Submission to the Electricity Commission on Draft Distribution Pricing Principles and Methodological Requirements - Discussion Paper

30 October 2009

OVERVIEW

1. Vector welcomes the opportunity to submit on the Electricity Commission's ("Commission's") Draft Distribution Pricing Principles and Methodological Requirements Discussion Paper ("discussion paper").

2. In our previous submission, Vector proposed a principles-based approach to distribution pricing methodologies, with modification to take into account potential transactions costs resulting from unnecessary tariff complexity.

3. More specifically our recommendations included:

    a. Adopting the Gas Authorisation[1] pricing principles, with modification to require distributors to demonstrate how their tariff structures have been developed to take into account the costs imposed on retailers/consumers;

    b. Closer alignment with the Commerce Commission's development of input methodologies and information disclosures under Part 4 of the Commerce Act: Recognising the interlinked nature of the two projects; the Commerce Commission's experience in developing pricing methodologies under the Gas Authorisation and Electricity Settlement; and its view that a principle-based approach has more favourable characteristics;

    c. Holding a series of workshops to obtain a more comprehensive picture of the issues retailers face in translating distribution tariffs into retail tariffs, with a view to assisting distributors with standardisation on matters of little efficiency or equity consequence (administrative issues);

    d. Distributors reporting on how their pricing approach has had regard to the pricing principles initially and then periodically when tariff structures or cost allocation methodologies have materially changed;

    e. The Commission monitoring distributors pricing approaches and compliance against the pricing principles;

    f. Targeted interventions where the pricing principles have not been satisfactorily met by particular distributors; and

[1] Commerce Commission Authorisation, Decision no. 657, Authorisation pursuant to the Commerce Act 1986 in the matter of controlled services supplied by Vector Limited, ("Gas Authorisation"),

g. Developing a template compliance statement to assist distributors in showing compliance.

4. Similar views, particularly around the need to adopt a principles-based approach were made by a number of other submitters.

5. Consequently, Vector support's the Commission's decision to adopt a principles-based approach and greater alignment with the Commerce Commission. The workshops in particular, have been helpful in identifying the key issues that need to be addressed.

6. In this submission we focus on the development of pricing principles and an appropriate compliance mechanism. At a general level, Vector supports the distinction made between the issues of tariff standardisation and fair and efficient pricing methodologies. We welcome the Commission's working group on administrative issues that will seek to address the main tariff standardisation concerns separately.

REFINING THE PRICING PRINCIPLES

7. The Gas Authorisation pricing principles form a useful base to develop a set of principles for electricity. These original principles have undergone rigorous review and consultation by the Commerce Commission, Vector and Powerco; are still considered valid by the Commerce Commission in its consultation on input methodologies; and indeed are based on IPART's electricity pricing principles[2]. Vector supports their use as a basis for electricity distribution pricing principles.

8. The Commission has contemplated several changes to the original principles in the Discussion Paper. In the table below we provide our assessment of these changes and offer alternatives where necessary. As a preliminary comment, however, we note that the Gas Authorisation allowed Vector and Powerco to comply with the requirements "to the extent practicable". There are inherent data and complexity limitations that mean practical decisions have to be made in setting a workable tariff structure. Vector submits that compliance with the pricing principles should be "to the extent practicable".

[2] IPART is the Independent Pricing and Regulatory Tribunal in New South Wales.

Principle	Commission's proposal	Vector Comments	Vector's proposal
(a)(i)	a) prices are to signal the economic cost of service provision, by: i) being subsidy free (equal to or greater than incremental cost, and less than or equal to stand-alone costs), except where subsidies arise from legislation	Minor clarification suggested.	a) prices are to signal the economic cost of service provision, by: i) being subsidy free (equal to or greater than incremental cost, and less than or equal to stand-alone costs), except where subsidies arise from compliance with legislation or other regulations.
(a)(ii)	…ii) having regard, to the extent practicable, to the level of additional usage on future investment costs.	No change suggested	…ii) having regard, to the extent practicable, to the level of additional usage on future investment costs.
(a)(iii)	…iii) Signalling, to the extent practicable, the impact of additional usage on future investment costs	No change suggested	…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 that	The Commission is right to identify the principle as Ramsey pricing. However, it is useful at this point to note that the Commerce Commission, recognising the difficulties with quantitatively applying Ramsey pricing (e.g. calculating and applying price elasticity's of demand), provided guidance that this principle should be considered as qualitative guidance. *"given the practical difficulties with attempting to*	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. qualitatively consistent with the economic principle of

[3] Commerce Commission, "Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd", Decisions Paper, 30 October 2008, (the "Decision Paper"), Paragraph 1182.

	they receive, to the extent practicable.	*quantitatively implement Ramsey pricing in practice, the Commission recognises that the approach is more useful as a source of general qualitative guidance, rather than as a means of determining precise and definitive prescriptions for pricing"*[3] As an example, a broad application of this principle might be that, within the subsidy free range, customers that are relatively less responsive to price changes should generally have higher prices than customer groups that are more responsive. The principle could more overtly recognise this qualitative assessment. Additionally, the proposed addition of quality of service extends the principle beyond the fundamental economics behind Ramsey pricing and is already captured by principle (c)(ii). Vector, therefore, believes this statement should be removed.	Ramsey pricing), to the extent practicable.
(c) (i)	Provided that prices satisfy (a) above, prices should be responsive to the requirements and circumstances of users in order to: a. Discourage uneconomic bypass	No comment	Provided that prices satisfy (a) above, prices should be responsive to the requirements and circumstances of users in order to: a. Discourage uneconomic bypass
(c) (ii)	…(ii) to allow for price/quality tradeoffs	It is not clear in the Discussion Paper, what the substitution of "allow negotiation to better reflect the economic value of specific services" for "allow for price/quality tradeoffs" achieves. Although the two phrases address a similar issue of allowing non-standard	…(ii) allow negotiation to better reflect the economic value of specific services, including price/quality tradeoffs.

		pricing in recognition of non-standard services, there may be other less tangible elements than the price/quality trade-off that need to be considered in the development of non-standard contracts (e.g. the desire for more or less fixed pricing to have regard to risk). The original text captured these elements and also placed greater emphasis on consultation with individual customers through negotiation. It should therefore be retained, but acknowledge that negotiation may involve price quality tradeoffs.	
(d)	Development of prices should <u>be transparent,</u> promote price stability and certainty for <u>consumers</u>, <u>and lead to prices that are able to be understood by users.</u>	Vector agrees with the addition of transparency to this principle. We assume the use of "consumer" over "customer" implies that distributors should ensure price stability and certainty for end-consumer, not retailers. However, price stability and certainty (which relates to promoting pricing structure stability) will also be important for retailers, especially in minimising any transaction costs resulting from material changes in price structures, which are inevitable when shifting to a new methodology. Vector, therefore, suggests substituting "stakeholders" for "consumers". Vector does not support the inclusion of the phrase "lead to prices that are able to be understood by users". Firstly, customer understanding of pricing is a subjective test, depending on how engaged the customer wants to be. Secondly, and more importantly, the phrase, as it reads now, implies that distributors should "dumb-down" pricing to facilitate customer understanding (e.g. fully fixed). This may be at the expense of other pricing principles and more general efficiency considerations. A better strategy would be to educate customers about pricing. Moreover, it is retailers' role to take distributor's pricing and translate that	Development of prices should <u>be transparent,</u> promote price stability and certainty for <u>stakeholders</u>, <u>and changes to prices should have regard to the impact on customers</u>.

		through to customers. With the advent of smart metering, tariff complexity is likely to increase to some degree, in order to better signal (possibly dynamically) the costs and benefits of using networks at different points in time. It will be up to retailers to determine how they wish to translate such pricing signals to end consumers. The inclusion of the phrase "be transparent" appropriately addresses consumer education. Vector also does not support the deletion of the phase "and changes to prices should have regard to the impact on customers". Having the flexibility in pricing to account for the impact on customers is extremely important. We gave great weight to this principle under the Gas Authorisation as we found the process of reformulating prices under new pricing principles led to some significant price changes that needed to be transitioned over several years. This phrase should be retained.	
(e)	Pricing structures should not place undue transaction costs on retailers and consumers, and should be competitively neutral across retailers	This phrase could generally be rewritten to align more closely with the language of other principles and to recognise that transaction costs may also be incurred by distributors. We are also unsure of the purpose of the statement "and should be competitively neutral across retailers". The equitable treatment of retailers is a contractual issue and isn't required as a pricing principle. It is unclear how distributors would determine competitive neutrality, beyond establishing that prices are available to all retailers.	Development of prices should, to the extent practicable, have regard to the transaction costs that impact various stakeholders.
(f)	Prices and pricing structures should promote efficient usage of electricity	Vector recognises that the Commission has broad obligations in these areas as highlighted in section 4.3 of the discussion paper.	(Remove)

	<u>and encourage investment in distributed generation (including renewable generation), distribution alternatives and technology innovation.</u>	However, it seems this principle has been crafted as a catch all for these additional obligations without due regard to how the current Gas Authorisation principles might already promote or encourage these activities or how they might relate to new regulation being developed by the Commerce Commission. The methodological requirements proposed in the discussion paper state that a consideration of time-of-use pricing, critical peak pricing, and incorporating the value of deferral of investment will give effect to the GPS provision of demand-side management and energy efficiency. However, these areas are already provided for under principle (a). That is, principle a(ii) and a(iii) require EDBs have regard to the level of available service capacity and signal the impact of additional usage on future investment, respectively. These principles, therefore, already consider peak time pricing, capacity constraints and the potential to price to defer investment. The Commerce Commission is also still developing regulatory incentives, under input methodologies, to price in a manner that encourages energy efficiency and demand side management. Currently, the nature of the distribution price-path formula means that if less units of electricity are delivered (e.g. due to a distribution alternative or energy savings scheme) then it is impossible to compensate for this quantity related revenue loss through a price increase. For a distributor to actively encourage alternatives to the use of the distribution network or energy savings would mean actively seeking to decrease their own revenue. In light of these arguments, it does not seem necessary to	

		develop a separate pricing principle at this stage on energy efficiency, demand side management, distribution alternatives or innovative technology. The Commission should at least wait until the Commerce Commission has deliberated on regulatory incentives mechanisms that promote these initiatives so that any principle is more targeted. At a minimum, distribution pricing should only be required to promote efficient use of electricity network services, not electricity, since this is the domain of retailers. Additionally, distributors should not have to encourage distributed generation, or technological innovation, rather pricing structures should be neutral to such matters, and promote allocatively efficient use of existing sunk networks.	

COMPLIANCE APPROACH

9. The Commission and, equally, Commerce Commission require a process by which an EDB can show how they have complied with the pricing principles. In considering one approach over another, the Commission should bear in mind the compliance cost, both direct and indirect, and draw from the experience of Powerco and Vector in complying with a similar approach under the Gas Authorisation.

10. The Gas Authorisation required the development of a pricing methodology report and audited cost of supply model both of which had to "have regard to and be consistent with the pricing principles and methodological requirements"[4].

11. The Gas Authorisation pricing principles were also tempered by the words "to the extent practicable" meaning strict compliance against a principle was not ever foreseen where it was not possible, or too difficult, to do so.

12. From our experience the phrase "have regard to" meant giving genuine attention and thought to the principles during the pricing analysis and decision making process, and such weight as is considered to be appropriate and practical. This recognised that there were competing tensions between the various pricing principles and other pricing objectives that needed to be balanced in the development of a pricing methodology.

13. Given this construct, each pricing principle impacted differently on pricing decisions depending on whether they were practical to comply with and, based on genuine and bona-fide consideration, on the relative weight assigned to them compared to other principles or pricing objectives. Showing compliance against pricing principles in the context of the Gas Authorisation, therefore, meant describing the holistic analysis and decision making that was undertaken to develop the final pricing methodology.

14. However, even under such a discretionary approach it was still costly for Vector to comply with the Gas Authorisation pricing methodology requirements. We have estimated the cost to the business for both internal and external resources to be several hundred thousand dollars, mainly attributable to:

    - the initial exercise of interpreting the requirements;

[4] Commerce Commission Authorisation, Decision no. 657, Authorisation pursuant to the Commerce Act 1986 in the matter of controlled services supplied by Vector Limited, ("Gas Authorisation"), Clause 7.3.1

- the development and audit of a new cost of supply model; and
- showing compliance against the methodological requirements in a prescribed pricing methodology report.

15. The Commission proposal seems to unnecessarily maintain some aspects of the Gas Authorisation compliance approach that led to these significant compliance costs. Instead, Vector would prefer to see a least cost approach targeted to providing only the necessary information required for the Commission and Commerce Commission to monitor how distributors have had regard to the pricing principles.

16. Vector has considered the Commission's latest proposal against both our own experience under the Gas Authorisation and the Commission's and Commerce Commission's requirements, and propose the following compliance approach:

The key test of compliance

17. The key test of compliance should be that an EDB should describe how they have had "regard to" the pricing principles and other pricing objectives in developing their pricing methodology. This would include describing holistically any analysis or decision making that took place as part of the pricing process in relation to each of the pricing principles.

18. In Vector's opinion, the proposal in the discussion paper that a distributor should also show compliance with the methodological requirements should be removed. The key test of compliance needs to be against the pricing principles and parties should maintain sufficient flexibility to weight principles and other pricing objective to derive efficient and innovative prices without further restrictions.

19. Our understanding is that Gas Authorisation methodological requirements provided the Commerce Commission with additional comfort that pricing methodologies were consistent with the legal requirements of the Gas Authorisation and with the accompanying Decision Paper. By comparison, it seems unnecessary under a light-handed regulatory approach to require compliance with similarly strict methodological requirements.

20. Vector submits that more useful guidance on completing the pricing methodology is already available under Requirement 23 of the Information Disclosure requirements. The additional utilisation of the proposed methodological requirements only duplicates and confounds the provisions of this requirement.

21. Further, should the Commission still hold the view that Requirement 23 is inadequate then there is likely to be an opportunity to submit on these requirements in the Commerce Commission's consultation on electricity distribution Information Disclosures, which should begin within the next year. In any case, minor amendments of requirement 23 may be required to align with the pricing principles and new Part 4 regulations.

22. Finally, Vector also supports the decision to not require the disclosure of a detailed cost of supply model to show compliance. The fundamental process by which costs are allocated is already required to be shown under Requirement 23 of Information Disclosures.

Reporting

23. The Commission proposed at the workshop that a statement of variation/compliance be published annually at the time of the Commerce Commission disclosure reporting using the same data and formats as far as possible.

24. Vector generally supports this reporting approach but submits that compliance against the pricing principles should be shown as a section of the pricing methodology document required under Information Disclosures, rather than as a separate report as proposed. That is, a section of the pricing methodology should be devoted to the key test of how an EDB has had regard to the pricing principles. This would represent the "statement of compliance". Further, and as mentioned above, many of the methodological requirements proposed in the discussion paper will already be captured in other sections of this pricing methodology disclosure under Requirement 23.

25. Proposed annual updates of this statement of compliance also seem unnecessary, as pricing structures and methodologies are unlikely to materially change often, although actual prices will - due to CPI-X regulation. This distinction is important. Any statement describing how a distributor has had regard to the pricing principles should not need updating for annual price changes. Accordingly, the statement of compliance should be disclosed initially by distributors in their first pricing methodology under new information disclosures and subsequently updated only after material change. For clarity, material change would include changes to pricing structures or cost allocation methodologies.

26. Vector also supports the decision not to require an independent audit for the compliance statement. An audit requirement would represent a significant cost to the distributors that, in our view, would significantly exceed the potential benefits. Furthermore, the audit of often non-financial

issues and interpretation of complex pricing and economic issues would also likely present some problems for financial auditors.

27. Despite our support for the proposal to not require Director's sign-off, it is likely to be required by the Commerce Commission for pricing methodology disclosures. Vector will submit on this issue as part of future Commerce Commission consultations on the matter.

Monitoring Compliance

28. It seems clear under the current proposal that if a distributor decides not to comply (e.g. by not disclosing a statement of compliance), or due to some level of disagreement over the interpretation of the principles, that the Commission will impose stricter compliance obligations on that business. Similarly, the Commerce Commission is likely to adopt the approach the Commission approves for information disclosures purposes meaning any blatant non-compliance (e.g. non-disclosure or not making a reasonable attempt) will be illegal under the Commerce Act for all EDBs identified as having to provide a pricing methodology.

29. To supplement the compliance statement, Vector supports the proposed Commission review process as the primary vehicle by which compliance is assessed, but this should be conducted at the industry level and be more akin to a monitoring and review process, similar to the current AMP review, rather then a formal approval process.

30. Our proposal is that the Commission produce a monitoring report, similar in style to the AMP review, at set intervals (perhaps every two years), which provides and assessment and summary of how distributors have had regard to the pricing principles, highlighting best practice and any areas of concern. The benefits of this review are that it will:

    - provide transparency to the industry over what the Commission perceives is an appropriate level of compliance whilst allowing robust debate to occur if the industry disagree; but only if accompanied by some form of consultation or right of reply process;

    - encourage the organic uptake of best practice compliance by distributors through sharing of techniques and processes and discouraging use of less acceptable approaches; and

    - provide a barometer of the potential for more stringent regulation and act as a warning to non-conforming distributors giving them an opportunity to comply or alternatively provide better explanations of their perceived non-compliance.

31. In this way the review will promote a cycle of continual improvement thereby increasing the standard of compliance, something which was evidential from PB Associates comments on the AMP review process:

> *"In our view the quality of disclosed AMPs has improved substantially since PB Associates undertook its first AMP reviews in 2005."*[5]

32. One distinction we would make between the AMP review and any potential pricing methodology review is that company ranking, currently used in the AMP review, would be impossible against what is essentially a qualitative and holistic pricing process where there exists significant trade-offs between competing pricing principles. By contrast, AMPs are based on engineering practices and there is likely to be a much narrower range of what constitutes good asset management practice.

Approach to Non-Compliance

33. Should the above monitoring and review process highlight consistent and deliberate non-compliance by an individual distributor over several monitoring periods, then further action may be warranted against that distributor. But the grounds for any charge of non-compliance need to be clearly explained.

34. At this stage the Commission has proposed that the distributor would need to submit a formal "pricing report" and any other evidence required to support their pricing (e.g. cost of supply model). Vector supports the concept of the distributor being required to explain their pricing approach more rigorously but does not support the proposed pricing report or view that it needs to be defined at this stage. Apart from in cases of blatant non-compliance, it is unlikely that the Commission will ever find a distributor in breach of the pricing principles so a full report may not even be necessary. The focus of debate, herein, should instead be on the process to encourage compliance.

35. In this regard, Vector proposes that the Commission adopt a bespoke approach for cases of supposed non-compliance by outlining its concerns in a detailed letter to the distributor in question. The letter should outline the outcomes the Commission expects will resolve the non-compliance but give reasonable flexibility to the distributor to define their own solution. The

[5] PBA, Summary Report: Electricity Lines Businesses, AMP Compliance Review, March 2008, page 3.

distributor should then be given until 1 April of the following year to remedy the situation (e.g. to align with the CPI-X reset) and to supply the necessary supporting evidence. This evidence *may* include a letter/report outlining how the distributor has remedied the non-compliance (or at least better explained the situation), and a cost of supply model, and supporting evidence from external consultants or auditors if the distributor believes these are necessary to prove their case.

CONCLUDING COMMENTS

36. Overall, Vector is supportive of the direction of the Commission's distribution pricing work programme. In particular, we support:

    a. a cost effective approach to distributors demonstrating that they have adhered to sound pricing principles; and

    b. a separate process facilitated by the Electricity Commission to achieve a greater degree of standardisation and rationalisation across distributors than is currently observed, whilst not compromising legitimate equity and efficiency objectives being pursued by EDBs.

37. Please do not hesitate to contact Nathan Strong on 04-803-9039 or by email at nathan.strong@vector.co.nz should you wish to discuss this further.