



**Submission on Decision-making and economic
framework for distribution pricing methodology
review: Consultation Paper**

22 June 2012

Summary

1. Powerco supports the Electricity Authority (Authority) reviewing the pricing principles and information disclosure guidelines against the Authority's statutory objective. We agree that the principles and guidelines meet the objective and the decision making and economic framework (DME Framework). This is not surprising given the principles originated from the Commerce Commission, which has a similar objective to the Authority.
2. Powerco's understanding is that the DME Framework is broadly the same as the pricing principles – it uses different language to describe similar concepts. Our main concern is that having to report against two criteria, with two sets of terminology, will be confusing and inefficient.
3. A simpler, and more efficient approach, is to require EDBs to demonstrate how the trade-offs they have made between the pricing principles meet the Authority's statutory objective. This could be achieved by adding the following preamble to the pricing principles (and not using the DME Framework at all),

“These Pricing Principles are to be interpreted and applied in a manner that is consistent with the Statutory Objective of the Electricity Authority “To promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.”

4. If the Authority is not comfortable with this approach, Powerco's second preference is to rank the pricing principles using the DME Framework (and again, not use the DME Framework in the assessment). Ranking provides a hierarchy, but avoids the complexity of the two approaches.
5. Finally, if the Authority continues with the DME Framework, Powerco recommends that the Authority delay the review against the Framework for at least a year. If this is not feasible, Powerco's second preference is for the Authority to:
 - review the pricing methodologies against the pricing principles and information disclosure guidelines, as was always envisaged; and
 - complete a “shadow” review using the DME Framework to provide feedback to EDBs and more clarity on the level of information expected.
6. The results of the shadow review would only be known to the EDB. This would be fairer and provide more clarity on the level of information the Authority expects in future pricing methodology documents.

Introduction

7. Powerco welcomes the opportunity to comment on the Electricity Authority's (Authority) consultation paper *Decision-making and economic framework for distribution pricing methodology review* (Consultation Paper), published on 7 May 2012. We also appreciated the opportunity to meet with the Authority on 12 June and better understand the aims and logic of the DME Framework.
8. Powerco has seen the Electricity Networks Association's (ENA) submission on the Consultation Paper, and agree with the issues ENA raise.
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It is reasonable for the Authority to review the pricing principles against its statutory objective

10. The electricity distribution pricing principles were formed between September 2009 and March 2010 by the Electricity Commission (Commission). The Commission was acting under the statutory objective to, "*(a) to ensure that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable, and environmentally sustainable manner; and (b) to promote and facilitate the efficient use of electricity*". The Authority's statutory objective is to "*promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers*". It is reasonable for the Authority to review the approach to distributor pricing under its different statutory objective.

We agree the pricing principles and information guidelines meet the statutory objective and the DME Framework

11. We agree that the principles and guidelines meet the Authority's statutory objective and DME Framework. This is not surprising given the Electricity Commission, and all parties submitting on the principles, would have been aware of the Authority's new statutory objective when the principles were finalised.¹ The principles also originate from the Commerce Commission, whose statutory objective is similar to the Authority in, "*promoting the long-term benefit of consumers in markets [...] by promoting outcomes that are consistent with outcomes produced in competitive markets*".
12. Powerco's understanding is that the concepts of the DME Framework are broadly the same as the concepts in the pricing principles.² The first main difference is the language. For example, the exacerbator concept is generally

¹ The Electricity Industry Bill was introduced into Parliament in December 2009, and the Commission finalised the principles in March 2010.

² The ENA submission highlights a number of challenges in interpreting the DME Framework and we support the ENA's analysis. In this submission we assume a level of pragmatism by the Authority in interpreting the DME Framework. If this does not occur, we reserve the right to have significant concerns about the Authority's approach.

similar to the idea of marginal cost pricing and sending effective price signals to consumers. The beneficiary concept is similar to the idea of Ramsey pricing. The second main difference is that the DME Framework has a hierarchy, where as the pricing principles are currently all equal.

We understand the Authority's objective is to have a hierarchy of options to improve transparency and certainty

13. Powerco understands the Authority's aim is to provide more transparency on how it will evaluate pricing methodologies. The DME Framework is seen as a way to provide a hierarchy and align with the approach with transmission pricing.
14. Powerco supported having criteria to help understand how the Authority will interpret the pricing principles. We are not opposed to the Authority ranking one aspect above another, as long as this is logical and consistent with economic theory. The most important issue is that the Authority is realistic in assessing pricing methodologies and understands the constraints around distributor pricing.

Powerco's aims are for the Authority to have a clear understanding of the constraints impacting distributor pricing and that there is an efficient scope for pricing methodology documents

15. Powerco's has three main aims for the Authority's approach to pricing methodologies. Firstly, that *the Authority's provides a clear, consistent and enduring expectation of distributor pricing*. Implementing pricing strategies takes time as it is important to avoid price shocks to retailers and consumers. If the Authority is seeking to regulate, it must have consistent and enduring expectations to allow EDBs to develop a long term approach.
16. Secondly, that *the Authority is realistic, and understands the constraints impacting distribution pricing*. This includes the constraints of what the end goal might look like (eg how difficult it is to send price signals when retailers can change the signal and consumers' demand is inelastic), and the speed of change to reach the end goal. (Eg most distributors consider strategic price changes nine months ahead of the actual price change. This allows adequate time for retailer consultation.) The ENA submission provides an overview of some of the main regulatory constraints impacting pricing.
17. Thirdly, *the requirements for pricing methodology documents must not be overly complex and allow EDBs to write user-friendly and concise publications*. Pricing teams should spend their time developing ideas and analyzing information to ensure pricing is appropriate. The pricing methodology document should not be an incredibly resource intensive piece of work that significantly distracts them from this task. We also hope that Powerco's consumers could read our pricing methodology and get a good understanding of our approach and the constraints and trade-offs we make. Keeping the requirements simple will help achieve both these aims.

Concerns with the DME Framework

18. Powerco is concerned that reporting against the DME Framework and the pricing principles will create a complex and confusing pricing methodology

document. This is mainly because we will have to describe how we meet the same basic approach twice, using the different terms for the same ideas. This is inefficient.

19. The DME Framework also requires us to explain why we do not consider pricing approaches that make little sense for a distribution network. For example, the transmission system is characterised by large lumpy investments with a smaller number of customers. Investing resource in identifying who is an exacerbator or beneficiary may have value when some customers pay millions of dollars a year in charges. However, distribution pricing has many more consumers paying much smaller annual charges. There are also thousands of investment and maintenance activities annually. Completing the level of analysis required to identify an exacerbator or beneficiary is likely to be highly inefficient and more complicated. We question whether disclosing this information in addition to the principles is an efficient use of time.

The pricing principles have a number of advantages over the DME Framework

20. Powerco considers that the principles, rather than the DME Framework, should remain the main reporting requirement for a number of reasons. Firstly, the pricing principles were based on principles used by regulators across a number of jurisdictions. The Commerce Commission formed its Gas Authorisation pricing principles from the recommendations of a report by Meyrick and Associates (Meyrick) in November 2007. This reviewed the approach to distribution pricing methodologies in the United Kingdom and several Australian states. Meyrick recommended that IPART's 2004/5-2008/9 pricing principles were a worthwhile model for consideration, with some degree of refinement to adequately reflect New Zealand circumstances and issues.³
21. Powerco is not aware of any other countries that use the "competition, exacerbator and beneficiary" framework to regulate electricity distribution pricing methodologies. Meyrick's report demonstrates that the principles approach is the most common method to regulate pricing methodologies in regimes with similar economic regulation to New Zealand. No other regime has required a framework in addition to the principles.
22. The NZ *Treasury's Guidelines for Setting Charges in the Public Sector* (Treasury Guidelines) were also developed for a different purpose to the regulation distribution pricing methodologies. The main objective of the Treasury Guidelines was "*to set charges that are appropriate and fair*"⁴. The concept of fairness is not part of the Authority's statutory objective. The Treasury Guidelines also caution that,

*"[...] neither the 'beneficiary pays' nor 'risk exacerbator pays' are necessarily efficient as charging rules. They are simply used here to identify charging options"*⁵

and,

³ IPART is the New South Wales regulator who regulated electricity distribution businesses until 2009.

⁴ New Zealand Treasury, *Treasury's Guidelines for Setting Charges in the Public Sector* (2002).

⁵ Ibid. 3., paragraph 9.12.

These guidelines do not set out to be definitive; rather, they provide a checklist of issues on which to base a sound analysis. In most cases the analysis will not generate a single answer, but will help identify a range of charging options for recovering the costs of providing the service. Which option is chosen will depend on the weight given to the different efficiency, equity and fiscal objectives of user charges.⁶

23. This suggests that the complexity of options makes it difficult to apply a hierarchy in practice. Adding the hierarchy to the overall approach also loosens the link between the pricing principles and the statutory objective. The focus should always be on if the statutory objective is being achieved, and this should be the standard that trade-offs between the principles are assessed against. Given these reasons, and the benefit of having just one approach, Powerco supports just using the principles.

The distribution approach does not have to be identical to the transmission approach

24. There are a number of valid reasons for having a different regulatory approach for distribution and transmission pricing. The main reason is that the issues being addressed in each sector are different. For example, in transmission the problem is who should pay the charge (ie generators or consumers). In distribution, it is widely accepted that consumers, rather than generators, should pay for distribution assets.
25. In distribution, the main concern raised by retailers is the transaction costs of dealing with many different pricing methodologies. This is driven by New Zealand having a large number of distributors. This is a different issue to transmission, and one that the DME makes little progress towards resolving. In fact, the DME framework seems to advocate a complicated pricing structure for distributors that could lead to more complex tariff structures. For example, applying the DME framework may require greater disaggregation of prices based on a variety of situations. This would increase the complexity of tariff structures and make it even harder to standardise approaches across distributors.
26. A key test of the DME framework will be if retailers see it as a valuable addition to the pricing principles. If retailers do not support disclosing against the DME framework in addition to the principles, it is questionable whether the DME framework assists in meeting the Authority's statutory objective.
27. There are also numerous examples of where transmission and distribution have different approaches to regulation. For example, different methodologies under the Commerce Commission's Part 4 regime. Transpower has an individual price path and its quality path and capital expenditure proposals are addressed differently. Distributors have a more general approach, using the default price path framework. Most regulators have sought to align where appropriate but recognize where a different approach is valid.

⁶ Ibid. 3., page 2.

Powerco's first preference is that the statutory objective is used as the criteria to assess compliance with the pricing principles

28. If the Authority wants the statutory objective to have a stronger link to the pricing principles, Powerco recommends the statutory objective is added as a preamble to the principles. The statutory objective is then clearly the benchmark when justifying trade-offs between the principles. The DME Framework is no longer needed. This approach would ensure ongoing alignment between the objective and the principles.
29. Powerco recommends the following is added before the pricing principles:

These Pricing Principles are to be interpreted and applied in a manner that is consistent with the Statutory Objective of the Electricity Authority "To promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers."

Powerco's second preference is that the principles are ranked to provide a hierarchy, rather than using the DME Framework

30. If the Authority is not comfortable with using a preamble, Powerco's second preference is to rank the pricing principles using the DME Framework. Again, the DME Framework is no longer needed. As already discussed, a significant concern is that EDBs will have to write a pricing methodology using two sets of terminology to describe the same concepts. Ranking the principles provides a hierarchy, but reduces the potential complexity.

If the Authority continues with the DME framework, Powerco recommends the review of pricing methodologies is delayed, or includes a "shadow" review

31. If the Authority continues with the DME Framework, we have three concerns:
- It is unfair to evaluate distributors' 2012/13 pricing methodologies against the DME Framework when the Framework was not published at the time methodologies were developed.
 - Powerco's 2012/13 pricing methodology has been approved by the Powerco Board and relates to a set of prices already in place. Re-publishing it six months later with more information creates a number of issues.
 - That there is a lack of guidance and significant uncertainty on what the Authority will expect in detailing compliance with the DME Framework.
32. If the Authority proceeds with the DME Framework, Powerco recommends that the Authority delays the review to be against 2013/14 pricing methodologies. This allows EDBs to fully consider the implications of the Framework after its finalised. We also recommend the review is published by the end of June 2013 to allow enough time to address issues in 2014/15 prices.
33. Powerco's second preference is for the Authority to:
- a. review the 2012/13 pricing methodologies against the pricing principles and information disclosure guidelines, as was always envisaged; and

- b. complete a “shadow” review using the DME Framework to provide feedback to EDBs and more clarity on the level of information expected.
34. Powerco recommends that the shadow review for each EDB is not published, but sent to the EDB. This would allow EDBs to share the results with other distributors if they wish to. The Authority could publish a summary report on its website on the overall level of compliance with the DME Framework.

Expectations on the rate of pricing change

35. The Consultation Paper did not seem to appreciate how early EDBs have to consider changes to pricing methodologies. This section provides information on the annual process to change distributors’ prices. It demonstrates why the Authority’s review of 2012/13 pricing methodologies will not be able to feed into 2013/14 pricing methodologies.
36. The diagram shows that Powerco begins consultation with retailers around 8-9 months before price changes on 1 April. Ideas and analysis for price changes are considered before these meetings. Draft prices are published around December and final prices are confirmed in January. Final price changes for 1 April 2013 will therefore have to be sent to retailers before the Authority publishes its review.

