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By email: submissions@ea.govt.nz

Dear Carl

Question value of framework for distribution pricing methodology review

Genesis Power Limited, trading as Genesis Energy, welcomes the opportunity to provide a submission to the Electricity Authority ("the Authority") on the consultation paper "Decision-making and economic framework for distribution pricing methodology review" dated 7 May 2012.

Overview of Genesis Energy's comments

We support the Authority's review of the existing regulatory framework for distribution pricing methodologies against the Electricity Industry Act 2010 ("the Act") and the Authority's statutory objective. We are comfortable with the Authority developing a decision-making and economic framework ("decision-making framework") to assist with this review and we consider that the decision-making framework has an appropriate hierarchy of preferred allocation methodologies.

We agree that no further changes are required to the information disclosure guidelines and that the pricing principles are consistent with the decision-making framework. However, we question why distributors should be required to consider both the decision-making framework and the pricing principles, when identifying what distribution pricing approach should be preferred. This adds an unnecessary layer of regulatory oversight and it is unclear what value the Authority will gain from using the decision-making framework in the review of distributors' pricing approaches. There is a risk that the decision-making framework will add unnecessary complexity to the process and will have a negative impact on retailers and consumers.

We recommend that the Authority focus on implementing the existing regulatory framework so that it can gather evidence on how well distributors' current pricing methodologies are aligning with the Authority's pricing principles. We are disappointed that the timing of the first full review has been pushed back to September/October 2012 as this will delay any insights and learning's from the review. We also suggest that the Authority should focus on other areas of distribution that will produce more tangible benefits for the end consumer. We expand on these points below.

Support alignment of existing regulatory measures with statutory objective and framework

Genesis Energy supports the Authority's decision to assess how the regulatory framework for distributors' pricing methodologies[1] aligns with the Act and the Authority's statutory objective. We consider that it is important that the Authority ensure that the regulatory framework developed by the previous Electricity Commission is still appropriate and meets the Authority's statutory objective.

<u>Use of a decision-making framework for both transmission and distribution</u>

The Authority has developed a decision-making framework to assist it with its assessment of the distribution pricing methodologies and has noted that "it is important that the decision-making and economic framework for distribution pricing is consistent with that for transmission".[2] Although Genesis Energy supports the Authority's decision-making framework for transmission pricing[3] we do not necessarily agree that the same approach is required for a decision-making framework for distribution pricing.

We agree that there are obvious similarities between these two sectors of the electricity industry, but importantly there are also different drivers behind the pricing methodology work. These differences include, for example:

[1] The voluntary pricing principles, the information disclosure guidelines and the regular reviews of distributors' pricing approaches.

[2] Paragraph 2.2.2 of the consultation paper.

[3] *Support decision-making framework to progress transmission pricing decisions*, Genesis Energy submission to the Electricity Authority, 23 February 2012.

- the review of the transmission pricing methodology addresses far more complex issues across both the HVDC and HVAC networks, and has been the subject of ongoing debate within the industry;

- the transmission pricing methodology work addresses the key issue of who should pay for the transmission charges (generators and/or consumers). This is not an issue for distribution pricing;

- investment in the transmission network is determined by large lumpy investments, while investment in distribution is much smaller in comparison and is characterised by a large number of annual investment activities; and

- the Commerce Commission takes a different approach to regulating electricity distributors and Transpower.

We are not convinced that the consultation paper presents a robust argument for why a decision-making framework is necessary for distribution pricing and if so, why the two frameworks should be the same.[4]

<u>Alignment of existing regulatory framework with decision-making framework</u>

Notwithstanding our concerns regarding the need for a decision-making framework for distribution pricing, we agree with the Authority that:

- the information disclosure guidelines are consistent with the promotion of "efficient use of and investment in distribution networks"[5] and therefore no changes are required to the guidelines; and

- the pricing principles are consistent with the decision-making framework.

We do not consider that any changes are required to the existing regulatory framework for distribution pricing. Distributors should continue to be guided by the pricing principles and the information disclosure guidelines when they consider their approach to pricing, in preparation for the first review in 2012.

[4] We note that if the Authority considers that the decision-making framework for transmission pricing is equally applicable to distribution pricing, it would have been prudent to undertake consultation concurrently, rather than through two separate processes.

[5] Paragraph 7.1.3 of the consultation paper.

Question the value of using the framework to assess distributor's alignment with pricing principles

The Authority considers that "distributors should follow the hierarchy established by the framework" when identifying their preferred pricing approach, and for this reason the Authority proposes to "use the framework for criteria for assessing distributors' application of the pricing principles".[6] We do not see how the requirement to apply the proposed decision-making framework to individual distributor's pricing approaches will provide any value above the existing regulatory framework. We consider this additional requirement would add an unnecessary layer of regulation for distributors.[7]

As proposed, if the pricing principles have been found to align with the decision-making framework and a distributor can show that its distribution pricing methodology aligns with the pricing principles then, by inference, a distributor's pricing methodology should align with the decision-making framework. Requiring distributors to specifically demonstrate alignment with the decision-making framework is therefore unnecessary and will add complexity to the Authority's assessment process. It may also create uncertainty, as each distributor can take a different approach to applying the decision-making framework to its pricing methodology. This is inconsistent with the Authority's approach to distribution standardisation, in particular the requirement for distributors that do not send accounts to consumers directly to use more standardised tariff structures.[8]

<u>Application of framework may adversely impact on retailers and consumers</u>

The consultation paper does not consider the impact on consumers and retailers from the potential revision of distributors' pricing methodologies to align with the decision-making framework. In particular, the paper does not provide a cost benefit analysis to justify the introduction of the decision-making framework into the existing regulatory framework.

We are particularly concerned that distributors may now find it necessary to carry out a reassessment of their pricing methodologies against this new decision-making framework, and as a result will establish new methodologies. We consider that this review will lead to significant transaction costs for both distributors and retailers, to the possible detriment of consumers. In addition to

[6] Paragraph 8.1.2 of the consultation paper.

[7] We note that in addition to regulation from the Authority, distributors are also subject to regulatory requirements set out by the Commerce Commission.

[8] One of the "new matters" to be included within the Electricity Industry Participation Code, clause 42(2)(e).

the time required for analysis and subsequent consultation on the proposed changes, there are likely to be costs resulting from the changes required to both distributors and retailers systems to implement the new pricing approaches.

Retailers will also require time to communicate any changes to consumers and ensure that customers are on the correct tariff. If distributors decide to adopt dramatically new pricing approaches or adopt more complex tariffs with a greater disaggregation of prices then there will be the potential for price shocks for consumers. We consider that this would be at odds with pricing principle six that notes that the development of prices should:

> "promote price stability and certainty for stakeholders, and changes to prices should have regard to the impact on stakeholders."[9]

While we appreciate that this is not a proposal to amend the Electricity Industry Participation Code ("the Code"),[10] the introduction of this market facilitation measure will clearly have cost implications for market participants that the Authority should factor this into its decisions. If the Authority had chosen to follow the Code amendment principles set out in its consultation charter,[11] we consider that this would have enabled to Authority to better understand the cost implications (principle three) and whether there is a clear need for a decision-making framework for distribution pricing (principle two).

Need to focus on application of existing regulatory framework

We strongly recommend that the Authority focus its efforts on implementing the existing regulatory framework for distribution pricing. The pricing principles and the information disclosure guidelines have been subject to a number of consultation rounds under the Electricity Commission since 2009 and the Authority approach has been informed by an initial "preparatory" review and consultation in 2011.[12] It is important that this work stream now moves forward.

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[9] *Distribution Pricing Principles and Information Disclosure Guidelines*, Electricity Commission, February 2010.

[10] Section 39(2) of the Electricity Industry Act 2010 sets out the process that the Authority must follow when amending the Code.

[11] Section 4 of the Authority's Consultation Charter (20 December 2010) sets out how the Authority may seek feedback from interested parties for areas where the Authority is not required to consult under the Electricity Industry Act 2010.

[12] *Criteria for assessing alignment against the Information Disclosure Guidelines and Pricing Principles*, Electricity Authority, 5 September 2011.

The first review in September/October 2012 will enable the Authority to gather evidence on how well distributors' current pricing methodologies are aligning with the Authority's pricing principles and to identify if there are any systemic issues with distributor's pricing approaches. This evidence will inform the Authority's on-going work with distribution pricing and guide what market facilitation measures or changes to the Code are required to ensure that distributors adopt efficient pricing approaches.

We suggest that the Authority treat the 2012 review as a baseline assessment[13] and seek input from retailers on the draft review findings. As a retailer, we currently trade on 58 distribution networks[14] and therefore can provide insight into the practical issues that arise from distribution pricing and the impact it has on our customers. For example, we have concerns with the congestion period demand (CPD) approach used on some GXP-based distribution networks. Under one particular CPD approach:

- a customer's distribution charges for the current year are based on the distribution network's peak demand from the previous year, until the distributor can measure the current year's peaks and wash-up the difference a month later; and
- rather than measuring the individual customers' actual demand, the distributor aggregates and charges CPD at a retailer level. The retailer is subsequently expected to "pass through" the network charges in a timely and transparent manner, while having no evidence to justify to the customer how the individual charge was set.

We consider that this approach provides the customer with no immediate incentive to change behaviour and we consider this goes against the pricing principle seeking transparency.[15] It is important that retailers' insights such as this are fed into the distribution pricing review. It provides an additional layer of evidence that can assist the Authority on where it can best intervene for the long-term benefit of consumers.

[13] For the reasons noted in our prior submission, *Value in initial review but stronger measures required for distributor-retailer contracting environment,* Genesis Energy submission to the Electricity Authority, 14 October 2011.

[14] Including embedded distribution networks.

[15] Principle (d) of the Authority's pricing principles.

Timing of review of distributors' pricing methodologies

As distribution pricing changes take effect from 1 April each year, distributors must begin consultation with retailers in the middle of the year to ensure that the changes can be implemented within the required timeframe. By October 2012, we note that most distributors will have all but finalised their pricing methodology for 1 April 2013 (with decisions based on estimates of Transpower's charges) and will be seeking board sign-off. Therefore, a review in September or October 2012 will not be able to influence the pricing approach for 2013. The earliest the Authority's review of distribution pricing could be expected to inform a distributor's pricing methodology is 1 April 2014. We consider this is a lost opportunity for the Authority as it will delay insights from the first review.

Effectiveness of voluntary approach

Distributors' alignment with the information disclosure guidelines and the pricing principles is only voluntary. Therefore, it is important that the Authority understand if these market facilitation measures are effective in achieving the intended outcomes. As noted previously,[16] we consider that voluntary measures are unlikely to be effective within a natural monopoly market. Therefore, it is unclear how effective the existing regulatory framework may be in incentivising improvements in distributors' pricing methodologies.

We have some concerns with the Authority's view that the reviews are expected to achieve the desired outcomes by:

> "(a) continuing to raise awareness among distributors of the different pricing approaches used by other distributors, and thus helping highlight examples of best practice; and
>
> (b creating a "competitive tension" among distributors in terms of incentivising them to score well relative to their peers."[17]

We note that retailers are continuously raising issues with distributors and proactively seeking change and that there is already an awareness of different distribution pricing approaches in the industry. However, in our experience this awareness is not consistent across all distributors. It is also unclear whether competitive tension is a sufficient driver for distributors given their monopoly

[16] *More standardisation of distribution arrangements: Proposed amendments to the Code*, Genesis Energy submission to the Electricity Authority, 23 June 2011.

[17] Paragraphs 3.2.2(a) and (b) of the consultation paper.

status. The only incentive available with the pricing principle approach is the publication of the results of the review ("name and shame").

We recommend that the Authority undertake a review of the existing regulatory framework in 2013 or early 2014 to assess if it has been effective and to consider whether Code amendments or other measures are required.

Authority should also focus on other areas of distribution

As raised in our prior submission,[18] we consider that there are a number of other work streams where the Authority could make progress towards distribution standardisation[19] and achieve tangible benefits for consumers. In particular, we consider the Authority should investigate:

- establishing the model use-of-system agreement as the default agreement that distributors must offer any retailer;
- the benefits of ICP versus GXP-based pricing;
- the most effective network billing methodologies; and
- mandating liability clauses in the Code.

We would welcome the opportunity to discuss these work streams further with the Authority and consider that some of this work could be progressed by one of the Authority's advisory or technical groups.

Restrictions arising from Commerce Commission regulation of distributors

While outside the direct scope of the Authority, we note that the Commerce Commission's regulation of distributors' revenue has had a direct impact on the innovation of retail tariffs. To date, Genesis Energy has faced difficulties with implementing a demand-side tariff in some distribution areas.[20] Many distributors have been reluctant as there is increased uncertainty and risk around distribution returns. By introducing a new methodology, the distributor may recover greater or lesser returns than expected, due to a greater or lesser change in demand-side behaviour by customers. Under recovery means the distributor loses money that it cannot recover in future periods, while over recovery subjects

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[18] *Value in initial review but stronger measures required for distributor-retailer contracting environment,* Genesis Energy submission to the Electricity Authority, 14 October 2011.

[19] The "new matters" set out in clause 42(2)(e) and (f) of the Electricity Industry Act 2010.

[20] Genesis Energy is currently trialling a multi rate tariffs in Auckland and will soon be trialling a multi-rate tariff in the South Island.

the distributor to scrutiny by the Commerce Commission. Given these risks, we have found that distributor's boards prefer to take a conservative approach, with a reduced variety in tariff groups and rates and increased confidence in returns

We recommend that the Authority raise these concerns with the Commerce Commission as the introductions of demand-side tariffs have clear benefits for consumers. From our experience to date with multi-rate trials, we have seen about an eight percent reduction in power consumption, on average, and a savings on the normal power bill of up to ten percent.

If you would like to discuss any of these matters further, please contact me on 04 495 6354.

Yours sincerely

Karen Collins
Senior Regulatory Advisor