Consultation Paper

Criteria for assessing alignment against the Information Disclosure Guidelines and Pricing Principles

Prepared by the Electricity Authority

5 September 2011

Executive summary

1. The purpose of this paper is to consult with interested parties on:

   a. the criteria in Appendix A, which provide further guidance on the application of the information disclosure guidelines (guidelines); and

   b. the initial criteria for assessing alignment with the pricing principles set out in paragraph 3.4.6.

2. An additional purpose is to bring to the attention of distributors and other interested parties the results of the initial review of their alignment with the guidelines undertaken by Concept Consulting Group Limited (Concept) on behalf of the Electricity Authority (Authority). This report (Concept Report) is attached as Appendix B. Concept assessed the extent to which distributors have:

   a. complied with the information disclosure guidelines; and

   b. considered the pricing principles when developing their tariff structures.

3. Concept was also asked to reconsider the pricing principles and guidelines as it undertook the review, and to recommend changes to the principles, guidelines or associated processes, that could improve distributors' achievement of the intent of the pricing principles.

4. The pricing principles and guidelines and associated reviews of distributors' performance, are designed to facilitate distributors' achievement of improved pricing approaches. The objective of the pricing principles and guidelines is to improve competition and efficiency outcomes for the long-term benefit of consumers without recourse to prescriptive regulation which dictates how distributors should price their services.

5. This initial review has focussed on a representative sample of nine distributors: Vector, Orion, Unison, Powerco, Horizon, The Lines Company, Marlborough Lines, PowerNet, and Westpower. The sample includes the four of the largest distributors as well as two smaller distributors from the North Island and three from the South Island to ensure adequate coverage.

6. A summary of the results is contained in sections 3.2 and 3.3. The overall observation is that all distributors provided reasonable information about what had been done in their pricing methodology but minimal information was provided as to why a particular approach was chosen. In this respect, the most significant omission in terms of methodological steps was explicit consideration and quantification of the cost drivers of the distributors' businesses, and how such cost drivers are reflected in tariff structures. What was principally missing were the rationales for:

   a. the method for determining the allocation of consumers to the consumer groups;

   b. the allocation of costs to consumer groups; and

c. tariff derivation.

7. The publication of the initial review is expected to result in further improvements in distribution pricing methodologies. The Authority intends to undertake a full review of alignment with the pricing principles in 2012 and publish those results with full attribution.

Contents

1. Introduction and purpose of this paper

1.1 Introduction

1.1.1 The distribution pricing principles (pricing principles) and information disclosure guidelines (guidelines) and associated reviews of distributors' performance, are designed to facilitate distributors' achievement of improved pricing approaches. The objective of the pricing principles and guidelines is to improve competition and efficiency outcomes for the long-term benefit of consumers without recourse to prescriptive regulation which dictates how distributors should price their services.

1.1.2 However, a light-handed principles-based approach relies on good quality public information being available to the Authority and interested parties to assess how well distributors' pricing methodologies are aligned with the pricing principles.

1.1.3 Publishing the results of the initial review on alignment with the guidelines and seeking comment on assessment criteria should result in further improvements in distributors' pricing methodologies. Better information will be required for the more comprehensive reviews to be undertaken in subsequent years.

1.2 Purpose of this paper

1.2.1 The purpose of this paper is to consult with participants and persons that the Authority thinks are representative of the interests of persons likely to be substantially affected by application of:

(a) the criteria in Appendix A; and

(b) the initial criteria for assessing alignment with the pricing principles set out in 3.4.6

1.2.2 An additional purpose is to bring to the attention of distributors and other interested parties the results of the initial review of their alignment with the guidelines undertaken by Concept Consulting Group Limited (Concept) on behalf of the Authority. This report is attached as Appendix B.

1.3 Submissions

The Authority's preference is to receive submissions in electronic format (Microsoft Word). It is not necessary to send hard copies of submissions to the Authority, unless it is not possible to do so electronically. Submissions in electronic form should be emailed to submissions@ea.govt.nz with Consultation Paper—'Criteria for assessing alignment against the Information Disclosure Guidelines and Pricing Principles' in the subject line.

If submitters do not wish to send their submission electronically, they should post one hard copy of their submission to the address below.

Submissions
Electricity Authority
PO Box 10041
Wellington 6143

Submissions
Electricity Authority
Level 7, ASB Bank Tower
2 Hunter Street
Wellington

Tel: 0-4-460 8860

Fax: 0-4-460 8879

1.3.1 Submissions should be received by 5.00pm on 17 October 2011. Please note that late submissions are unlikely to be considered.

1.3.2 The Authority will acknowledge receipt of all submissions electronically. Please contact the Submissions' Administrator if you do not receive electronic acknowledgement of your submission within two business days.

1.3.3 Your submission is likely to be made available to the general public on the Authority's website. Submitters should indicate any documents attached, in support of the submission, in a covering letter and clearly indicate any information that is provided to the Authority on a confidential basis. However, all information provided to the Authority is subject to the Official Information Act 1982.

2. Background

2.1 Introduction

2.1.1 Under section 42 of the Electricity Industry Act 2010 (Act), the Authority must amend the Electricity Industry Participation Code 2010 (Code) to require certain types of distributors (those that do not send accounts to consumers directly) to use more standardised tariff structures, or report to the Minister of Energy and Resources on why the Code has not been amended to achieve that outcome and what alternative measures the Authority is undertaking to address the matter.

2.1.2 The Authority published a consultation paper in May 2011 that, *inter alia*, considered "more standardisation" of distribution tariff structures. Code amendments were proposed that included:

(a) a requirement that distributors consult with traders before making tariff structure changes. The Authority also proposed developing guidelines to facilitate good consultation practices;

(b) a requirement that distributors and traders standardise the way in which information about tariff rate changes is exchanged, by requiring distributors and traders to comply with a new Electricity Information Exchange Protocol (EIEP12) and use standardised tariff codes; and

(c) a requirement that distributors invoice retailers using an "as-billed" approach if using ICP pricing.

2.1.3 The Authority has considered submissions on the above and, in its August 2011 consultation paper, has confirmed that it intends to progress with proposals (a) and (b) above[1]. Proposal (c) has been updated such that distributors using ICP pricing will be required to invoice retailers using an "as-billed normalised" approach unless both parties agree on an alternative approach.

2.1.4 The Authority did not propose full standardisation of distribution tariff structures because:

(a) transaction cost inefficiencies arising due to multiple tariff structures can be addressed to some extent by standardising the way in which tariff information is exchanged, rather than the tariff structures themselves; and

(b) the 'one size fits all' approach required for full standardisation would result in inefficient outcomes and would risk unnecessary 'rate shocks' to consumers.

2.1.5 However, while the consultation paper did not propose standardisation of tariffs because the structure of tariffs was not such a significant barrier to retail

[1] Available at: http://www.ea.govt.nz/our-work/consultations/priority-projects/standardisation-muosa-and-proposed-code/

competition compared with other barriers (e.g. access to wholesale hedges), the paper noted that the Authority would continue to address the efficiency of distribution tariff structures through the distribution pricing principles project. After consideration of submissions, the Authority has not altered its position.

2.1.6 The Authority's work in this area builds on the earlier work undertaken by the Electricity Commission. In March 2010 the Electricity Commission published a set of Pricing Principles and Information Disclosure Guidelines (principles and guidelines)[2]. The principles and guidelines were designed to facilitate distributors developing more efficient and pro-competitive pricing structures, and making information available to stakeholders to assess whether distributors are doing so.

2.1.7 The Electricity Commission noted at the time that any necessary changes to distribution pricing methodologies, consistent with the pricing principles, would be expected to emerge after March 2010. It proposed the review process detailed in the table below:

Table 1: Indicative process for determining alignment

Indicative Process	Commenced
Step 1: Distributors use the information disclosure guidelines to report against the pricing principles, with a review to assess alignment	March 2011
Step 2: Possible decision on whether more standardisation of tariff structures is required	October 2011
Step 3: Formal review against the pricing principles using the information disclosure guidelines	March 2012
Step 4: Distributors receive an independent expert's draft report on compliance of the distributor's pricing approach against the pricing principles	July 2012
Step 5: Distributors respond to the Authority on the findings of the report	September 2012
Step 6: Authority publishes a summary of the independent reviews	November 2012

2 http://www.ea.govt.nz/our-work/programmes/transmission-work/principles-ormodel-approaches-to-distribution-pricing/

2.2 Process

2.2.1 The Authority engaged Concept to undertake the review signalled in step 1 of table 1. Concept has completed its report (attached as Appendix B) for the Authority which assesses the extent to which distributors have:

(a) complied with the information disclosure guidelines; and

(b) considered the pricing principles when developing their tariff structures.

2.2.2 This initial review focussed on a representative sample of nine distributors: Vector, Orion, Unison, Powerco, Horizon, The Lines Company, Marlborough Lines, PowerNet, and Westpower. The sample includes the four largest distributors as well two smaller distributors from the North Island and three from the South Island to ensure adequate coverage.

2.2.3 The review:

(a) was based on a combination of desk-top research, coupled with direct discussions (via telephone) with distributors;

(b) assessed those matters outlined in paragraph 2.2.1;

(c) did not determine whether the pricing structures of each distribution company are consistent with the pricing principles. As per the timeline in table 1, this review will commence in March 2012; and

(d) attempted to evaluate each distributor's pricing methodology on an objective and consistent basis by scoring how well each distributor has met each guideline according to a more detailed set of evaluation criteria that was developed as part of the review.

2.2.4 While the review was not required to determine whether distributors' pricing approaches were consistent with the principles, in many respects the review could be considered a 'dry run' for the more substantive review in 2012 which is intended to consider such matters. Thus, two of the key desired outcomes for the review were to:

(a) highlight potential information disclosure deficiencies which may hinder successful completion of the 2012 review; and

(b) suggest the types of analysis which would be most useful for the 2012 review and which could thus form the basis for the more detailed criteria necessary for such a review.

2.2.5 The scoring exercise involved a degree of subjectivity. However, the application of consistent criteria has ensured the relative performance of different distributors was recorded, and it should highlight good practice which should lead to further improvements. This has been the experience with evaluation of asset management plans by the Commerce Commission.

2.2.6 The Concept Report sets out substantiating reasoning for any scoring, along with explicit references to relevant sections of distributor documents. To ensure transparency and to improve on the review process, the nine distributors were sent their individual draft scores along with an early draft of the report and asked to provide comments at a follow-up meeting with Concept and the Authority.

2.2.7 The distributors were also asked to consider the following questions and to report back at the follow-up meeting:

(a) To what extent did you find that the guidelines provided sufficient guidance?

(b) Are there any aspects of the detailed evaluation criteria set out in Table 1 of the attached report that you disagree with?

(c) Are there any aspects of our assessment of your alignment with the guidelines (as measured against the detailed evaluation criteria set out in the report) that you disagree with or would like to comment on? If so, what are they, and why?

(d) Are there any changes you think should be made to the guidelines (whether to the guidelines themselves, or any supporting material provided by the Authority) in order to assist distributors in preparing a disclosure that would satisfy the intent of the guidelines? If so, what are they?

(e) To what extent has the publication of the pricing principles led you to consider changes or developments to your pricing methodology?

(f) Do the pricing principles provide a sufficient framework to develop economically efficient prices that further the best long-term interests of consumers? If not, what changes would you suggest to achieve this (whether to the pricing principles themselves, or any supporting material provided by the Authority)?

(g) Are there any further comments you would like to make about this review, the guidelines or the pricing principles?

2.2.8 The feedback on these questions was used to amend the assessment criteria in Appendix A and the draft scores of the distributors. This consultation seeks further feedback on those assessment criteria.

3. Analysis

3.1.1 Concept was asked to report on three matters:

(a) Assessment of distributors' consistency with the guidelines;

(b) The extent to which distributors had considered the pricing principles in formulating their pricing methodologies; and

(c) Key recommendations - changes that could be made to the guidelines or pricing principles or other information produced by the Authority to improve alignment.

3.2 Assessment of distributors' consistency with the Information Disclosure Guidelines

3.2.1 The following discussion is a summary of the findings from the review for each of the guidelines. The summary evaluation table on page 7 of the Concept Report contains the scores against each of the guidelines. The findings incorporate the feedback provided at the interviews on the draft results.

Guideline (a): Prices should be based on a well-defined, clearly explained and published methodology, with any material revisions to the methodology notified and clearly marked

3.2.2 All distributors provided reasonable information about *what* had been done in their pricing methodology. However, minimal information was provided as to *why* a particular approach was chosen, with the most significant omission (in terms of methodological steps) being the explicit consideration and quantification of the cost drivers of the distributors' businesses. Company D and Company E were the best at providing explicit consideration and quantification of cost drivers.

3.2.3 If this information was not well developed, the subsequent rationales for other aspects of the pricing methodologies (particularly tariff structures) were also not well developed. Where rationales were given for why a particular approach was chosen, these were generally qualitative in nature with little or no quantitative analysis presented or referenced to substantiate why a particular approach was chosen. Again, this was particularly the case for tariff structure rationales.

3.2.4 Distributors that provided more supporting rationale as to why their approach was likely to be dynamically efficient also had tariff structures that sent the strongest price signals for load control at times of peak demand.

3.2.5 All of the nine distributors' disclosures were published on their company website, and hence were considered to have met this aspect of the guideline. Where additional supporting information, or simplified information targeted at consumers, was provided, the benefit of this was acknowledged by a higher score, suggesting they had met the criteria well.

3.2.6 This lack of information as to why a particular pricing approach has been adopted will, if it continues, make it harder for the Authority to undertake its review in Autumn 2012 to determine whether the various distributors' tariff structures are consistent with the pricing principles.

Guideline (b)(i): The pricing methodology disclosed should demonstrate how the methodology links to the pricing principles, and any non-compliance

3.2.7 Distributors achieved similar scores for this guideline with respect to outlining the linkage, with each specifically demonstrating, at a high level, those areas where their pricing methodology complied with the pricing principles. All distributors stated that they were compliant.

3.2.8 However, information presented in response to this guideline was lacking in detail and analysis to enable any assessment of the extent of the alignment with the pricing principles. Company A was an exception, providing a graphical presentation.

3.2.9 Further, it was observed that there was significant variation in approach for the different pricing methodologies. Analysis presented in Appendix F of the Concept paper suggests this variation could result in material differences in efficiency, which would not be consistent with the intent of the principles.

3.2.10 In addition, several distributors commented that the following factors constrained them from introducing more efficient pricing approaches:

(a) Potential legal action from retailers opposed to some pricing methodology changes;

(b) Restrictions on rural price changes relative to urban prices and the low-fixed charge regulations;

(c) Any changes that could result in significant 'price shocks' to some groups of customers; and

(d) Asymmetric risks due to the application of the Commerce Act price control regime (potential to breach).

3.2.11 A number of distributors suggested that the constraints above meant that, as any potential improvements to existing methodologies could not be practically implemented, the effort involved in producing information for the pricing methodology reviews would not be justified.

3.2.12 Those distributors that scored higher gave reasons for non-alignment or noted future work was planned to achieve alignment.

Guideline (b)(ii): The pricing methodology disclosed should demonstrate the rationale for consumer groupings and the method for determining the allocation of consumers to the consumer groups

3.2.13 Most distributors did well at outlining what the consumer groups are, and what consumers belong to each group, with many making good use of tables and visual aids, but then did not provide sufficient rationale.

3.2.14 There was a significant diversity in the approach to consumer grouping among the different distributors. Therefore it was considered important that an explanation as to why the approach used is appropriate for that network was well developed in the pricing methodology document. In this regard, it was expected that the cost drivers would significantly influence the consumer grouping approach used, and that this relationship would be outlined.

3.2.15 It is acknowledged that some distributors have a greater number of consumer groups, and hence such a level of detail may not be practical for each group – although explanation as to why they have felt the need to have so many consumer groups would be appropriate.

3.2.16 From discussions with distributors, and from some indications within some pricing methodology documents, it appears that 'historical inertia' (in terms of not wanting to move away from historic approaches because of the consequential bill impacts on customers) was a key factor driving many current customer grouping approaches and the large number of customer groupings. Whilst avoiding bill impacts and delivering consistent price signals are desirable objectives in themselves, it is felt that such objectives should be explicitly mentioned, and used to help evaluate the trade-off between continuing with a current approach, and potential economic efficiency gains from moving to a new approach.

Guideline (b)(iii): The pricing methodology disclosed should demonstrate quantification of key components of costs and revenues

3.2.17 All distributors provided an adequate breakdown of their costs, and the revenues recovered from the consumer groups. Those that gave their cost breakdown at a level that was related to their cost drivers or allocation method were considered to have met this particular criterion better, as this illustrated that the cost breakdown had been communicated as being part of a larger overall process to achieve the objectives of the pricing principles.

3.2.18 The main factor influencing the scores against this guideline was whether cost drivers were adequately identified. Distributors performed poorly on this aspect with minimal information provided on cost drivers with no substantiating quantitative evidence provided or referenced. Company D and Company E were the main exceptions to this, in that they were the only distributors to present reasonable quantitative information. Company D was also the only distributor that explicitly included "establishing the cost drivers" as an explicit methodological step in their overall pricing methodology approach.

3.2.19 While all distributors generally considered that peak demand was the most significant cost driver in their business, a number of these same distributors view their costs as being fixed. The distributors with more variable charges consider a significant proportion of their costs to be variable over the long-term. The view of whether costs are fixed or variable adopted by the distributor had a significant influence on the resulting tariff structures, with potential economic efficiency impacts.

Guideline (b)(iv): The pricing methodology disclosure should demonstrate an explanation of the cost allocation methodology, and the rationale for the allocation to each consumer grouping

3.2.20 There was generally good information provided about what approach was used to allocate costs among consumer groups, but much less information provided about why the particular approach was adopted (e.g. allocated based on a measure that relates to the generation of that cost).

3.2.21 A range of cost allocation methods were used by the distributors, which in itself is not a problem, as allocation involves some subjective judgement. However, the rationale for the allocation method was generally not explained, including the extent to which it is affected by differing cost drivers or network characteristics.

3.2.22 A number of distributors indicated that:

(a) different consumer grouping and cost allocation approaches were unlikely to result in material differences in the economic efficiency of outcomes so why bother; and

(b) they were constrained in their ability to cost-reflectively allocate costs (see paragraph 3.2.10 for the reasons).

3.2.23 The cost drivers should form the basis of any economically rational pricing approach. Distributors with methodologies that were more strongly influenced by their cost drivers also scored higher against the guidelines overall.

Guideline (b)(v): The pricing methodology disclosed should demonstrate an explanation of the derivation of tariffs to be charged to each consumer group and the rationale for the tariff design

3.2.24 This is an area where there was significant variation in observed approaches. Most companies did not provide substantiating quantitative evidence apart from Company D and Company E. These companies explicitly set out how their pricing structure was driven by cost-drivers with supporting quantitative analysis.

3.2.25 Further, there was significant variation in the qualitative rationales provided for the distributors' chosen approaches. Some (notably those who had strong price signals at times of peak demand) placed a strong focus on their cost drivers when designing their tariff structures, whereas others appeared to place greater weighting on other considerations.

3.2.26 Distributors when determining both consumer groupings and tariff structure approaches are focussed on either the cost drivers (e.g. peak demand) or ongoing incentives for retaining and attracting end-use consumers and use of the existing sunk network. These different approaches may reflect fundamental differences in the network situations. For example, such differences in approach may be economically efficient if those distributors focussed on the cost drivers were faced with network capacity constraints, whereas the second group had little requirement to make investments to meet demand growth for the foreseeable future. However, to the extent these differences are not due to particular "network situations" there may be room for efficiency improvements from better alignment.

Guideline (b)(vi): The pricing methodology disclosed should demonstrate pricing arrangements that will be used to share the value of any deferral of investment in distribution and transmission assets, with the investors in alternatives such as distributed generation or load management, where alternatives are practicable and where network economics warrant

3.2.27 The majority of distributors stated that they had some form of arrangements (demand-side or embedded generation) in place to share the value of deferred investment. For the demand-side these mostly involved controlled and/or peak/night tariffs. However, the discussion around these arrangements was inadequate and therefore difficult to draw any conclusions in a review of alignment with the pricing principles.

Guideline (c)(i): The pricing methodology should employ industry standard terminology, where possible

3.2.28 All of the distributors used terminology that was appropriate for a pricing methodology disclosure, and hence all were considered to have met this guideline. However, any terminology standard would best be developed by the industry itself.

3.2.29 Instances of best practice have been signalled where a glossary has been included or referenced, or complex terms and acronyms have been explained. The majority of distributors had provided such material.

Guideline (c)(ii): The methodology should, where a change to the previous pricing methodology is implemented, describe the impact on consumer classes and the transition arrangements implemented to introduce the new methodology

3.2.30 Distributors that had not changed their methodologies since the previous year were not assessed against this guideline. Only two distributors had made methodology changes in 2011. Company B provided some useful tables quantifying the resulting effects on the number of consumers in each group, and the change in consumer tariffs. Consequently, Company B scored relatively well against this criterion. Additionally, both of these distributors discussed their policy of reducing price shocks to customers by limiting price changes to 10% per year.

3.2.31 As the pricing principles and guidelines encourage further changes by distributors towards more economically efficient pricing, information provided under this guideline is likely to be of increased interest. This could be an area where the Authority could usefully engage with distributors with a view to developing a consistent approach to transition arrangements for price changes.

Summary

3.2.32 The results were reasonably positive given the standards are not mandatory and distributors did not have foreknowledge of the detailed evaluation criteria, with 5 out of 9 achieving a score of more than 50%. Publishing the results and criteria (see discussion below) should drive greater awareness of what is expected and progressively better information disclosure.

3.2.33 Some of the distributors indicated that they would be unhappy about the scores being published, preferring the ranking to be anonymous or reporting using a more generalised ranking method (e.g. poor, average and good). Those that have performed poorly argued that it is unfair to highlight their scores when only a sample of distributors (nine) were assessed and that it is an interim assessment with an expectation that distributors would transition over time to adopting practices in line with the principles/guidelines.

3.2.34 The Authority has accepted the arguments not to publish the names and scores for this review. The reasons for this were as this is the first year the Authority has prepared this report and only a sample of distributors had been consulted, it would be inappropriate to publish the results for this year. In addition, the Authority did not signal at the outset that it would be publishing the names with the scores. However, for next year's review, names and scores will be published. As noted, the effectiveness of a light-handed regime derives primarily on information disclosure and competitive pressure to perform at a level comparable to one's peers. Not publishing the results next year may reward the poor performers at the expense of the better performers. Also driving greater awareness that the industry is improving its performance reduces the pressure on the Authority to regulate.

3.3 Consideration of pricing principles in formulating their pricing methodologies

3.3.1 All distributors had considered the pricing principles because they explicitly stated that their methodologies were consistent with them. However, this consideration was not uniform as:

(a) very different approaches were adopted for customer groupings, cost allocation, and tariff structures resulting in major differences in price signals;

(b) there are significant inconsistencies in pricing signals sent to different classes of customers within some distributors' network areas; and

(c) some distributors feel more constrained than others by the factors set out in paragraph 3.2.10.

3.3.2 To the extent that such differences are not due to different network characteristics, Concept's analysis set out in Appendix F of the Report indicates:

(a) there could be material adverse effects on economic efficiency, which would be inconsistent with the pricing principles; and

(b) differences in approach to tariff structure design (as distinct to customer grouping and cost allocation approaches) could be resulting in the most significant differences in the economic efficiency of outcomes.

3.4 Key recommendations from the Concept Report - changes that could be made to the guidelines or pricing principles or other information produced by the Authority to improve alignment

3.4.1 ***The pricing principles and guidelines do not need revising***—The pricing principles are defined at a relatively high level with the consequential potential to result in a wide range of pricing approaches consistent with them. However, more specific pricing principles would require prescriptive specification of methodologies which would be undesirable due to compliance costs, unintended consequences and the differences between networks. All nine distributors considered that the pricing principles and guidelines were appropriate.

Authority response

3.4.2 The Authority does not intend to revise the pricing principles or the guidelines.

3.4.3 ***The Authority should develop and publish the detailed assessment criteria which the Authority will use to assess distributors against the guidelines***—As well as providing useful guidance to the distributors about the nature of the information they need to provide, such detailed criteria should help further clarify the nature of the desired outcomes the Authority is seeking to achieve, without resorting to prescription about particular methodologies. The assessment criteria are set out in Appendix A.

Authority response

3.4.4 The Authority agrees and has published detailed criteria (Appendix A) for consultation.

3.4.5 ***The Authority should provide indicative evaluation criteria which the Authority will use to assess distributors against the pricing principles***—The Authority should publish a set of indicative criteria for distributors to consider with respect to seeking alignment with the pricing principles. Suggestions for the type of analysis that would be most useful for evaluation against the pricing principles are set out in section 6.3 of the Concept Report. Such suggestions could form the basis of more detailed evaluation criteria.

Authority response

3.4.6 The Authority agrees and has reviewed Concept's suggested criteria in section 6.3. The Authority seeks feedback on those criteria, specifically:

(a) Analysis which indicates how distributors' costs would likely change over an investment timeframe (i.e. 20-30 years) based on changes to key cost drivers:

   (i) Network peak demand (including analysis of the extent to which local network peak may be different from regional transmission peak).

   (ii) The size of customers' connections.

   (iii) Customer location / density.

   (iv) Network topography (e.g. potential issues from 'challenging' rural terrain, or undergrounding issues associated with urban networks).

   (v) Any other key driver identified by distributors as materially impacting on their costs.

(b) Consideration of customer grouping & cost allocation approaches should demonstrate:

   (i) Relationship with key cost drivers.

   (ii) That prices are 'subsidy free' – i.e. 'equal to or greater than incremental costs, and less than or equal to standalone costs' and where EDBs are aware of significant levels of cross-subsidy they should provide information on the scale of such effects.

   (iii) Regulatory constraints on the ability of EDBs to achieve pricing approaches that best meet the intent of the pricing principles should be highlighted.

   (iv) The extent to which they have considered the transaction cost implications from the complexity / simplicity of their chosen approach, and any trade-offs between achieving transaction cost savings through simplicity and potential economic impacts from altered consumer outcomes from such simplicity (e.g. altered customer location decisions).

(c) Tariff structure approaches should demonstrate the extent to which they have variablised charges to recover costs which should be considered fixed, or vice versa. Transpower costs should be included in this analysis.

(d) The rationale for any transition approaches should be set out, including how the benefits of such an approach (i.e. limiting price shocks) have been weighed up against the costs (i.e. delay to sending efficient price signals, and lack of consistency of price signals).

Q1.	**Do you consider the type of analysis suggested is appropriate given the pricing principles, and are there important aspects which have been omitted?**

3.4.7 Concept's suggestions are similar to the methodological requirements and pricing methodology report template published by the Commerce Commission in relation to gas distribution businesses (see Schedule 4 in Appendix B of the Concept Report).

Q2.	**Do you consider that the Commerce Commission's template for gas distribution businesses would be an appropriate guide?**

3.4.8 ***The Authority should seek clarification from distributors on the extent to which constraints in paragraph 3.2.10 limit changes to their pricing methodologies and work with the Commerce Commission to ensure consistency of regulatory disclosure requirements, and potentially consider a single disclosure requirement relating to electricity distribution pricing that would cover both the requirements of the Commerce Commission and the Authority—***As noted above some distributors suggested the constraints meant producing information for the reviews would not be justified as any potential improvements to existing methodologies could not be implemented. Despite the implementation issues, which may be more perceived than real, it is only through the provision of good quality information that decision makers can consider the impact of the constraints and make appropriate choices.

Authority response

3.4.9 With respect to such potential barriers, as long as they are perceived to exist it is less likely that distributors will move to implement changes to their pricing methodologies, even if they may deliver better outcomes for consumers in the long-run.

3.4.10 Therefore the Authority would like to engage with distributors to establish the impact of the above constraints. The Authority has also discussed the draft results with the Electricity Networks Association who noted that it had formed a working group with an independent chair to develop a guideline to assist distributors considering the introduction of more cost-reflective tariffs (CRT). In developing the CRT guidelines the working group intends to engage with retailers.

Q3.	**To what extent do the constraints listed in paragraph 3.2.10 impact on your ability to align your pricing methodologies with the pricing principles?**

3.4.11 The Authority is keen to ensure a consistent approach by both regulators to prevent duplicating information requirements and frustrating any desired outcomes. In this respect the Authority and the Commerce Commission are already discussing how best to ensure consistent and efficient regulatory outcomes.

Appendix A Assessment Criteria for alignment with the Information Disclosure Guidelines

1. The following assessment criteria which further interpret the intent of the guidelines should provide appropriate guidance for distributors in developing and amending their pricing methodologies and other associated pricing material.

Guideline (a): Prices should be based on a well-defined, clearly explained and published methodology, with any material revisions to the methodology notified and clearly marked

2. A methodology is well-defined where:

    (a) A clear objective is described.

    (b) All aspects of the methodology which will have a material impact on consumer prices are described.

    (c) The various steps required to produce final prices are logically set out.

    (d) The factors considered most significant in determining a particular approach adopted are discussed.

    (e) The methodology's suitability for the network, given its characteristics or situation, is demonstrated, referencing substantiating qualitative analysis where suitable.

    (f) Any key assumptions that have been used (i.e. values for factors over which there is a material degree of uncertainty and which can materially change prices) are:

        (i) identified as such;

        (ii) referenced to any source substantiating their use; and

        (iii) appropriately described with respect to the range of uncertainty, and consequential implications of such a range on final prices is indicated.

3. The methodology is clearly explained where:

    (a) The methodology is easy to follow and progresses in a logical manner.

    (b) The document is well structured to aid comprehension.

    (c) There is discussion to introduce complex concepts or background information, referencing other publically available documents (ideally on the distributor's website) where appropriate.

4. The methodology is published where the disclosure is on the distributor's website with a "best practice" approach including:

(a) the provision of additional customer-oriented material or information on changes/reviews/consultations etc; and

(b) an 'archive' of all previous years' methodologies and associated documents also being provided on the distributor's website.

5. Revisions are notified and clearly marked where:

(a) Any changes that are made to the methodology from the previous year are clearly outlined in the document. Ideally, a summary 'running record' of the main changes made to the methodology over past years is published (potentially as a separate document).

(b) If no changes have been made, this is explicitly stated.

Q4.	**Do you agree with the assessment criteria for Guideline (a)?**

Guideline (b)(i): The pricing methodology disclosed should demonstrate how the methodology links to the pricing principles and any non-compliance

6. Linkage to pricing principles is demonstrated by:

(a) A summary section of the pricing methodology disclosure identifying each of the pricing principles, and set out how the pricing methodology achieves each pricing principle.

(b) Supporting quantitative analysis is provided at a level of detail necessary to demonstrate how the various aspects of the pricing methodology support achievement of the overarching objective of the pricing principles – i.e. economically efficient outcomes. This information need not be included within the disclosure itself (e.g., it could reference external documents or spreadsheets (all of which should also be available on the distributor's website, or other public websites).

7. The methodology identifies material non-compliance by:

(a) Specifying where there is non-compliance and describing the reasons for such sub-optimal alignment.

(b) Identifying any intentions, or not, to improve such alignment, along with the proposed approach and indicative timeframe.

Q5.	**Do you agree with the assessment criteria for Guideline (b)(i)?**

Guideline (b)(ii): The pricing methodology disclosed should provide the rationale for consumer groupings and the method for determining the allocation of consumers to the consumer groups

8. The pricing methodology provides the rationale for consumer groupings by:

(a) The segregation of customers into consumer groups, ideally, this would be set out in a clear table or tree diagram.

(b) Including the metrics or statistics relating to each consumer group (e.g. contribution to network peak kW demand, sum of individual anytime maximum demands, number of connections, GWh energy demand, connection capacities, value of lost load, etc.).

9. Rationale for consumer groupings provides an explanation for why the groups have been designed as they have, with a discussion of:

(a) How the groups relate to cost drivers.

(b) How the groups relate to consumer or network characteristics.

(c) Any benefits or limitations associated with the groupings (e.g. rural/urban considerations).

(d) Any supporting quantitative information as appropriate.

Q6.	**Do you agree with the assessment criteria for Guideline (b)(ii)?**

Guideline (b)(iii): The pricing methodology disclosed should quantify key components of costs and revenues

10. Key components of costs to be quantified include:

(a) The costs to be recovered.

(b) A clear and explicit description of each line item.

(c) Identification of the drivers of the key costs, ideally with analysis presented or referenced setting out how the range of possible outcomes for such drivers over an investment timeframe (i.e. 30 years) will impact on such costs.

(d) A well considered cost breakdown with a description of the method of allocation across consumer groups and/or the drivers of those costs.

11. Key components of revenues include the revenue generated across each consumer group and ideally, revenue is given at the same level of breakdown as costs are provided, and a comparison between the two set out.

Q7.	**Do you agree with the assessment criteria for Guideline (b)(iii)?**

Guideline (b)(iv): The pricing methodology disclosed should explain the cost allocation methodology and the rationale for the allocation to each consumer grouping

12. Cost allocation methodology is demonstrated by:

(a) Outlining the metrics used to allocate costs.

(b) Showing the allocation of each cost item across the groups.

13. Rationale for the cost allocation method is provided by presenting:

(a) The reasons for the use of each chosen metric.

(b) The implications or benefits of the use of those metrics are discussed.

Q8.	**Do you agree with the assessment criteria for Guideline (b)(iv)?**

Guideline (b)(v): The pricing methodology disclosed should explain the derivation of tariffs to be charged to each consumer group and the rationale for the tariff design

14. The methodology should clearly explain the different elements of the tariff structures including:

(a) The different types of charge (e.g. fixed charges (and whether per ICP, or per kVA connection capacity, etc.), variable kWh charges, capacity charges, etc.).

(b) Application of any time-based measurement criteria (e.g. different prices at different times of the day or year; assessment of demand based on anytime maximum demand or coincident peak demand, etc).

(c) The nature of any discount for controlled tariffs.

(d) 'ICP-pricing' or 'GXP-pricing' approaches.

15. Rationale for the tariff design is provided by discussing:

(a) How the tariff structure and levels are linked to the key cost drivers identified, with quantitative comparisons provided.

(b) How the tariff design will further the achievement of the objective of the pricing principles (i.e. economically efficient outcomes).

(c) Any other material considerations taken into account when developing the tariff structure.

Q9.	**Do you agree with the assessment criteria for Guideline (b)(v)?**

Guideline (b)(vi): The pricing methodology disclosed should provide the pricing arrangements that will be used to share the value of any deferral of investment in distribution and transmission assets, with the investors in alternatives such as distributed generation or load management, where alternatives are practicable and where network economics warrant

16. The nature of any such arrangements should:

(a) Be clearly described.

(b) Reference relevant supporting analysis for deriving the value of any such payments or discounts for such alternatives, particularly how such payments/discounts relate to cost drivers.

(c) Describe any other material considerations taken into account when developing such arrangements (e.g. arrangements relating to section 54Q of the Commerce Act).

Q10.	**Do you agree with the assessment criteria for Guideline (b)(vi)?**

Guideline (c)(i): The pricing methodology should where possible employ industry standard terminology

17. The disclosure should use industry standard terminology.

18. Ideally, a glossary should be provided (or referenced) explaining the meaning of terms, and possible alternative terminologies that are known to have been used to describe the same aspect.

Q11.	**Do you agree with the assessment criteria for Guideline (c)(i)?**

Guideline (c)(ii): The pricing methodology should where a change to the previous pricing methodology is implemented, describe the impact on consumer classes and the transition arrangements implemented to introduce the new methodology

19. If changes to the methodology have occurred:

(a) The reasons for any changes are discussed.

(b) The effect this has on prices for customers, in terms of size and duration, is discussed and quantified if possible.

(c) If changes have occurred, any arrangements to ‘phase-in’ the effects of those changes are discussed.

Q12.	**Do you agree with the assessment criteria for Guideline (c)(ii)?**

Appendix B Concept Report