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Electricity Commission
Level 7, ASB Bank Tower
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by email: submissions@electricitycommission.govt.nz

SUBMISSION ON DRAFT DISTRIBUTION PRICING PRINCIPLES AND METHODOLOGICAL REQUIREMENTS

1 Orion New Zealand Limited (**Orion**) welcomes the opportunity to respond to the draft distribution pricing principles and methodological requirements discussion paper (**the discussion paper**) released by the Electricity Commission's (the **Commission**) in September 2009.

2 Our submission comprises the following sections:

- general comments;
- discussion on pricing principles;
- suggested guidelines to assist EDBs ; and
- a suggested compliance process.

General comments

3 We are pleased to see that both the Commerce Commission and the Commission are in general agreement that a principles-based approach to pricing rather than a prescriptive model based approach (such as PAWG) is appropriate for EDBs. We note the Commission's acknowledgement of the problems identified by the Commerce Commission in regard to the PAWG approach in the context of Part 4 of the Commerce Act.

4 We acknowledge of course that the Commission has a broader remit than the Commerce Commission's objectives under Part 4 (as outlined at the

October 2009 workshop and in paragraph 4.5.3 of the discussion paper). However, and as the Commission acknowledges, it shares the Commerce Commission's view of the similarities between the objectives and desired outcomes in section 172N of the Electricity Act, and section 52A (the purpose) of Part 4 of the Commerce Act[1].

5 The Commerce Commission has indicated that its preliminary view is that it would adopt the principles produced by the Electricity Commission to the extent that they are consistent with Part 4.

6 We believe that, despite the acknowledged differences in the legislative objectives of the Commissions, these differences are not so great that it would be unreasonable for EDBs to expect a single set of pricing principles and a single compliance process to be used by both Commissions. This is particularly true given both Commissions accept the similarities between the objectives and desired outcomes in section 172N of the Electricity Act, and section 52A (the purpose statement) of Part 4 of the Commerce Act.

7 At the October workshop the Commission rightly pointed out that it needed some level of confidence that EDBs would actually comply with the pricing principles. We believe that maximum levels of transparency will be an essential part of any compliance approach that will provide the sort of confidence that the Commission indicated[2] it will be looking for.

8 Orion considers that it would be in-efficient and contrary to best practice regulation to have two different annual pricing methodology information disclosures and two sets of principles and guidelines. While we acknowledge that there are some issues to be worked though, we believe it is possible to have one regulatory instrument for both Commissions.

9 To this end we have been interacting with PwC and other EDBs on this issue. We outline below an approach which we believe will satisfy the Commission's concerns that EDB's are basing their pricing methodologies on the Commission's principles and that will provide sufficient transparency to satisfy both Commissions of EDBs' compliance. While there may be differences in some detail between EDBs we consider that there is broad agreement for the basic approach outlined below.

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1 Electricity Commission *Draft distribution pricing principles and methodological requirements – discussion paper* 30 September 2009 para 4.5.2

2 EC distribution pricing workshop 12 October 2009

Pricing principles

10 The discussion paper sets out the Commission's preliminary view on a set of principles[3] based on the:

10.1 pricing principles set out in the Commerce Commission's gas authorisation of Powerco and Vector;

10.2 Commerce Commission's June 2009 input methodologies discussion paper;

10.3 detailed recommendations on pricing principles put forward in submissions on the Commission consultation paper.

11 Orion and many other EDBs supported an approach based on the gas authorisation principles. The Commission discussed its proposed principles at the October workshop where there was general agreement that a number of the principles were not required and also that some of the Commission's additions may not be required.

12 Following the workshop we have further reviewed the Commission's proposed pricing principles, and our comments and recommendations in this regard are outlined in table 1 below.

Table 1

EC's Proposed Pricing Principles	Comments	Orion's Recommendation
(a) Prices are to signal the economic costs of service provision, by: (i) being subsidy free (equal to or greater than incremental costs, and less than or equal to standalone costs)<u>, except where subsidies arise from legislation</u>; (ii) having regard, to the extent practicable, to the level of available service capacity; and (iii) signalling, to the extent practicable, the impact of additional usage on future investment costs.	Legislation will and must take precedence over any and all of these principles, so the addition is redundant.	We recommend removing the added words and retaining Gas Principles wording: (a) Prices are to signal the economic costs of service provision, by: (i) being subsidy free (equal to or greater than incremental costs, and less than or equal to standalone costs); (ii) having regard, to the extent practicable, to the level of available service capacity; and (iii) signalling, to the extent practicable, the impact of additional usage on future
(b) Where prices based on 'efficient' incremental costs would under-recover	Specific mention of Ramsey pricing is unnecessary. We note the Commerce	We recommend removing the added words and retaining Gas Principles

[3] Electricity Commission *Draft distribution pricing principles and methodological requirements – discussion paper* 30 September 2009 para 4.6.1

allowed revenues, the shortfall should be made up by setting prices in a manner that has regard to consumers' demand responsiveness <u>(i.e. Ramsey pricing) and/or the quality of service that they receive,</u> to the extent practicable.	Commissions, recognition that while Ramsey pricing may provide qualitative guidance there are significant practical difficulties in applying Ramsey pricing in a quantitative manner.[4] *Ramsey pricing provides a useful source of qualitative guidance to regulators when attempting to assess whether natural monopolies are recovering the costs of production in an efficient manner (subject to the constraint that the supplier has the opportunity to earn at least a normal rate of return*).[27] 27 *In other words, Ramsey pricing principles are generally not applied as a means of determining precise and definitive prescriptions for pricing. This is because Ramsey-Boiteux prices are difficult to implement in practice. The most obvious issue that can be identified with Ramsey-Boiteux prices is that it can be difficult to determine the base marginal cost for a particular service and, even where no complicating factors arise, it is a difficult empirical question to measure elasticities, and there are a number of other complexities that are usually present (e.g., W. Baumol and G. Sidak, Toward competition in local telephony, AEI Press, Cambridge, 1994, pp. 36-37)*. Also mention of quality of service is logically misplaced in this principle which is about non-distortion of principle a) (iii) in the recovery of residual revenue.	wording: (b) 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 to the extent practicable.
(c) Provided that prices satisfy (a) above, prices should be responsive to the requirements and circumstances of users in order to: (i) discourage uneconomic bypass; and (ii) to <u>allow for price/quality tradeoffs</u>.	This principle is about allowing individual negotiation by site. We do not support the Commissions proposed change which refers to the term 'price/quality trade-off'. This is not defined and may mean different things to different EDBs or consumers. Nor do we consider that the alternative wording in the gas principles in relation to allowing negotiation to better reflect the economic value of specific services is an appropriate principle. It is not clear to us how this could be applied in a meaningful way as a general pricing principle for an integrated electricity distribution network. We consider that it is more appropriate to have a principle that encourages investment in distribution alternatives when network	We recommend the following modified wording: (c) Provided that prices satisfy (a) above, prices should be responsive to the requirements and circumstances of users in order to: (i) discourage uneconomic bypass; and ii) where network economics warrant; encourage investment in distribution alternatives (e.g. distributed generation) and technology innovation.

[4] Commerce Commission *Input Methodologies discussion paper* 19 June 2009 para 2.43

	economics warrant it.	
(d) 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.	Transparency should not be included as a principle: rather as transparency is the underlying rationale of a disclosure regime. The rest of this proposed principle is very unclear and can be interpreted in different ways. What is meant by stability and certainty? No time of use pricing? No changes in structure of pricing? No dynamic pricing? Who are users? We presume these are the users of distribution prices who are predominantly retailers. The only entire exception we are aware of is The Lines Company who bill consumers directly.	We recommend the following modified wording: (d) Consultation with retailers should be undertaken before material changes in price structure are undertaken. Changes to prices should have regard to the likely impact on consumers."
(e) Pricing structures should not place undue transaction costs on retailers and consumers, and should be competitively neutral across retailers.	What is undue? The term is inherently uncertain and subjective. 'Economically equivalent' treatment of retailers is the appropriate definition for economically-based pricing principles rather than 'competitively neutral'.	We recommend the following modified wording: (e) Changes to prices should have regard to the likely cost impact on retailers. Retailers should be treated in an economically equivalent manner."
(f) Prices and pricing structures should promote efficient usage of electricity and encourage investment in distributed generation (including renewable generation), distribution alternatives and technology innovation.	The economics of a network supporting distributed generation is extremely site-specific. This is not a principle but an outcome that is conditional upon network economics at a particular site. 'Electricity' is much more than energy (kilowatt-hours). It includes the delivery system (grid, networks) and all related services (fault calls etc). This is as it should be. We also note that the Electricity Governance (Connection of Distributed Generation) Regulations 2007 include a specific set of pricing principles.	We recommend that this clause be deleted as fits better under principle (c) as we describe above.

Guidelines

13 The Commission proposes in the paper a set of methodological requirements[5] that are quite specific in nature and largely based on the Gas Authorisation methodological requirements. The Gas Authorisation

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5 Electricity Commission *Draft distribution pricing principles and methodological requirements – discussion paper* 30 September 2009 para 4.7.2

was done for a different purpose, under different legislation, and represents a completely different level of regulatory intervention than is appropriate for EDB pricing methodology disclosures. It should not be adopted wholesale by the Commission in this quite different legislative context.

14 For this reason we believe that the proposed methodological requirements are not necessary. Instead, guidance should be provided to assist EDBs with the content of their pricing methodology disclosures.

15 Useful guidance, (and a regime , EDBs are already familiar with) is already available in the form of requirement 22 and 23 of the Commerce Commission's Information Disclosure Requirements, as follows:

> ***22. Disclosure of pricing methodologies—***
> *Every disclosing entity must publicly disclose,—*
>
> *(a) At the beginning of each financial year, the methodology used at the beginning of that financial year to determine the line charges payable or to be payable; and*
>
> *(b) Any change in the methodology or adoption of a different methodology, within 1 month of the change or the different methodology taking effect.*
>
> ***23. Contents of pricing methodology disclosures—***
>
> *Every disclosure under requirement 22 must—*
>
> *(a) Describe the methodology used to calculate the prices charged or to be charged; and*
>
> *(b) Include the key components of the revenue required to cover costs and profits of the disclosing entity's line business activities, including cost of capital and transmission charges, which must include the numerical value of each of the components; and*
>
> *(c) State the consumer groups used to calculate the prices charged or to be charged, including—*
>
> *(i) The rationale for the consumer grouping; and*
>
> *(ii) The method by which the disclosing entity determines which group consumers are in; and*
>
> *(iii) For each of these consumer groups, the statistics relating to that group which were used in the methodology; and*
>
> *(d) Describe the method by which the disclosing entity allocated the components of the revenue required to cover the costs of its line business activities amongst consumer groups, which must include the numerical values of the different components allocated to each consumer group and the rationale for allocating it in this manner; and*

(e) Describe the method by which the disclosing entity determined the proportion of its charges which are fixed and the proportion which are variable, and the rationale for determining the proportions in this manner.

16 We consider those requirements are equally applicable in the pricing methodologies context.

17 In addition, the Commerce Commission has recently provided its preliminary views[6] of information disclosure requirements regarding prices, terms and conditions and pricing methodologies. In regard to pricing methodologies the Commerce Commission's preliminary view is that the minimum disclosure should include:

- *a description of the methodology used and how the methodology links to any applicable pricing principles;*
- *the rationale for customer groupings and the method for determining the allocation of customers to the customer groupings;*
- *quantification of key components of regulated revenue and costs;*
- *description of the methodology and quantification of allocation of revenues and costs to the customer groupings; and*
- *customer and volume statistics.*

18 We believe that an approach based on the above information disclosure requirements will provide adequate guidance to EDBs on the level of disclosure required and could be applied by both Commissions and applied equally to both non-exempt and exempt EDBs.

Compliance Process

19 As the October workshop the Commission pointed out that, understandably, it needed some level of confidence that EDB's would actually comply with the pricing principles. The Commission proposed using a compliance process that was developed for the Gas Control Authorisation. During discussions both Vector and Powerco noted that from their experience the gas compliance regime was extremely expensive and difficult to implement.

[6] Commerce Commission *Information disclosure discussion paper* 29 July 2009 Chapter 9

20 A compliance regime that is expensive and difficult to implement should be of concern to both Commissions particularly as the DPP is intended to be a relatively low cost regulatory approach.

21 For this reason we do not support the Commission's proposals for the publication of annual statements of variance/compliance, submission of a cost of supply model, disclosures of future pricing expectations, Commission audit and review and possible regulation. This is simply not justified and inconsistent with the regulatory mandate of both the Commerce Commission and the Commission in respect of pricing methodologies. The cost of compliance of such a process will be excessive, and inconsistent with the potential benefits (if any) of such an intrusive compliance process.

22 We therefore propose an alternative compliance process, based on the well-established AMP disclosure process established by the Commerce Commission as part of the existing information disclosure requirements for EDBs and more consistent with the regulatory objectives for pricing methodology disclosures. We consider that this would form part of the Commerce Commission's information disclosure requirements and be accessible to the Commission. The key aspects of the AMP compliance process and a suggested pricing methodology compliance process are set out in table 2 below:

Table 2

AMP Compliance process	Possible Pricing Methodology compliance process
An EDB must publish an AMP annually, before the start of the planning period.	An EDBs must publish annually (i.e before the beginning of each financial year) the methodology used at the beginning of that financial year to determine the line charges payable or to be payable; and Any change in the methodology or adoption of a different methodology, within 1 month of the change or the different methodology taking effect.
The AMP must contain the information set out in the Information Disclosure Handbook (which is a list of topics that must be covered/information that must be provided).	The pricing methodology must contain the information set out in the Information Disclosure Handbook (which is a list of topics that must be covered/information that must be provided).

Directors must provide a statutory declaration for the AMP.	Directors must provide a statutory declaration for the pricing methodology.
The AMP is published on the EDB's website, available for inspection, and a copy is sent to the Commerce Commission.	The pricing methodology is published on the EDB's website, and available for inspection, and a copy is sent to the Commerce Commission and the Commission.
Each year the Commerce Commission engages asset management planning experts to review each AMP and prepare a report, which is published, which assesses each aspect of each AMP for compliance and best practice. In addition a summary of the review is published, indicating compliance trends, issues and best practice.	Each year the Commerce Commission and the Commission jointly engage a consultant to review each pricing methodology and prepare a report, which is published, which assesses each aspect of each pricing methodology for compliance and best practice. In addition a summary of the review is published, indicating compliance trends, issues and best practice.
Assuming the reviews are available before the next AMP is prepared (this has not always been the case); an EDB is able to address areas of non-compliance and consider the approaches adopted by other EDBs which are deemed to represent best practice.	Assuming the reviews are available in adequate time before the pricing methodology is prepared for the next financial year; an EDB is able to address areas of non-compliance and consider the approaches adopted by other EDBs which are deemed to represent best practice.

23 We believe the outcome of this process in relation to AMP's has been continuous improvement in AMPs. That improvement is not just from a compliance perspective but also in the manner in which information is presented and the linkages which become more evident between AMPs and other business processes, including consultations with consumers over quality of service. The key to the success of this process is the timely review of all AMP disclosures by appropriate experts and the publication of the review findings. Certainly Orion tries to achieve one of the best AMPs in New Zealand. In our view a similar process for compliance with the pricing methodology would result in analogous improvements over time.

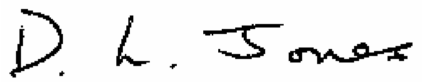
CONCLUDING REMARKS

24 We also note and support the establishment of an industry working group to consider standardisation of relevant terminology where possible and we endorse the ENA's nominations. We look forward to the opportunity to provide further input into the Commission's Distribution Pricing

Methodology Consultation and in particular to provide further input into the Guidelines and compliance process to be developed.

25 Thank you for the opportunity to make this submission. If you have any questions relating to this submission, please contact Dennis Jones (Industry Developments Manager) DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours faithfully



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