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Discussion Paper – Draft Distribution Pricing Principles and Methodological Requirements (30 September 2009)

1. Introduction

Unison Networks Limited (Unison) appreciates the opportunity to submit on the Electricity Commission's (Commission) 'Distribution Pricing Principles and Methodology Requirements Discussion Paper' (Discussion Paper) dated the 30th of September 2009.

Unison is pleased that the Commission is proposing to adopt pricing principles rather than a prescriptive model approach. The prescriptive model approach originally proposed by the Commission would have had a significant negative impact on the regulatory environment for Unison as an electricity distribution business ("EDB").

Unison appreciated the Commission conducting the recent workshop for industry participants. It is important that participants can voice concerns and provide feedback on what the Commission is proposing. We consider that the Distribution Pricing Administrative Issues Working Group (DPAIWG) will be very beneficial to facilitate common understanding of consumer, retailer and EDB perspectives at a more detailed level in respect to administrative issues. It will also assist in the separation of the administrative issues, which may be the real genesis of retailer concerns, from issues of tariff standardisation.

2. Summary

Following the assessment of the submissions received on the Distribution Pricing Methodology Consultation Paper (5 June 2009), the Commission has reconsidered its approach in respect to the degree of prescription required for pricing methodologies. It is positive that the Commission has taken into account submitter viewpoints and the intention of Part 4 of the Commerce Act.

Unison is concerned that the Commission is proposing to provide methodological requirements. In our view non-mandatory guidelines would be more appropriate for assisting EDBs in their pricing methodology disclosures. We consider that the existing Information Disclosure Requirements could be utilised as a basis for these non-mandatory guidelines. The proposed reporting requirements would result in an onerous compliance burden on EDBs. Due to the limited time to complete this submission, we would like to give the form of regulatory monitoring more consideration. Our preliminary view is that a self-reporting process, similar to the approach used to regulate Asset Management Plans (AMPs) may be an efficient way to ensure compliance by EDBs.

Unison is still concerned that the focus at the recent workshop[1] was on retailer competition in the New Zealand electricity market. We do not dispute that retailer competition is important, nor do we dispute that stakeholders should make changes where possible, such as standardisation of terminology, to reduce unnecessary transaction costs that are ultimately borne by the consumer. However, we do not believe that tariff complexity is the barrier to retail competition, nor do we believe that there are material transaction costs compared to the economic cost of restricting EDB prices.

3. Proposed Pricing Principles

Unison supports the Commission's principle-based approach in the Discussion Paper. It is positive that the Commission has considered the Commerce Commission's preliminary views on pricing methodologies, and is utilising the approach adopted by the Commerce Commission in the Gas Authorisation for Powerco and Vector. Such an approach will better enable distributors to provide innovative pricing arrangements to encourage more efficient use of networks and promote improvements in economic efficiency. The principles-based approach is aligned to the Part 4 requirement; that the regulatory regime must promote incentives to improve energy efficiency, and ensure that there are incentives for EDBs to innovate and invest.

We refer to our views expressed in our previous submission[2] in respect to the benefits of a principles-based approach compared to a prescriptive model approach. The process of setting EDB prices is complex, and the resulting prices must allow an EDB to recover common and asset related costs across customers with different usage profiles and service requirements. Without price signals from EDBs there will be quality, cash-flow and energy efficiency consequences.

An example of where Unison's pricing methodology resulted in beneficial investment and more efficient outcomes, was the introduction of power factor charges by Unison in 2007 for end consumers with time of use metering. The new price signals provided the incentive for the affected consumers to stagger the start-up of their machinery, rather than starting all their machinery at the same time. This dramatically reduced the start up demand load from these consumers, reducing peak consumption, and therefore optimising network investment. This example emphasises the need for consumers to receive efficient price signals.

Unison is concerned that at this present time the full impact of the signals for peak capacity usage are being lost by the retailers repackaging transmission and distribution pricing. Therefore the consumer can only respond to the overall energy cost.

We consider it is crucial that a principle-based approach is adopted as the electricity market is entering into more dynamic phase where smart meters will enable much better price signalling. A principle-based approach will better enable distributors to provide innovative

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[1] 12th of October, Wellington.

[2] Unison's submission to the Electricity Commission "Proposed Model Approach to Distribution Pricing Methodology (5 June 2009); dated 10 July 2009; pages 6-8.

pricing arrangements to encourage better use of networks and promote improvements in economic efficiency.

In general Unison agrees with the Commission's proposed principles. However, we recommend certain changes to ensure certainty and clarity of intention, as discussed at the recent workshop. These recommendations along with explanatory comments are contained in Appendix A. We also note that the Gas Authorisation requires pricing methodologies to "have regard to and be consistent with the pricing principles",[3] i.e. does not require rigid adherence. The pricing principles and methodological requirements in the Gas Authorisation also allow Vector and Powerco to comply with the requirements "to the extent practicable". In our view a similar approach should be taken in respect to EDB compliance to the pricing principles, to take into account the inevitable limitations on EDBs trying to achieve a workable tariff structure.

4. Compliance with the Proposed Pricing Principles

4.1 Proposed Methodological Requirements

Unison considers that the proposed methodological requirements are not necessary. It is more appropriate for the Commission to provide non-mandatory guidelines to assist EDBs in regards to what should be contained in their pricing methodology disclosures.

The basis for this view comes from the concern that the Commission is suggesting an unnecessary high level of regulatory intervention. The principles can be adhered to by a form of self-reporting, as implied in our previous submission[4]. We also stress below that care needs to be taken that there is not a duplication of reporting in respect to the requirements under Part 4 of the Commerce Act. There needs to be an effective and practicable approach to monitoring the uptake of the proposed principles, without the imposition of unnecessary compliance costs.

Unison considers that there is already useful guidance in the Commerce Commission Electricity Information Disclosure Requirements[5], under requirement 23 'Contents of pricing methodology disclosures'. Although this requirement currently assumes a building blocks approach (and therefore does not recognise that prices are subject to price controls) this could be corrected with minor modifications.

> *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*

[3] Commerce Commission, Commerce Commission Authorisation, "Authorisation pursuant to the Commerce Act 1986 in the matter of controlled services supplied by Vector Limited", Decision No. 657, 30 October 2008, clause 7.3.1.

[4] Unison's submission to the Electricity Commission "Proposed Model Approach to Distribution Pricing Methodology (5 June 2009); dated 10 July 2009; page 15.

[5] Commerce Commission Electricity Information Disclosure Requirements issued 31 March 2004 (Consolidating all amendments to 31 October 2008).

(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.

The guidance contained in requirement 23 is consistent with the Commerce Commission's preliminary views on its approach to information disclosure regulation under Part 4 of the Commerce Act[6].

> *The level of disclosure may need to be tailored for each industry sector, but it is the preliminary view of the Commission 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.*

Unison's view is that the Commerce Commission's Information Disclosure Requirements should be used as a basis for the formation of non-mandatory guidelines. Best practice will also naturally develop from the proposed review process described below.

The Commerce Commission's existing and proposed Information Disclosure Regulation, default price-quality path and forthcoming input methodologies will provide sufficient mechanisms to ensure service levels, protection of consumers and the delivery of efficient prices. The Commission's proposed methodological requirements represent an open book approach to pricing development and tariff setting that goes far beyond the Commerce Commission's requirements, potentially harming the commercial interests of EDBs as well as jeopardising the long term development of services for consumers. While pricing development and tariff's should be consistent with an agreed set of principles, demonstrated by information disclosure, EDBs should have the discretion to exercise commercial judgement in tariff setting to achieve long term business objectives that benefit both the consumer and the business. Included in this discretion should be the ability to: set and transition tariffs to mitigate price shocks; maintain relativity among tariffs to encourage efficient asset utilisation and discourage bypass; and encourage the uptake of services to achieve economies of scale.

[6] Commerce Commission Information Disclosure Discussion Paper (29 July 2009).

4.2 Compliance Reporting and Pricing Report

The proposed compliance reporting requirements, and the proposed Pricing Report if the Commission considers that the EDB has not met the criteria for compliance, would be onerous and costly to EDBs. Further to the suggestion that the proposed methodological requirements be amended to guidelines, we recommend a lower cost option would be more appropriate than such highly detailed disclosure reporting requirements.

We believe the Commission needs to reconsider the proposed reporting requirements in light of the Gas Authorisation experience. We understand that Vector and Powerco's experience of complying with the Commerce Commission's Gas Authorisation has proved to be a costly compliance exercise. A compliance statement every time you change your pricing methodology would be a high cost to an EDB, and therefore a barrier to innovation.

At the recent workshop Powerco commented that, based on its experience under the Gas Authorisation, the reporting requirements proposed by the Commission will result in high costs to EDBs, as there will need to be increases in resources to manage the compliance reporting, plus the auditing of the cost of supply model.

The costs associated with preparing a compliance statement every time that a pricing methodology is changed will provide a strong disincentive for an EDB to change its pricing methodology, which in turn will discourage the innovative changes to pricing that we highlighted in our earlier example. The absence of innovations in pricing will lead to further costs, as neither demand nor network investment will be optimised. Ultimately the increased compliance costs and the foregone opportunities for investment optimisation will impact on the end consumer.

4.3 Recommended Approach to Monitoring

The proposed pricing principles, taking into account the suggested changes, are highly likely to be the final approach adopted by the Commerce Commission as part of their input methodologies for pricing.

The Commerce Commission requires EDBs to disclose their pricing methodology each year on the basis of the Information Disclosure Requirements. These existing requirements are currently under consultation to ensure they are appropriate for the new Part 4 Regime, and for the development of information disclosure determinations for the suppliers of regulated services. The Discussion Paper under Phase I of this consultation process (as detailed above), states the Commerce Commission's preliminary view is that the revised pricing disclosure requirement should include a description of the methodology used, and how the methodology links to any applicable pricing principles. Effectively EDBs will need to demonstrate how they have had regard to the principles, and it will then be apparent whether an EDB's pricing methodology is compliant. Non-mandatory guidelines provided by the Commission would assist an EDB in preparing for this disclosure. We consider the principal compliance test will be that the EDB must describe how they have had "regard to" the pricing principles. Non-mandatory guidelines will provide the EDB with the flexibility to achieve efficient and innovative prices without unnecessary restrictions.

We therefore recommend that a description of how the pricing principles have been applied should be part of the pricing methodology documentation required under the Commerce Commission's Information Disclosure Regulations. Our preliminary view is that such a disclosure could incorporate the 'statement of variation/compliance' that was discussed at the recent workshop. We are of the view this statement does not need to be audited. The cost of an independent audit would outweigh any potential benefits.

To assess whether the EDB is compliant either the Commission or the Commerce Commission could appoint an external consultant to produce a compliance report. Due to the limited time to complete this submission, we need to give this form of regulatory monitoring more consideration. At this stage our preliminary view is that this external review process resulting in a report could be similar to the AMP review process. In our experience to date the AMP process has encouraged compliance by EDBs and highlighted their best practices and innovative procedures. This self-reporting process has benefits for all stakeholders, at the same time minimising compliance costs.

Similar to how EDBs strive to improve the quality of their AMPs, EDBs would be incentivised to disclose their pricing methodology to demonstrate it as effective and economically sound as other EDBs. An EDB would not want consumers and stakeholders to perceive that their pricing methodology does not embrace the agreed pricing principles. As well as a regulatory requirement, EDBs find the AMP and the resulting report beneficial for internal business practices. Such a reporting process for pricing would add value to the business, not just be an additional regulatory obligation. Our initial view is that the report produced should focus on the quality of the decision making, as each EDB is different due to a number of factors, like size, geographical location, ownership and age. This would also be beneficial in providing the opportunity for the regulatory body that carries out this process to be targeted in their recommendations to particular EDBs.

We agree that if the regulatory body monitoring the compliance with the pricing principles believes an EDB is consistently and deliberately not taking those principles into account, then the regulatory body should have the ability to request further information from the EDB. However, the regulatory body needs to clearly specify what they believe to be non-compliance, and there needs to an opportunity for the EDB to change its methodology.

5. Workshop

From the recent workshop, we are still concerned that the Commission appears to be captured by retailer concerns, in particular their concerns around administrative and transaction costs inhibiting competition. EDBs are not saying that there is no benefit from the standardisation of pricing tariffs, but we are questioning how much the benefit would be in comparison to the cost involved. The retailers' administrative costs are only one category of costs that need to be considered, and should be balanced against other costs such as sub-optimal network management and development, and excessive consumption in peak periods. New Zealand's distribution is characterised by having 29 EDBs, plus embedded networks. Every EDB in New Zealand has a unique demand profile, and has a unique set of consumers, and therefore has different drivers at different times. As we have previously submitted, if the retailer problem is with the number of small EDBs in New Zealand, we have the concern that the proposed approach will have significant impacts on all the EDBs without addressing the underlying problem.

Concerns were also raised at the recent workshop in respect to how the Commission would ensure that any improvements by pricing regulation were not outweighed by the compliance cost. As noted earlier in this letter, high compliance costs will discourage pricing innovation, potentially leading to sub-optimal network development. Both the costs of compliance and the costs of sub-optimal network development will be passed on to consumers. The Commission needs to be sure that the benefits from standardised pricing structures would be sufficiently large that they outweigh these costs.

Unison is pleased that there was discussion at the workshop about what advanced metering infrastructure (AMI) means for pricing innovation. We stress that care needs to be taken that the potential benefits of AMI are not constrained by "dumb pricing". As highlighted in Unison's response to the "Improving Electricity Market Performance Discussion Paper"[7], recommendations in the Discussion Paper supported the notion of AMI providing an information service for EDB customers that allows them to make the most of the options and choices available to them; everything from embedded generation, demand automation and response as well as competitive retail options. We proposed that it is the EDBs who are best positioned to take this role of providing the information service, and in so doing facilitate the development of enhanced competition in the retail market. Least-common-denominator distribution pricing terms are not the solution to increasing retail competitiveness. Separating transport from energy is.

6. Clarity of the Commission and Commerce Commission's roles

We appreciate that the Commission has to develop an approach to distribution pricing and monitor the uptake of the approach, under the Electricity Act 1992 and the 2009 Government Policy Statement on Electricity Governance. However, the Commission's work stream is happening simultaneously with the Commerce Commission's work on input methodologies.

The retailer capture of the Commission resulted in the last Consultation Paper proposing a prescriptive model approach. This was an inappropriate approach for consultation, and could have been avoided if the two commissions had worked more closely together. We are pleased that there has been a change of focus in the current Discussion Paper, and the Commission has supported the development of the DPAIWG to facilitate common understanding of consumer, retailer and EDB perspectives.

However, we reiterate our unease that we are yet to see clarity on how the roles of the two commissions will work. Our understanding from the Discussion Paper is that we will have to disclose the same information, in the same format, to both the commissions. In addition the Commission will require additional information[8], and potentially also the same information in a different format. What value is there in the information being sent to both commissions? Will they both monitor compliance? What will the impact be on the EDB, if one of the commissions decides the EDB is non-compliant? These issues need to be addressed before the Commission advances its proposals any further.

6. Concluding comments

In conclusion, Unison supports the Commission's decision to adopt a principles-based approach. We have appreciated the recent Commission organised workshops to facilitate discussion, and consider that the development of the DPAIWG is very beneficial in facilitating common understanding of consumer, retailer and EDB perspectives at a more detailed level.

As expressed in this submission, we consider that non-mandatory guidelines would be more appropriate than the proposed methodological requirements. We look forward to further

[7] Unison's submission "Improving Market Performance Discussion Paper; page 16; dated 16 September 2009.

[8] Discussion Paper; page 27.

engagement with the Commission in respect to how EDB’s compliance with the pricing principles can be monitored.

Should you require further information or have the need to consult with Unison further on this submission, please contact Amanda Reid in the first instance on (06) 873 9372.

Yours sincerely,

Amanda Reid

Regulatory Affairs Analyst

Appendix A:

Deletions shown as strikethrough and additions made in italics.

(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), except where subsidies arise from legislation *or other regulations*;

(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.

Comment: We note that the mention of legislation is not strictly necessary, as legislation must always take precedence over principles. However, it is useful for lay readers to be reminded that there are considerations other than the just the pricing principles that must be taken into account. This reminder could be by way of a preamble to the principles or, as suggested by the Commission's change, by way of specific mention in the principles. We recommend that the wording is amended to also recognise that *regulations* may also constrain pricing (such as the *Electricity* (*Low Fixed Charge Tariff Option for Domestic Consumers*) *Regulations*, which can significantly constrain an EDB's ability to price in an efficient and cost-reflective manner).

(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. *is qualitatively consistent with* Ramsey pricing)~~ and/or the quality of service that they receive,~~ to the extent practicable.

Comment: For clarity we recommend the removal of "and/or the quality of service that they receive", as the focus of this principle is on demand responsiveness. The introduction of the concept of a price quality trade-off is confusing when the principle is looking at demand elasticities. We also note that efficient incremental costs should take account of the level of quality delivered.

We recommend that the mention of Ramsey Pricing is qualified by the addition of the words "*is qualitatively consistent with …*" It is well recognised that Ramsey Pricing is extremely difficult to apply in practice, particularly because it is very difficult to accurately measure demand elasticities.

(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;

~~(ii) to allow for price/quality tradeoffs;~~

(ii) *allow negotiation to better reflect the economic value of specific services; and*

(iii) *where network economics warrant; encourage investment in distribution alternatives (e.g. distributed generation) and technology innovation.*

Comment: Recommend the inclusion of the allowance for individual negotiation (as in the Gas Authorisation). It is good business practice to have consultation with customers, and to cater for their specific business requirements.

~~(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.~~

Development of prices should be transparent, promote price stability and certainty for stakeholders, and changes to prices should have regard to the likely impact on customers.

Comment: We consider that transparency will be demonstrated through compliance with the Commerce Commission's Information Disclosure regime.

To clarify the intention of this principle we recommend "consumers" is changed to "stakeholder", to recognise that price stability and certainty is important to retailers as well as end-consumers.

We recommend the removal of "and lead to prices that are able to be understood by users" on the basis that this would be a subjective test, depending on the level of consumer engagement. With the roll out of AMI and the view to have distribution charges being transparent to customers, EDBs strategies are moving towards educating customers on pricing. This is important as over simplified pricing will be at the expense of other efficiencies which will have a greater benefit to the end customer.

We do not support the deletion of "and changes to prices should have regard to the impact on customers", This is an important aspect of flexibility that needs to be retained, and allows EDB to apply a transitional approach to mitigate price shocks.

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

Development of prices should, to the extent practicable, have regard to the transaction costs that impact various stakeholders.

Comment: Further to our comments under the heading "5. Workshop" in this submission, we have seen no material evidence that the transaction and administrative costs incurred by retailers due to current EDB pricing methodologies are exorbitantly high thus resulting in barriers to retail competition.

Unison does consider that it is important when changing prices to have regard to the cost impact on retailers, this is demonstrated by the consultation process that occurs each year. This should not however be given dominance over the benefits of price signalling. Transaction costs may also be incurred by EDBs.

The use of "have regard to", requires EDBs to demonstrate that they have considered the cost impact on retailers. We consider this more appropriate than a subjective test of what "undue transaction costs" are.

Neither the requirement that prices "should be competitively neutral across retailers" nor the requirement that retailers "should be treated in an economically equivalent manner" are a necessary part of the pricing principles, as they are already required by section 36 of the Commerce Act 1986.

(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~~.

Comment: In our view this fits more logically as part of principle (c). Pricing should not specifically encourage investment in distributed or renewable generation, or in distribution alternatives, unless it is efficient to do so. A more appropriate principle is, therefore, simply that prices and pricing structures should promote efficient use of delivered electricity, including existing electricity infrastructure, distributed and renewable generation, and distribution alternatives. This is addressed by our suggested addition to principle (c).