

Distribution pricing principles and methodological requirements

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Introduction to this session ...

- Presentation on proposed pricing principles followed by discussion (Peter Smith)
- Presentation on methodological requirements followed by discussion (Robert Reilly)
- Presentation on proposed implementation and reporting process followed by discussion (Robert Reilly)
- Presentation on other issues (Karen Bradley)

Why pricing principles? (1)

- Consider pricing principles may achieve the same result more efficiently as noted in this morning's session
- Commission has been working closely with the Commerce Commission since February 2009
- Desire by retailers, distributors and consumers to have the Commission and Commerce Commission aligned as much as possible:
 - similar approach (i.e. use of principles)
 - same timing and templates for reporting of compliance.

Why pricing principles? (2)

- The Commission has a broader mandate than the Commerce Commission and has amended the Commerce Commission's approach accordingly
- Commission also notes some support for a more prescriptive approach (various degrees of “prescriptiveness” suggested)

Proposed pricing principles (1)

Prices are to signal the economic costs of service provision, by:

- being subsidy free (equal to or greater than incremental costs, and less than or equal to standalone costs), except where subsidies arise from legislation
- having regard, to the extent practicable, to the level of available service capacity
- signalling, to the extent practicable, the impact of additional usage on future investment costs

Proposed pricing principles (2)

Where prices based on 'efficient' incremental costs would under recover allowed revenues, the shortfall should be made up by setting prices in a manner that has regard to consumers' demand responsiveness (i.e. Ramsey pricing) and/or the quality of service that they receive, to the extent practicable.

Provided that prices satisfy (a) above, prices should be responsive to the requirements and circumstances of users in order to:

- discourage uneconomic bypass
- to allow for price/quality tradeoffs

Proposed pricing principles (3)

Development of prices should be transparent, promote price stability and certainty for consumers, and lead to prices that are able to be understood by users.

Pricing structures should not place undue transaction costs on retailers and consumers, and should be competitively neutral across retailers.

Prices and pricing structures should promote efficient usage of electricity and encourage investment in distributed generation (including renewable generation), distribution alternatives and technology innovation.

Any conflict dealt with by recourse to the Commission's principal objectives

Proposed methodological requirements (1)

- (a) Prices should be based on a well-defined, clearly explained and published methodology, with any revisions notified and clearly marked.
- (b) Price development should incorporate, to the extent practicable, an analysis of the cost of service provision that includes:
 - (i) definition of the **classes of service** provided and the parameters by which the **quality of service** in each class are measured;
 - (ii) an examination of the **cost elements** that arise from the use, operation and expansion of the network;
 - (iii) identification of the relationship between the quality of service provided and the level of current and future cost for each class of service;

Proposed methodological requirements (2)

(iv) an allocation of existing and future network costs to service classes, and an explanation of the cost allocation methodology used;

(v) the translation of allocated costs into service prices at the defined level of quality of service – including the re-allocation of transmission charges while preserving the transmission pricing signal;

(vi) analysis of the extent to which costs are marginal, and whether the associated price components in the tariff structure reflect those marginal costs;

Proposed methodological requirements (3)

(vii) analysis of the development of time of use prices and critical peak pricing **where these can practically be applied**;

(viii) estimates of the range of subsidy-free prices for each service class and the extent to which subsidies, if any, are caused by legislation; and

(ix) development of pricing arrangements that will be used to reflect the cost / value of deferral of investment in distribution assets, where this is practicable.

(c) Information relating to standard services on customer class price levels and structures, quality of service standards, underlying costs, price derivation methods and rationale, and **medium term price and quality of service strategies** should be publicly disclosed.

Proposed methodological requirements (4)

(d) Underlying service classifications, cost data, cost allocations and other elements that contribute to pricing decisions should be periodically reviewed and updated where relevant to reflect industry developments and changes in user requirements and preferences, methods of service provision and costs.

(e) Pricing structures should:

(i) consist only of the minimum number of tariffs necessary to meet the provisions of the pricing principles; and

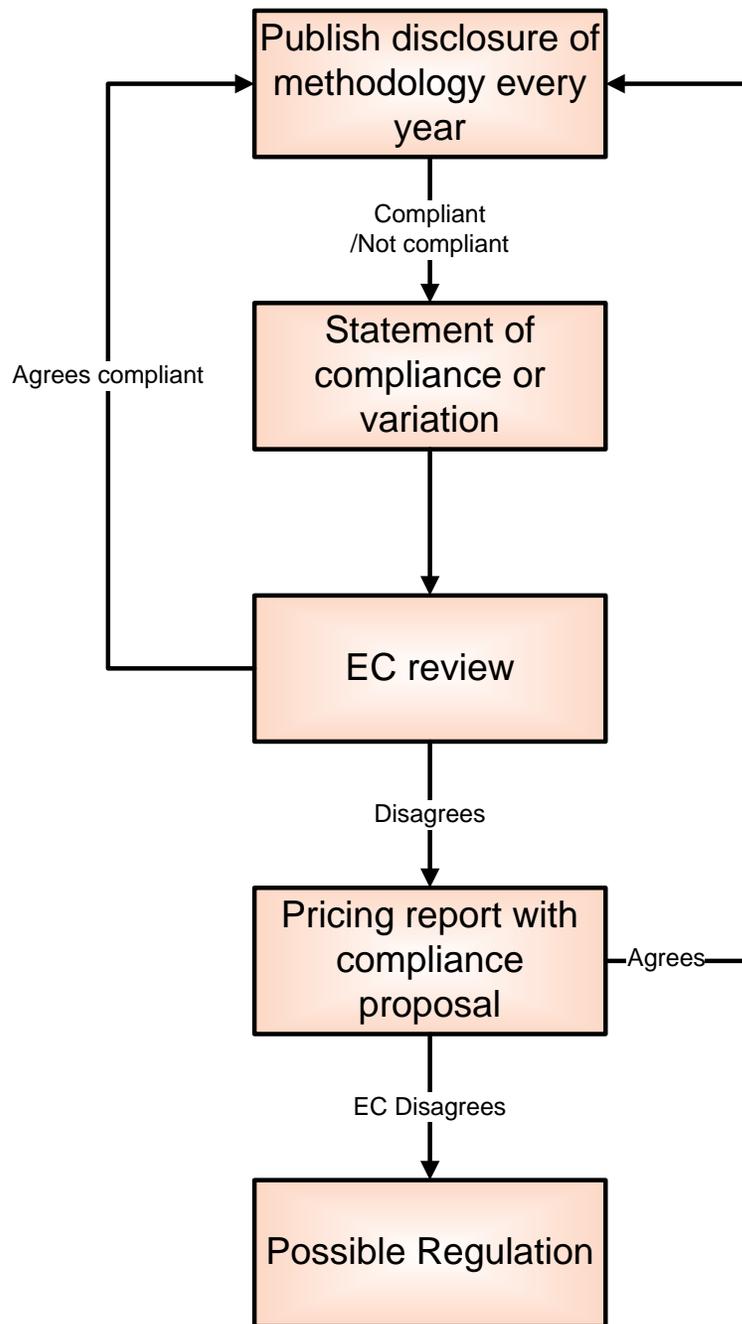
(ii) employ industry standard tariff formats and nomenclature, where possible.

Proposed methodological requirements (5)

(f) Where a change to the existing pricing methodology is proposed to improve compliance with the pricing principles, details of the impact on customer classes and the transition arrangements proposed to mitigate the effect of redistribution of costs and “rate shock” should be publicly disclosed.

Reporting

- Statement of Variations/Compliance annually at time of Commerce Commission disclosure report using the same data and formats as far as possible.
- Commission evaluation.
- Full pricing report if Commission disagrees with a proposed compliance arrangement.
- Mandatory methodology for persistent non-compliance.



Proposed pricing report (1)

The Pricing Report provides an opportunity for the business to explain and support their proposed methodology and the prices derived from applying this methodology. It may be required if the business fails to meet the Commission's criteria for compliance with its current methodology.

Section 1 Overview

Description of business' tariff setting policy framework, including the outcomes sought by the business from its tariff policy.

Summary of overall tariff strategy for the next five years (the period).

Section 2 Pricing Methodology

Description of pricing methodology.

Description of the development of the pricing methodology.

Proposed pricing report (2)

Section 3 Impact of Applying the Proposed Pricing Methodology

Schedule setting out a reconciliation of how the proposed next pricing year's tariff schedule has been derived from the overall revenue requirement through the application of the methodology.

Section 4 Medium Term Tariff Strategy

Expected tariff reform and/or restructuring for the remainder of the period.

Expected tariff movements for each service class in each remaining year of the period.

Proposed pricing report (3)

Section 5 Public Disclosure

Proposals for public disclosure of pricing information

Attachments to be provided

Director's certificate of compliance of the pricing methodology

Cost of supply model.

Auditor's certificate for cost of supply model.

Example: *Pricing Methodology for Gas Distribution and Metering Services*,
Powerco, 1 May 2009

Next steps (1)

- Consultation on proposed pricing principles, methodological requirements and reporting. **On-going.**
- Establish working group on standardisation. **Group report by the end of November 09.**
- Commission discuss regulatory issues relating to principles with the Ministry of Economic Development. **On-going.**

Next steps (2)

- Commission publish final draft pricing principles, methodological requirements and reporting regime for consultation.
End of December 09.
- Commission publishes a relatively detailed model distribution pricing methodology, which is intended to provide distributors with an example of a methodology that, in the Commission's view, satisfies the pricing principles and methodological requirements.
End of December 09.
- Monitor compliance.