22 June 2012

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Decision-making and economic framework for distribution pricing methodology review

Thank you for the opportunity to comment on the Electricity Authority's (EA) consultation paper on the decision making and economic framework for the Distribution Pricing Methodology Review. No part of this submission is confidential. Our response to the detailed consultation questions are outlined in the attachment to this letter.

1. SUMMARY

- Mighty River Power does not support the introduction of the proposed framework at this time.
- The existing distribution pricing principles and guidelines have not been proven to be deficient and should be reviewed consistent with the EA's original intent and process.
- If inefficiencies are identified, then Mighty River Power would support more detailed analysis of the costs and benefits of any proposed reforms, consistent with good regulatory practice.
- There are higher priorities for regulatory reform that would improve cost recovery for retailers and distributors, such as reviewing the Low Fixed Charge Tariffs.

2. OVERVIEW

We note the Authority is planning to apply the same decision making and economic framework developed as part of the Transmission Pricing Methodology (TPM) to distribution. This is to be implemented as an additional overlay to the existing pricing principles and information disclosure guidelines developed in consultation with the industry. Distributors will be required to give consideration to both the new framework and the principles in developing their pricing approaches.

We appreciate that the previous principles and guidelines were developed under the Electricity Commission and have not been assessed against the Authority's new statutory objective. We agree with the Authority's statements that the pricing principles are consistent with the economic efficiency intent of the framework and seek to promote the efficient use of and investment in the network.

We do not support the application of the proposed framework to distribution at this stage for the following reasons:

1. The characteristics of distribution and transmission are different;
2. The existing pricing principles have not been demonstrated to be deficient;
3. Application of the framework could potentially impose costs which have not been sufficiently considered; and
4. There are other issues, such as low fixed tariff requirements, which are of greater concern that the Authority should focus efforts.

The points are expanded upon in the following sections.

2.1 Different characteristics of Distribution and Transmission

Distribution and Transmission systems differ in many key aspects which make the application of the EA's proposed framework problematic. The rationale advanced for Transmission was that disparate approaches existed for the pricing of the various elements: connection, interconnection and HVDC and creating consistency was desirable.

Transmission investment is characterised by periodic and large capital costs which must be recovered in some form from users – both generators and consumers. In some instances the identification of beneficiaries and exacerbators is relatively straightforward (for example a spur line to a generator) but quickly becomes more problematic where there are multiple users of the grid and benefits and costs are not easily attributable, as the recent Transmission Pricing Advisory Group review process demonstrated.

By way of comparison, investment in distribution is characterised by much smaller continuous incremental investments to maintain and upgrade the network and ensure reliability, particularly during peak periods. Unlike transmission, only in very rare cases are generators connected directly to the network such that the main users of the network are unambiguously consumers.

Arguably the meshed nature of distribution networks and the fact that consumers are the main users reduces the usefulness of the proposed framework, in that users are likely to simultaneously be exacerbators *and* beneficiaries of network investment. Only for very small numbers of loads would a distinction be usefully able to be made.

2.2 Existing principles not demonstrated as deficient

Further to the points above, while greater consistency was considered desirable for transmission, as the discussion paper notes for distribution a 'principles' rather than 'model' approach was more appropriate. This was on the basis that a model approach was "considered to be too prescriptive in nature and thus would run the risk of not appropriately recognising the different situations of networks around the country".

We do not consider the rationale for this approach has changed. Given the EA clearly states in the discussion paper that the principles are consistent with the intent of the framework and are likely to deliver efficient use of and investment in the network, further justification is required as to why the implementation by the EA of a model approach is necessary.

Further, we note that the existing pricing principles and the disclosure regime have only recently been introduced and have yet to be comprehensively assessed. Criteria has been developed by the Authority in this regard and we consider a review should be an important first step before the need for additional changes, such as the proposed framework, are considered.

If material inefficiencies are identified we would support the EA developing measures to address these, consistent with Principle Two of the Authorities code amendment principles. This principle states changes should only be considered where there are clearly identified efficiency gains or market regulatory failure.

This principle is consistent with good regulatory practice and we note that the efficiency gains of imposing the proposed framework as an additional consideration for distributors has not been quantified, nor have the cost implications for retailers (and ultimately consumers) been adequately considered.

2.3 Consideration of potential cost implications required

Cost implications arise from the fact that the proposed framework will represent an additional consideration that distribution companies will have to demonstrate they have taken into account. One potential outcome is that the implementation of market approaches or the identification of beneficiaries and exacerbators is not practically possible, resulting in the retention of the existing administrative pricing approaches. In this instance, the application of the framework will have provided additional costs without additional benefits over the outcomes delivered by the existing pricing principles.

Another cost implication that Mighty River Power is most concerned about is that the application of the framework could result in a greater emphasis on cost reflectivity, leading toward more granular network pricing, potentially to the ICP level which would be unworkable in a cost sense for retailers. This issue is discussed in further in the Attachment.

We note that the existing principles contain important references to ensuring pricing approaches are cognisant of the impact of transaction costs on retailers, consumers and other stakeholders. Given the above, we do not agree with the EA's assertion that the proposed framework is consistent with the pricing principles.

2.4 Other priority areas

The discussion paper notes that there are a range of impediments that have been identified that prevent distributors from efficiently recovering costs. Chief among these from Mighty River Power's perspective is the Low Fixed Charge Tariff Option for Domestic Consumers and the impact this imposes on both retailers and distributors. We consider that rather than focussing on the application of the framework the Authority should focus on ways to resolve such impediments and improve efficient cost recovery for the industry consistent with its statutory objective.

3. CONCLUSIONS

Mighty River Power considers that for the reasons outlined above the rationale and benefits of implementing the proposed framework as an addition regulatory overly for distribution has not been demonstrated and is not necessary.

We recommend the EA continue with the review process established for the pricing principles and disclosure regime. If inefficiencies are identified with the current approach, then we would support more detailed analysis of the costs and benefits of any proposed reforms, consistent with good regulatory practice as outlined in Principle 2 of the EA's code amendment principles.

We consider there are existing identifiable market regulatory failures, such as the Low Fixed Charge Tariff, that should be seen as higher priorities for reform.

Please direct any queries on this submission to Nick Wilson, Senior Market Regulatory Adviser on nick.wilson@mightyriver.co.nz or 09 580 3623.

Yours sincerely

Nick Wilson
Senior Market Regulatory Adviser

ATTACHMENT: DISCUSSION PAPER QUESTIONS

No.	Question	Response
Q1.	Do you agree with the Authority's interpretation of its statutory objective with respect to distribution pricing? If you agree, please explain why. If you do not agree, please explain how you consider the statutory objective should be interpreted with respect to distribution pricing and the reasons for your interpretation.	No. We consider the existing pricing principles are a closer match to the Authority's statutory objective as they place more emphasis on promotion of (retail) competition than is evident in the Authority's interpretation, which seems more focussed on cost reflectivity in distribution pricing. These two objectives – retail competition and distribution cost reflectivity – can conflict because of Retailer transaction costs, and in our view the paper does not strike an appropriate balance. If cost reflectivity in distribution pricing were taken to its logical extreme one potential outcome could be individual ICP pricing for the mass market, which is unworkable for mass market-metered sites.
Q2.	Do you agree with the above application of the three limbs of the statutory objective to distribution pricing? If not, why not, and are there other examples of how distribution pricing can influence competition, reliability and efficiency?	The application of the three limbs of the statutory objective set out in table 3 is reasonably fair. However, the rest of the paper does not appear to be fully based on this application, primarily because of the impact of the higher Retailer transaction costs (pricing principle (e) that would flow from more cost reflective pricing, particularly for the mass market.

No.	Question	Response
Q3.	Do you agree that a market-based distribution pricing methodology would tend to promote efficiency in network use and in investment in distribution networks, generation, demand management and the electricity industry more generally? If so, what are your reasons? If you disagree, what are your grounds for disagreeing?	We find it difficult to understand how a market based methodology would work for other than very large loads, as only such loads will normally have the incentive, expertise and management time to devote to negotiating their distribution pricing. Our preference would be for market based pricing with a consistent methodology across all distributors for HHR. Although we do have pricing by individual ICP, notably Orion, we would not want to see this for every network.
Q4.	Do you agree that market-based distribution pricing methodologies are likely to be more durable and stable than approaches involving administered charges? If so, what are your reasons? If you disagree, what are your grounds for disagreeing?	Answer as for Q3.
Q5.	Do you agree distributors should use pricing methodologies that give preference to market-based approaches to distribution charges wherever such charges will be efficient and implementation will be practicable? If so, what are your reasons? If you disagree, what are your grounds for disagreeing?	Answer as for Q3.

No.	Question	Response
Q6.	Do you agree the second, third and fourth ranked preferences should be for administrative approaches to distribution charges of exacerbators pay, beneficiaries pay and other charging options wherever such charges will be efficient and implementation practicable? If so, what are your reasons? If you disagree, what are your grounds for disagreeing?	No. In most cases it will be very difficult to either identify exacerbators/ beneficiaries or quantify their impact and costs on the network. It is useful to divide the mass –metered market into two segments: Small and Medium Commercial – Such charging options can be appropriate depending on how they are implemented. For example, mass market fixed charges set at the ICP level (such as Electricity Invercargill and The Power Company) imposes severe restrictions on contestability. However, the capacity, demand and distance structure used by Aurora in our view strikes a good balance of cost reflectivity and contestability. Residential – To maximise contestability, residential ICPs need as simple and as generic a pricing structure as possible. This precludes any pricing structures based on individual ICP characteristics.
0Q7.	Do you agree these actions can exacerbate investment? Are there other actions and, if so, what are they?	We agree that these actions can exacerbate investment but we reiterate that this criterion, other than for major loads, is only valid / easy to implement in a relatively small number of cases, for example irrigators etc as set out in paragraph 5.5.2.
Q8.	Do you agree that exacerbators should be identified by determining which party or parties have the ability to act differently, thereby avoiding the need to augment the network? Is there an alternative approach? If so, please provide details.	Answer as for Q7.

No.	Question	Response
Q9.	Do you agree with the assessment of the price that should apply to exacerbators? Do you agree with the assessment of how exacerbators pay should apply in practice? Do you agree with the proposed approach for identifying the preferred option or options for applying exacerbators pay? Please provide explanations in support of your answers.	Answer as for Q7.
Q10.	Do you agree these considerations should be taken into account under an exacerbators pay approach? Please provide an explanation in support of your view.	Answer as for Q7.
Q11.	Do you agree that these ways can be used to identify beneficiaries? Are there others? If so, please provide details.	The same issues arise with beneficiaries as arise with exacerbators as set out in Q7.
Q12.	Do you agree with the assessment of the price that should apply to beneficiaries? Do you agree with the assessment of how beneficiaries pay should apply in practice? Please provide an explanation in support of your answer.	Answer as for Q11.
Q13.	Are there other alternative pricing options? Do you agree with the assessments of how incentive free and postage stamp pricing should be applied in practice? Please provide reasoning in support of your answer.	The broad smearing of cost recovery postulated in paragraph 5.7.3 would result in quite the opposite impact on distribution prices to the exacerbators pay approach, under which individual customers or groups of customers would carry the full costs of network augmentation. This internal inconsistency may give rise to unpredictable pricing policies on the part of network companies, thereby magnifying the current plethora of approaches.

No.	Question	Response
Q14.	Do you agree that the guidelines are consistent with the proposed decision-making and economic framework and therefore do not require any changes? If you agree please explain why and, if not, please explain why not.	No. We do not believe proposed framework if applied would sufficiently capture existing principles of addressing retailer impacts due to the emphasis on cost reflectivity. At this stage we believe that the principles and guidelines should be retained unchanged and that the Authority progress with its review process. Should this process identify material inefficiencies with the existing principles then policy measures should be developed to address this consistent with the Authority's code amendment principle 2. We consider that against the principle the rationale for implementing the proposed framework cannot be supported. Refer to cover letter for further detail.
Q15.	Do you consider that the pricing principles and guidelines are consistent with the proposed decision making and economic framework? If you agree, please explain why. If you disagree please explain why not and how the principles should be changed.	As above for q 14.
Q16.	Do you agree that pricing principle (b) should be interpreted as implying that where an alternative charging option is required prices should be set in a manner that minimises the impact of the charge on the use of the asset? If you agree please explain why. If you disagree please explain why not and please state how you consider this principle should be interpreted.	We have no view on this question.

No.	Question	Response
Q17.	Do you agree with the Authority's proposal to use the economic framework for distribution pricing as criteria for assessing distributors' application of the pricing principles? If you agree, please explain why and, if not, please explain why not.	No. As stated in the cover letter we do believe the rationale for implementing the framework has not been sufficiently demonstrated and could lead to unnecessary costs. At the extreme it is possible that some networks may interpret the framework as a license to implement individual ICP pricing for the mass market, which from a retailer perspective would be unworkable.
Q18.	Do you have any comments on the proposed process for confirmation of the decision-making and economic framework and the Authority's review of distributors' pricing methodologies?	Given that the review will be available in early 2013 (paragraph 8.2.2(d)), and that distributors are invited to align their pricing "in as timely a manner as they are reasonably able to achieve" (paragraph 8.3.3), this could lead to significant rate shock in April 2014. We believe that if any significant changes in distribution pricing are to come from this review, the impact of rate shock must be taken into account, and any changes phased in over a number of years.
Q19.	Do you have any comments on how the Authority intends to take into account the timing implications of this consultation and the Authority's review of distributors' pricing methodologies?	Answer as for Q18.