

8 August 2017

«First_name» «Last_name»
«Position»
«Organisation»
Email: «Email»

Dear «First_name»

Thank you for your response to our request to develop and publish a plan setting out the process and timeframes under which distributors will reform their distribution price structures (a 'roadmap').

I would also like to offer the Electricity Authority's (Authority) views on distributors' progress, discuss some issues that have already arisen that need further consideration and to outline what we see as the next steps for distribution pricing.

The status quo is not sustainable: distribution price structures need to change

An exciting range of technologies and the advent of new business models in the electricity sector are starting to transform the way consumers use electricity. These new technologies and business models often give consumers more choice and control.

Distribution prices affect the way consumers invest in, and use these evolving technologies. If prices are designed appropriately, consumers' decisions will help all New Zealanders to benefit from the advances in technology. However, most distributor's prices for residential and small commercial consumers are still poorly designed for this purpose.

Since the publication of our *Implications of evolving technologies for pricing of distribution services* consultation paper in late 2015,¹ we have advocated for distributors to adopt service-based and cost-reflective price structures. A service-based price is one where the cost of the distribution services is charged to, and only to, the parties that receive the benefit of those services. The services can be described as:

- access to the network (you are electrically connected)
- use of the network, whether to import (buy) or export (sell), eg, losses, congestion, reactive power

A cost-reflective price means a price that reflects the cost of delivering the service.

We are broadly pleased with progress so far

Distributors' progress towards more service-based and cost-reflective distribution pricing since we published our consultation paper in 2015 is encouraging. All distributors responded to our request to develop roadmaps, although not all distributors provided a roadmap as part of their response.

¹ Electricity Authority, *Implications of evolving technologies for pricing of distribution services – Consultation Paper*, 3 November 2015.

The roadmaps developed are a good first step towards industry-wide adoption of more efficient distribution price structures. The roadmaps provide us and other industry stakeholders, especially retailers and consumers, with greater visibility about when and how distribution price structures will change.

The few distributors that did not develop a roadmap generally cited factors that prevent them from reforming their price structures at this stage. I note that many of these same factors have not presented a barrier to other distributors reforming their price structures. The Authority will contact those distributors that did not develop a roadmap to understand why their specific circumstances represent a barrier to them developing a roadmap.

Despite the progress that has been made, there is still a lot to be done. Roadmaps set out the path that distributors plan on taking. These plans now need to be executed.

There are a number of matters that need to be resolved to ensure that distributors adopt service-based and cost-reflective distribution prices in a timely fashion. Some of these have already been identified and discussed by distributors and retailers, including the implementation issues proposed to be considered by a joint distributor/retailer working group (discussed below). Many of these matters affect other industry participants. This means that distributors cannot undertake these reforms in isolation. Distributors need to work with the rest of the electricity industry to ensure that the changes they are making can be integrated with the rest of the industry.

We will be monitoring distributors' progress against their roadmaps and look forward to receiving six monthly progress updates from each distributor.

We are encouraged by the industry co-operation that is occurring

We recently participated in the joint Electricity Networks Association (ENA) and Electricity Retailers' Association of New Zealand (ERANZ) 4 July workshop. The workshop discussed distribution pricing and how distributors and retailers can work together to introduce more efficient distribution price structures. We were encouraged by the discussion around partnerships between retailers and distributors as a way to advance towards more service-based and cost-reflective price structures.

We are similarly encouraged that attendees at the workshop unanimously endorsed the establishment of a joint distributor and retailer working group (subject to approval from the ENA Board). This working group will be a great way to reassure stakeholders that you are moving forward as an industry.

We strongly encourage the working group be established and up and running as quickly as possible. As mentioned at the conference, the Authority is prepared to support and facilitate the working group and the broader industry-led approach.

Issues we think that industry should consider

In our review of the roadmaps and our discussions with distributors a number of issues have already come to light that we would like to address.

Timeline for change

A number of distributors have queried the speed at which we expect distributors to adopt more efficient distribution price structures.

It is not practical, or reasonable, for the Authority to specify a date by which we would expect distributors to have adopted service-based and cost-reflective price structures. Each distributor

faces a unique set of circumstances (resourcing, smart meter penetration, topography, ownership structures, etc), and the speed at which each distributor can move will differ.

Although there is a diversity of circumstances across distributors, an individual distributor is unlikely to face circumstances that are entirely unique to its network. This provides distributors with the opportunity to learn from each other. The diversity of responses each distributor develops in reaction to a problem enables a competition of ideas that allows distributors to learn from each other to develop optimal responses. The varying responses of each distributor to a common issue will allow the Authority to form an opinion about the level of urgency that each distributor is placing on price reform.

We expect distributors to reform price structures as quickly as practicable. Distributors also have to be mindful of the speed at which evolving technologies are changing. These changes create uncertainty across the industry. Distributors' adopting more efficient distribution price structures quickly is an efficient way to manage the challenges as well as enabling opportunities that come with rapid technology change and innovation in the electricity sector.

It is in distributors' best interests to adopt service-based and cost-reflective price structures

As we outlined in some detail in our 2015 consultation paper *Implications of evolving technologies for pricing of distribution services* (see section 7.3), "distributors appear to face a number of incentives to adopt more efficient (service-based) distribution prices". These incentives centre on avoiding inefficient asset stranding and ensuring distributors undertake efficient network investments in the future.

As the cost of evolving technologies falls, such as for solar panels, consumers will adopt these technologies in greater numbers and an ever-decreasing share of the energy they consume will be delivered across distributors' networks.

Distributors have choices about how they respond to decreasing volumes.

Distributors that adopt service-based and cost-reflective price structures will significantly reduce the current inefficient artificial stimulus to invest in some technologies that substitute for distribution services. A desire to avoid the cost of network augmentation provides another incentive to distributors to adopt more efficient pricing. Network augmentation is expensive and the costs of such activity are ultimately borne by consumers. It may be less costly to address congestion by encouraging consumers to reduce their discretionary consumption of distribution services at times of congestion by charging prices that more closely reflect the cost of providing services at that time. Doing so may allow distributors to lower the overall cost of providing distribution services by not having to recover the costs of expensive and long-lived assets from consumers.

Distributors and retailers need to cooperate more on communications with consumers

As stated earlier, we are pleased to see that distributors and retailers are talking to each other about distribution pricing and identifying issues that need to be addressed. One of these issues is who communicates with consumers and what they say to consumers.

We consider that the party that has the contract with individual consumers should be broadly responsible for communicating how changes in distribution pricing will affect them. In most cases this will be retailers, but there are also cases when distributors hold those contracts. However, in regard to broader communities, distributors should explain why they need to change their price structures generally and why their new price structures are the most appropriate response.

In most cases, retailers have the primary relationship with residential and small business consumers and are responsible for packaging each of the inputs needed for an electricity service in a manner that those consumers demand.

These consumers will only see changes to distribution price structures if retailers offer products that pass them through and consumers choose to sign up to these products. It is retailers who decide when and how those consumers will see any changes (if any) and explain to their customers how their price structures work.

Distributors cannot necessarily predict how or when changes to distribution price structures might affect consumers on their network.² Communications that discuss how changes in distribution price structures could affect retailer's customers may be unnecessarily confusing and misleading. Distributors need to be mindful of avoiding such outcomes when communicating with consumers.

Accordingly, the Authority endorses the *ENA/ERANZ joint guidance note for retailers and distributors on communication with consumers about new options for distribution pricing*.

The guidance note states that:

1. Distributors and retailers should keep each other informed when consulting with consumers about distribution pricing.
2. When communicating with consumers, distributors should distinguish between distribution prices and retail prices.
3. Distributors need to make it clear to consumers that the extent to which they will be affected by changes in distribution prices depends on their retailer.

We consider that by adhering to these principles and our guidelines on how retailers and distributors should communicate consumer electricity charges³, distributors and retailers are likely to ensure that communication with consumers about changes to distribution price structures is undertaken in a positive and productive manner.

There are still a range of issues that need further discussion

Distribution pricing raises a range of issues that are still to be discussed in detail. In particular, we consider that detailed discussion needs to be had on the following issues:

- *The trade-offs between efficient pricing and practical pricing.* Theoretically efficient pricing may be difficult to implement, whereas it may be more practical to introduce more simple and easily understood price structures. There has been little discussion about the trade-off between these two outcomes.
- *The role of pricing.* Distribution pricing is more than just about cost recovery. Distribution prices, as is the case for other services or products, affect demand. To date, there has been little discussion about how various options for price reform affect demand on a network by signalling the cost of using the network at a point in time.

Next steps

We are currently reviewing the voluntary distribution pricing principles and the associated information disclosure guidelines. We expect to consult on the distribution pricing principles and information disclosure guidelines later in the year.

² The exception being distributors that bill consumers directly.

³ Electricity Authority, *Guidelines – improving transparency of consumers' electricity charges*, 14 April 2015.

In addition to this, we will monitor the progress of:

- distributor and retailer collaboration on technical and implementation matters
- individual distributors adopting more efficient pricing, including 6 monthly progress updates.

Kind regards,

Carl Hansen
Chief Executive