Distribution Pricing Arrangements: Models or Principles

Presentation to Electricity Commission Workshop

17 June 2009

Overview

- We will talk about Vector's experiences with pricing methodology development
- Raise questions about what objectives are being addressed and the problems with the proposed model approach
- Suggest a way forward

Vector's experience

- Vector is in a unique position
  - Complied with a prescriptive cost allocation model under Administrative Settlement with Commerce Commission
  - Developed a principle-based approach to determine a pricing methodology under the Gas Authorisation for our Auckland gas business
- From the lessons we have learnt (the hard way) the principles-based approach should overwhelmingly be preferred
- We recognise that retailers have raised concerns about the complexity of distribution pricing, but this does not directly translate into a need for a single cost allocation approach or single pricing structure – understanding the **detail** of retailer issues should be a key focus for this workstream
- … please learn from our experience (Santayana)

Electricity Administrative Settlement

- Vector acquired two networks which meant up to three different pricing and cost allocation methodologies – moved to a standardised approach
- Vector voluntarily commenced price rebalance in 2005
- Commerce Commission became concerned about speed of rebalancing and some apparent anomalies in the direction of some price movements
- The rebalance was completed under a much more prescriptive process detailed in Administrative Settlement
- Results
    - Substantial rate shock for some customers
    - Tariff structure that does not make sense – unintended consequence of mechanical application of cost allocation methodology
    - Price volatility because customers change their relative behaviour over time, so costs reallocate in proportion to changes in network use

Gas Authorisation

- Vector has determined Auckland gas distribution prices according to application of Commerce Commission mandated pricing principles
  - No cross-subsidies
  - Discourage uneconomic bypass
  - Cost-reflective
  - Signal costs of new investment
  - Signal price-quality trade-offs
  - Ramsey compliant
  - Price stability and impact on customers is considered
- Principles-based approach provided Vector with the necessary flexibility to price in a manner that was suitable for its customer base
  - Has allowed determination of a stable cost allocation approach and stable tariff structure over time
  - Mechanical cost allocations (such as those indicated in PAWG/EC proposal) were impractical – led to perverse tariff structures because of non-linearities in network use – so were not used
  - Managing customer impacts a key element of design

Implications

- Mechanically following a cost allocation model does not generate sensible outcomes, significant judgment and smoothing is required
  - Implies large amount of variance reporting under voluntary model approach
  - Implies price volatility and perverse tariff structures under compulsory approach
- Changing cost allocators will lead to rate shocks for customers, but does not generate fairer tariffs
  - Why does the Commission feel need to establish a model cost allocation methodology?
- The efficiency properties of tariffs is separable from cost allocation methodologies
  - It is the relative difference in prices that drives customer behaviour, not absolute levels
- There is a substantial cost entailed in developing and reporting on new cost allocation and pricing models, particularly when simultaneous compliance with price caps is required
- It is important to be able to take account of customer welfare concerns when establishing cost allocation approaches and pricing methodologies

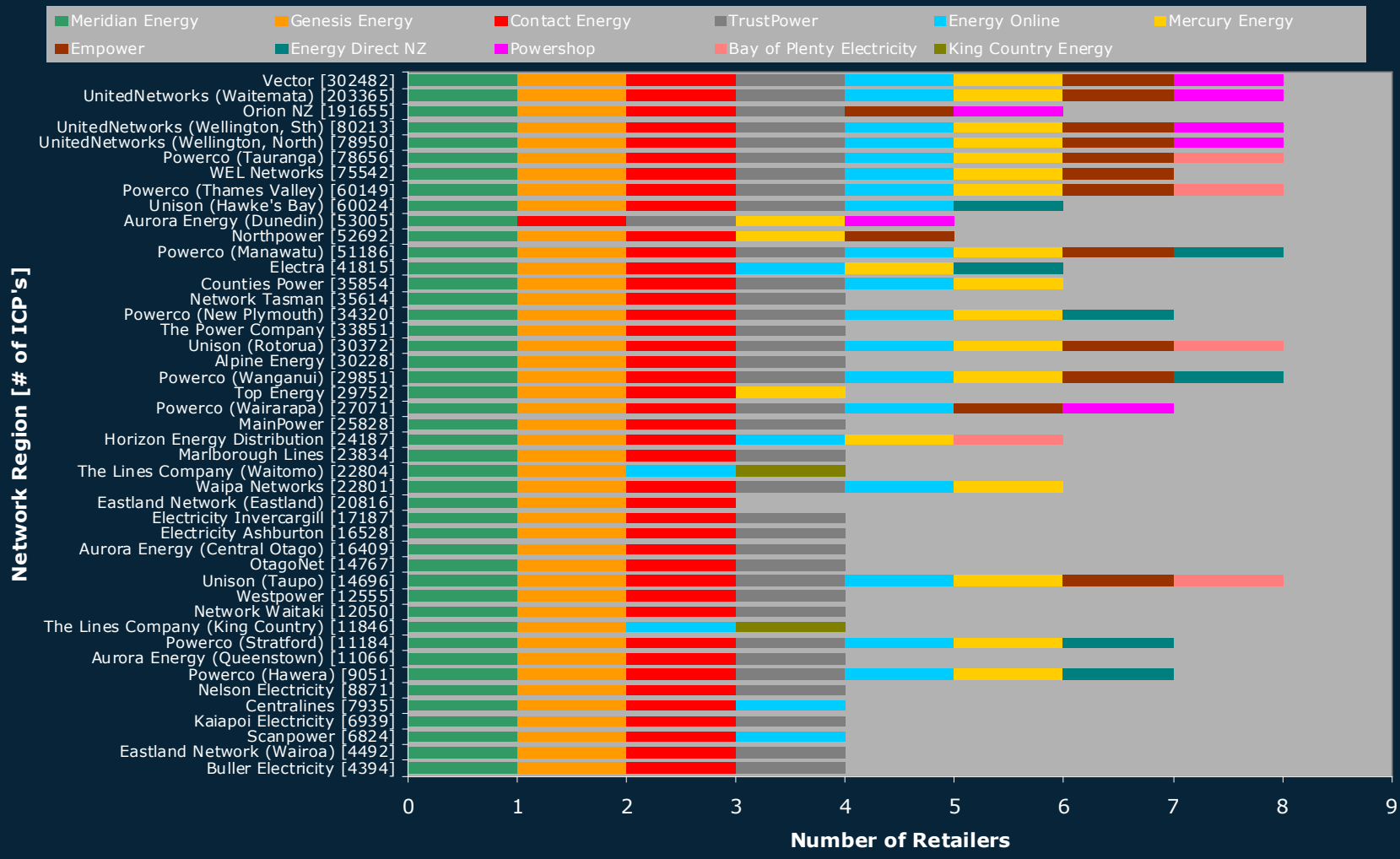
Role of EC Model Approaches in "Input methodologies"?

- Input methodologies are intended to be mandatory under Commerce Commission regime – what does this mean for the Electricity Commission work?
- It is important to understand what the EC's proposed approach would mean if the model becomes mandatory
  - Large rate shocks as distributors are required to move from one cost allocation model to another (not fairer or better, just different)
  - How does pricing innovation occur – different distributors have different drivers at different times
  - Prices potentially become less efficient over time because of a one-size-fits all solution
  - How are revenue risks from new tariff structures dealt with under price cap regulation
  - Compliance costs relative to retailer transaction costs?

What steps would we like to see?

- Start from a clear, empirically-based understanding of the exact issues: the current proposal appears to be based on assumptions, and a presumption of a model approach
- What is the precise nature of retailer issues?
    - Model approaches, even if they were to become mandatory will not fix the "problem" of 29 different lines companies, retailers will still face the costs of dealing with at least 29 price books
- Electricity Commission could facilitate precise understanding of retailer and distributor interface issues: what are the systems, processes, classification, terminology differences that might be addressed
- Regulation targeted at the specific problems

How big are the transaction costs?



What might an alternative solution look like?

- Electricity Commission facilitates workshops between retailers and distributors to educate and develop understanding of the issues
- Electricity Commission publishes pricing principles (Gas Authorisation provides a good starting point)
- Additional principle
    - Tariffs should not place undue transaction costs on retailers and consumers
- Companies report compliance with principles
- Where the Commission believes individual distributors have not met the principles, process of engagement and consultation but backstop that the Commission may regulate
- Benefit is that regulation is proportionate and targeted. Unnecessary rate shocks avoided. Reduced compliance costs.
- Can always consider more prescriptive approaches later