain the concern outlined in our submission on the 2012 issues paper that reallocating according to a new methodology the costs of investments long since agreed with industry on the basis of the existing methodology is problematic.

Application B alleviates our concerns about the “fairness” of backdating transmission charges and would, in our view, satisfactorily support the Authority’s objective to promote the long term interest of consumers.

We acknowledge that an area, such as the Upper South Island, could under Application B find itself in the future having to cover the near full costs of the next phase of transmission investment while also subsidising transmission investment to the rest of the country.

Although we find this undesirable, it is no less desirable than requiring upper North Island consumers to subsidise the costs of pre-2004 national transmission investment and not receive a similar subsidy from other regions once “its turn” arrived post-2004 via NIGUP and NAaN.

It is clear that for whatever date the Authority identifies as the cut-off for transition to a new TPM there will be winners and losers.

With this in mind, it makes sense, in our view, not to backdate charges for investment delivered in agreement with industry under a different methodology.

We therefore have no opposition to, and could support, implementation of Application B as it is in our view the “least unfair” approach to introducing a new charging methodology.

But we could also, under certain circumstances, support the implementation of Application A.

Noting our concern that investment decisions for almost all major electricity market participants are long term and therefore vulnerable to mid-cycle regulatory change, we would support in principle a gradual phasing in of Application A.

We note Alternative 4 (s. 12.8.iv) provides for a five year phasing in period.

We support the concept of a phased introduction of Application A, but consider five years to be too short.

The five year phasing period appears to be geared towards limiting the financial exposure of some parties to a sudden change in transmission charges.

We consider the more appropriate objective of phasing should be to promote a fair and predictable regulatory environment for major electricity investors.

Market participants who predicated investment on the existing methodology should not be unduly penalised as this sends a signal to the wider market that uncertainty in the sector is high and must therefore be priced accordingly.

To ensure investors, and in turn consumers, are thus not impacted beyond what is necessary, the change in methodology should be implemented over a timeframe which takes into consideration the lifecycle of electricity assets.

In our view, a phasing-in period of at least 10 years should be considered.

As well as instilling a greater level of confidence in the electricity market that the regulatory environment is predictable and consistent, a 10 year-plus phasing-in period is likely to be more manageable "politically".

It is in our view extremely important that the market is left with a sense of confidence that the TPM will not be revised any time in the foreseeable future following this review.

Moreover, the market must have confidence that other market costs and regulations will, when revision is required, be introduced slowly, predictably and in full cognisance of the long term nature of infrastructure investment.

We acknowledge changes the Authority has made to its 2012 TPM proposal following extensive engagement with the industry and congratulate the Authority on its continued commitment to providing a fair, robust and enduring TPM.

We thank the Electricity Authority for this opportunity to provide feedback.