Criteria for assessing alignment against the Information Disclosure Guidelines and Pricing Principles: Consultation Paper

17 October 2011

Executive Summary

1. Powerco welcomes consultation on the criteria used to assess compliance with the information disclosure guidelines and pricing principles. We were surprised by a number of the criteria used to review the 2011 pricing methodologies, and disagreed with some of the requirements. This consultation provides an opportunity to comment and will help ensure a fair and transparent process.

2. Powerco supports the Authority's proposal not to change the principles and guidelines. They have already been consulted on and must be allowed to bed-in.

3. Our main concern is the level of detail required by the criteria for the information disclosure guidelines. To be 100% compliant would be very resource intensive, particularly in updating the level of information required each year. For example, providing every cost driver of Powerco would require a lot of detail and replicate much of the information in Powerco's Asset Management Plan. It is questionable whether this additional information will deliver any practicable benefits to consumers.

4. Appendix A of this submission provides wording changes, consistent with those provided by the Electricity Networks Association (ENA). These have been carefully considered to manage the line between providing full and transparent information, but also delivering benefits to the end consumer.

5. We also recommend that the pricing methodologies are only assessed every two years. The methodologies are long-term documents and do not change very much year to year. Reviewing 29 methodologies using the criteria will be an expensive exercise. We do not consider there is sufficient need for an annual review process. A biennial review also aligns with the Commerce Commission's consideration of only reviewing Asset Management Plans every two years.

6. Powerco has seen the ENA's submission and fully supports its content. The contact person for this submission is Charlotte Littlewood, Regulatory Manager, 06 759 6241, charlotte.littlewood@powerco.co.nz).

Context of the disclosure

7. Powerco's overarching comment is that there are a variety of reasons why the Authority should be modest in the level of detail and granularity required in the pricing methodology disclosure. For example:
    a. there are a number of regulatory constraints, such as the low fixed tariff regulations impacting pricing;
    b. retailers rebundle distributors' prices and price signals are often lost;
    c. electricity is a relative inelastic good, meaning price signals have limited impact; and
    d. the dominance of fixed costs means the subsidy free zone is wide, and there are a range of possible costs and options.

8. Powerco's Asset Management Plan has increased in size from 100 pages in 2003 to over 250 pages in 2011. This is to meet the increasing demands of the Commerce Commission's reviews to provide more information. It is questionable whether this has delivered better network management to consumers, or been a box ticking exercise. Given the points above, it is important that pricing methodologies do not have to grow to substantial documents to be compliant each year, with little benefit to consumers.

Comments on Timeframe

9. The Authority has proposed the following review process for determining alignment of pricing methodologies with the principles and disclosure guidelines. Powerco:

    - supports steps 4 and 5 – that distributors are able to respond to the expert review before it is published;
    - supports receiving the independent review in July, as this allows more time to try and accommodate concerns into the annual pricing review process;
    - notes that step 3 should refer to April 2012, as the pricing methodologies are not disclosed until 1 April 2012; and
    - recommends that the reviews are completed every two years as pricing changes take time to be implemented and it will be more efficient.
        - 29 reviews will be expensive to undertake, especially given the volume of information the Authority wishes to be included;
        - pricing methodologies do not change very quickly, and often set goals 3-5 years in advance;
        - the methodologies will still be disclosed each year; and
        - the approach is inline with the Commerce Commission's consideration of only requiring review and comprehensive disclosure every two years.

Table 1: Indicative process for determining alignment

Indicative Process	Commenced
Step 1: Distributors use the information disclosure guidelines to report against the pricing principles, with a review to assess alignment	March 2011
Step 2: Possible decision on whether more standardisation of tariff structures is required	October 2011
Step 3: Formal review against the pricing principles using the information disclosure guidelines	March 2012
Step 4: Distributors receive an independent expert's draft report on compliance of the distributor's pricing approach against the pricing principles	July 2012
Step 5: Distributors respond to the Authority on the findings of the report	September 2012
Step 6: Authority publishes a summary of the independent reviews	November 2012

Response to Questions

Q1: Do you consider the type of analysis suggested is appropriate given the pricing principles, and are there important aspects which have been omitted?

10. The Authority has proposed "indicative evaluation criteria" related to the Principles. It is helpful to see how the Authority would evaluate the principles, although Powerco does not think these need to be published criteria.

11. This is because the principles are designed to guide the development of the pricing methodologies. They do not pre-determine a single methodology. In practice it is common for there to be tensions between the principles. There will be a period of "learning by doing" as lines businesses learn and develop ways to improve the design and disclosure of their pricing methodologies.

12. The task of Powerco in this principle-based approach is to develop a pricing methodology that achieves the principles as far as practical. The disclosure requirements place a discipline on the business to document not only its chosen methodology, but also why it has chosen it and what the implications are of its methodology for various consumer groups.

13. In undertaking this task it is important that the principles are clear, and that there is no ambiguity between the principles and other forms of guidance provided by the Authority. The review has not found the principles to be unclear. Further, the proposed criteria do not attempt to clarify the principles but rather they attempt to indicate how they should be implemented. Thus these proposed criteria are not required for the purposes of clarity.

Q2: Do you consider that the Commerce Commission's template for gas distribution businesses would be an appropriate guide?

14. No, Powerco does not consider the Gas Authorisation Pricing Methodology Report template to be suitable for electricity distribution businesses. It was part of an arduous and punitive regulatory control process, which is very different to the Commission's current DPP regulatory regime. The Commerce Commission is also not requiring Powerco and Vector to continue to follow this template when the gas businesses transition to the gas DPP. This recognises the more invasive requirements of the Gas Authorisation Pricing Methodology process.

15. There are also a number of features of this report that have no relevance to electricity distribution. Many of the requirements relate to having a very detailed and audited cost of supply model, which is not required by the Electricity Authority.

16. The Authority also suggests that the Concept criteria are similar to a number of requirements in the template and methodological requirements. This is clearly not the case. For example, the following were not considered as part of the Gas Authorisation process:

- An analysis of the extent to which local network peak is different to regional transmission peak.
    - This was not a requirement in the Gas Authorisation.
- Any other key driver materially impacting costs
    - This is an exhaustive requirement and the list of cost drivers is substantial and well documented in the AMP.
- Consideration of the transaction costs implications of the complexity/ simplicity of the chosen approach.
    - This was not a requirement in the Gas Authorisation.
- The extent to which the charges have been variablised to recover costs that are fixed and vice versa.
    - While this area was considered in the Gas Authorisation Pricing Methodology review, the Commerce Commission has mixed conclusions on the approach. For example, on the one hand, that fixed prices should reflect fixed costs, and on the other, that variable charges promote smaller users connecting and therefore increase the efficiency of the assets.

Q3: To what extent do the constraints listed in paragraph 3.2.10 impact on your ability to align your pricing methodologies with the pricing principles?

17. The limitations of the constraints in paragraph 3.2.10 are detailed below. These are significant challenges and very much restrict how an EDB is able to price.

Potential legal action from retailers opposed to some pricing methodology changes.

- Powerco has a significant consultation programme with retailers and always tries to accommodate any concerns over price changes. We note that:

- retailers have a preference for price stability to minimise the amount of administration work, impact on customers and reduce changes to billing systems;
- Powerco serves 17 retailers, and they do not always have the same preferences; and
- there is always likely to be a tension between retailers, whose costs vary by volume of electricity and customer numbers; and distributors, whose costs vary more by peak demand.

Restrictions on rural price changes relative to urban prices and the low-fixed charge regulations.

- These are obvious constraints Powerco has to accommodate and restrictions can limit the degree of cost reflectivity. Powerco operates over some very rural areas, and the cost to serve a small number of consumers on long, aging feeders is much higher than the price paid by consumers.

Any changes that could result in significant 'price shocks' to some groups of customers.

- This is a common restriction and needs to be carefully managed. This issue limits the rate of change, rather than the total change.

Asymmetric risks due to the application of the Commerce Act price control regime (potential to breach).

- This again is a factor and links to the rate of change able to be undertaken.
- Any restructuring also requires demonstration to the Commerce Commission that the lines company has not benefited from higher revenue by virtue of restricting prices and this also presents a risk.

Comments on assessment guidelines

18. Powerco supports the changes proposed by the ENA (provided in Appendix A). These changes will assist is making this process efficient and useful. Our main concern is the level of detail required for a 100% compliant methodology and how much work will be required in providing updated data each year. The criteria must be realistic and not promote a bureaucratic process. We have the most significant concerns about the following criteria.

Q4: Do you agree with the assessment criteria for Guideline (a)?

19. We are concerned about the level of potential information that EDBs would be required to provide and it is therefore somewhat pleasing that the Authority have suggested that only factors that will have a 'material' impact on prices need to be disclosed in the methodology.
20. We are therefore supportive of the changes proposed by the ENA as detailed in appendix A in regards to the assessment criteria for Guideline (a).

Q5: Do you agree with the assessment criteria for Guideline (b)(i)?

21. We are concerned by the requirement that "supporting quantitative analysis is provided at the level of detail necessary to demonstrate how the various aspects

of the pricing methodology support achievement of the overarching objectives of the pricing principles – ie economically efficient prices”.

22. This will be very difficult and burdensome to prove in practice. We support the ENA wording change, and this will allow EDBs to provide quantitative evidence where it is available.

Q6: Do you agree with the assessment criteria for Guideline (b)(ii)?

23. We believe that a description of the customers in each group and an explanation for why the groups have been designed in that fashion should be enough to satisfy this guideline (as detailed in appendix A).

Q7: Do you agree with the assessment criteria for Guideline (b)(iii)?

24. We do not believe that *analysis setting out a range of possible outcomes* for our cost drivers would add any value to the disclosure and the phrase should be should be removed. We believe that detailing this process would potentially expose EDBs to challenges from increasingly well organised customers groups.

Q8: Do you agree with the assessment criteria for Guideline (b)(iv)?

25. Yes.

Q9: Do you agree with the assessment criteria for Guideline (b)(v)?

26. Powerco has changed the wording of the assessment criteria to remove including “any other material considerations taken into account when developing tariff the tariff structure”. While the term “material” removes some issues, the terminology to “provide supporting analysis and evidence where appropriate” is much more realistic.

Q10: Do you agree with the assessment criteria for Guideline (b)(vi)?

27. Powerco disagrees with the criteria to “reference relevant supporting analysis for deriving the value of any such payments or discounts for such alternatives, particularly how such payments/alternatives relate to cost drivers”. The term “where relevant” should be added before this.

Q11: Do you agree with the assessment criteria for Guideline (c)(i)?

28. Yes, although Powerco supports the wording change suggested by ENA’s submission (as detailed in appendix A).

Q12: Do you agree with the assessment criteria for Guideline (c)(ii)?

29. Yes, although Powerco supports the wording change suggested by ENA’s submission (as detailed in appendix A).

Appendix A: Proposed Changes

See attached document.

Appendix A: Proposed changes

Guideline (a): Prices should be based on a well-defined, clearly explained and published methodology, with any material revisions to the methodology notified and clearly marked

- The methodology is well-defined where:
  - A clear context and pricing objective is described.
  - The methodology is suitability described, referencing key decisions made or any analysis undertaken where appropriate.
  - Each step required to produce final prices is logically set out, alongside the key decisions made or any other analysis undertaken where appropriate.
  - Any key assumptions that have been used are identified or
  - referenced to source material where appropriate.
- The methodology is clearly explained where:
  - It is understandable, easy to follow and progresses in a logical manner.
  - Complex concepts are explained and background information is provided or referenced where appropriate.
- The methodology is published where it is disclosed on the distributor's website.

Guideline (b)(i): The pricing methodology disclosed should demonstrate how the methodology links to the pricing principles and any non-compliance

- Linkage to pricing principles is demonstrated by:
  - Explaining the extent to which, and how, the pricing methodology achieves each pricing principle, providing or referencing supporting evidence or analysis where appropriate.
  - Providing reasons why any principle is not achieved.

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<#>The methodology's suitability for the network, given its characteristics or situation, is demonstrated, referencing substantiating qualitative analysis where suitable.¶

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Guideline (b)(ii): The pricing methodology disclosed should provide the rationale for consumer groupings and the method for determining the allocation of consumers to the consumer groups

- The pricing methodology provides the rationale for consumer groupings by:
    - Describing the customers in each group.
    - Explaining why the groups have been designed as they have. This rationale could include a discussion of cost drivers and/or consumer or network characteristics. Supporting information and/or analysis should be provided as appropriate.

Guideline (b)(iii): The pricing methodology disclosed should quantify key components of costs and revenues

- The pricing methodology identifies the key cost items that are to be recovered through prices, over the pricing horizon by:
    - Describing each cost line item to be recovered through prices.
    - Indentifying the costs that are relevant to each consumer group, where appropriate.
    - Indentifying the drivers of the costs, including the implications for the methodology.
- The pricing methodology identifies the key revenue items that are to be recovered through prices over the pricing horizon by identifying the proportion of total revenues expected to be collected from each customer group.

Guideline (b)(iv): The pricing methodology disclosed should explain the cost allocation methodology and the rationale for the allocation to each consumer grouping

- Cost allocation methodology is demonstrated by:
    - Outlining the metrics used to allocate costs.
    - Showing the allocation of each cost item across the groups.
- Rationale for the cost allocation method is provided by presenting:
    - The reasons for the use of each chosen metric.

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<#>Including the metrics or statistics relating to each consumer group (e.g. contribution to network peak kW demand, sum of individual anytime maximum demands, number of connections, GWh energy demand, connection capacities, value of lost load, etc.).¶
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Key components of revenues include the revenue generated across each consumer group and ...

- The implications or benefits of the use of those metrics are discussed.

Guideline (b)(v): The pricing methodology disclosed should explain the derivation of tariffs to be charged to each consumer group and the rationale for the tariff design

- The methodology should clearly describe and explain the tariff structures including:
    - The different types of charge and which customers they apply to.
    - The nature of any discount for controlled tariffs.
    - 'ICP-pricing' or 'GXP-pricing' approaches.
- Rationale for the tariff design is provided by:
    - Explaining how the tariff structure and levels are linked to cost drivers and/or consumer or network characteristics.
    - Explaining how the tariff design will further the achievement of the pricing principles.
    - Providing supporting evidence or analysis as appropriate.

Guideline (b)(vi): The pricing methodology disclosed should provide the pricing arrangements that will be used to share the value of any deferral of investment in distribution and transmission assets, with the investors in alternatives such as distributed generation or load management, where alternatives are practicable and where network economics warrant

- The nature of any such arrangements should be clearly described., and their rationale explained. This should include or reference, where relevant, supporting analysis used for deriving the value of any such payments or discounts.

Guideline (c)(i): The pricing methodology should where possible employ industry standard terminology

- The disclosure should use industry standard terminology, and provide additional information or a glossary where necessary for understanding.

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Guideline (c)(ii): The pricing methodology should where a change to the previous pricing methodology is implemented, describe the impact on consumer classes and the transition arrangements implemented to introduce the new methodology

- If changes to the methodology have occurred:
  - The reasons should be explained.
  - Transition arrangements, and the impact on customer groups, should be described.

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If changes have occurred, any arrangements to 'phase-in' the effects of those changes are discussed.