The Treasury

New Zealand Aluminium Smelters (NZAS) Information Release

September 2013

Release Document

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Transmission pricing

Date:	9 July 2013	Report No:	T2013/1862

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Note** contents	Tuesday 9 July 2013
Associate Minister of Finance (Hon Steven Joyce)	**Note** contents	Tuesday 9 July 2013
Minister for State Owned Enterprises (Hon Tony Ryall)	**Note** contents	Tuesday 9 July 2013

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Enclosure: No

Treasury Report: Transmission pricing

1. Following your meeting with Pacific Aluminium (PA) on 9 July you requested advice on how transmission pricing charges are set, and on PA's request for relief on the transmission charges that it pays.

Transmission pricing

2. Transpower's charges are governed by a regulatory framework set by the Commerce Commission (CC). This framework determines the spending that Transpower is permitted to incur on the national transmission network, as well as the quality of service that Transpower must provide. Transpower's revenue is then set to allow recovery from its customers of this spending, plus a regulated rate of return on Transpower's asset base. The CC determines what assets Transpower is allowed to earn a return on, i.e. the CC must approve the construction of any significant new transmission assets. Approval is sought (and granted) on the basis that any new investments generate economic benefits for New Zealand.

3. For 2013/14, Transpower's total revenue requirement was set by the CC at $878 million, which includes a 7.55% post-tax rate of return on its regulated asset base.

4. The Electricity Industry Participation Code, under the Electricity Industry Act 2012, sets out the Transmission Pricing Methodology (TPM). The Code is administered by the Electricity Authority (EA). In broad terms the TPM takes the overall revenue requirement for Transpower, set by the CC, and decides how it will be allocated to users of transmission services.

5. The TPM currently allocates Transpower's costs in three categories:

- the costs of the HVDC link between the North and South Islands are allocated to South Island generators (approximately $162 million in 2013/14)
- the costs of the "core" transmission network are allocated to all customers connected to the grid, based on their peak demand (approximately $575 million),
- customers also pay an interconnection charge, based on the costs of connecting them to the "core" transmission network (approximately $136 million).

Transmission charges faced by the NZ Aluminium Smelter (NZAS)

6. The table below shows the transmission charges paid by NZAS in recent years, and forecast to be paid in the next few years. The forecasts assume smelter peak demand remains unchanged (if it fell, then transmission charges would also reduce):

	$m	Change from previous year ($m)
2010/11	[2]	
2011/12		
2012/13		
2013/14 (forecast)		
2014/15 (forecast)		
2015/16 (forecast)		
2016/17 (forecast)		
2017/18 (forecast)		
2018/19 (forecast)		

Source: Transpower

7. NZAS's interconnection charges are currently around [2] and remain constant over the next few years. The bulk of NZAS's transmission costs (over [2]) and all of the increase, is therefore due to the costs of the "core" transmission network.

8. Until recently, NZAS (along with others) also received "loss and constraint rentals" from the transmission network, which offset its transmission charges. These rentals vary from year to year depending on market circumstances, and amounted to [2] in 2012/13 – reducing NZAS's net transmission charges from [2] to [2] The EA's new financial transmission rights (FTRs) regime affects how these rentals are distributed, and in the time available we are not able to work out what the impact on NZAS is, so we have not included this in the figures above.

Transpower's dividend policy

9. Transpower currently has a policy of paying dividends equal to 65-75% of its free cashflow, after the deduction of maintenance capital expenditure.

10. Over the last 11 years Transpower has made capital investments of around $4.3 billion, while paying dividends of around $700 million (including the period from 2006/07 to 2010/11 when it paid no dividends). Over the next three years Transpower is planning a further $1.3 billion of capital investment and forecasts $550 million of dividends.

11. Transpower's dividends have <u>no impact</u> on the prices that customers pay for transmission pricing. As discussed above, those prices are regulated by the CC, and so reducing Transpower's dividends would not reduce transmission charges.

12. Conceptually, dividends reflect a transfer of cash from a company to its shareholders. They <u>do not</u> impact the returns that shareholders get from their investment in a company. If Transpower does not pay a dividend, it retains the cash itself, and its value increases accordingly (assuming no changes to its spending). The total return to Transpower's shareholders is unchanged – because that is determined by the CC - but more of that return is retained within the company, and less is paid to the Crown as shareholder.

13. Nor do dividends impact Transpower's capital spending, which again is determined by the CC. Under Transpower's policy, its dividends are based on free cashflow, <u>after</u> capital expenditure. So capital expenditure affects dividends, not the other way around. If Transpower needed to spend more on grid investments, then it would either borrow or reduce its dividends.

14. Transpower is able to pay dividends to the Crown in the coming years because it has completed the majority of the significant investments in the transmission grid.

15. Nor would there be any economic justification for "rebating" dividends back to Transpower's customers. The dividends reflect an appropriate return to the Crown, as shareholder, for the equity that it has invested in Transpower. Transpower's customers have not provided that equity – the Crown (on behalf of all New Zealanders) has. The level of return the Crown receives from Transpower (and the asset base on which it is earned) are determined by the CC.

16. In theory the Crown could over-ride the CC and reduce the rate of return that Transpower is allowed to include in its charges. This would reduce the <u>price</u> of transmission services, but not the <u>cost</u> of the services (given that the true cost of any good or service includes an appropriate return on capital). As such, a reduction in Transpower's rate of return set by the CC would reflect a subsidy from taxpayers (as the ultimate owners of Transpower) to electricity consumers, including NZAS. The cost of this subsidy to the Crown would need to be met by either reducing other Government spending, or increasing taxes.

17. [4]

Pacific Aluminium's request

18. As you know PA has sought "a cap on the electricity transmission charges payable by NZAS at a unit rate of [2] . PA argues that "NZAS has suffered significant increases in annual transmission charges over the past two years, as Transpower has, in effect, levied users to fund the development of its extensive infrastructure projects. These projects, primarily located in the North Island, have provided little, if any, benefit to NZAS."

19. Based on NZAS's consumption of around 4,800 MWh, in 2011/2012 it implicitly paid around [2] to Transpower for transmission before loss and constraint rentals, or [2] net of those rentals (noting that transmission prices are not actually set on a dollar per MWh basis). Assuming no change in consumption by the smelter, this will [2] by 2016/17.

20. Capping NZAS's transmission charges [2] would require the following estimated subsidies to NZAS:

	$m
2013/14	[2]
2014/15	
2015/16	
2016/17	
2017/18	
2018/19	

21. Assuming subsidy payments after 2018/19 remained at around [2] and continued until 2025, then total subsidies over the 12 years would be around [2] . At the public sector discount rate of 8% this would be around [2] in today's dollars.

Treasury comment

22. It is true that NZAS has faced some increases in the amount it pays for transmission in recent years, and these charges will increase significantly in the future. However the same is true for all other users of transmission services, i.e. all businesses and residential households in New Zealand.

23. These increases, for all consumers, reflect the significant investments that Transpower has made in improving the transmission network, after a number of years of low investment.

24. In our view NZAS does receive some benefit from these improvements. For example the recent upgrades to the HVDC allow for greater volumes of electricity to be transmitted from the North Island to the South Island, when required. This can potentially be of significant benefit to NZAS. Low inflows earlier this year meant that electricity generation from Manapouri was restricted, and so continued supply of electricity to the smelter was dependent on generation elsewhere in New Zealand, which had to be transmitted over Transpower's network.

25. However, the recent increases in the transmission charges faced by NZAS are probably in excess of the direct benefits that the smelter receives from the recent investments by Transpower.

26. There is a significant transmission line from Manapouri to the NZAS site at Tiwai Point. Part of this line is considered to be part of the "core" transmission network, and so its costs are recovered from all of Transpower's customers. Another part of this line is a connection asset, but its costs are allocated to Meridian, as the owner of Manapouri. Therefore NZAS only pays a small portion of the costs of the transmission assets which directly supply the smelter (but equally, it also pays a small portion of the costs of all of Transpower's grid).

The EA's proposed changes to transmission pricing

27. As you know the Electricity Authority (EA) is currently consulting the industry on proposed changes to the transmission pricing methodology (TPM). Broadly, the EA's proposed changes are based on the principle of "beneficiary pays", and so would probably result in some reduction in transmission charges faced by NZAS. Given the complexity of the EA's proposed changes, and the fact that they are still being consulted on and may change significantly as a result of industry feedback, we are unable to estimate the potential benefit to NZAS.

28. We understand that later this month the EA board will be announcing its revised timetable for progressing changes to the TPM. We expect that any changes to TPM, if ultimately agreed by the EA, would take effect from either 2016 or more likely 2017.

A subsidy for NZAS

29. PA is asking the Government to subsidise the price it pays for transmission services. This is in addition to its request for a further subsidy to reduce the price it pays for electricity, beyond the price reductions (and other concessions) already offered by Meridian.

30. As you know, Treasury's view is that there is no economic justification for offering a government subsidy to ensure the continued operation of the smelter.

31. However, if the Government did wish to subsidise NZAS's transmission charges, we do not think it would be appropriate to do so by making changes to the regulatory framework. In order to do this, the Government would need to pass special legislation to over-ride the Electricity Industry Act 2010 and the Electricity Industry Participation Code. Apart from the principled arguments against changing a regulatory regime to benefit one company, this would have the effect of re-allocating some of NZAS's transmission costs to Transpower's other customers.

[5,6]

[5,6]

Possible talking points for a discussion with PA

38. We suggest the following talking points for a discussion with PA:

- Ministers understand the significant increases in transmission costs that the smelter is facing, and why this would be of concern to its owners.
- Those increases are not “unconstrained”. Transmission costs are regulated by the Commerce Commission and are based on a reasonable rate of return on the significant investments that Transpower has made in the national grid.
- Ministers cannot and will not over-ride the independent regulators who set the transmission costs the smelter faces.
- Ministers understand that the smelter’s owners believe that they are paying more in transmission costs than the benefits they think the smelter receives from the recent transmission investments. Those investments were made on the basis of national benefits, not the benefits to individual electricity consumers like the smelter.
- Ministers do not agree that the smelter gets no benefits from these investments. In particular we believe the smelter benefits from the increased capacity of the HVDC link between the North and South Islands.
- While the smelter pays its share of the costs of the national grid, it also only pays a small portion of the costs of the transmission assets that directly supply it.
- Ministers are aware the Electricity Authority is progressing changes to transmission pricing which could be of benefit to the smelter, and we are hopeful that a new transmission pricing regime will be in place in the next few years. But again, the Electricity Authority is an independent regulator and Ministers are unable to influence its decisions.

Recommended Action

We recommend that you **note** the contents of this report.

Chris White
Director Government Share Offer Programme

Hon Bill English
Minister of Finance

Hon Steven Joyce
Associate Minister of Finance

Hon Tony Ryall
Minister for State Owned Enterprises