



30 October 2009

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Dear Kate

Draft Distribution Pricing Principles and Methodological Requirements

Introduction and opening comments

1. Mighty River Power welcomes the opportunity to comment on the Electricity Commission's discussion paper "Draft Distribution Pricing Principles and Methodological Requirements", 30 September 2009. No part of our submission is confidential and we are happy for it to be publicly released.
2. Given the overlaps between the Electricity Commission's electricity distribution pricing methodology (EDPM) work and the Commerce Commission's input methodology development, we believe the submission we have made to the Commerce Commission on input methodologies should also be helpful for the Electricity Commission. Accordingly, we have attached our submission to the Commerce Commission "Input methodologies and default price-quality paths for EDBs", 29 July 2009.¹
3. We are pleased to see from the Electricity Commission's discussion paper that the Commerce and Electricity Commissions are liaising to ensure a coordinated approach to dealing with overlaps in responsibilities for electricity distribution business (EDB) pricing. We reiterate our view that the legislative overlap in responsibilities between the two Commissions is an unsatisfactory situation for both the Commissions and industry stakeholders. We hope it will be addressed, one way or the other, through the legislative changes that may arise out of the Ministerial Review on Improving Electricity Performance.

Approach to regulation of EDPMs

4. Mighty River Power is on record that "the most critical barrier to competition in the electricity retail market is the existence of an excessive number of EDBs each with their

¹ Refer to the sections "Overlaps between the Electricity and Commerce Commissions" and "Role of a regulated pricing input methodology".

own set of terms and conditions for access and pricing” and that we therefore are supportive of proposals to development a regulated EDPM.²

5. It is generally recognised that the smaller a market is the less competition there will be. To the extent different EDB network areas operate as separate retail markets it will generally be the case that the smaller the EDB the weaker competition will be. This has been well documented in the Electricity Commission’s Market Design Review and in the Ministerial Review on Improving Electricity Market Performance. The problems electricity retailers face with entering small EDB network areas can be compounded by the diversity of electricity distribution tariff arrangements, particularly in small networks with an inordinate number of tariff categories. This can be contrasted with, as an example, the telecommunications industry where there is one fixed line incumbent, Telecom, with a single nationwide interconnection price. This makes it relatively straightforward to enter into the telecommunications market on a nationwide basis. In our Ministerial Review submission we made the point that “Clear Communications’ entry into the telecommunications market in 1989 would have been further delayed, much moiré difficult and more limited if it had to gain network access [from] 29 regional Telecoms, rather than one national Telecom. For starters it would likely have had to focus on gaining entry into the main centres rather than offering a nation-wide service.”³
6. Network access arrangements, including pricing, can impact on the level of competition in any market where network access is needed in order to compete. Examples of such markets include airports, electricity, gas, ports and telecommunications. It is precisely because of this that the Government introduced access regimes under the Telecommunications Act and the Dairy Industry Restructuring Act, including regulation of price.
7. It is because of the impact of network pricing on competition that the Commerce Commission is presently undertaking an investigation into whether it should recommend regulation of mobile termination rates under the Telecommunications Act. As is clear from the Commerce Commission’s investigations into mobile termination rates, the benefits of regulating price can come from greater competition, which we have focussed on in our submissions to the Commerce and Electricity Commissions relating to electricity distribution pricing. There can also be allocative efficiency gains from more cost reflective pricing. For example, regulation of mobile termination rates would be likely to result in greater phone calls to mobile phones, particularly from fixed-line phones and mobile-to-mobile calls across different networks e.g. 2 Degrees to Vodafone.
8. Unfortunately, in contrast to telecommunications, the legislative arrangements the Government has put in place for network access and pricing in relation to electricity is patchy. The Commerce Commission has responsibility for price control (including input methodologies for pricing), while there isn’t a coherent regulatory framework for network

² Page 26 of Mighty River Power’s submission to the “Ministerial Review on Improving Electricity Market Performance”, 16 September 2009.

³ Page 43, Appendix 2 of Mighty River Power’s submission to the “Ministerial Review on Improving Electricity Market Performance”, 16 September 2009.

access. Instead, the Electricity Commission has responsibility for developing network access arrangements (including pricing methodologies), with regulation making power underpinning these responsibilities in the Electricity Act.

9. A key issue that has been the focus of much of the discussion and debate around how the Electricity Commission should deal with electricity distribution pricing has been around a principles or model approach.
10. As should be clear from Mighty River Power's previous submission⁴ Mighty River Power is generally supportive of a principles-based approach. A substantial focus of the PWAG work was on how to allocate different costs i.e. consumer specific costs, load independent costs, and load dependent costs (of various forms). Mighty River Power recognises there are a number of legitimate ways to allocate costs that aren't specific to any particular consumer etc, e.g. common costs, and prefers to leave discretion to EDBs on such matters. We also recognise that cost allocation amongst consumer groups etc will generally not impact on retail competition. We are therefore fully supportive of principle-based bounds on cost allocation such as that prices should be within the bounds of incremental and stand-alone cost.
11. Mighty River Power is generally comfortable with the proposed pricing principles and methodological requirements. We are supportive of providing EDBs with discretion over such matters as cost allocation (within bounds such as incremental and stand-alone costs). Where we believe greater prescription than the Electricity Commission is proposing is on "low level elements". Matters such as customer definition, number of tariff categories and complexity of tariff structures can have a substantial impact on transaction costs and retail competition, particularly in small EDB network areas.
12. As a general rule, we believe the smaller the EDB the less flexibility they should have over their pricing. We believe the smaller the EDB the less tariff categories they should have and the simpler their tariff structures should have to be. Establishing a unique retail tariff to correspond with an EDB residential line tariff which has six customers on it, for example, would simply make no sense.
13. We were disappointed by PowerNet's dismissive and flippant response to the issue of excessive number of tariff categories that "computers address this issue".⁵ Any electricity retailer (with a computer) that reflected each of PowerNet's tariffs into unique electricity retail tariffs would have a large number of retail tariffs with an extremely small number of customers on each. The electricity retailer would also have to deal with the complexity residential consumers would face choosing between PowerNet's 16 different residential customer tariffs. Telling the customer that "computers address this issue" would not be tenable.

⁴ And various submissions to the Commerce Commission in relation to its price investigations into Vector (electricity and gas), Powerco (gas) and Unison (electricity).

⁵ Paragraph 1.8 of PowerNet's "Submission in response to the Consultation Paper on the Model Approach to Distribution Pricing Methodology prepared by the Electricity Commission", 9 July 2009.

14. What this means is that Mighty River Power is generally supportive of principles such as the proposal that electricity distribution prices be subsidy free, but feel principles such as “Pricing structures should not place undue transaction costs on retailers and consumers, and should be competitively neutral across retailers” and “Pricing structures should ... consist only of the minimum number of tariffs necessary ...” warrant further prescription and detail in order to be effective.
15. The Electricity Commission has stated that its proposed voluntary approach provides “an opportunity to show a light handed approach will result in improvements. Improvements to the way distributors set their prices therefore need to be demonstrated in a transparent manner so that the Commission and interested parties can confirm that distributors have set or are in the process of setting their prices in accordance with the pricing principles.”⁶
16. The Electricity Commission is certainly correct that it is up to EDBs to demonstrate a voluntary approach would work. A positive step would be for the 21 small EDBs that have banded together to provide joint submissions under the umbrella of PricewaterhouseCoopers to pool their resources more constructively to develop a generic pricing methodology they would all be happy to adopt.
17. Unfortunately, the comments made by EDBs and experience too date means Mighty River Power has a very low expectation of a voluntary approach being successful.
18. We referred to the comments from PowerNet above. Equally disturbing was the claim from Wellington Electricity that, for some reason, “the EDB must have the sovereign power over its pricing methodology”.⁷ While a sovereign right or power is something that can only be held by Government the statement sends a clear message about Wellington Electricity’s attitude to regulation and the concerns expressed by the two Commissions and parties such as Mighty River Power.
19. Consistent with the view that EDBs will not voluntarily adopt a model approach, Genesis Energy point out:⁸

The Electricity Commission’s work on model use of system agreements is instructive when considering the efficacy of the “model” approach to regulation of natural monopolies. In Genesis Energy’s experience, model use of systems agreements have not markedly improved the contracting environment for retailers.

20. Similarly, MEUG argue:⁹

Experience has shown that a voluntary approach to distributors following and reporting compliance with model pricing and contracts has been abysmal. For example, ... the consultation paper reports that only 4 out of 28 distributors responded to a Commission

⁶ Paragraph 5.1.2 of the discussion paper.

⁷ Page 5 of the Wellington Electricity’s “Submission to the Electricity Commission on its Consultation paper on a model approach to Distribution Pricing Methodology”, 10 July 2009.

⁸ Page 2 of Genesis Energy’s submission to the Electricity Commission “Model Distribution Pricing Methodology”, 10 July 2009.

⁹ Page 4 of the Appendix to MEUG’s “Submission on Proposed Model Approach to Distribution Pricing Methodology”, 10 July 2009.

request for information on changes in pricing methodology since 2005 and progress in implementing the ... PAWG ... recommendations.

We see no change in the external environment that will result in a change the behaviour of distributors to volunteer information and self-report more than at present.

21. It should be stressed that the Electricity Commission could introduce a principles-based approach or model approach or a composite of the two as either voluntary or mandatory or, even, a mix of voluntary and mandatory. In order for the Electricity Commission to form a final view about whether a voluntary or mandatory approach to EDPMs should be introduced, the Electricity Commission should consider the following regulatory decision-making framework:
 - a. Is competition in the relevant market is limited (met as EDBs are natural monopolies); and
 - b. Would regulation promote competition (met as consolidation of EDPMs would reduce barriers to retail competition); and
 - c. Would regulation would be to the long-term benefit of acquirers or end-users.
22. Mighty River Power believes the Electricity Commission would have to have a high degree of confidence of voluntary uptake of its electricity distribution pricing principles for it to countenance a voluntary approach. Even then, given the high degree of discretion a principles-based approach would provide EDBs, what would the downside of a mandatory approach be?
23. If the Electricity Commission ends up deciding to retain its position that the approach to electricity distribution pricing should be voluntary, then Mighty River Power reiterates our view that the Electricity Commission should be explicitly clear about the arrangements it will adopt for reviewing future EDB tariff practices, including for determining what practices would be acceptable or not, so EDBs have a clear understanding of what they need to do in order to ensure the approach remains voluntary.¹⁰
24. We think that it would be helpful for the Electricity Commission to undertake a review of current tariff setting practices to identify what is industry best practice and what stands out as being of particular concern. This would be particularly helpful in order to operationalise principles such as that "Pricing structures should not place undue transaction costs on retailers ..." and that "Pricing structures should ... consistent only of the minimum number of tariffs necessary to meet the provisions of the pricing principles."
25. This would be invaluable in providing EDBs guidance on the reviews they will need to undertake of their pricing methodologies and how to best comply with the Commission's pricing principles and methodological requirements.

Concluding remarks

26. In short there are too many EDBs in New Zealand. This is compounded by many EDBs have excessive tariff categories and unnecessarily complicated tariffs. We note that a

¹⁰ Our previous submission to the Electricity Commission on EDB pricing detailed our views on an appropriate review framework.

large number of the small EDBs are pooling their resources for combined submissions on electricity distribution pricing and other matters. We believe a lot of constructive progress could be made simply by pooling resources with a mind to develop a pricing model that could be used to satisfy the Electricity Commission's proposed electricity distribution pricing proposals. Voluntary and constructive action now by EDBs could substantially reduce the justification for greater Electricity Commission intervention in the future.

27. We do not believe the Electricity Commission's proposals are unreasonable for EDBs to comply with.

28. The upshot is that EDBs are natural monopolies and the Electricity Commission's proposals are at the lower end of the regulatory scale. The Commission's proposals leave EDBs with considerable discretion over how to set their prices; particularly for small trust-owned EDBs exempt from the price thresholds regime under Part 4 of the Commerce Act. The onus needs to be on EDBs to demonstrate their pricing practices are reasonable and justified. If EDBs cannot demonstrate that their pricing practices best serve the long-term interests of consumers (in terms of efficiency and encouraging retail competition (and consequent lower retail prices) in their network areas). If EDBs cannot do this then greater regulatory intervention must surely be justified.

29. If you have any queries regarding this submission please do not hesitate to contact me on 09 308 8259 or robert.allen@mightyriver.co.nz.

Yours sincerely

Robert Allen
Regulatory Manager



29 July 2009

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Dear Ms Murray

Input methodologies and default price-quality paths for EDBs

Introduction

1. Mighty River Power welcomes the opportunity to submit to the Commerce Commission on the "Input Methodology Discussion Paper" and the "Default price-quality paths for EDBs Discussion Paper", each dated 19 June 2009. Mighty River Power has not commented on the "WACC Discussion Paper" and "Transpower Process and Recommendation Discussion Paper", also released on 19 June 2009, due to the volume of consultation material and the limited time for comment. This submission should be read in conjunction with our earlier submission on "Regulatory Provisions of the Commerce Act", 16 February 2009.
2. No part of our submission is confidential. We are happy for our submission to be made publicly available.
3. In making this submission, we acknowledge the Commerce Commission faces considerable challenges in moving to the new economic control regime under Part 4 of the Commerce Act 1986; particularly, given the relatively tight time frame the Commission has for doing this.

Maximising the value of input methodology setting

4. A particular challenge the Commerce Commission faces is to ensure all the input methodologies it develops are robust, given they will be "locked-in" for several years. One saving grace is that the work the Commerce Commission has undertaken under various jurisdictions to date (under, the Commerce Act, the Dairy Industry Restructuring Act 2001 and the Telecommunications Act 2001) provides considerable precedent it can draw on.
5. Mighty River Power recognises there is value in having key input decisions set as a stand-alone process in advance of any inquiry and recommendation to regulate. This should help provide greater certainty around the outcome of any investigation, and on how the Commerce Commission will regulate. This will be particularly important for Electricity

Distribution Businesses (EDBs) and Gas Pipeline Businesses (GPBs) considering whether or not to seek a customised price-path, given a possible outcome of such an application is that the Commerce Commission could set a harsher customised path than the default path.

6. In the past, issues such as the setting of WACC have been considered on an industry or investigation specific basis, even though decisions on such matters in one jurisdiction/sector will have precedent value for subsequent decisions in other jurisdictions/sectors.

7. This is why there have been several Commerce Commission investigations, in a particular industry, where the Commerce Commission has received submissions on generic issues from interested parties in other industries, though this has tended to be sporadic. For example, TelstraClear made a submission on the Unison price control inquiry because they considered that:¹

... there is substantial commonality of issues in relation to whether to price control Unison and the designation of various services under the Telecommunications Act. For the sake of regulatory certainty and stability, it is important that the Commerce Commission is as consistent as possible (taking into account industry specific factors and differences in the regulatory regimes). We note that various other network utilities have taken a similar interest with telecommunications proceedings, for example, Vector, NGC and Contact Energy all commenting on the Commission's mobile termination.

8. Mighty River Power has made observations about the approach the Commerce Commission has taken in different proceeding under the Commerce and Telecommunications Acts. For example, in a submission on the Unison Price Control inquiry we expressed the view:²

... the CC's approach to the calculation of WACC and treatment of indirect costs in the present Unison inquiry differs from that taken in the airport and gas pipeline price control inquiries. This reflects that the CC has adjusted its approach on the basis of submissions made in investigations (mobile termination) and determinations under the Telecommunications Act (TSO net cost determinations and TSLRIC interconnection price determination).

For the sake of regulatory certainty and predictability it is important that these differences and the reasons for these differences are as explicit as possible. Anyone that was not familiar with the telecommunications proceedings, for example, may well have been surprised by the CC's decision not to include indirect costs.

9. It is more efficient to review a matter once, where the issues are generic, consulting with interested parties in all relevant sectors. This will also assist in helping to ensure greater

¹ TelstraClear, submission to the Commerce Commission "Price Control of Unison Network" dated 21 October 2005 at page 1.

² Paragraphs 17 and 18 of Mighty River Power's Oral Submission to the Commerce Commission in response to the Consultation Paper "Regulation of Electricity Lines Businesses - Targeted Control Regime - Intention to Declare Control - Unison Networks Limited", 17-18 November 2005.

consistency of approach, e.g. the Commerce Commission may change its approach on a key input between inquiries, because it hears new and better submissions in the later inquiries.

10. Mighty River Power believes the biggest benefits from input methodology setting will be where the input methodology is able to be set in generic terms, rather than industry specific terms.

Overlaps between the Electricity and Commerce Commissions

11. The Commerce Act and Electricity Act 1992 contain a number of overlaps between the responsibilities of the Commerce and Electricity Commissions, in relation to economic regulation of EDBs and Transpower. Mighty River Power considers this to be entirely unsatisfactory.
12. Ultimately, we believe the best way to resolve these issues would be for the Government to give sole responsibility for economic regulation (including network access and pricing) to the Commerce Commission. This would mean transferring responsibility for electricity distribution and transmission pricing methodology and network access setting, transmission service quality setting, and transmission investment approval over to the Commerce Commission. As part of such a reconfiguration of responsibilities, we believe generic network access legislation should be introduced, modelled on the Telecommunications Act 2001.³
13. These matters are obviously outside of the Electricity and Commerce Commissions' control, being something for the Ministerial Taskforce to consider. In the meantime, the two Commissions should work out how to best navigate the overlaps in responsibilities.
14. Obvious overlaps in responsibilities, relating to input methodologies, exist in relation to electricity distribution and transmission pricing methodologies and setting a WACC for Transpower, which the Electricity Commission uses in the Grid Investment Test.
15. Mighty River Power is concerned about the lack of visibility over how the overlaps in responsibilities are being managed. The Input Methodology Discussion Paper discusses in some detail the issues around the overlaps in responsibilities and how this may impact on the Commerce Commission's input methodology setting, which we commented on in some detail in our submission to the Electricity Commission in response to its Electricity Distribution Pricing Methodology (EDPM) consultation paper.⁴ In contrast, the Electricity

³ We have expressed this view in various submissions e.g. the submissions to the Electricity Commission on the Benchmark Agreement arrangements for transmission, available at: <http://www.electricitycommission.govt.nz/pdfs/submissions/pdfstransmission/benchmark06/MRP.pdf>.

⁴ Mighty River Power "Submission to the Electricity Commission on: Distribution Pricing Methodology", 10 July 2009, available at: <http://www.electricitycommission.govt.nz/submissions/substransmission/distrib-pricing/?searchterm=electricity%20distribution%20pricing>

Commission's EDPM consultation paper, and its workstream reviewing the transmission pricing methodology, does not acknowledge the Commerce Commission's role, let alone what implications this may have for the design of an EDPM.

16. Mighty River Power **notes** we do not believe it is sensible for the Commerce and Electricity Commissions to be running separate consultation processes on electricity distribution pricing methodologies in tandem.
17. Given Mighty River Power's view on where responsibility for economic regulation should lie it, coupled with the difficulties the Electricity Commission is having progressing a large number of projects, it may make sense for the Commerce Commission to take a led role in some of these matters.
18. It would be very simple, for example, for the Electricity Commission to simply adopt the WACC that the Commerce Commission establishes for Transpower, which the Commerce Commission will need to determine as an input methodology, in the application of the Grid Investment Test (GIT) under Part F of the Electricity Governance Rules. We would certainly like to avoid having to continue submitting on this matter to both the Commerce Commission and the Electricity Commission.
19. Too date, the Electricity Commission has relied on a "default" WACC/discount rate of 7% for the GIT, which is a number Transpower proposed some years ago:⁵

We are also concerned about the lack of justification for many of the inputs into the GIT model. A good example is the EC's use of the GIT's 'fall-back' option of 7% for the discount rate. The discount rate has a very material impact on the value of delay in the investment, and the NPV of the proposed investment and alternative projects. It also has a very material impact on the costs that Transpower would be able to recover for an approved GUP if used as Transpower's WACC. Yet the GIT/EC has relied on an out-of-date unsubstantiated assertion by Transpower of what its WACC is. Ironically, we consider that this has resulted in a bias against Transpower's GUP – as it has meant an inflated WACC/discount rate, and an overstatement of the value of deferral of investment.
20. Mighty River Power has previously argued the Electricity Commission should apply the methodology used by the Commerce Commission for setting WACC.⁶ Mighty River Power remains of this view.
21. The Electricity Commission would, at the very least, need to satisfy itself that the approach the Commerce Commission was adopting was meeting its own objectives and functions.

⁵ Paragraph 24 of Mighty River Power's "Submission in response to the Electricity Commission's Draft Decision on: Transpower's Auckland 400kV Grid Investment Proposal", 23 June 2006.

⁶ See the consultancy report, "Review of the WACC/discount rate", Mighty River Power commissioned from Marsden Jacob Associates on this matter, which we submitted to the Electricity Commission as part of our "Submission in response to the Electricity Commission's Draft Decision on: Transpower's Auckland 400kV Grid Investment Proposal", 23 June 2006.

Role of a regulated pricing input methodology

22. As the Commerce Commission is well aware, network access arrangements, including pricing, can impact on the level of competition in any market where network access is needed in order to compete. Examples of such markets include airports, electricity, gas, ports and telecommunications. It is precisely because of this that the Government introduced access regimes under the Telecommunications Act and the Dairy Industry Restructuring Act, including regulation of price. It is also because of this that the Commerce Commission is presently undertaking an investigation into whether it should recommend regulation of mobile termination rates under the Telecommunications Act.
23. As is clear from the Commerce Commission's investigations into mobile termination rates, the benefits of regulating price can come from greater competition, which we have focussed on in submissions to the Electricity Commission relating to electricity distribution pricing. There can also be allocative efficiency gains from more cost reflective pricing. For example, regulation of mobile termination rates would be likely to result in greater phone calls to mobile phones, particularly from fixed-line phones and mobile-to-mobile calls across different networks e.g. 2 Degrees to Vodafone.
24. The role of regulation of pricing/pricing methodologies as part of network access arrangements or price control can be quite blurred. In the Commerce Commission's original fixed-to-mobile termination rate investigation Vodafone suggested the investigation lay properly under Part 4 of the Commerce Act rather than under the Telecommunications Act. This reflected Vodafone's view that regulation of fixed-to-mobile termination rates would not promote competition. TelstraClear, in response, suggested the Commerce Commission could readily have undertaken the investigation under either Acts. TelstraClear also suggested the overlaps in the tests for regulation under the two Acts were such that if the Telecommunications Act tests for regulating fixed-to-mobile termination rates were satisfied, the tests under Part 4 of the Commerce Act would be satisfied.
25. Unfortunately, in contrast to telecommunications, the regulatory arrangements for network access and pricing in relation to electricity and gas are patchy. The Commerce Commission has responsibility for price control (including input methodologies for pricing), while there isn't a coherent regulatory framework for network access. Instead, the Electricity Commission and Gas Industry Company (GIC) have responsibilities for developing network access arrangements (including pricing methodologies) in the electricity and gas sectors, respectively, with regulation making power underpinning these responsibilities in the Electricity and Gas Acts.
26. Different aspects of pricing methodologies will have differing benefits in terms of facilitating network access/competition and improving allocative efficiency. For example, cost allocation amongst customer categories may have implications for allocative

efficiency, but isn't so important in terms of network access/competition. Consistent with this, Mighty River Power made the observation in our submission to the Electricity Commission on electricity distribution pricing that:⁷

.... a reduction in (and standardisation of) customer categories will have a material impact on the commercial viability of entry into any particular EDB network area, particularly for smaller EDBs ...

27. One of the difficulties the two Commissions would need to manage, in relation to electricity distribution pricing, is that the Commerce Act precludes the Commerce Commission from mandating a distribution pricing methodology/pricing principles for small trust-owned EDBs. Yet, as our submission on the Electricity Commission's EDPM consultation paper makes clear, it is the small EDBs that most warrant regulation. In contrast, the Electricity Act enables the Electricity Commission to introduce regulation mandating a pricing methodology or pricing principles for all EDBs.
28. The Commerce Commission can set pricing input methodologies for the operation of the default price path, customised price path or information disclosure. The Commerce Commission could also decide not to set pricing input methodologies at all.
29. Mighty River Power **notes** we not support the Commerce Commission's "preliminary view" that the default price path should not include a pricing input methodology but the customised price path should.⁸ Either both should include a pricing input methodology or neither.
30. For the Commerce Commission's view to make sense would require there to be greater concerns about the pricing methodologies of network utilities that seek customised price paths than other network utilities. Mighty River Power does not believe there are any grounds for believing this to be the case.
31. In fact, the opposite could be the case, if it turns out to be larger network utilities that tend to seek customised price paths, given the concerns we have expressed about small EDB pricing arrangements.
32. Why, for example, should the concerns about the pricing methodology applied by a network utility for whom the default price path is inadequate to enable the investment it needs to make, be any different to a network utility for whom the default price path is overly generous? The same could be asked in relation to any of the other reasons the Commerce Commission has identified for why a network utility may seek a customised price path.

⁷ Paragraph 66 of Mighty River Power's "Submission to the Electricity Commission on: Distribution Pricing Methodology", 10 July 2009.

⁸ Paragraph 9.9 of the Commerce Commission's "Input Methodologies Discussion Paper", 19 June 2009.

33. If a pricing input methodology is adopted for customised price paths, while none is provided for default price paths, this would impose an unnecessary hurdle/barrier to regulated businesses seeking a customised price path. This could ultimately prove to be a barrier to adequate investment where a regulated business seeks a customised price path because the default does not enable it to make adequate investment, which is likely to be the main reason for customised price path applications.
34. The Commerce Commission has stated that “The input methodologies for pricing methodologies could also be indirectly relevant to information disclosure for all electricity lines ... businesses, in terms of monitoring and analysing information.”⁹ Mighty River Power agrees with this.
35. We also agree with the Commerce Commission that “the pricing methodology that is relevant for the purpose of monitoring and analysis would not necessarily have to be specified as part of an input methodology determination. For example, it could be specified as part of an information disclosure determination, or be based on a pricing methodology determined by a third party such as the Electricity Commission.”¹⁰
36. In our submission to the Electricity Commission on EDPMs we expressed the view that a voluntary model EDPM would be ineffective and that the Electricity Commission would need to, at least, establish a compliance monitoring framework, with sanctions against EDBs that did not have adequate reasons for not following the model (including, ultimately, mandating the model EDPM). For the same reasons, Mighty River Power **notes** we are sceptical about how effective information disclosure could be in terms of improving network utility pricing arrangements. The Commerce Commission’s Electricity Information Disclosure Requirements have pricing methodology disclosure requirements, and the original Electricity (Information Disclosure) Regulations 1994 even had a model pricing methodology, but these requirements have achieved little.
37. Submissions for EDBs to the Electricity Commission on its proposals for introducing on a model pricing methodology suggest the extent of adoption of voluntary arrangements would be minimal.
38. The comments made by Powernet and Wellington Electricity were particularly disturbing.
39. In our presentation to the Electricity Commission’s 17 June EDPM workshop we highlighted Powernet’s pricing as an example of a small EDB with too many tariff categories, though we did not mention Powernet by name. Their response to this was dismissive and flippant at best simply stating “computers address this issue”¹¹ which does

⁹ Paragraph 9.10 of the Commerce Commission’s “Input Methodologies Discussion Paper”, 19 June 2009.

¹⁰ Paragraph 11.104 of the Commerce Commission’s “Input Methodologies Discussion Paper”, 19 June 2009.

¹¹ Paragraph 1.8 of PowerNet’s “Submission in response to the Consultation Paper on the Model Approach to Distribution Pricing Methodology prepared by the Electricity Commission”, 9 July 2009.

not full us with any confidence they are open to addressing the legitimate concerns of retailers.

40. Wellington Electricity claim, for some reason, that “the EDB must have the sovereign power over its pricing methodology”.¹² While a sovereign right or power is something that can only be held by Government the statement sends a clear message about Wellington Electricity’s attitude to regulation and the concerns expressed by the two Commissions and parties such as Mighty River Power.
41. Commentary by other submitters, both EDBs and retailers, also reinforce our lack of confidence in a purely voluntary approach such as information disclosure.
42. Vector state “... we believe that most distributors would be unwilling or unable to adopt a model approach ...”¹³ Powerco conceded that “The PAWG model has been available since 2004 for EDBs to voluntarily adopt. Requiring companies to report against it will not be a significant enough factor to generate change. It will simply create a valueless information disclosure requirement, with additional compliance costs.”¹⁴ Presumably Powerco’s view would hold for any alternative input methodology the Commerce Commission developed for disclosure purposes.
43. Consistent with the view that EDBs will not voluntary adopt a model approach, Genesis Energy point out that:¹⁵

The Electricity Commission’s work on model use of system agreements is instructive when considering the efficacy of the “model” approach to regulation of natural monopolies. In Genesis Energy’s experience, model use of systems agreements have not markedly improved the contracting environment for retailers.

44. Similarly, MEUG argue that:¹⁶

Experience has shown that a voluntary approach to distributors following and reporting compliance with model pricing and contracts has been abysmal. For example, ... the consultation paper reports that only 4 out of 28 distributors responded to a Commission request for information on changes in pricing methodology since 2005 and progress in implementing the ... PAWG ... recommendations.

We see no change in the external environment that will result in a change the behaviour of distributors to volunteer information and self-report more than at present.

¹² Page 5 of the Wellington Electricity’s “Submission to the Electricity Commission on its Consultation paper on a model approach to Distribution Pricing Methodology”, 10 July 2009.

¹³ Paragraph 5 of Vector’s “Submission to the Electricity Commission on Distribution Pricing Consultation Paper”, 10 July 2009.

¹⁴ Paragraph 42 of Powerco’s submission to the Electricity Commission “Submission on Distribution Pricing Methodology”, 10 July 2009.

¹⁵ Page 2 of Genesis Energy’s submission to the Electricity Commission “Model Distribution Pricing Methodology”, 10 July 2009.

¹⁶ Page 4 of the Appendix to MEUG’s “Submission on Proposed Model Approach to Distribution Pricing Methodology”, 10 July 2009.

45. Meridian similarly are also sceptical about uptake under voluntary arrangements “We are not clear that revising the model approach will result in more distribution companies using the methodology. An important question may be, “Why have more distribution companies not used the existing model approach?””¹⁷
46. Realistically this means that if the Commerce Commission wants to see adoption of its preferred pricing arrangements, be it principles of a model methodology, information disclosure will not be adequate. In relation to electricity distribution, Mighty River Power **recommends** the Commerce and Electricity Commissions work together to determine whether the Commerce Act or the Electricity Act is the best legislation for regulating EDPMs.

Cost allocation for financial separation purposes

47. Mighty River Power **notes** we support application of ACAM for the purpose of: (i) financial separation for regulated utilities’ activities from other activities; and (ii) setting price floors and ceilings for regulated utilities.¹⁸ Mighty River Power **notes** that ACAM is the only economically robust cost allocation methodology, discussed in the Commerce Commission’s consultation papers, for identifying monopoly profits and cross-subsidies.
48. We do not believe the Commerce Commission has presented any economically or legally robust arguments against ACAM. We believe our previous submissions to the Commerce Commission, relating to application of ACAM, have specifically addressed all of the objections the Commission had presented against ACAM.
49. Importantly, the existing ACAM can be readily adapted to deal with multi-network utilities and to avoid double-counting of costs. Mighty River Power has detailed how this could be done, in a straight forward manner, in several of our submissions (which the Commerce Commission acknowledges in the Input Methodology Consultation Paper).
50. Mighty River Power recognises the importance of ensuring network utilities are not able to abuse their substantial market power/market dominance by subsidising services in up or downstream markets. This can have the affect of thwarting competition. For this reason, we support ownership separation under the Electricity Industry Reform Act, the administration of economic control of network utilities under Part 4 of the Commerce Act, and financial disclosure requirements for network utilities.

¹⁷ Page 2 of Meridian’s submission to the Electricity Commission “Distribution Pricing Methodology Consultation on Model Approach”, 10 July 2009.

¹⁸ For a more fulsome discussion on the reasons for adopting ACAM, refer to our previous “Submission to the Commerce Commission: Regulatory Provisions of the Commerce Act”, 16 February 2009.

51. ACAM is critical to identifying whether network utilities are extracting monopoly profits from any of their regulated businesses (or combinations of regulated businesses) and prices are subsidy free, consistent with the Commerce Commission's pricing principles:¹⁹

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

a) being subsidy free (greater than incremental costs and less than stand alone costs)

...

52. Fully allocated cost methodologies (FACM)²⁰ do not identify whether monopoly profits are being earned or cross-subsidies exist, which is the principle function of financial separation. The results of application of FACM will be a function of arbitrary cost allocations.

53. We illustrated these points in a previous submission with the following stylised example:²¹

- IC EDB = \$10.
- IC Generation Business = \$2
- CC = \$3.

ACAM will indicate the EDB is monopoly pricing if the line revenue exceeds \$13, and the Generation Business is uneconomic/being subsidised if the generation revenue is less than \$2.

Let's say the application of FACM results in common costs being equally shared between the EDB and Generation Business. This would incorrectly suggest that the EDB is monopoly pricing if line revenue exceeded \$11.50, and the Generation Business was being subsidised if its revenue was less than \$3.50.

54. Any move to FACM approaches would make financial disclosure less useful in determining whether monopoly profits or subsidies exist – the apparent monopoly profit or subsidy could simply be a function of arbitrary cost allocations.

Treatment of multi-network utilities

55. Mighty River Power **notes** that the ACAM can readily be specified in a way that avoids double counting of common costs.

56. We are disappointed the Commerce Commission would rely (again) on the argument that "Allowing a multi-service firm to recover stand-alone costs across each of its business units would mean that that firm recovers the common costs of providing the service in question multiple times – although it only incurs those costs once".²²

57. Mighty River Power has addressed this argument previously. It represents a mis-application of ACAM.

¹⁹ Commerce Commission "Draft decisions paper – pricing principles, guidelines, and reporting requirements", 7 December 2007.

²⁰ The term FACM is treated as being interchangeable with FAC, FDC and ABC in this submission.

²¹ Mighty River Power submission to the Commerce Commission "Review of the Information Disclosure Regime". 8 March 2008.

²² Paragraph 5.51 of the Input Methodology Discussion Paper.

58. We agree the existing information disclosure regimes do not deal with multi-network utilities very well. The Ministry of Economic Development (then Ministry of Commerce) detailed how the existing Information Disclosure Regulations' application of ACAM did not address common costs between different regulated activities and how this could be resolved in its review of the Gas (Information Disclosure) Regulations 1997 it undertook in 1999.
59. In particular, a joint multi-network utility such as Vector and Powerco could earn excessive profits without these showing up in its gas and electricity disclosures because it can attribute (double count) common costs to both its GPB and EDB financial statements. In the stylised example above, if the Generation Business was changed to GPB, the application of ACAM separately to the multi-network utility's GPB and EDB would suggest that the EDB could earn \$13 and the GPB \$5 before they earned excessive profits, even though this would result in actual excessive profits of \$3 ie double recovery of common costs.
60. This issue was raised during the review of the economic control provisions in the Commerce Act, including by Mighty River Power.
61. The information disclosure provisions now in the Commerce Act enable the Commerce Commission to impose joint-disclosure requirements across different regulated sectors. Specifically, section 53D(4) states "If a supplier supplies more than 1 kind of regulated goods or services, the Commission may require the supplier to provide consolidated information and performance measures relating to all, or any combination of, the regulated goods or services."
62. In the case of multi-network utilities, that provide EDB and GPB services, the following tests are needed to determine whether there is overcharging in the form of excess returns/double counting of costs:
- | | |
|---|---|
| $R(\text{GPB}) \geq \text{SAC}(\text{GPB})$ | $R(\text{GPB}) \geq \$5^{23}$ |
| $R(\text{EDB}) \geq \text{SAC}(\text{EDB})$ | $R(\text{EDB}) \geq \$13^{24}$ |
| $R(\text{GPB} + \text{EDB}) \geq \text{SAC}(\text{GPB} + \text{EDB})$ | $R(\text{GPB} + \text{EDB}) \geq \15^{25} |
63. In terms of the diagrams in Figure 5.1 of the Commerce Commission's Input Methodology Discussion Paper, the application of ACAM translates to:

²³ In the context of the Commerce Commission's Figure 5.1, the \$5 would include area A (for a 'Fully Regulated' Firm) and areas B, C and E (for a 'Partially Regulated' Firm).

²⁴ In the context of the Commerce Commission's Figure 5.1, the \$13 would include area A (for a 'Fully Regulated' Firm) and areas C, D and E (for a 'Partially Regulated' Firm).

²⁵ In the context of the Commerce Commission's Figure 5.1, the \$15 would include area A (for a 'Fully Regulated' Firm) and areas C, D and E (for a 'Partially Regulated' Firm).

- a. The 'Fully Regulated' Firm being able to recover area A (once), but given discretion as to the extent to which it recovers area A from its EDB or GPB (it will likely aim to recover the majority from its EDB, consistent with Ramsey pricing principles); and
 - b. The 'Partially Regulated' Firm being able to recover areas B, C, D and E (once), with D recovered from its EDB, E from its GPB and the firm having discretion as to the extent to which it recovers areas C and B from its EDB or GPB (as per area A in the example of the 'Fully Regulated' Firm).
64. A proper application of ACAM does not result in double counting of common costs, as the Commerce Commission suggests. A proper application of ACAM would mean multi-network utilities would be restricted from earning more than their stand-alone costs for each of their regulated services individually and in combination.

Cost allocation and investment in other activities

65. Mighty River Power **notes** that we believe FACM, and other fully distributed cost allocation methodologies, can create a barrier to regulated network utilities investing in other legitimate activities.
66. We also have sympathy for network utilities given application of a FACM could distort legitimate investment activities in other markets, where it makes use of economies of scope without there being any concerns about anti-competitive behaviour.
67. A topical example is the potential for EDBs to tender for funds under the Government's Broadband Investment Initiative.
68. The possibility the Commerce Commission will take a FACM approach to cost allocation between the EDB's network business and other activities (including broadband services), means any EDB considering tendering for the Initiative would need to take into account not only the actual (additional) costs it would incur from such activity, but also the reduction in revenue the Commerce Commission would allow under its price-path.
69. The Commerce Commission has recognised that "expanding operations into new areas may also result in efficiency gains from economies of scale ..." ²⁶ yet wants to 'tax' such activities (the tax being the proportion of areas B, D and E in Figure 5.1) that would be allocated to the unregulated business. The Commerce Commission would effectively be requiring regulated firms, such as Vector, to price their broadband Initiative tenders (materially) above the incremental or avoidable cost they would incur from supplying such services. Firms like Telecom would face no such constraint. Such a tax on other activities would act as a barrier to entry into other legitimate markets and, in relation to the Broadband Initiative, potentially result in a less competitive tender. Ironically this would benefit the incumbent telco, Telecom.

²⁶ Paragraph 5.9 of the Input Methodology Discussion Paper.

70. The problem with FACM approaches is exacerbated because of uncertainty as to how much of B, D and E would have to be allocated to the other business. As the Commerce Commission acknowledges “there are problems with the FAC/FDC/ABC approach. In particular, there may not be an objective basis for choosing one allocator over another, even though the choice can have a large impact on the allocation of costs.”²⁷

71. We are not sure how the Commerce Commission envisages EDBs considering tendering in the Government’s Broadband Initiative should factor in an unknown, but potentially large, ‘regulatory tax’ into their tenders? We are also unsure of the basis on which the Commerce Commission would consider this satisfies section 52T(3) of the Commerce Act. In Mighty River Power’s view, the Commerce Commission’s proposal to adopt some kind of FACM approach over ACAM would clearly and unambiguously breach section 52T(3) which requires that the input methodologies must not unduly deter regulated firms from investing in other (regulated and unregulated) goods or services.

72. We are puzzled by the Commerce Commission’s claim:²⁸

If a small amount of the common costs was allocated to the unregulated service, profitability of that service would increase and therefore firms would have incentives to invest in such services. On the other hand, allocating a large amount of the common costs to the unregulated service would decrease the profitability of that service and therefore might deter firms from investing in such services.

73. Allocating any common costs to the unregulated service would reduce its probability, whether the amount was “small” or “large”. The size of the amount would only impact on the degree to which its profitability is reduced.

74. Mighty River Power assumes the Commerce Commission relies on the above, incorrect, claim to reach the conclusion it would accept the use of ACAM where there are small common costs, but not where common costs are material. Mighty River Power does not consider it would be good practice to have multiple cost allocation rules. ACAM should be used in all cases (albeit modified from the status quo, to address treatment of common costs between regulated businesses).

Cost allocation and efficiency gains

75. The Commerce Commission seems to rely on section 52A(1)(c) of the Commerce Act to justify allocating a proportion of areas B, D and E in Figure 5.1 to the regulated business(es). The Commerce Commission claims that “Most importantly, FDC/FAC/ABC approaches assist in ensuring that efficiency gains are shared with consumers of regulated services”.²⁹ Section 52A(1)(c) provides that a regulated supplier “share with

²⁷ Paragraph 5.70 of the Input Methodology Discussion Paper.

²⁸ Paragraph 5.34 of the Input Methodology Discussion Paper.

²⁹ Paragraph 5.71 of the Input Methodology Discussion Paper.

consumers the benefits of efficiency gains in the supply of the regulated goods or services including through lower prices” (emphasis added).

76. If a regulated firm, such as Vector, can gain economies of scope from entering into telecommunications/broadband services this is not an efficiency gain in the supply of the regulated goods or services. The cost of supplying the regulated goods or services will not have reduced one iota. We, accordingly, do not agree with the Commerce Commission’s interpretation of the sharing of efficiency gains.³⁰
77. The Commerce Commission also expresses the view that “the use of SACs for the regulated business unit may disadvantage consumers of regulated services in case where the same provider offers unregulated services (s 8(a) of the GPS).”³¹ If ACAM is properly applied the consumer should be entirely unaffected. This is because the SAC of providing the regulated service does not vary depending on whether the firm also provides unregulated services.
78. A situation where the consumer of the regulated service would be made worse off is if the ‘regulatory tax’ a firm incurred under FACM, as a result of providing unregulated services, meant it was no longer viable. If the firm withdrew from providing unregulated services costs allocated to the regulated service (and allowable revenues) would increase, which could justify higher prices for the regulated service.

Cost allocation and workably competitive markets

79. The Commerce Commission states the purpose of Part 4 is to promote outcomes consistent with outcomes produced in competitive markets. More accurately, promoting outcomes that are consistent with outcomes provided in competitive markets (as reflected in section 52A(1)(a)-(d)) is a means of promoting the long-term benefit of end-users. What this means is that the Commerce Commission should only promote outcomes consistent with outcomes produced in competitive markets to the extent this helps promote the long-term benefit of end-users.
80. The Commerce Commission then attempts to turn this purpose against ACAM, by arguing that “in a workably competitive market, common costs for two or more activities will generally result in prices for each activity that are lower than the prices that would recover for the SAC of each activity but they would at least recover the IC of the activity.”³²
81. Mighty River Power considers this argument to, at best, be a stretch in logic:
- a. In a workably competitive market firms would be restricted from earning monopoly profits (prices more than stand-alone cost);

³⁰ Question 27 of the Input Methodology Discussion Paper.

³¹ Paragraph 5.130 of the Input Methodology Discussion Paper.

³² Paragraph 5.49 of the Input Methodology Discussion Paper.

- b. In a workably competitive market firms would not be able to cross-subsidise activities (price below incremental or avoidable cost);
 - c. In a workably competitive market a firm would be able to enter a new market (eg the Government's Broadband Initiative) on the basis of the economic cost (incremental or avoidable cost) to that firm, without cost distortions created by mandatory allocation requirements; and
 - d. In a workably competitive market prices could be any where between (and including) incremental and stand-alone cost. Where prices lay between these bounds would depend on a number of factors, such as degree of competition in the market, elasticity of demand, relative size of the firm's different business units etc. Another way of looking at this, in a workably competitive market prices would not necessarily be determined by arbitrary (FACM) allocations between business units.
82. Ironically, given the Commerce Commission's workably competitive market argument against ACAM, and its support for Ramsey pricing, Ramsey pricing would suggest that a greater proportion of common costs should be allocated to a regulated firms EDB than to its GPB, precisely because interfuel substitutability means supply of GPB services is more contestable than supply of EDB services. If both markets were workably competitive then Ramsey pricing would not necessarily suggest greater allocation to the EDB.
83. Application of ACAM, for financial separation purposes, is not inconsistent with workably competitive market outcomes.

Cost allocation and benchmarking

84. The Commerce Commission makes the assertion that "an FDC/FAC/ACB approach increases the ability of interests parties to assess whether the purpose of Part 4 is being met, by enabling parties to make comparisons across business units, and monitor business performance over time".³³
85. Application of FACM approaches actually does the opposite.
86. Application of FACM approaches can mean a firm's regulated business(es) disclosed costs/profits could bounce around over time, not because of changes in the regulated business's costs, prices or profits (these could remain unchanged) but because of factors such as entry or exit from other activities (regulated or unregulated) or simply because of volatility in the arbitrary variables used to allocate costs amongst the businesses.

Cost allocation for pricing purposes

87. The Commerce Commission should take care to avoid mixing up the issue of cost allocation for financial separation purposes (essentially to identify monopoly profits and

³³ Paragraph 5.72 of the Input Methodology Discussion Paper.

cross-subsidies) and cost allocation for pricing principles. ACAM is appropriate for the former, but only offers upper and lower bounds for pricing purposes. ACAM is, quite appropriately as it is not its role, silent on how common costs should be recovered.

88. Mighty River Power is relatively relaxed about how regulated businesses go about this exercise, which is why we have questioned the extent to which the Commerce Commission has focussed on customer group tariff setting in its investigations into whether to introduce price control for Unison and Vector's EDBs. In relation to multi-network utilities, we would expect a company like Vector to prefer to recover more of the common costs between gas and electricity networks from the latter, as electricity use is far less discretionary than gas. The same would be the same in relation to the Broadband Initiative example above. This is consistent with Ramsey pricing, and the interests of end-users.

Concluding remarks and recommendations

89. For the convenience of the reader, Mighty River Power's recommendations are detailed below:
90. Mighty River Power **notes** we do not believe it is sensible for the Commerce and Electricity Commissions to be running separate consultation processes on electricity distribution pricing methodologies in tandem.
91. Mighty River Power **notes** we not support the Commerce Commission's "preliminary view" that the default price path should not include a pricing input methodology but the customised price path should.
92. Mighty River Power **recommends** the Commerce and Electricity Commissions work together to determine whether the Commerce Act or the Electricity Act is the best legislation for regulating EDPMs.
93. Mighty River Power **notes** we support application of ACAM for the purpose of: (i) financial separation for regulated utilities' activities from other activities; and (ii) setting price floors and ceilings for regulated utilities.
94. Mighty River Power **notes** that ACAM is the only economically robust cost allocation methodology, discussed in the Commerce Commission's consultation papers, for identifying monopoly profits and cross-subsidies.
95. Mighty River Power **notes** that the ACAM can readily be specified in a way that avoids double counting of common costs.
96. Mighty River Power **notes** that we believe FACM, and other fully distributed cost allocation methodologies, can create a barrier to regulated network utilities investing in other legitimate activities.

97. If the Commerce Commission has any queries in relation to this submission please do not hesitate to contact me on 09 308 8259 or robert.allen@mightyriver.co.nz.

Yours sincerely,

Rob Allen
Regulatory Manager