19 September 2022

OPEN LETTER TO DISTRIBUTORS

Distribution Pricing Reform

This letter builds on our 6 May 2022 letter to each distributor in which we highlighted the Authority's three main areas of focus for distribution pricing reform in 2022:

- options for promoting faster reform
- addressing pricing issues for new/expanded connections
- pass-through of the new transmission charges.

We have appreciated the time and effort put in by distributors since then to engage with the Authority on pricing reform, especially in the context of continued workforce stress caused by the COVID-19 pandemic. We are conscious that distributors will currently be considering their 2023/24 pricing methodologies. To help the sector understand what the Authority will be focussed on in assessing those methodologies, we have set out below our immediate expectations for faster reform of distribution pricing. The five areas of focus are:

1. **Distributors' roadmaps responding to future network congestion**
2. **Distributors' response to any significant first mover disadvantage (FMD) issues facing customers seeking to connect to their networks (new and expanded connections)**
3. **The extent to which distributors are following the Authority's guidance on pass-through of new transmission charges**
4. **Whether distributors are increasing their use of fixed charges to match the phase-out path of the low fixed charge tariff regulations**
5. **Distributors avoiding, or transitioning away from, recovery of costs that are fixed in nature through use-based charges, such as charges based on a customer's Anytime Maximum Demand (AMD)**

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We expect to see specific changes in distributors' 2023/24 pricing methodologies and roadmaps for focus areas 3, 4, and 5. By contrast we acknowledge that some aspects of focus areas 1 and 2 may only feature in distributors' roadmaps (not their methodologies). Further detail on the five focus areas is attached to this letter.

Context

The Authority remains committed to promoting the ongoing reform of distribution pricing. We expect that more efficient pricing will contribute to better investment in and use of distribution networks, provide appropriate signals to consumers as they consider investing in their own distributed energy resources, and better ensure that New Zealand's transition to a low-emissions economy is on the most efficient path.

To help build a shared understanding of the current context with distributors:

- Since May we have met every distributor to better understand their pricing approach, progress, barriers to change, views on reform and on the Authority's Distribution Pricing Practice Note.
- Distributors have requested that we provide guidance on the pass-through of the new transmission charges – detailed draft guidance was released to the sector in August.
- We have engaged with some distributors' larger customers, and other agencies such as the Energy Efficiency and Conservation Authority (EECA), to better understand potential connection issues that can emerge where customers' consumption increases as they electrify process heat, and what role distribution pricing plays.

Distribution pricing reform is part of the wider context of New Zealand's ongoing electrification. For example, the uptake of electric vehicles, and new commercial-scale solar farms being announced/built at an unprecedented pace, will create a range of challenges and potential responses from distributors. We expect this pace of change to continue, along with pressure to ensure that distribution pricing is playing its part by removing distortions, sending the right signals, and responding to a dynamic environment.

It is with this in mind that we have selected our five focus areas. We are confident that the Authority is focussing on the right areas for immediate distribution pricing reform that will assist customers and the sector to make meaningful and beneficial change.

Reform expectations

We will continue to actively engage with the sector to improve our understanding of pricing issues and to provide general and specific guidance. That includes working through pricing approaches that we do not agree with and highlighting significant improvements (such as the significant progress made by Scanpower and Westpower in their 2022/23 methodologies and roadmaps). We look forward to engaging further with distributors on pricing, including learning with and from the sector about new and innovative approaches, and hearing distributors' views on how we can help them to achieve faster reform. We are grateful for the time distributors continue to invest in helping the Authority to 'walk in their shoes' and understand their specific regional context and challenges, and are looking forward to visiting a number of you soon.

At the same time as we continue to work with distributors on pricing, we will be assessing progress on pricing reform, with scorecard assessments of distributors' pricing methodologies restarting following the release of their 2023/24 methodologies and roadmaps. To ensure there are no surprises, we will provide you with more detail about how we will approach these scorecard assessments later this year.

Next steps

We will publish this open letter on our website on 20 September 2022. We would be happy to host a discussion forum for distributors to work through these focus areas if that would be useful – please let us know.

The Authority will also review the regulatory settings for distribution pricing after those scorecards have been finalised, and it is clearer to what extent progress on pricing reform has been made over the previous two years. Our assessment will be guided by the five focus areas identified in this letter.

We welcome any questions or views you have on the focus areas – please contact me, or Harpreet Singh in our Network Pricing team.

Yours sincerely

Tim Sparks
Director, Network Pricing

Attachment: Five focus areas

Without limiting our overall assessment of distributors' methodologies, we have the following specific expectations of progress for the sector in the five focus areas, consistent with the Distribution Pricing Practice Note (DPPN).

1 Distributors' roadmaps responding to future network congestion

- The DPPN focussed significantly on potential pricing responses to congestion.[1] Distributors' pricing methodologies, roadmaps and supporting strategies should reflect this:
  - What they are doing about current congestion (if any)[2]
  - How they are assessing likely future congestion[3]
  - What window of opportunity they are applying to signal this likely congestion
  - What pricing options they are considering/testing in response
- With the removal of the TPM RCPD charge, it will be particularly important for distributors to reassess any potential congestion on their networks that may have been effectively masked by that (overly) strong transmission pricing signal, and consider whether they now need to apply their own distribution pricing signal to reflect any distribution network congestion
- We are also interested in how distributors intend to price for congestion arising from New Zealand's key initial emissions reduction activities, ie, the conversion of process heat, and the mass adoption of EVs
- We note the parallel in some early thinking on EV pricing[4] with existing load control tariffs for hot water ripple control. Load control can act as an efficient alternative to network investment, with prices appropriately reflecting a different network service standard. The Authority considers separate load control tariffs to be an appropriate and cost-reflective way to approach mass EV charging and hot water heating, consistent with the distribution pricing principles[5]

We expect that distributors will actively consider the impact of future congestion on their networks, and set out a time-limited plan for responding to that congestion in their roadmaps

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1 For example, the various pricing scenarios in Part 4 of the DPPN.

2 Some distributors have raised concerns about access to metering data that is relevant to assessing congestion. This is being considered in the Authority's related workstream on regulatory settings for distribution networks.

3 We acknowledge that the timing of some future congestion is predictable, and some less so. But even less predictable congestion may be worth considering now. For example, even on networks that have almost no EVs at this point, there is a real risk that distributors will not get much notice of congestion driven by EV charging in pockets of their network before it occurs. This is because EV purchases do not get registered for electricity network purposes, and it would only take a small number of EV purchases, with fast chargers, at adjacent households to potentially have a material impact on a single low voltage transformer. On this basis, all networks should be thinking about and planning for pricing responses to significant EV penetration now. We appreciate that significant work has already been done to date on EV-related pricing by some distributors, and encourage continued sharing of learnings from that work. We also note the recent August 2022 EECA green paper, Improving the performance of electric vehicle chargers (eeca.govt.nz), which considered responses to network congestion arising from EV charging. We intend to work closely with EECA on developing policy responses to this issue.

4 See for example the discussion on managed appliance tariffs in Concept Consulting and Retyna, October 2021, Shifting gear, How New Zealand can accelerate the uptake of low emission vehicles, Report 2: Consumer electricity supply arrangements (concept.co.nz).

5 In accordance with the principle that prices reflect differences in service provided to consumers.

2 Distributors' response to any significant first mover disadvantage (FMD) issues facing customers seeking to connect to their networks (new and expanded connections)

- A number of stakeholders have raised FMD concerns relating to distribution networks with the Authority, including in the context of large/expanding connections related to process heat being electrified – a key initial step in New Zealand's transition to a low-emissions economy. It is important that electricity network pricing is not a barrier to an efficient/low-cost transition
- Responding to potential FMD issues for connection assets was a key aspect of the suite of reforms introduced in the new TPM and was flagged as something to be looked at further (as part of broader connection/capital contribution policy issues) in the DPPN
- Addressing FMD issues related to interconnection/upstream assets may be more complex and goes to the heart of a distributor's pricing
- We also acknowledge a related connection issue regarding the incremental cost pricing principle applied to distributed generation under Part 6 of the Code, and the implications of that principle for the recovery of the costs of building anticipatory capacity into these connections. We are actively considering this issue

The Authority expects that distributors' pricing methodologies and/or capital contribution policies will ensure that first movers and exacerbators[6] are generally[7] neither advantaged nor disadvantaged compared to other customers[8]

For connection assets, we expect that:

- *In the first instance the distributor should charge the first mover based primarily on the cost required to supply them*
- *Distributors should rebate the first mover as subsequent movers connect such that the first mover and subsequent movers end up paying a share based on their comparative needs*

We expect that distributors will consider FMD issues for upstream assets, but understand that for the 2023/24 pricing year this consideration may only feature in their roadmaps

3 The extent to which distributors are following the Authority's guidance on pass-through of new transmission charges

- The new Transmission Pricing Methodology (TPM) will come into effect from 1 April 2023
- Consistent with distributor requests, the Authority has produced detailed guidance on pass-through, which it has tested with the sector
- The new TPM is based on specific design decisions aimed at producing particular incentives

The Authority has a strong expectation that distributors will pass transmission charges through in accordance with the guidance, preserving the TPM's intended incentives, where possible

6 An exacerbator is a connecting or expanding customer that exacerbates the need for expansion of an existing asset (whether connection or upstream).

7 Where distributors consider deviating from this approach would lead to a better outcome that is consistent with our pricing principles, we expect distributors to be able to explain their reasoning.

8 For example, we query the value of blanket propositions in relation to new connections such as "it should not cost existing users anything", which implies an approach of allocating all costs to the first mover regardless.

4 Whether distributors are increasing their use of fixed charges to match the phase-out path of the low fixed charge tariff regulations

- Increased use of fixed charges has been a significant focus of the Authority's pricing reform efforts for years, as reflected in the DPPN
- The phase-out path for the low fixed charge tariff regulations is now clear
- Many distributors have told us they are also transitioning to fixed charges for revenue stability reasons
- A higher level of fixed charges will be a change for many electricity consumers, who may prefer more variable tariffs that depend directly on the consumer's own usage. But higher fixed charges reflect the fixed nature of distributors' network costs, so are core to cost-reflective pricing, which in the long term leads to lower tariffs overall for consumers

We expect the overall proportion of revenue distributors collect from fixed charges to increase year on year. In setting fixed charges for individual customers, we expect distributors to seek to ensure that an individual customer's usage has no or minimal influence on that customer's own charge[9]

5 Distributors avoiding, or transitioning away from, recovery of costs that are fixed in nature through use-based charges, such as charges based on a customer's Anytime Maximum Demand (AMD)

- A core part of the TPM reform was removing charges that sent excessive/unjustified signals with respect to the cost of network use. This primarily occurred through the TPM's specific application of a Regional Coincident Peak Demand (RCPD) charge – when combined with the wholesale electricity market nodal price, the RCPD charge signalled substantially more than the economic cost of use, and therefore discouraged consumption at peak times when consumers valued it the most, and often needlessly – on lines that had no congestion issues
- We consider that a similar issue may be occurring on distribution networks, through charges based on an individual customer's own AMD (or similar use-based charges) to recover fixed costs where there is no congestion on the network, or it is being addressed with a different price signal. Such charges strongly incentivise customers to alter their use at specific times despite that use having little impact on network costs. This pricing creates a distortion, and should be avoided, particularly for smaller customers that have an individually small share of any network infrastructure. More generally we query whether setting an individual customer's charges based on that customer's own AMD is useful in any circumstances, given it is likely to over-signal, and does not link well to the drivers of network cost
- Where distributors are looking for a metric related to customer size, the Authority's view is that there are alternative measures that are less distorting (less likely to create strong usage incentives), for example, total annual usage (kWh) – noting that usage incentives created by an annual kWh measure may be blunted by applying a lag and a moving average

We expect distributors to reduce their use of charges based on a customer's own AMD as soon as possible and have a clear roadmap for removal of such misaligned charges.

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9 As an example, a fixed daily dollar amount is an ideal fixed charge. By contrast if an individual customer's charges are set based on that customer's own AMD or recent kWh measures, those charges are not fixed charges. Where a kWh measure is used to set charges, the influence of usage on the charge can be dampened using a lag and averaging over a significant time period. Note that use-based allocation of costs between customer groups (residential, commercial etc) can be acceptable if the distributor is satisfied that an individual customer's usage is unlikely to influence its own charge.