TPM Group submission to the Electricity Pricing Review (EPR)

Executive Summary

Thank you for the opportunity to submit on the Electricity Pricing Review. Our group, known as the TPM Group, has serious concerns about the Electricity Authority's (EA) attempts to change the transmission pricing methodology guidelines (TPM) as regards process, fairness and timing (Q 19 of the First Report). We welcome the Panel's invitation to comment on these issues and outline some possible solutions.

In terms of process, our view is that the EA has failed the test of what constitutes a robust process in several ways. These include running an omnibus consultation which meant several distinct steps of the process all happened at once; an unclear and ever-shifting problem definition; short consultation timeframes; lack of compliance with the consultation requirements in the Electricity Act and a lack of a feedback loop.

In terms of fairness we are concerned about their push to apply new TPM guidelines to existing assets. The existing TPM has been largely unchanged for twenty or so years and investment decisions across the supply chain have been made on the basis of its price signals and cost allocations. Changing the cost allocation structure after investments have been made is obviously going to be problematic for those who have already made their investments. We believe that the proposed re-allocation is likely to increase unfairness, not fairness.

We are also concerned about the EA's ability to truly assess who the beneficiaries of assets actually are and the durability of their proposed changes.

In terms of timing it is our view that there is no urgent need to change the TPM guidelines because Transpower have said no significant upgrade to their assets is needed in the short term. In addition we think considering the Government has set up this very review to consider, amongst other things, the 'regional aspects of transmission pricing' it is not appropriate or necessary to change the TPM until any changes resulting from this review are implemented.

In this submission we outline the background of our group and our perspective on the issues of process, fairness and timing when it comes to the EA's attempts to change the TPM guidelines. We also propose some solutions which we would be keen to discuss further with the panel.

The TPM Group

We are a group which formed in 2016 because we were concerned about the changes to the TPM Guidelines proposed by the EA. We were (and still are) concerned about the processes the EA ran to come up with a proposed new TPM Guidelines, timing issues and the impact of such changes on different consumer groups.

We comprise organisations from right across the electricity sector including large consumers, energy consumer trusts, stakeholder groups, electricity network companies, and electricity generators and retailers.

Current active members of the TPM group are:

- Counties Power

- EMA Northern
- Entrust
- Federated Farmers (Auckland and Northland)
- Horizon Networks
- Norske Skog Tasman Ltd
- Northpower
- Oji Fibre Solutions
- Top Energy
- Trustpower
- Vector

Since 2016, various TPM Group publications and events have also been directly supported by:

- Auckland Airport (process issues, regional impact)
- The Northland Mayoral Forum (regional impact)
- Northland Inc (regional impact)
- The Mayor of the Far North District Council (regional impact)
- The Mayor of Kawerau District Council (regional impact)
- EA Networks (process issues)
- New Zealand Federated Farmers (process issues)
- Auckland Chamber of Commerce (regional impact)
- Counties Power Consumer Trust

Background

The TPM group supports the Electricity Pricing Review and its aim of running a 'fairness and equity' ruler over the electricity sector.

The Panel's terms of reference state that the review will consider *"the regional distributional aspects of transmission pricing."*

We touch on this topic in our submission but note the EPR Panel's position, outlined in its First Report, that it is not its role to arbitrate the current TPM debate and so we have not waded into the technical aspects of transmission tariffs in this submission.

We particularly welcome the EPR Panel's statement that it will *"stand back and ask whether, from a policy and not an operational perspective, the TPM debate can tell us anything useful about how reforms are introduced in order to determine a TPM that delivers efficient, durable and fair outcomes."*

In our view the current regulatory structures have allowed the EA to run a process that has led to it proposing changes to the TPM that will not lead to efficient, durable or fair outcomes.

Therefore we believe structural change is required in order to address these issues.

We outline our views under the four points below, which reflect the issues raised by the EPR Panel in Question 19 of their First Report.

1. Process
2. Fairness

3. Timing
4. Proposed solutions

In 2016 the TPM Group commissioned an independent analysis of the 60 expert reports, referred to as the Covec Report, that have been submitted to the EA over the course of its lengthy TPM reform process. We have supplemented our comments on these four topics with relevant quotes from this "expert report on the expert reports".

1. Process

The EA has failed the test of what constitutes a robust process in several ways. These include running an omnibus consultation which meant several distinct steps of the process all happened at once; an unclear and ever-shifting problem definition; short consultation timeframes; lack of compliance with the consultation requirements in the Electricity Act and a lack of a feedback loop.

The EPR Panel's First Report outlines the drawn-out and still unresolved process the EA has run to try and implement a new TPM.

It quotes one stakeholder who said:

"*The mere fact the TPM issue has gone on so long is itself an issue".*

We agree. We note the EA began the process of trying to change the TPM in 2011 and now seven years on, we still do not have TPM Guidelines which solve any kind of clear problem, or are supported by a robust cost benefit analysis.

Nor do our members understand which parts of their submissions on the three previous sets of proposed TPM Guidelines are agreed with and which are not, and why. Yet we have recently been advised a fourth set of proposed TPM Guidelines is on its way.

Process is important not just because it is a legal requirement but because it improves the substantive decision-making.

Some of the key issues with the TPM process to date include:

Initial 'omnibus' consultation process

In 2012, the EA presented its stakeholders with an omnibus paper which simultaneously:

- reviewed the current TPM and found it completely wanting;
- developed options to address those defects including an option never previously used for transmission pricing anywhere in the world;
- presented a top down cost benefit analysis of the benefits of its preferred option; and
- proposed detailed guidelines for Transpower to develop a new TPM.

This put stakeholders in the difficult position of having to deal with a variety of first, second, third, and even fourth or fifth orders order issues all at once, which is deeply challenging for even the best resourced industry participants. Not surprisingly the response was unprecedented opposition.

The process which followed next was unusual. The EA began a selective re-engagement process on a series of topics over a three year period but there was no clear over-arching timetable or decision points.

Covec commented on this process in the following terms

> This proposal (the Electricity Authority's first TPM issues paper in October 2012) attracted strongly negative feedback. …In response, the EA neither implemented nor withdrew the proposal. Instead the EA began issuing further consultation papers dealing with subsets of the TPM development process, such as cost-benefit analysis, sunk costs, different ways to design beneficiaries-pay charges, and the problem definition." (Paras 90 and 91, Section 2.4.1).

The unclear and ever-shifting problem definition:

Members of the TPM group have also found it difficult to understand what the precise issues are with the current TPM.

Indeed the EA's own views seem somewhat fluid on this topic:

- **T**he 2012 Issues paper appeared to focus on overall investment efficiency as the main criteria, namely the risk that Transpower and other industry participants, such as generators and large load, would invest in the wrong place and at the wrong time. However it is difficult to reconcile this objective with its solution, namely the reallocation of the costs of transmission assets going back to 2004 as the investment decisions in relation to these transmission assets had clearly already been made.
- The EA's initial problem definition was "clarified" in a problem definition paper issued two years later in 2014 where the focus appeared to shift to the inequity of the cost allocation of certain recent investments.
- It appears to have been further "clarified" in almost every EA TPM publication since. For example in the most recent announcements the EA's focus appears to have shifted to the risk that new technologies such as batteries will cause businesses to unfairly shift costs onto consumers.

Covec relevantly commented:

> Experts noted that the EA had described the problem it was trying to address as the absence of the EA's preferred solution (asset-based beneficiaries pay). This suggested that beneficiaries pay (in the form proposed by the EA) had not emerged from a disciplined policy analysis process.(Para 90 (a), Section 2.4.1)

A more usual process would be for the regulator to identify potential issues with the current TPM and invite stakeholders to "have their say" on those issues.

This would then lead to a clear statement of the problem which is being addressed and the evidential foundation for that problem. This is the approach the Commerce Commission adopts for similar processes such as its reviews of the input methodologies.

The EA's failure to clearly establish decision-points along the way has made the engagement process confusing, frustrating, inefficient and ultimately unproductive.

Consultation timeframes

A sound process is important, particularly when the reform is controversial. Stakeholders need to feel that as a minimum they have had an adequate opportunity to develop and present their views on their core topics.

The experience of the group has been that while the process overall has been long, there have been times when stakeholders have been given inexplicably short timeframes to make important submissions. For example, with the Second Issues Paper, only 10 weeks was given, despite the enormous complexity of the paper and the need for submitters to commission external advice.

This raises questions about whether the EA really wanted stakeholder feedback.

Compliance with the Electricity Industry Act 2010 (Act)

There are also legal considerations.

Section 21 of the Act states.

(1) The Authority must establish 1 or more other advisory groups to provide independent advice to the Authority on the development of the Code and on market facilitation.

(2) Every advisory group must include people whom the Authority considers have appropriate knowledge of, and experience in, the electricity industry and consumer issues, but members need not be independent persons.

This gives a pretty clear steer as to how Parliament expected the EA to engage on complex policy issues. However the EA has chosen to ignore that steer. It dis-established the working group that was advising it on transmission reform in 2011.

Section 39 of the Act states:

*(1) Before amending the Code, the Authority **must**—*

(a) publicise a draft of the proposed amendment; and

(b) prepare and publicise a regulatory statement; and

(c) consult on the proposed amendment and the regulatory statement.

> (2) *The regulatory statement required for a proposed amendment to the Code **mus**t include the following:*
>
> > (a) *a statement of the objectives of the proposed amendment:*
> >
> > (b) *an evaluation of the costs and benefits of the proposed amendment:*
> >
> > (c) *an evaluation of alternative means of achieving the objectives of the proposed amendment.*

The Authority has now presented a number of quantitative and qualitative CBAs in support of its various proposals to replace the current TPM Guidelines.

Members of the TPM Group, including Trustpower in particular, have made extensive submissions on these various CBAs. Problematic errors associated with the EA's most recent CBA included:

- the modelling analysis actually estimated $13.7 million of net *costs* associated with the removal of the HVDC charge – not the net *benefits* of $13.7 million in the CBA;
- fixed operating costs captured in the modelling were understated *by a factor of one billion* when compared with capital and variable operating costs; and
- the HVDC charge assessed was modelled as being applied to an apparently random selection of *North Island and South Island generators*, rather than purely to *South Island generators* as provided in the TPM.

These kind of "rookie" errors simply would not have occurred had an advisory group of industry and consumer experts been established to provide advice to the EA on its reform proposals.

Lack of feedback loop

There has been a lack of meaningful feedback given to stakeholders on their submissions throughout the last seven years. This meant stakeholders had no clear understanding on which parts of their submissions the EA had taken on board or which they agreed or disagreed with.

Of particular concern was (a) the lack of feedback on the expert reports that submitters had obtained from local and international experts; and (b) the EA's unwillingness to test its own views on the problems with the current TPM by obtaining supporting advice from its own international experts.

Covec have stated:

> *"Alongside these concerns about the problem definition, experts have been very critical of the EA's proposed beneficiaries-pay charges, including the core features of asset-level benefit charging, and the inclusion of pre-existing assets, which have remained in place since the first issues paper in October 2012. Carefully drafted expert reports have examined in detail the way these proposals are likely to affect the conduct of grid users, and concluded that there are serious problems with the EA's analysis.*

> *The EA has modified its proposals over this period but remained firmly in favour of highly detailed asset-level estimation and allocation of benefits, and firmly in favour of extending beneficiaries pay charges to pre-existing assets approved since 2004.*
>
> *I have been left with the impression that the EA has not been heavily influenced by the criticism these experts have made of its proposals. While there have been many consultation papers since October 2012, and the proposals have changed over that time, the EA remains firmly committed to the original two underlying goals.*" (paras 297 to 299, Section 6)"
>
> And
>
> "*As an independent regulator, the EA is expected to stand-up to vested interests when that is necessary to fulfil its statutory obligations. So the volume of criticism identified in this review should not necessarily be determinative. Instead, the EA is obliged to dispassionately weigh up the evidence in reaching its determinations. Often this weighing up process is reflected in a regulator's consultation papers, including with citations to submissions making the arguments that are being weighed up.*
>
> *For the most part, the EA's style throughout this process has been to avoid citing particular critics. Instead it has tended to refer to "submissions" in the aggregate, without identifying particular arguments made by individual experts, claim they have been considered and then reiterate the EA's view. This style is unfortunate in the current context, where there is a substantial weight of expert opinion that opposes the EA's desires: it suggests that the EA is not actually engaging with the submissions."* (paras 300 and 301 Section 6)

Process issues appear to be ongoing

Despite significant feedback on its process, members of the TPM Group have not seen any change of direction from the EA.

The EA has not used the considerable time since its withdrawal of the last CBA in April last year to establish a working group, provide further feedback on expert views, or even share the results of its fact finding trip to the US.

Instead the EA has merely said that it is now working on a new set of TPM Guidelines (the fourth set) which will include a new benefits based proposal and the re-allocation of the costs of existing assets as well as a new CBA. Further announcements are due in December (presumably another omnibus proposal).

2. Fairness

> We are concerned about the EA's push to apply new TPM guidelines to existing assets. The existing TPM has been largely unchanged for twenty or so years and investment decisions across the supply chain have been made on the basis of its price signals and cost allocations. Changing the cost allocation structure after investments have been made is obviously going to be problematic for those who have already made their investments. We believe that the proposed re-allocation is likely to increase unfairness, not fairness.
>
> We are also concerned about the EA's ability to truly assess who the beneficiaries of assets actually are and the durability of their proposed changes.

An unchanging feature of the EA's TPM reform has been the desire to re-allocate the costs of existing assets. This is said to be fairer as it results in a closer co-relation between cost allocation and the beneficiaries of particular assets. The EA has also said it will be more durable because it is fairer.

We disagree with all three points.

1. We do not think the re-allocation of the costs of existing assets after investments have been made is fairer.
2. We are not confident that the EA can accurately identify beneficiaries of particular assets on an intermeshed grid of long life assets.
3. The EA's proposals depend on rate shocks and as such are unlikely to be durable.

(a) Application to existing assets

The EPR Panel's First Report says that:

"We are unaware of any other country undertaking retrospective reallocation of past grid investment. Indeed some say retrospective reallocation is the principal obstacle to progress on a new TPM".

We could not agree more. This is a very significant issue for the TPM Group.

The existing TPM has been largely unchanged for twenty or so years. Investment decisions across the supply chain have been made on the basis of its price signals and cost allocations. Changing the cost allocation structure after investments have been made is obviously going to be problematic for those who have already made their investments.

Members of the TPM Group therefore believe that the proposed re-allocation is likely to increase unfairness, not fairness.

Implementation now of an asset based beneficiary pays approach will mean that areas that received significant investment in new transmission at a time when the costs were borne equally by everyone, will be advantaged over those that now have to pay for transmission upgrades that benefit their regions.

For example,

- significant investment was made and paid for by all New Zealanders in transmission capacity to Tiwai Point in Southland, resulting in substantial ongoing economic benefits to that region

- In contrast areas like Northland haven't had such significant investment in their transmission and the flow-on commercial opportunities that arise from infrastructure upgrades. Why penalise the North now?

(b) assessment of beneficiaries

The current TPM allocates the costs of the core grid on a "postage stamp" basis. This means that everyone pays the same amount irrespective of location. This is a practical approach which reflects the fact that it is very difficult to calculate the beneficiaries of power flows across interconnected assets (power flows in different directions at different times) and because users of particular grid assets frequently change over the long lifetimes of the relevant asset.

The EA believes it can develop a methodology, using a truck load of computing power, to address this issue and identify precisely the beneficiaries of each transmission asset on the grid. Experts (including Transpower) disagree and note that any such methodology is heavily assumption dependent. This creates a very real prospect of equity issues around incorrect assumptions, bright line boundaries and the effect of market changes.

Members of the TPM Group have already seen significant swings in their proposed TPM cost allocations arising from past TPM Guidelines depending on the assumptions used. These assumption-based swings seriously undermine confidence in the fairness of this type of charging.

Furthermore, all consumers benefit from a unified electricity market because it has allowed the economies of scale which means large South Island hydro investments can make a return through having the large Auckland market. Everyone also benefits through increased resilience, which has been illustrated over the last year with electricity flowing from the North Island generators to South Island consumers because of low lake levels. The EA's approach to split the benefits regionally ignore these larger and more important national benefits.

(c) durability

By design the EA's proposals involve rate shock. The EA wants to incentivise deemed beneficiaries to challenge grid investment decisions that impose costs on them so that only the most efficient investments are made.

The risk is that parties do not receive clear enough signals about the price effects or even if they do that they do not have the resources and expertise to engage in the regulatory processes which will avoid them experiencing rate shock.

Ultimately as Transpower has pointed out the system should not favour those who can afford to lobby for and against particular investments but instead decisions should be made on what is in NZ Inc.'s interests.

This is what the regulatory grid investment test currently does and in our view, this test, which is overseen by the Commerce Commission, works well.

3. Timing

There is no urgent need to change the TPM guidelines because Transpower have said no significant upgrade to their assets is needed in the short term. In addition we think considering the Government has set up this very review to consider, amongst other things, the 'regional aspects of transmission pricing' it is not appropriate or necessary to change the TPM until any changes resulting from this review are implemented.

The EA believes that urgency is needed in TPM reform. In June its Chief Executive said:

> "The longer the current transmission pricing methodology stays in place, the greater the risk that investors will make decisions that end up costing consumers more through higher transmission charges over the long term."

However Transpower has a different view. It states that further investment in the grid is not necessary from now to 2025 and that more information is required before committing beyond that:

> "We anticipate the future will call for investment in more renewable generation and while Te Mauri Hiko provides important longer-term context for our industry, **it's important to be clear about what this proposal is seeking in RCP3 (2020-2025). We are proposing investment in the grid to sustain and maintain our infrastructure** – while being mindful of the investment opportunities to set New Zealand up for a more electrified future.
>
> Transpower **has grid capacity in place to help meet expected demand growth**, but anticipates that over RCP3 – particularly the latter part of this period – significant additional connections of new generation to the grid will start to be required in a sustained fashion, flowing into RCP4. It is important to be clear that such connections to the grid are funded by generators and direct investment from Transpower to support these connections is not in the scope of this proposal. "

(Quotes from 'Securing our Energy Future 2020-2025, Transpower)

This suggests that there is in fact no urgent need to change the TPM and that there is time for incremental change based on sound and robust rule-making processes.

In addition, members of the TPM Group are concerned that the EA has elected to continue its process at the same time as the EPR Panel has been asked to consider "variations across different customer groups, "whether the costs of providing electricity services are or should be socialised across different classes of consumers or across regions" and specifically the "regional aspects of transmission pricing".

Under the EA's last proposal (Dec 2016):

- Consumers connected to electricity lines companies were worse off to the tune of $115m a year, while those who would be better off were only better off to the tune of $46m a year. Thousands of low-income pensioners, many small businesses, DHB's and schools, would have been hit with an unexpected increase in prices without any compensating arrangement.

- Regions like Northland were impacted the most. In 2016 it was calculated that Northlanders would lose $15M more a year in increased power prices, significantly more than they would gain in regional development assistance.
- Large businesses (the Tasman paper mill in Kawarau, and the Kaitaia mill in Northland for instance), already on tight margins, could be pushed into unsustainable positions, affecting hundreds of employees and many small towns.

This raises the prospect that the EA might come up with another set of TPM Guidelines which do not align with the Government's preferred mix of efficiency, equity and fairness and we have to start the process again.

4. Proposed Solutions

We think the best solution to retrieve the situation we are now in is for there to be more clarity from government about its expectations around the TPM and a change of regulator.

This will enable an appropriate focus to be placed on the equity issues associated with any change and prevent transmission pricing reform undermining other central government policy initiatives such as regional development assistance or plans to increase the interconnectivity of regions.

More specifically our proposed solution is:

(a) the Government to issue a mandatory GPS or legislated pricing principles which set out the high level policies which should apply to the TPM;
(b) the responsibility for regulatory oversight of the TPM should be transferred to the Commerce Commission to restore stakeholder confidence; and
(c) as part of this transfer a clear role is delineated for Transpower to develop and implement a TPM which best suits its assets and customers.

Members of the TPM Group note there is a strong precedent for the even spread of transmission charges across all consumers in the telecommunications sector and we cannot see why the electricity services should be treated differently to telecommunications services. For example, all mobile and telecommunications companies charge their customers on the same basis irrespective of their location.

We would welcome the opportunity for further consultation with the Panel on our submission and proposed solutions.

Yours sincerely

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