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Submissions
Electricity Authority
PO BOX 10041
WELLINGTON

To whom it may concern,

Submission on the Authority's Draft decision on NAaN exemption application

Introduction and recommendations

1. Vector welcomes the opportunity to submit on the Electricity Authority's (Authority) Consultation Paper entitled "Draft decision on exemption application – classification of NAaN assets under the TPM" (Draft Exemption Decision), dated 4 September 2013 and released on 17 September 2013. Responses to the Authority's questions are contained in the Appendix to this submission.
2. Vector acknowledges that the Electricity Industry Act 2010 does not require the Authority to consult on decisions relating to exemption applications but agrees with the Authority that it is appropriate to undertake consultation in this case.[1]
3. Vector's contact person for this submission is:

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4. Vector requests the opportunity to meet with the Authority to discuss its submission.
5. No part of this submission is confidential and Vector is happy for it to be made publicly available.

Summary of Vector's views

6. Vector does not support the analysis or conclusions of the Draft Exemption Decision.
7. Importantly, the Authority has not addressed the question of whether the following assets are, in fact and at law, connection assets prior to the completion of the NAaN Grid Upgrade Project:
   a. Switch 742 (Albany) (ALB742);
   b. Albany to Wairau Road line section (ALB_WRD); and
   c. Hobson Street to Wairau Road line section (HOB_WRD);

   (together the NAaN Interconnection Assets).
8. Vector considers that the correct categorisation of the NAaN Interconnection Assets is that they are, at all times, interconnection assets - whether the NAaN Grid

[1] Paragraph 5, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

Upgrade Project has been completed or partially completed. The definition of interconnection assets in the transmission pricing methodology (TPM) does not exclude the staged commissioning of a major interconnection project. This approach is also consistent with a purposive interpretation, which recognises that the assets have been planned, approved and built as interconnection assets.

9. As a result, the Authority should apply the TPM on the basis that the NAaN Interconnection Assets are interconnection assets, not connection assets. Accordingly, there are no NAaN connection assets to exempt. Vector is of the view that this is the most correct approach, and the Authority should be explicit in rejecting Transpower's exemption application on this basis.

10. If, however, the Authority instead interprets the TPM as treating the staged commissioning of interconnection assets as connection assets, the Authority should grant Transpower the exemption it has applied for.

11. The key issue here is that even if the Draft Exemption Decision treats the staged commissioning of the NAaN Interconnection Assets as connection assets, it must recognise this is not a normal connection scenario. It should not be assumed without analysis that the normal pricing approach to connection assets would best satisfy the Authority's statutory objective to promote the long-term interests of consumers. The Draft Exemption Decision errs in making this assumption. In fact, when the features of this project are considered, including how the assets were approved and how they are configured, the normal approach to connection pricing is not appropriate. This conclusion is consistent with the Authority's decision making and economic (DM&E) framework (the framework developed to assist the Authority to determine what the optimal TPM would be).

Are the NAaN Interconnection Assets interconnection or connection assets under the TPM?

12. The Draft Exemption Decision has not properly addressed the question of whether the NAaN Interconnection Assets are, in fact and at law, connection assets prior to completion of the final commissioning of the NAaN Grid Upgrade Project. The Draft Exemption Decision skips this issue, proceeding on the basis that the assets are connection assets without examination. For example, the Draft Exemption Decision simply states "The Authority agrees that the relevant assets are connection assets".[2]

13. The first step in considering whether to grant Transpower an exemption should be to determine whether Transpower has correctly interpreted the TPM by temporarily categorising the NAaN Interconnection Assets as connection assets.

14. In our view, the proper interpretation of the TPM is that the NAaN Interconnection Assets are at all times interconnection assets and do not temporarily become connection assets for the purposes of the TPM. These assets are intended to be interconnection assets; their engineering specifications are on that basis and the investment was approved by the Electricity Commission on the basis that they are interconnection assets. As a factual matter, they are interconnection assets.

15. A fundamental feature of the current TPM is that the costs of interconnection assets should be socialised, and the costs of connection assets should be attributed to users/causers. There is a review of the TPM underway that may result in a different treatment of some interconnection assets. However, the results of that review should not be prejudged in the context of an exemption application from the current TPM.

16. The question is whether the TPM requires the NAaN Interconnection Assets to be temporarily treated as connection assets during the staged commissioning process, contrary to the physical reality, purpose of the assets themselves, and the

[2] Paragraph 3.3.6, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

understanding of all industry participants to date (including the regulator that approved the investment).

17. The relevant provision in the TPM is section 5, which sets out the respective definitions of connection and interconnection nodes and links. Vector considers that the term "connected" in the definition of interconnection node should be read to include the staged commissioning of interconnection assets. In this regard, we note that neither section 5 nor the TPM in general explicitly address a staged commissioning of assets. However, staged commissioning is an uncontroversial feature of large scale interconnection projects, including establishing the connection between interconnection nodes.

18. On a plain or literal interpretation, "connected", in the definition of interconnection node, can accommodate the concept of a staged commissioning of assets in the context of a large scale interconnection project.[3]

19. Our view is that the definitions in the TPM categorise an asset by reference to the asset's final and intended use. When categorising the NAaN Interconnection Assets as connection assets, they are being incorrectly viewed in a preliminary state and not the final and intended use.

20. When approaching the interpretation of the TPM, we also draw the Authority's attention to the fact that (as noted recently by the Electricity Rulings Panel) "the meaning of an enactment must be ascertained from its text and in light of its purpose."[4] The Rulings Panel was referring to the interpretation of the Electricity Industry Participation Code 2010, of which the TPM is a part.

21. In the same decision, the Rulings Panel went on to say:[5]

> We accept … the decision made by both Transpower and the Authority, that S.5 Acts [sic] Interpretation Act 1999 provides <u>that a full interpretation requires an analysis of the context, to ensure that applying the textual meaning does not result in a result that is meaningless or inconsistent with the purpose of the legislation</u>. The approach taken by the Panel is therefore to begin by assuming that the literal meaning of the text is intended, and to test whether this is rebutted by context, or the intent of the rules as that can be discerned. We bear in mind and adopt the requirement set out by the learned authors in JF Burrows & RI Carter Statute Law in New Zealand, 4th Ed Lexis Nexis 2009, that we must adopt an interpretation that is sensible, just and practical. (emphasis added)

22. The requirement that the interpretation be "sensible, just and practical" was explicitly applied by the Rulings Panel in its decision:[6]

> This conclusion, particularly in the light of industry experience, and past practice by the Authority is sensible, just and practical.

23. Vector therefore considers that if the Authority adopts an interpretation that the NAaN Interconnection Assets are connection assets, this must be tested against whether it would result in an outcome that is sensible, just and practical. This is not dissimilar to the test also discussed by the Rulings Panel which asks whether the literal interpretation results in an outcome that is "meaningless or inconsistent with the intent and purpose of the legislation".

24. Vector is of the view that an interpretation that the NAaN Interconnection Assets are temporarily connection assets during a pre-commissioning period would result in outcomes that are inconsistent with the intent and purpose of the TPM and the

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[3] Transpower (Page 3, Application for an exemption from the Electricity Industry Participation Code 2010, reference 432517) incorrectly state that our legal advice relies on a purposive interpretation of the Code that the NAaN Interconnection Assets are interconnection assets under the TPM.

[4] Paragraph 26. Decision of the Electricity Rulings Panel on the Preliminary Question of Applicability of Rule 5 of Section VI of Part F to Transpower, 28 February 2013.

[5] Ibid, paragraph 29.

[6] Ibid, paragraph 66.

statutory objective. The law is clear that when a literal interpretation results in perverse outcomes, a purposive approach should be taken. In this case:

a. The facts are that the NAaN Interconnection Assets are intended to be interconnection assets and will be operated as such for their lifetime;

b. The cables of the NAaN Interconnection Assets exceed the technical requirement for connection lines to substations. In other words, the NAaN Interconnection Assets have been engineered to interconnection asset specifications; and

c. The NAaN Interconnection Assets were approved by the Electricity Commission as interconnection assets and Transpower is recovering the costs of the assets as interconnection revenue.

25. It should be noted that the current connected substation is not on load, and Vector only has a temporary increase in security of supply with respect to its line from Albany to Wairau Road. Alternative supply from the south is not realised until the entire NAaN Grid Upgrade Project is completed. The connection costs Vector faces, in the absence of an exemption or determination that the NAaN Interconnection Assets are interconnection assets, far exceed any temporary, intangible benefits Vector may receive until such time as the final stage of the NAaN Grid Upgrade Project is completed.

26. Importantly, ignoring the substantive status of the NAaN Interconnection Assets would be inconsistent with the intent of the TPM and the statutory objective. The NAaN Interconnection Assets are very different from the connection scenarios contemplated by the current TPM. The engineering specification of the NAaN Interconnection Assets is considerably higher than the technical requirements for connection lines to substations. Allocating the charges for the NAaN Interconnection Assets as if the assets were agreed between Transpower and Vector as connection assets would, accordingly, result in Vector cross-subsidising other grid connection customers that will use and benefit from the assets when commissioning is completed.

27. Accordingly, in our view, the definition of interconnection node is properly interpreted as including the staged commissioning of the NAaN Grid Upgrade Project. Vector considers that the NAaN Interconnection Assets are interconnection assets in fact, and for the purposes of pricing transmission, consistent with the Authority's statutory objectives.

28. We consider that the most appropriate response to Transpower's exemption application is for the Authority to reject the application on the basis that the NAaN Interconnection Assets are interconnection assets, not connection assets, and that there are no connection assets which require exemption.

Criteria for granting exemption

29. If the Authority disagrees with Vector's analysis regarding the proper legal classification of the NAaN Interconnection Assets as interconnection assets, then Vector considers that the Authority should grant Transpower exemption because the tests in section 11(2) of the Electricity Industry Act have been met.

30. When considering whether to grant the exemption, the test in section 11(2) of the Electricity Industry Act states that:

> The Authority may grant an individual exemption to an industry participant only if the Authority is satisfied that—
>
> (a) it is not necessary, for the purpose of achieving the Authority's objective under section 15, for that participant to comply with the Code or the specific provisions of the Code; and
>
> (b) exempting the participant will reduce overall administration and compliance costs.

31. The Draft Exemption Decision notes that section 11(2)(b) is satisfied in this case – the exemption Transpower seeks would reduce overall administration and compliance costs.

32. The remaining question is whether an exemption would support the achievement of the Authority's objective under section 15 of the Electricity Industry Act i.e. that the provision of an exemption would be to the long-term benefit of consumers.

33. In addressing this question, the Draft Exemption Decision applies the DM&E framework to determine the appropriate pricing approach that would be to the long-term benefit of consumers. However, in doing so, the Draft Exemption Decision moves straight from the conclusion that the NAaN Interconnection Assets meet the definition of connection in the TPM to an automatic application of how the DM&E framework prices connection. This is an error, as it assumes away the very question raised by the exemption application.

34. Even if the Draft Exemption Decision treats the staged commissioning of the NAaN Interconnection Assets as connection assets, it must recognise this is not a normal connection scenario and we cannot assume without analysis that the normal pricing approach to connection assets will best satisfy the Authority's statutory objective to promote the long-term interests of consumers.

35. In the sections below, we work through the application of the DM&E framework to the particular circumstances of the NAaN Interconnection Assets. As the Authority is aware from our submissions in the TPM review process, we have reservations about the way the Authority considers satisfaction of the DM&E framework as synonymous with satisfying the Authority's statutory objective. We do not repeat those concerns here.[7]

36. While Vector does not believe it should necessarily be assumed that satisfaction of the DM&E framework will necessarily equate to satisfaction of the Authority's statutory objective, we believe that treatment of the NAaN Interconnection Assets as interconnection assets during commissioning of the NAaN Grid Upgrade Project would satisfy both criteria.

Applying the DM&E framework to the particular facts of the NAaN Interconnection Assets

37. Vector considers that the application of the DM&E framework in the Draft Exemption Decision to the question of whether to grant an exemption to Transpower contains a number of material errors. As discussed above, the central issue here is that the Draft Exemption Decision does not consider how the NAaN Grid Upgrade Project differs from a normal connection scenario and ask whether an exemption is justified. It moves straight from classification as connection to a mechanical application of how the DM&E framework treats a normal connection scenario.

38. Once the particular facts of the NAaN Grid Upgrade Project are considered, a decision not to grant an exemption and price the NAaN Interconnection Assets in the same way as normal connection assets would be contrary to the DM&E framework. Pricing the NAaN Interconnection Assets this way would violate the:

    a. the market-based and market-like approaches; and

    b. exacerbator pays; and

    c. beneficiary pays; and

    d. alternative charging options.

Application of market-based and market-like approaches

[7] See, for example, Vector, Cross-submission to the Electricity Authority on the Transmission Pricing Methodology: Issues and proposals, 28 March 2013.

39. When applying the DM&E framework to the exemption applications, the Authority must first consider whether treatment of the NAaN Interconnection Assets as connection assets is consistent with a market-based or market-like approach. Vector considers that the Draft Exemption Decision has not done this properly. Treating the NAaN Interconnection Assets as connection assets would not be consistent with a market-based or market-like approach.

40. Transpower has noted that the NAaN Interconnection Assets have been engineered to an interconnection asset specification which "far exceeds Vector's CBD network feeder requirement"[8] and "If the cable between Albany and Wairau Road was in fact a connection link, it would have been built to a lower, less costly, specification".[9] The cables of the NAaN assets significantly exceed the technical requirements for connection lines to substations.

41. Clearly, Vector would not consider installing 220kV cables and transformers to supply Wairau Rd as other options are far cheaper (and ultimately cost effective for our customers) and a more appropriate size for our requirements.

42. In a workably competitive market, a business would not pay more for connection services than the cost of assets that meet the technical requirements required for provision of the service.

43. Furthermore, in a workably competitive market, where a new service is introduced, it can be the case that the supplier does not fully recover the cost of the service until it extends its service and builds up a critical mass of customers. This was the case for Sky TV, for example. Sky TV could not have recovered its full cost initially when it only had a small number of initial customers. Similarly, just because Vector is the first customer to be connected to the NAaN Grid Upgrade Project does not mean it should bear the full cost of the NAaN Interconnection Assets prior to connection of other EDBs. Such an outcome would be inconsistent with a market-based or market-like approach.

Application of exacerbator pays

44. The Draft Exemption Decision discusses market-like approaches and beneficiary pays, but ignores that exacerbator pays is ranked above beneficiary pays in the DM&E framework and fails to evaluate the exemption against exacerbator pays.

45. It is clear that Vector is not the sole causer of the costs of connecting the NAaN Interconnection Assets to Vector's network. The NAaN Grid Upgrade Project was approved as a reliability investment, not as an economic investment. The cost of those assets are caused by the need for the NAaN Grid Upgrade Project in order to transmit electricity supplied by generators to EDBs at a reliability level that the then Electricity Commission deemed to be appropriate.

46. The Authority has noted that "The primary purpose of the NAaN is to provide secure transmission capacity to all load on the northern side of the Auckland Harbour …"[10] Allocating the cost to one party, even temporarily, would violate the exacerbator pays approach in the DM&E framework.

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[8] Page 1, Transpower, Application for an exemption from the Electricity Industry Participation Code 2010, reference 432517.

[9] Page 3, Transpower, Application for an exemption from the Electricity Industry Participation Code 2010, reference 432517.

[10] Paragraph 2.1.2, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

Application of beneficiary pays

47. While the Authority does not explicitly refer to the beneficiary pays approach in its Draft Exemption Decision, various aspects of its arguments in favour of rejecting the exemption are based on beneficiary arguments.

48. Vector has a number of comments on this. (The discussion below is based on the interpretation the Authority has applied to beneficiary pays in its TPM Proposal.[11])

49. It is not valid to assume that "A lower bound of private benefit to [Vector] … appears to be … $356 million plus $79 million avoided distribution investment …"[12]

50. The Authority's $356 million benefit figure is based on a number of incorrect assumptions.

51. The NAaN was approved as a reliability asset, not as an economic asset.[13] The Electricity Commission approval of the NAaN Grid Upgrade Project did not require that the benefits exceed the cost. Therefore, it should not necessarily be assumed that "the NAaN project is efficient" or that "the private benefit of reduced unserved energy exceeds the upper bound project cost of (2009) $473 million …"[14]

52. Nor is it valid to assume that Vector receives 75.2% of the benefit of the NAaN Grid Upgrade Project.

    a. It is unclear why the Draft Exemption Decision calculates reliability benefit solely for Vector, Northpower and Top Energy.

       Based on the Electricity Authority's SPD modelling,[15] it is not just Vector/Auckland that benefit from the NAaN Grid Upgrade Project, or even EDBs in Auckland/North Isthmus. Consumers in all regions benefit to varying degrees, as well as generators, with Auckland (which includes Vector and part of Counties network) receiving 23.1%, the North Isthmus 26.1% (which includes part of Vector's network), consumers in other regions 38%, and major generators and 5 direct customers 12.9%.[16]

    b. Nor is it clear why the Authority calculates benefit on the basis of share of coincident peak evenly distributed among the GXPs.

53. The resulting calculation that Vector receives 75.2%[17] of the benefit of the NAaN conflicts with the Authority's benefit calculation using its SPD method which indicates the benefit to Vector is 40.3%.[18] Neither the 40.3% nor the 75.2% figures are valid because they purport to measure the benefit of the (completed) NAaN Grid Upgrade Project and not the benefit to Vector of connecting to the NAaN Interconnection Assets as part of a staged commissioning process.

54. Allocating 100% of the annual cost of the NAaN Interconnection Assets to Vector during commissioning (and for an extended period thereafter) is clearly inconsistent with the Authority's preferred approach to beneficiary pays.

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[11] Electricity Authority, Transmission Pricing Methodology: issues and proposal, 10 October 2011.

[12] Paragraph 2.1.10, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

[13] http://www.ea.govt.nz/industry/ec-archive/grid-investment-archive/gup/2007-gup/north-auckland-and-northland-proposal-history/#naaninvestmentproposal

[14] Paragraph 2.1.10, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

[15] Electricity Authority, Transmission Pricing Methodology: issues and proposal, 10 October 2011.

[16] *Transmission investment private benefit by retail area, generator and large load (updated 1/11/2012)*

[17] Paragraph 2.1.9, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

[18] Paragraph 2.1.9, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

55. The $79 million avoided distribution investment is also incorrect.[19]

56. Instead of spending $79 million on new assets (cables between ALB_WRD and PEN_Quay), Vector has entered into customer investment contracts (CICs) with Transpower for the construction and operation of new GXPs at WRD and HOB owned by Transpower. The value of the CICs is $73 million.

57. Transpower recovers the capex through new investment charges payable under the CIC from 1 April following commissioning (note carrying costs are incurred from commissioning up until 1 April so effectively Vector pays from the moment the assets are commissioned). Transpower recovers the opex (operation and maintenance with respect to the CIC assets) as connection charges under the TPM.

58. The statement in the Draft Exemption Decision that "Treating the assets as interconnection assets over the interim period would mean grid users generally would be charged for those assets when it is only Vector that is connected to the relevant assets and Vector's customers that benefit"[20] takes a narrow/short-term application of beneficiary pays and ignores the real world context of commissioning large scale interconnection projects. Vector may be the only party that is connected to the NAaN Interconnection Assets in the interim period but, as the Draft Exemption Decision acknowledges, all parties connected to the transmission grid are beneficiaries of the NAaN Grid Upgrade Project.

Alternative charging options

59. Applying the DM&E framework to the particular facts of the NAaN Interconnection project makes it clear that applying the standard approach to pricing connection assets would violate each of the market-based, market-like, causer pays and beneficiary pays approaches in the DM&E framework. This would leave the residual approach for alternative charging options.

60. The Authority has stated that a residual or "postage stamp" charge is essentially analogous to a tax or levy because there is no direct relationship between the amount paid, the cost of supply for individual components and the benefit grid users derive from them."[21] The allocation of interconnection costs under the current TPM on a postage stamp basis is clearly a better match to the residual approach – and beneficiary pays based on the Authority's calculation – than treating the NAaN Interconnection Assets as if they are connection assets and allocating their annual cost entirely to Vector until the staged commissioning of the NAaN Grid Upgrade Project is completed.

61. The conclusion Vector reaches when applying the DM&E framework to Transpower's exemption application is that providing an exemption is the only option that is consistent with the framework.

Long-term benefit of consumers test

62. Vector is of the view that an approval of the Transpower exemption application – if the NAaN Interconnection Assets are considered by the Authority to be connection assets during the staged commissioning – would be consistent with both the DM&E framework and the Authority's statutory objective and therefore should be granted.

Impact on efficiency

63. The Draft Exemption Decision proposes that it is efficient, consistent with the purpose in section 15 of the Electricity Industry Act, for the NAaN Interconnection

[19] Paragraph 2.1.10, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

[20] Paragraph 5, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

[21] Paragraph 26, Electricity Authority, Transmission Pricing Methodology: issues and proposal, 10 October 2011.

Assets (or assets during a staged commissioning generally) to be treated as connection assets on the basis that:

a. "If Vector decides not to commission its Hobson Street GXP, it would indicate that, in fact, the private benefits to Vector are less than the increase in connection charges, in which case the decision not to commission the GXP would be efficient";[22] and

b. "If Vector nevertheless decides to commission the GXP, this supports the conclusion that the relevant assets give rise to net benefits to Vector. In which case, it is efficient, and necessary to achieve the Authority's objective, to ensure that the costs of those assets are allocated to Vector …"[23]

64. The Draft Exemption Decision also suggests that "Transpower's concern about the potential for customers to be deterred in the future from co-operating with efficient staged commissioning approaches in the event that the exemption application is declined … considers "efficiency" solely in terms of the delivery of the project, and not how the customers may also benefit from the connection."[24]

65. Again, these views in the Draft Exemption Decision assume the NAaN Grid Upgrade Project is a standard connection proposal, when it is not.

66. Subject to the Authority's decision on Transpower's exemption application, Vector is urgently considering delaying the connection of its Hobson Street GXP, because the potential increase in connection charges (in the absence of an exemption) far exceeds any potential temporary, incidental private benefits to Vector (and its customers).

67. The Authority is incorrect that such an outcome would be efficient. There would be efficiency losses from: (i) foregone benefits of earlier connection of the assets to Vector's network (improved security of supply, over and above the level required under Vector's default price-quality path (DPP)); and (ii) Transpower incurring higher commissioning costs as part of the NAaN Grid Upgrade Project.

68. An early supply from the 220kV into Hobson reduces energy losses to CBD customers. For the same CBD load supplied at 220kV, the energy losses are a quarter of that supplied at 110kV. Vector gains no benefit from this loss reduction. These losses are allocated to customers through retailer charges (110kV) or Transpower charges (220kV)

69. The notion that it would be efficient for Vector not to connect as part of a staged development of the NAaN Grid Upgrade Project, where the private benefits to Vector (and its customers) were outweighed by the connection charges, would only be valid if the costs of the NAaN Interconnection Assets were actually avoidable. They are not. They will be incurred regardless of whether Vector connects its assets at this stage or not. While the NAaN Grid Upgrade Project has not been completed, the costs of the NAaN Interconnection Assets are effectively fixed and/or sunk.

70. The Draft Exemption Decision asserts that "If Vector nevertheless decides to commission the GXP, this supports the conclusion that the relevant assets give rise to net benefits to Vector. In which case, it is efficient, and necessary to achieve the Authority's objective, to ensure that the costs of those assets are allocated to Vector". This prejudges the central issue in the current TPM review that beneficiary pays – even for fixed and/or sunk assets – is the most efficient way to recover the cost of transmission assets. It also ignores that Vector is not the sole beneficiary of

[22] Paragraph 3.3.7, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

[23] Paragraph 3.3.19, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

[24] Paragraph 3.3.8, Electricity Authority, Consultation Paper, Draft decision on exemption application – classification of NAaN assets under the TPM, 4 September 2013.

the NAaN Interconnection Assets. Vector is simply the first beneficiary to be connected to the NAaN Grid Upgrade Project.

71. The precedent of a decision not to grant an exemption would, as Transpower puts it, "discourage customers from cooperating in the future efficient staged commissioning of interconnection assets and therefore would not promote the reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers".[25]

72. We agree with Transpower that it is efficient to incentivise EDBs to agree to staged commission because:[26]

- commissioning is a resource intensive and high risk stage in any project. Spreading the timing of commissioning helps to smooth out resource demands, and to confine commissioning-related risks to one set of assets at a time. This helps reduce construction costs.
- in addition, phased commissioning provides a buffer for identifying and fixing defects in one set of assets prior to commissioning dependent assets. This can also help reduce construction costs.
- the link reduces losses, and hence demand. As shown by the Authority's SPD analysis of the NIGU project, reduced losses benefit consumers across New Zealand.
- commissioning the link also improves security of supply relative to leaving the link idle.
- energising assets is better than leaving them idle. Idle assets deteriorate more quickly, and it is more difficult to monitor their condition.

73. The only benefit to consumers that Vector can identify from a decision to reject Transpower's exemption application would be short-term regulatory opportunism, because Vector would not be able to pass on the NAaN Interconnection Asset costs in 2013/14 (a wealth transfer). Vector does not consider this to be a long-term benefit to consumers, and notes that the Authority does not consider wealth transfers to be long-term consumer benefits.

Commerce Act, Part 4 considerations

74. The Authority's decision on whether to grant Transpower with an exemption will impact on the operation of price regulation under Part 4 of the Commerce Act.

75. Transpower has noted that if Vector is charged connection fees, then Transpower could over-recover its allowable revenue in both 2013/14 and 2014/15, with the over-recovery returned in the 2015/16 and 2016/17 years.[27] The Authority's efficiency assessment has not considered the (allocative efficiency) impact of transmission prices being set above and below cost, or of the added volatility to transmission charges.

76. The situation is different for Vector because the DPP it operates under does not include a wash-up mechanism to offset any under or over-recovery of allowable revenues.

77. This means that for Vector to recover any unexpected increase in transmission charges in 2013/14, Vector would need to raise its prices in the same assessment period. Unlike Transpower, Vector cannot offset any under-recovery in the subsequent assessment period. The NAaN Interconnection Asset costs would amount to some $6.5 million for 2013/14 which would have a material impact on Vector's cost recovery.

78. While Vector's standard use-of-system agreement (UoSA) provides for more than one change in tariff rates in any period of 12 consecutive months, where there has

[25] Page 3, Transpower, Application for an exemption from the Electricity Industry Participation Code 2010, reference 432517.

[26] Page 2, Transpower, NAaN pricing treatment – staged commissioning, 13 September 2013.

[27] Page 3, Transpower, Application for an exemption from the Electricity Industry Participation Code 2010, reference 432517.

been a material increase in pass-through and/or recoverable costs, consistent with the Authority's model UoSA, there are restrictions in pre-existing UoSAs with retailers that restrict Vector's ability to do so.

79. However, as the Authority is aware, not all retailers on our networks have signed up to the UoSA and they are generally on legacy contracts that do not permit mid-year price adjustments to deal with increases in pass-through and recoverable costs.

80. One option for Vector is therefore to only charge the increased recoverable costs to those retailers who have signed the new Vector UoSA. This would not enable Vector to fully recover the costs charged by Transpower but would reduce our losses. Retailers receiving the increased charge would then need to decide whether to absorb the costs or pass them on to their consumers, knowing some of their competitors would not be incurring equivalent costs. This outcome would be challenging to implement but is not impossible and would be a legitimate step for Vector to take in order to mitigate our losses from this situation. We do not believe such an outcome would promote competition in the electricity industry for the long-term benefit of consumers. Hence, we do not consider the Authority's objective would be promoted by incentivising Vector to take such a step.

81. It should also be noted that the Commerce Commission sets the Default Price-Quality Paths (DPPs) for regulated suppliers such that their expected profitability for the regulatory period, if they fully recover their allowable revenue, would be no more than their cost of capital.

82. While Vector recognises that the operation of price or economic regulation should not provide a guarantee that regulated suppliers will be able to recover their cost of capital, the operation of regulation should provide regulated suppliers with an expectation that they will be able to do so if they operate as a reasonably efficient service provider.

83. Vector had reasonable grounds, given the basis for approving the NAaN investment and the pricing instructions from Transpower, to consider that the NAaN Interconnection Assets would be treated as interconnection assets and this was reflected in the prices that Vector set for its customers. If the NAaN Interconnection Assets are to be treated as connection assets, then Vector will need to pay additional funds to Transpower, meaning that Vector is unable to fully recover the costs of its own investments.

84. This situation, with the risk Vector will not be able to fully recover its cost of capital, is a consequence of Transpower deciding (after setting its prices) that it did not have a "reasonable degree of certainty when applying the TPM" and that "an exemption is necessary to provide that level of certainty".[28]

85. The Authority should consider whether it would be efficient for it to make a decision that would result in Vector being unable to recover its cost of capital in 2013/14 on its investments. While Vector can adjust its prices in 2014/15 to reflect the treatment of the NAaN Interconnection Assets as connection assets, and can consider precluding Transpower from connecting to the CIC assets in order to prevent the temporary increase in connection charges that might result until the NAaN Grid Upgrade Project is fully commissioned, any revenue shortfall in 2013/14 would be through no fault of its own and will not be able to be recovered in future years.

[28] Page 3, Transpower, Application for an exemption from the Electricity Industry Participation Code 2010, reference 432517.

Concluding remarks

86. The Authority should reach the conclusion that the appropriate interpretation of the TPM is that the NAaN Interconnection Assets are interconnection assets, not connection assets and that, accordingly, there are no connection assets to exempt.

87. If the Authority instead considers that the NAaN Interconnection Assets are connection assets, during the staged commissioning of the NAaN Grid Upgrade Project, the Authority should grant Transpower the exemption it is seeking on the basis that an exemption would:

    a. result in better efficiency outcomes and be to the long-term benefit of consumers as required by the statutory objective in section 15 of the Electricity Industry Act; and

    b. to the extent relevant, be consistent with the Authority's DM&E framework.

Kind regards

Bruce Girdwood
Regulatory Affairs Manager

Appendix: Responses to the Authority's questions

Question No.	Electricity Authority question	Vector response
1	Do you consider that the proposed decision to decline the exemption is correct? If not, please describe why you consider the exemption should be approved.	No. The only valid basis to decline the exemption application is on the basis that the NAaN Interconnection Assets are interconnection assets, not connection assets, such that there are no connection assets to exempt. If, however, the Authority instead interprets the TPM as treating the staged commissioning of interconnection assets as connection assets, the Authority should grant Transpower the exemption it has applied for on the basis that this would be to the long-term benefit of consumers.
2	Is there additional information that the Authority should have considered when making its decision, or errors of fact in the material presented in this paper, that may have affected the Authority's decision making? If yes, please provide the additional or corrected information.	Yes. The Authority should consider the following information: • Whether the correct interpretation of the TPM is that the NAaN Interconnection Assets are interconnection assets or connection assets. Vector considers that the correct interpretation is that the NAaN Interconnection Assets are interconnection assets during commissioning. • The Authority's SPD method puts Vector's share of the benefit of the NAaN assets at 40.3%, not the 75.2% used in the Draft Exemption Decision. • If the NAaN Interconnection Assets are treated as interconnection assets, Vector will pay approximately 26% of the cost of those assets. • Instead of spending $79 million on new assets (cables between ALB_WRD and PEN_Quay), Vector has entered into customer investment contracts (CICs) with Transpower for the construction and operation of new GXPs at WRD and HOB owned by Transpower. The value of the CICs is $73 million. • If Vector does not connect the Hobson NAaN Interconnection Assets prior to completion of the NAaN Grid Upgrade Project, there are no avoided costs or efficiency gains, regardless of whether the

Question No.	Electricity Authority question	Vector response
		private benefits to Vector are greater or less than the connection costs. • The Authority's benefit calculations conflict with the calculations it undertook as part of the TPM review using the SPD method. • The Authority should have considered the disparity between the interim period of 7 months (commissioning of Wairau Road in May 213 until expected commissioning of NAaN in December 2013), and the period of 15 months (expected commissioning of NAaN in December 2013 and start of new pricing year in 2015). During this 15 month Vector would have to continue to pay connection charges for assets which are indisputably (regardless of interpretation of the TPM definitions) interconnection assets. This is partly the result of the TPM and partly the result of the way Transpower implements the TPM.
3	Do you agree with the approach the Authority has taken to considering this exemption application against the requirements for granting exemptions in Section 11(2) of the Act? If not, what approach do you consider should have been taken?	No. The Draft Exemption Decision applies the DM&E framework without considering the differences between the NAaN Interconnection project and a standard connection investment. Vector considers that the DM&E framework, when properly applied to the particular facts of the NAaN Interconnection project, supports granting of an exemption. Vector also considers it should not necessarily be assumed that satisfaction of the DM&E framework will equate to satisfaction of the Authority's statutory objective. Vector submits a direct application of the long-term benefit of consumer test also supports granting of an exemption.