

30 October 2009

Electricity Commission  
PO Box 10041  
WELLINGTON 6143

Dear Sir/Madam

**Submission on the Draft Distribution Pricing Principles and Methodological Requirements**

Following submissions on the earlier consultation paper<sup>1</sup>, the Electricity Commission (“the EC”) has released a Discussion Paper “Draft Distribution Pricing Principles and Methodological Requirements, 30 September 2009” (“the Discussion Paper”).

This letter forms our submission on the Discussion Paper which has been prepared by PricewaterhouseCoopers on behalf of the following 22 Electricity Distribution Businesses (“EDBs”):

- Alpine Energy Limited;
- Aurora Energy Limited;
- Buller Electricity Limited;
- Counties Power Limited;
- Eastland Network Limited;
- Electra Limited;
- Electricity Ashburton Limited;
- Electricity Invercargill Limited;
- Horizon Energy Distribution Limited;
- MainPower New Zealand Limited;
- Marlborough Lines Limited;
- Nelson Electricity Limited;
- Network Tasman Limited;
- Network Waitaki Limited;
- Northpower Limited;
- OtagoNet Joint Venture;
- ScanPower Limited;
- The Lines Company Limited;
- The Power Company Limited;
- Top Energy Limited;
- Waipa Networks Limited; and
- Westpower Limited.

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<sup>1</sup> Electricity Commission, Distribution Pricing Methodology, Consultation Paper on a Model Approach, 5 June 2009

Individual EDBs which support this submission may have also made submissions on areas of particular interest or importance to them.

## **Background**

1. After receiving submissions on the earlier Consultation Paper, the EC has reconsidered its proposed approach to model distribution pricing methodologies, and consistent with a number of submissions received, including the PwC submission made on behalf of 22 EDBs, has moved to a less prescriptive approach. The Discussion Paper sets out a proposed principle based approach. It includes methodological requirements, in addition to a set of proposed principles and more detail regarding the compliance process which the EC is proposing accompanies these new requirements.
2. These issues were discussed at a workshop hosted by the EC in Wellington on 12 October. A number of the EDBs which support this submission attended the workshop and we would like to express our support for the opportunity facilitated by the EC for interested parties to express their views and gain a better understanding of the views of other parties. Our submission has been prepared in response to the Discussion Paper and the views expressed at the workshop. We note that some information, in particular in respect of the proposed compliance process, was presented for the first time at the workshop. Although this information does not appear in the Discussion Paper, we have responded to it in this submission.
3. We have not repeated the points made in our submission on the earlier Consultation Paper although we note our submission was fully supportive of a principle approach to pricing methodologies for EDBs. In order to assist in moving the debate forward and to help the EC complete its distribution pricing methodology work stream we have therefore focussed this submission on issues pertaining to implementing the principle approach in practice and the overlap with the Commerce Commission's ("the CC") emerging requirements of EDBs under Part 4 of the Commerce Act.
4. Our submission is structured as follows:
  - Proposed Approach
  - Legislative Requirements
  - Retail Competition
  - Principles in Practice
  - Compliance Process.

## **I Proposed Approach**

5. The Discussion Paper agrees that a principle approach to pricing methodologies is appropriate, which we support. It proposes that principles which are similar to those used in

the recent CC Gas Authorisation of Vector (Auckland distribution) and Powerco are adopted, with some modifications. We support the Gas Authorisation principles and comment on the proposed modifications in Section IV of this submission.

6. In addition, the proposals in the Discussion Paper include adoption of the form of the Pricing Methodology Report which the CC required of Vector and Powerco for the Gas Authorisation, and a similar compliance review process to that required of the controlled businesses. This is not appropriate. These requirements are well in excess of what is required to meet the EC and CC mandates and objectives for model distribution pricing methodologies. The Gas Authorisation involved the CC, after a considerable period of detailed investigation, establishing controlled prices for the relevant gas distribution networks for a defined period (up to 2012). The compliance process was designed to ensure the controlled prices were implemented in a manner consistent with the Authorisation and hence it required detailed disclosures and model audits and will continue to do so until the Authorisation expires. With the possible exception of a customised price path (CPP) which may be implemented under Part 4, there is in our view, no mandate, justification or intention for either the EC or the CC to implement such a significant level of regulatory intervention into EDB pricing methodologies.
7. We outline our suggested alternative approaches to pricing methodology disclosures and compliance processes in the remainder of this submission.

## **II Legislative Requirements**

8. The Discussion Paper includes a comprehensive summary of the statutory objectives and policy requirements of both the EC and the CC of relevance to distribution pricing. These are important because they determine the mandates for both Commissions and provide guidance as to the policy objectives for regulatory intervention in electricity distribution pricing.
9. There is considerable overlap between the respective statutory objectives of the EC and the CC which, in our view, suggests that the regulatory requirements for pricing methodologies for EDBs are broadly consistent. This is an important objective as it will ensure that there are no inconsistencies between CC and EC requirements, and will minimise compliance costs. In addition, in our view there is little justification for both Commissions to have mandates for distribution pricing, and we hope in the longer term this overlap can be eliminated with responsibility being assigned to one or the other.

10. The table below illustrates the significant overlap between the statutory objectives of the EC and the CC.

<b>Commerce Commission (Part 4 Commerce Act)</b>	<b>Electricity Commission (Electricity Act and GPS)</b>
Overall purpose of Part 4 is to promote the <b>long-term benefit of consumers</b> (s52A)	Electricity is produced and delivered to <b>consumers in an efficient, fair, reliable and environmentally sustainable manner</b> (s172N(1)) Barriers to competition are minimised for the <b>long-term benefit</b> of end users (s172N(1))
Overall purpose of Part 4 ... promote outcomes consistent with outcomes produced in <b>competitive markets</b> (s52A)	To promote and facilitate the <b>efficient use of electricity</b> (s172N(1)) Energy and other resources are used <b>efficiently</b> (s172N(2))
Have incentives to <b>innovate and invest</b> (s52A)	Incentives for <b>investment</b> in ... lines (s172N(2))
Have incentives to <b>improve efficiency</b> (s52A)	Delivered electricity prices are subject to <b>sustained downward pressure</b> (s172N(2))
Have incentives to ... provide services at a <b>quality that reflects consumer demands</b> (s52A)	Electricity is produced and delivered to <b>consumers in a ... reliable and environmentally sustainable manner</b> (s172N(1)) <b>Costs of transporting</b> each additional unit are signalled (s172N(2))
Share with consumers the benefits of efficiency gains.... including through <b>lower prices</b> (s52A)	<b>Costs of transporting</b> each additional unit are signalled (s172N(2))
Are limited in their ability to extract <b>excessive profits</b> (s52A)	Electricity is produced and delivered to <b>consumers in an efficient, fair ... manner</b> (s172N(1))
Promote incentives, and avoid disincentives, to invest in <b>energy efficiency, demand side management and to reduce energy losses</b> (s54Q)	Incentives for investment in ... <b>energy efficiency and demand side management</b> (s172N(2)) Contribute to achieving climate change objectives by .... <b>managing distribution losses... promoting demand side management and energy efficiency</b> (s172N(2))

11. In addition, section 172O of the Act requires the EC to give effect to Government Policy Statements. In respect of distribution pricing the following are relevant:

- Paragraph 100 – develop principles or model approaches, and monitor their uptake;

- Paragraph 101 – consider whether standardisation or simplification of tariff schedules would facilitate market entry by retailers;
  - Paragraph 102 – distributors are to keep any changes to rural line charges in line with changes to urban line charges.
12. The GPS requirement to develop principles or model approaches is similar to the Commerce Act requirement for the CC to develop a pricing input methodology, and is consistent with the existing requirement on all EDBs to disclose pricing methodologies as part of information disclosure regulation. Paragraphs 101 and 102 of the GPS however include objectives which are outside of those which the CC has. The CC, in developing its pricing input methodology has indicated however that it will be mindful of the EC's obligations in this respect.
13. The Discussion Paper suggests at paragraph 4.5.4 that the EC's approach to distribution pricing has a much broader application than does the CC's. We accept that there is a wider mandate for the EC, but we dispute the inference that there is a significant difference for the following reasons:
- Although the pricing input methodology does not have to be applied by EDBs which meet the consumer owned exemption criteria for the purpose of the Part 4 information disclosure regime, consumer owned businesses must disclose the pricing methodology they do use and thus it will be possible to monitor the extent to which these are consistent with the EC's principles;
  - As the EC has no mandate to force retailers to adopt the tariff structures or prices published by EDBs, there is a limit to what extent any principles or model approaches implemented by the EC will enhance retail competition. This issue is discussed further in Section III of this submission;
  - In its Input Methodology consultations the CC has already recognised that EDBs have additional legislative obligations they must meet in terms of pricing (including the low fixed charge regulations for example) and is intending to incorporate recognition of these in its pricing input methodology.
14. Accordingly, we submit that given the considerable overlap between the legislative obligations of the two regulatory bodies, the requirements on EDBs for pricing methodologies should be consistent, and can be implemented without duplicating compliance processes. This is an important objective, as duplication and potential inconsistencies must be avoided to ensure regulatory compliance costs are minimised. We address the compliance process further in section V of our submission.

### **III Retail Competition**

15. In our earlier submission, we questioned whether distribution prices were a real barrier to retail competition. The discussions at the workshops facilitated by the EC and attended by both retailers and distributors, suggest that while there may be complexity and possible

misunderstandings at a retail level concerning distribution prices, it was questionable whether these were truly inhibiting retail competition.

16. There was some discussion at the workshop about how standardisation of terminology used by EDBs in their tariff design could assist retailers incorporate line charges from many distributors into retail pricing. We support such an initiative. It is in the long term interests of consumers to simplify retail pricing processes. We believe this will contribute to the EC's objective of enhancing retail competition and maintaining downward pressure on prices.
17. In addition, we note that many of the examples of distribution pricing complexity discussed at the workshops, reflected circumstances relevant to one or a few distributors and/or retailers. The examples given indicate that these issues can be resolved by discussion between parties. We believe this is the best course of action where specific issues exist with an EDB's tariff structure. It is not appropriate to impose additional regulation on all EDBs simply to attempt to address current issues affecting a limited number of parties, which may be readily resolved in the manner described above.
18. In addition, as noted above, there is no mandate for the EC to ensure that EDB pricing signals or tariff structures are reflected in retail tariffs and passed onto consumers. Accordingly, while we support the development of pricing principles that ensure EDBs' prices are economically efficient and consistent with other legislative requirements, we believe it is inappropriate to introduce further regulatory intervention into distribution prices where the perceived benefits of such intervention cannot be achieved due to structural market constraints.

#### IV Principles in Practice

19. The Discussion Paper proposes a set of pricing principles which are broadly based on those developed for the CC's Gas Authorisation. Our earlier submission supported the adoption of the Gas Authorisation principles. The Discussion Paper however proposes a number of additions and amendments to the Gas Authorisation principles, which we have included (and underlined) below:
  - 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 stand alone costs) except where subsidies arise from legislation;*
    - (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.*
  - 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 responsiveness (i.e.: Ramsey pricing) and/or the quality of service they receive, to the extent practicable.*

- c) *Provided that prices satisfy (1) above, prices should be responsive to the requirements, and circumstances of users in order to:*
  - (i) discourage uneconomic bypass, and*
  - ~~*(b) allow negotiation to better reflect the economic value of specific services.*~~
  - (ii) to allow for price/quality tradeoffs.*
- d) *Development of prices should be transparent, promote price stability and certainty for ~~customers~~ consumers, and ~~changes to prices should have regard to the impact on customers.~~ lead to prices that are able to be understood by users.*
- e) *Pricing structures should not place undue transaction costs on retailers and consumers, and should be competitively neutral across retailers.*
- 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.*

20. We acknowledge that the proposed modifications to the Gas Authorisation principles are intended to incorporate specific objectives of the EC. However, we do not support a number of the proposed modifications which we believe are inconsistent with a principle approach to pricing, and also incorporate objectives which are better served by other regulations and guidance. Pricing methodologies are not the only mechanism the EC or the CC have available to encourage certain behaviour or incentivise EDBs or the end consumers of distribution services.

21. Specifically we submit the following amendments are required to the proposed principles, for the reasons set out in the following table:

Proposed Principle	Reason Not Supported
<p><i>a) Prices are to signal the economic costs of service provision by:</i></p> <ul style="list-style-type: none"> <li><i>(i) being subsidy free (equal to or greater than incremental costs, and less than or equal to stand alone costs) <u>except where subsidies arise from compliance with legislation or other regulations;</u></i></li> <li><i>(ii) having regard, to the extent practicable, to the level of available service capacity; and</i></li> <li><i>(iii) signalling, to the extent practicable, the impact of additional usage on future investment costs.</i></li> </ul>	<p>Suggested insertions clarify that compliance obligations may distort economic pricing signals.</p>
<p><i>(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</i></p>	<p>The proposed insert is not necessary, is inconsistent with a “principle” approach, can be included in supplementary guidance, and as set out in the CC’s Input Methodology paper, there are practical limitations to</p>

<p><del>responsiveness (ie: Ramsey pricing) and/or the quality of service they receive, to the extent practicable.</del></p>	<p>Ramsey Pricing which need to be considered. The principle (as it exists in the Gas Authorisation) is appropriate. The introduction of quality of service in this principle is also confusing, and issues pertaining with quality are better addressed in (c).</p>
<p>(c) <i>Provided that prices satisfy (1) above, prices should be responsive to the requirements, and circumstances of users in order to:</i></p> <p><del>(i) discourage uneconomic bypass, and (ii) allow negotiation to better reflect the economic value of specific services.</del></p> <p><del>(ii) to allow for price/quality tradeoffs.</del></p> <p><i>(ii) allow negotiation to better reflect the economic value of specific services.</i></p>	<p>We do not support the 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. We believe the existing wording 'economic value of specific services' is more valid, as this links the service requirement to its value, which is the appropriate principle to underpin pricing. The concept of negotiation is also useful, as it reflects the reality of setting service standards for those consumers which are able to consider possible alternatives.</p>
<p><del>(d) Development of prices should be transparent, promote price stability and certainty for customers consumers, and changes to prices should have regard to the impact on customers. lead to prices that are able to be understood by users. Changes to prices should have regard to the impact on customers consumers</del></p>	<p>There is no need for the transparency requirement, as this is what disclosures are attempting to achieve. The remainder of the insert is also not required, as it is unreasonable to expect stability and certainty, when innovation is important, and price signals are an important mechanism to influence behaviour. Also the term 'users' is not defined, and it is not clear who this is referring to. We support the original reference to the impact on consumers as transitioning new pricing structures is an important component of any pricing methodology.</p>
<p><del>(e) Pricing structures should not place undue transaction costs on retailers and consumers, and should be competitively neutral across retailers. Changes to prices should have regard to the likely cost impact on retailers. Retailers should be treated in an economically equivalent manner.</del></p>	<p>The term 'undue' is ambiguous. It is more appropriate to refer to economically equivalent in the context of the economic pricing principles than competitively neutral.</p>
<p><del>f) Prices and pricing structures should promote efficient usage of electricity and</del></p>	<p>These objectives are better met using other forms of regulation and place undue</p>

<p><u>encourage investment in distributed generation (including renewable generation), distribution alternatives and technology innovation.</u></p>	<p>limitations on distributors' ability to recover their costs, including the recovery of investment in sunk assets. In addition electricity is not just a provision of energy it is delivery and quality, including reliability. Energy efficiency is already covered above in (a). In addition the CC is developing explicit regulatory mechanisms to address energy efficiency, to ensure EDBs are not disincentivised from investing in energy efficiency initiatives.</p> <p>Distributed generation is adequately covered by the Distributed Generation Regulations and inclusion of this requirement in a pricing methodology principle is confusing, excessive and creates potential inconsistencies in the regulations applying to EDBs.</p> <p>Distribution alternatives and technology innovation are not objectives which are readily achieved through pricing methodologies, but they are objectives which can be disincentivised by overly prescriptive regulation.</p> <p>Innovation, including possible distribution alternatives, is best dealt with through the price-quality path and is being explicitly considered by the CC as it develops its efficiency carry over mechanisms and CPI-X regime. In addition the uneconomic bypass requirement in principle (c) above already addresses this requirement.</p>
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22. In addition we have reviewed the proposed methodological requirements included in the Discussion Paper. We believe that these are not required, and as proposed are inconsistent with the principle approach to pricing methodologies. In particular the proposed requirements are too limiting and they presuppose that certain approaches will be applied and exclude other potential approaches. They are also far too prescriptive and we strongly oppose the level of detail included in them particularly as they were developed originally to ensure a control authorisation was implemented appropriately.
23. We acknowledge the proposed methodological requirements were loosely based on the Gas Authorisation requirements. However, as noted above the Gas Authorisation represented a detailed investigation into two networks which resulted in controlled prices being set for a defined period. Accordingly the CC imposed a high level of regulatory oversight on how the

controlled prices were to be implemented. This approach is not appropriate for either the CC's or the EC's objectives (and mandates) in respect of pricing methodologies for EDBs. We address this issue further in Section V of this submission.

24. In order to assist EDBs to comply with the principles, we believe a set of Guidelines is required which sets out the information that is expected to be included within a disclosed pricing methodology. This is similar to the guidance provided in the Electricity Distribution (Information Disclosure) Requirements (IDRs) for pricing methodologies and is also an approach used for Asset Management Plan (AMP) disclosures.

25. Useful examples of such Guidance already exist in Requirement 23 of the IDRs as follows:

Every disclosure must:

- Describe the methodology used to calculate the prices charged or to be charged;
- Include the key components of the revenue required to cover costs and profits, including cost of capital and transmission charges, which must include the numerical value of each of the components;
- State the consumer groups used to calculate the prices charged or to be charged, including:
  - The rationale for the consumer grouping;
  - The method by which the disclosing entity determines which group the consumers are in;
  - For each of these consumer groups, the statistics relating to that group which were used in the methodology; and
- Describe the method by which the disclosing entity allocated the components of 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
- Describe the method by which the disclosing entity determined the proportion of its charges which are fixed and variable, and the rationale for determining the proportions in this manner.

26. In addition, the CC's recent Information Disclosure Discussion Paper, published in July 2009, which includes a review of the information disclosure requirements for EDBs, sets out the CC's proposed minimum requirements for pricing methodology disclosures as follows:

- 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;

- Customer and volume statistics.<sup>2</sup>
27. The examples set out above should form the basis of any Guidance to be provided to EDBs to assist them in preparing their pricing methodology disclosures.
28. The presentation at the workshop session on 'Distribution pricing principles and methodological requirements' included the content of a proposed pricing report, largely based on the Gas Authorisation requirements. This proposal is not consistent with the CC's recommendations for EDB disclosures. In particular we do not support the following suggestions, which appear to originate from the Gas Authorisation requirements:
- Explanation of proposed methodology – as far as we are aware there is no intention that an EDB would put forward a proposal and nor should there be. The purpose of the pricing methodology disclosure is to document the approach taken in deriving the tariffs which have been introduced. The EC's proposal suggests there would be some form of approval required, which we strongly oppose. There is no requirement for such under Part 4 of the Commerce Act (other than in relation to the pricing aspect of a CPP) nor is there in any of the mandates as we understand them for the EC;
  - Summary of the overall tariff strategy for the next five years and the medium term tariff strategy – we also believe this is excessive, unreasonable and outside the mandates of both Commissions. EDBs have been subject to considerable regulatory intervention, uncertainty and change. In addition as noted previously, EDBs must be able to innovate and adapt in response to consumer behaviour and technological change;
  - Cost of supply model – there is no mandate for the EC or the CC to require EDBs to provide cost of supply models (other than possibly in respect of a CPP proposal), nor have them audited. This was appropriate for the Gas Authorisation, but not for a disclosure requirement to apply to all EDBs. The compliance and review costs for this proposal are simply not justified.

## V Compliance Process

29. As stated above, we do not believe that a compliance process that was developed for the Gas Control Authorisation is appropriate for pricing methodology guidance to apply to a large number of entities who are not subject to the same level of regulatory intervention as that implied by the control authorisation.
30. For this reason we do not support the proposals for the publication of annual statements of variance/compliance, submission of a cost of supply model, disclosures of future pricing expectations, EC audit and review and possible regulation. This is not justified and inconsistent with the regulatory mandate of both the CC and the EC in respect of pricing methodologies. The cost of compliance of such a process will be excessive, and inconsistent with potential benefits (if any) of such an intrusive process.

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<sup>2</sup> Commerce Commission, Information Disclosure, Discussion Paper, July 2009, Paragraph 484

31. We therefore propose an alternative compliance process, similar to the AMP review process established by the CC as part of the existing information disclosure requirements for EDBs and more consistent with the regulatory objectives for pricing methodology disclosures. The key aspects of the AMP compliance and review process are as follows:
- EDBs must disclose AMPs;
  - The AMPs must contain the information set out in the Information Disclosure Requirements;
  - Periodically the CC engages asset management planning experts to review the AMPs and prepare a report, which is published, which assesses the AMPs for compliance and best practice. In addition a summary of the review is published, indicating compliance trends, issues and best practice;
  - In subsequent AMPs EDBs are able to address any areas of non compliance and consider the approaches adopted by others which are deemed to represent best practice.
32. The outcome of this process has been continuous improvement in AMPs, not just from a compliance perspective, but also the manner in which information is presented and the linkages which are 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 AMPs by appropriate experts and the publication of the review findings. We have observed that few Network Managers appreciate their AMPs receiving a poor review and this has often resulted in a major review and update of the AMP.
33. A similar review process could be considered for pricing methodology disclosures, and is consistent with a principle rather than a prescriptive approach to pricing. The purpose of the review should be to monitor how EDB pricing methodologies have regard to the pricing principles. We suggest that one of the Commissions (not both) takes responsibility for initiating a review of disclosed pricing methodologies. It is our expectation that examples of best practice will emerge from such a review and if there are any compliance issues these will also become evident.

### **Final Thoughts**

We note that there has been no specific mention of the manner in which EDBs recover the costs of losses in the pricing methodology papers issued by the EC. It is important that the EC recognises, and endorses that EDBs are entitled to recover from retailers the full costs of the transportation of unaccounted for energy.

We look forward to the opportunity to provide further input into the EC's Distribution Pricing Methodology Consultation and in particular to provide further input into the Guidelines and compliance process to be developed. We also note and support the proposal for an industry working group on standardisation of relevant terminology where possible.

If you have any queries in relation to this submission, please contact either of the signatories below.

Yours faithfully



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