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To whom it may concern,

## **Decision-making and economic framework for distribution pricing methodology review**

### **Introduction**

1. Vector welcomes the opportunity to submit on the Electricity Authority's (Authority) consultation paper "Decision-making and economic framework for distribution pricing methodology review" (Distribution Framework Paper), dated 7 May 2012. Vector also appreciated the opportunity to participate in the meeting between the Electricity Networks Authority (ENA) and the Authority to discuss the Distribution Framework Paper. We found this to be very helpful.
2. No part of this submission is confidential and Vector is happy for it to be publicly released.
3. Vector's contact person for this submission is:  
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4. Responses to the Authority's questions are provided in the Appendix. Vector considers that the Authority's questions omit a number of important issues which need to be considered to ensure robust decisions and policy development. These include:
  - a. What is the market failure/problem with existing distribution pricing regulation the Authority's decision-making and economic (Distribution Pricing) Framework is intended to address?
  - b. What are the costs and benefits of the Authority's proposals? Would the Authority's proposals result in more efficient electricity distribution pricing methodologies (EDPMs)?
  - c. If the Authority adopts a Distribution Pricing Framework for electricity distribution should it be the same as the Transmission Pricing Framework?
  - d. Has the Authority properly applied the Distribution Pricing Framework in its evaluation of the existing Pricing Principles?
  - e. What is the appropriate role of the proposed Distribution Pricing Framework? For example, should the Framework be used to evaluate the existing Pricing Principles or extended to require electricity distribution businesses (EDBs) to apply the Framework?
5. Vector addresses these questions below.

## Summary of Vector's views

6. Vector has the following views on the Authority's Distribution Framework Paper:

### *Evaluation of the Pricing Principles against a Distribution Pricing Framework*

- a. It is appropriate for the Authority to review the distribution Pricing Principles against its revised statutory objective in the Electricity Industry Act 2010.
- b. A Distribution Pricing Framework could be used to assist with the review of the distribution Pricing Principles. This is analogous to the approach the Authority is taking of reviewing the Electricity Transmission Pricing Methodology (ETPM) against a Distribution Pricing Framework. Coupling an evaluation of the current Pricing Principles against the Authority's statutory objective as well as a Distribution Pricing Framework amounts to a "belts and braces" approach.
- c. The Authority's evaluation of the Pricing Principles should also include the Pricing Principles for distributed generation.
- d. There are substantive differences between electricity distribution and transmission that mean it is not appropriate to simply adopt the same Pricing Framework for both sectors.
- e. For example, a key debate in electricity transmission is whether consumers or generators or some combination of the two should pay for transmission (or particularly parts of the transmission grid). Concepts such as exacerbator and beneficiary pays may be helpful in resolving such questions. Electricity distribution does not have two (more or less) equal sides of the market who could potentially pay. The generation side is limited to a small amount of embedded or distributed generation.<sup>1</sup>
- f. It should be recognised that the principal reason for developing a Distribution Pricing Framework for transmission is to address industry disagreement and controversy over the ETPM.
- g. Vector agrees with the Authority that the existing Pricing Principles are broadly consistent with the Authority's statutory objective and the proposed Distribution Pricing Framework.
- h. The Pricing Principles (no subsidies, no monopoly pricing, sending appropriate signals for future investment cost etc, linking prices to service levels, limit prices where competitive bypass or substitution is possible and Ramsey Pricing) are characteristics of prices to be expected from a market-like approach<sup>2</sup> ie the Pricing Principles are consistent with workably competitive market benchmarks and outcomes.<sup>3</sup>

### *Amendments to the Pricing Principles*

- i. Based on the proposed Distribution Pricing Framework, Vector believes Principle (b) should be amended to state that any revenue shortfall, required for an EDB to fully recover its costs/allowed revenue, should be recovered in a way that minimises distortions to pricing signals. It should be recognised that the use of two-part tariffs (fixed charges) is the first best way to do this

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<sup>1</sup> ENA make similar comments about the different size of counterparties.

<sup>2</sup> Given the Authority concluded a market approach was likely to be of limited applicability to electricity distribution we were surprised the Authority did not (explicitly) assess the Pricing Principles against a market-like approach. The Authority would have needed to do this to properly assess whether the Pricing Principles satisfied the Distribution Pricing Framework.

<sup>3</sup> Vector interprets a market-like approach and adoption of workably competitive market benchmarks as one in the same thing. The Authority does not explicitly define a market-like approach in the Distribution Framework Paper. The Transmission Framework Paper, however, refers to mimicking or replicating workably competitive market outcomes, albeit without using the term market-like approach.

and Ramsey Pricing, which is presently reflected in Principle (b), is a second-best option and has practical limitations.

*Extending the role of the Distribution Pricing Framework to require EDBs to comply with it*

- j. Vector's main disagreement with the Authority is over the role the Distribution Pricing Framework should have beyond reviewing the existing Pricing Principles.
- k. The Distribution Framework Paper does not identify any market failure/problem with existing distribution pricing regulation (voluntary Pricing Principles<sup>4</sup>, Information disclosure and consultation requirements) that would justify introducing a requirement for EDBs to adopt the Distribution Pricing Framework.
- l. The Authority has also not provided an assessment of the costs and benefits, either qualitative or quantitative, of its proposed Distribution Pricing Framework. Nor has the Authority offered any consideration of alternative options. These are both core components of the Authority's Consultation Charter.
- m. Vector considers that current electricity distribution pricing regulation is appropriate and there is not likely to be any further net-benefits from overlaying this with a requirement for EDBs to apply a Distribution Pricing Framework.
- n. There are a number of issues with the Authority's proposals that would need clarification if EDBs were required to apply the Distribution Pricing Framework. For example, what would the Authority's position be if an EDB complied with the Pricing Principles in full, but did not apply the Distribution Pricing Framework? What if an EDB's interpretation of the Distribution Pricing Framework resulted in prices inconsistent with the Pricing Principles? Does the Distribution Pricing Framework take precedence over the Pricing Principles or vice versa?

## **Background**

- 7. Vector supported the Authority's proposed adoption of a Distribution Pricing Framework for reviewing the ETPM because we agreed with the Authority that TPAG "did not provide a comprehensive and durable framework for making decisions about the TPM"<sup>5</sup>, "[c]onsideration of a clear framework for the Review of the TPM should contribute to robust decision-making", and "instituting a comprehensive and durable decision-making framework is warranted, particularly given the ongoing debate about the TPM."<sup>6</sup> Given the ongoing industry debate about the ETPM, Vector considered it sensible for the Authority to go back to "first principles" to determine an administratively robust decision-making framework and process for the ETPM review.<sup>7</sup>
- 8. If the Authority had not developed a transmission Distribution Pricing Framework we doubt it would have felt any need to develop one for distribution.
- 9. There are substantive differences between electricity distribution and transmission that mean it is not appropriate to simply adopt the same Pricing Framework for both sectors. The Distribution Framework Paper is entirely silent on this matter. It

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<sup>4</sup> Mandatory for distributed generation.

<sup>5</sup> Page 2, Electricity Authority, Summary Paper, Decision-making and economic framework for transmission pricing methodology review, 3 February 2012.

<sup>6</sup> Paragraph 2, Electricity Authority, Consultation Paper, Decision-making and economic framework for transmission pricing methodology review, 26 January 2012.

<sup>7</sup> Paragraphs 18 and 19, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review, 24 February 2012.

simply adopts the Transmission Pricing Framework for distribution, without any explanation of why this is appropriate.

10. There are many important differences between electricity transmission and distribution. The issues around the establishment of a pricing methodology for transmission are far more complex and controversial than for distribution. The ENA submission goes into this in more detail than we do here.
11. During the meeting between the ENA and Authority on the Distribution Pricing Framework, the ENA suggested a difference between transmission and distribution is that distribution networks tend to be substantially more meshed than the transmission network. Vector believes this illustrates that, amongst other things, there can be a wide divergence between incremental and stand-alone cost and therefore a wide range of prices that would satisfy the Authority's Pricing Principles. Determining an "efficient" set of prices is not akin to "balancing angels on the head of a needle".
12. The Authority raised the scenario where a network could be depicted by two linked, but clearly separable, meshed networks. An inference from this is that separate cost calculations (and sets of prices) could be made for each of the areas. Vector acknowledges this. It does, however, highlight a trade-off between the level of disaggregation that could be taken versus standardisation and simplification of EDB tariffs. Vector is acutely aware of the concerns of retailers about the transaction costs that a high degree of disaggregation can cause. The Authority should recognise that a principal impact of a high degree of disaggregation in the application of Pricing Principle (a) will not necessarily be on efficiency, in any material way, but on wealth transfers amongst consumers.
13. Another example is the debate in electricity transmission as to whether consumers or generators or some combination of the two should pay for transmission (or particularly parts of the transmission grid). Concepts such as exacerbator and beneficiary pays may be helpful in resolving such questions.
14. Electricity distribution does not have two (more or less) equal sides of the market who could potentially pay. The generation side is limited to a small amount of embedded or distributed generation. The issues around who should pay are principally limited to whether distributed generation should contribute to common costs (currently precluded by the Authority).
15. While the Authority has adopted the same Distribution Pricing Framework for electricity distribution and transmission, Vector **notes** that distribution and transmission do not need to have the same Framework; even to ensure consistency.<sup>8</sup>

### **Application of the Distribution Pricing Framework to the distribution Pricing Principles**

16. Vector agrees the Authority "should confirm that the pricing principles and guidelines align with the Electricity Industry Act and, in particular, the statutory objective" given "the pricing principles and guidelines were developed under the Electricity Act 1992".<sup>9</sup> Use of the Distribution Pricing Framework to evaluate the distribution Pricing Principles may also assist with this review.
17. The Distribution Pricing Framework first requires the Pricing Principles to be compared against the market approach (first preference), cascading down to the second preference (market-like approach), third preference etc until it is either

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<sup>8</sup> If the Authority intended the distribution and transmission Distribution Pricing Frameworks to be the same it would not have made sense to consult on them separately nor to finalise the transmission Framework before starting consultation on the distribution Framework.

<sup>9</sup> Paragraph 3, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

confirmed that the Principles meet the requirements of the Framework or inconsistencies are identified.

18. This is explained by the following commentary in the Distribution Framework Paper:<sup>10</sup>

Even if an approach only partially covers costs, under the framework it would still be appropriate to apply the more preferred approach to the extent possible provided it is efficient and practicable to implement. A less preferred approach would then be applied to the remainder.

19. Vector does not believe the Authority has properly applied the Distribution Pricing Framework against the Pricing Principles:

- a. The evaluation of the Pricing Principles against the Distribution Pricing Framework considers the market-based approach, exacerbator pays approach, beneficiary pays approach and alternative approaches but not the market-like approach.
- b. The Distribution Framework Paper uses market approach and market-based approach as interchangeable terms, even though market-based properly includes both market and market-like approaches.
- c. The Authority's assessment is entirely silent on the second preferred approach (market-like approach). The Distribution Framework Paper includes no discussion of the market-like approach or even a definition of what it is. The market-like approach is only identified in the Figures illustrating the Distribution Pricing Framework.<sup>11</sup>
- d. The discussion of market-based approaches<sup>12</sup>, for example, only includes mention of market-approaches (nodal pricing and long-term contracts) and does not includes any market-like approaches (such as LRMC).
- e. The Distribution Framework Paper lists LRMC pricing (and its variations) as exacerbator pays<sup>13</sup> even though it is also a market-like approach. The Authority did something similar in relation to transmission pricing. Vector previously observed that "The TPM Framework Paper's discussion on market-based approaches revolves around locational-pricing, but the Paper only discusses locational-pricing as an exacerbator pays option."<sup>14</sup>

20. Given the Decision Framework Paper includes no assessment of the Pricing Principles against the market-like approach it would appear reasonable to assume the Authority has failed to consider the market-like approach and has, therefore, not properly applied the Framework.

21. The Pricing Principles (no subsidies, no monopoly pricing, sending appropriate signals for future investment cost etc, linking prices to service levels, limit prices where competitive bypass or substitution is possible and Ramsey Pricing) are characteristics of prices to be expected from a market-like approach. This reflects that the Commerce Commission developed the original version of the Pricing Principles (which are largely unchanged by the Authority) against a workably competitive market benchmark, which is the same as a market-like approach. The Pricing Principles were developed as part of the Authorisation for Vector and Powerco's GDBs. The Commerce Commission noted that it "sees the primary

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<sup>10</sup> Paragraph 7.2.3, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

<sup>11</sup> Figures 1, 4 and 7, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

<sup>12</sup> Section 5.3, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

<sup>13</sup> Section 5.5, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

<sup>14</sup> Paragraph 29, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review, 24 February 2012.

objective of the Authorisation as setting control terms for the controlled businesses that promote outcomes that are consistent with a workably competitive market".<sup>15</sup>

22. Vector **notes** we consider the Pricing Principles to be broadly consistent with the Authority's statutory objective, the proposed Distribution Pricing Framework and, specifically, a market-like approach. An important consequence is that an EDB could reasonably follow the Distribution Pricing Framework and conclude it would be practicable to implement an EDPM consistent with a market-like approach and the Pricing Principles and therefore they would have no need to consider the lower-order approaches of exacerbator pays, beneficiary pays and other alternative approaches.

### ***Amendment of the Pricing Principles***

23. A potential area of conflict between the Distribution Pricing Framework and the Pricing Principles relates to Pricing Principle (b). Adoption of a "market-like approach" to pricing of natural monopolies can result in a revenue shortfall as marginal cost will be less than total cost in natural monopoly markets, while marginal cost equals total cost in workably competitive markets. Principle (b) indicates this shortfall should be recovered by Ramsey Pricing.<sup>16</sup> While Ramsey Pricing is adopted in some workably competitive markets (consider, for example, the pricing practices of airlines) it is not universally adopted and is inconsistent with the Framework's statement that revenue shortfalls should be recovered on an "incentive-free" basis.
24. From an efficiency perspective, and that of the Authority's statutory objective, it would be better to adopt a two-part tariff (including fixed charges) which aims to avoid distorting price signals, rather than Ramsey Pricing which aims to minimise distortions.<sup>17</sup>
25. The Commerce Commission has noted that Ramsey Pricing is a "second best" approach to allocatively efficient pricing" and there are "practical difficulties with attempting to quantitatively implement Ramsey pricing in practice."<sup>18</sup> Ramsey Pricing requires customer information that EDBs may not necessarily be able to reasonably acquire. It would be better to re-frame the Ramsey Pricing Principle into a least-distortionary principle.
26. Vector accordingly **recommends** Pricing Principle (b) be amended to read "Where prices based on 'efficient' incremental costs would under-recover allowed revenues, the shortfall should be made up by recovering any revenue shortfall in as least-distortionary manner as possible ~~setting prices in a manner that has regard to consumers' demand responsiveness, to the extent practicable~~".

Prices should ensure recovery of the revenue requirement (TRC)

27. While Vector believes Principle (b) should be amended we also consider it desirable to preserve the consistency between the Commerce Commission Gas Pricing Principles and the Electricity Authority Pricing Principles. Accordingly, if the Authority accepts Vector's view that Principle (b) should be amended, Vector additionally **recommends** the Authority discuss with the Commerce Commission whether it would consider making the same amendment to the Pricing Principles in the Gas Input Methodologies.

### ***Consideration of the distributed generation Pricing Principles***

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<sup>15</sup> Paragraph 20, Commerce Commission, Decisions Paper, Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, 30 October 2008.

<sup>17</sup> And can be used to extract consumer surpluses that would arise if price discrimination was not adopted.

<sup>18</sup> Paragraph 159, Commerce Commission, Decisions Paper, Authorisation for the Control of Supply of Natural Gas Distribution Services by Powerco Ltd and Vector Ltd, 30 October 2008.

28. An omission from the Distribution Framework Paper is consideration of clause 6.9, Pricing Principles, in Part 6, Connection of distributed generation, Electricity Industry Participation Code 2010.
29. Any consideration of the Distribution Pricing Framework in relation to electricity distribution Pricing Principles should include distributed generation access pricing.
30. It should also be recognised that the Pricing Principles in Part 6 constrain the way in which EDBs can apply the Distribution Pricing Framework and EDPM Pricing Principles. Part 6, notably, favours distributed generators at the expense of consumers by precluding allocation of any common costs to distributed generators. This conflicts with the statutory objective of promoting the long-term benefit of consumers. It is difficult to see what benefit consumers would get from paying distributed generators a share of common costs. It would also conflict with Ramsey Pricing unless distributed generation (rather implausibly) has a zero elasticity of demand for distribution network access.
31. Vector **recommends** the evaluation of the Pricing Principles include the Pricing Principles for distributed generation and their exclusion of common costs.

### **Role of the Distribution Pricing Framework beyond reconfirming the Pricing Principles**

32. Having considered the Pricing Principles against the Distribution Pricing Framework, and having concluded the Pricing Principles are consistent with the Distribution Pricing Framework,<sup>19</sup> it is not clear the Framework has any useful additional role. Vector does not believe there is a need to require EDBs to also follow the Framework in developing their EDPMs. Assessment against the Principles should suffice.
33. Vector **notes** that we do not consider it necessary or desirable to overlay current electricity distribution pricing regulation (voluntary general Pricing Principles, mandatory distributed generation Pricing Principles information disclosure and consultation requirements) with a Distribution Pricing Framework that EDBs must also adopt.
34. Introducing a requirement for EDBs to apply a Distribution Pricing Framework may result in a level of complexity and cost that may be appropriate for developing an ETM or Pricing Principles but not for application and development of the EDPMs by 29 EDBs. This seems far removed from retailer concerns about the extent of variation amongst EDB's EDPMs, and the Authority's intention to encourage EDBs "to use more standardised tariff structures".<sup>20</sup>
35. An overlay of the Distribution Pricing Framework on top of the Pricing Principles would give rise to a number of issues the Authority would need to clarify, for example:
  - a. Would compliance with the Distribution Pricing Framework be voluntary?  
The Authority's statement that "the Authority proposes that distributors should follow the hierarchy established by the framework"<sup>21</sup> (emphasis added) suggests the answer is yes.
  - b. What would the Authority's position be if an EDB complied with the Pricing Principles in full, but did not apply the Distribution Pricing Framework?  
For example, Vector's EDPM was developed through Commerce Commission Part 4 process.

<sup>19</sup> Or require some minor fine-tuning, as proposed by Vector.

<sup>20</sup> In accordance with section 42(2)(e) of the Electricity Industry Act 2010.

<sup>21</sup> Paragraph 30, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

- c. What would the Authority's position be if an EDB complied with the Distribution Pricing Framework and came up with an EDPM that conflicted with the Pricing Principles?
- It is imminently reasonable to assume different EDBs could apply the Distribution Pricing Framework and come up with different outputs, which do not necessarily mirror, in full, the Authority's own interpretation.
- d. Is there any value in EDBs going through the Distribution Pricing Framework, for example, reviewing whether there are practicable market-based approaches when the Authority has concluded that the scope for market-based approaches in electricity distribution is limited? To what extent would the Authority consider it appropriate for EDBs to rely on the analysis and conclusions in the Distribution Framework Paper?
36. At the meeting between the ENA and Authority on the Distribution Pricing Framework<sup>22</sup>, the Authority expressed concern that there is no guidance as to how the Pricing Principles should be prioritised, or how conflicts should be addressed. The Authority considers that there is a hierarchy among pricing approaches that would provide such guidance.
37. Vector believes that the proposed Distribution Pricing Framework is too far removed from the Pricing Principles to provide useful guidance.
38. Under the status quo, Vector would address any conflicts through consultation with retailers and stakeholders.
39. The Authority's concerns about prioritisation could also be dealt with directly through amendment of the Pricing Principles. Vector **notes** that we would support the Authority adopting the ENA's proposal to amend the Pricing Principles to require they are interpreted consistently with the Authority's statutory objective. Vector considers this simple amendment would help allay the Authority's concerns.
40. Vector **recommends** that if the Distribution Pricing Framework is applied to EDBs for distribution pricing:
- Adoption of the Framework be on voluntary basis;
  - The Authority make it clear the Pricing Principles take precedence over the Framework; particularly where conflicts arise (if applicable); and
  - The Authority specify, for the avoidance of doubt, that EDBs can rely on its own assessment of the practicability of the approaches under the Framework.

### **Impediments to efficient pricing**

41. As the Authority is aware, there are a number of impediments to efficient distribution pricing that are outside of the control of EDBs. The ENA submission provides details of these.
42. One of the impediments is the Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations 2004. The impact of these Regulations is getting more severe annually as the low fixed charge is fixed in nominal terms. A 30c fixed charge in 2004 would be 37c (as of the first quarter in 2012) if it was maintained in real terms.<sup>23</sup>
43. The Authority has signalled a "potential research project looking into the effects on efficiency and competition of the Electricity (Low Fixed Charge Tariff Option for

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<sup>22</sup> Held on 12 June 2012.

<sup>23</sup> Equivalently, 30c in 2004 is equivalent in real terms to 24c as at the first quarter in 2012.



Domestic Consumers) Regulations (Low Fixed Charge Regulations) 2004” in its 2012/13 Work Plan.

44. The Authority should review the impact of the Low Fixed Charge Regulations against its statutory objective to determine whether they are efficient and to the long-term benefit of consumers. This should include consideration of the impact of the Low Fixed Charge Regulations on electricity distribution pricing, and options for either revoking or moderating the Low Fixed Charge Regulations.
45. Vector **recommends** the Electricity Authority work with the Ministry of Economic Development on a review of the Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations 2004 including consideration of revoking the Regulations or otherwise making the following amendments:
  - a. The low fixed charge of 30c is set solely by EDBs, rather than EDBs and Retailers both being able to set 15c; and
  - b. A lower 7,000 kWh per annum threshold is adopted in warmer parts of New Zealand;<sup>24</sup> and
  - c. The 30c per day cap is raised; including periodic review to reflect inflation etc.

### **Concluding remarks and recommendations**

46. It makes sense for the Authority to review the electricity distribution Pricing Principles against its statutory objective in the Electricity Industry Act 2010, given that the statutory objective has changed since the Pricing Principles were developed.
47. Adoption of Distribution Pricing Framework(s) is useful for establishing whether there should be changes to the existing ETPM and/or electricity distribution Pricing Principles and what those changes should be. For the avoidance of doubt, the issues Vector raises in this submission are specific to distribution and do not bring into question, in any way, the efficiency of adopting a Pricing Framework for the ETPM or for evaluating the electricity distribution Pricing Principles.
48. Vector considers that the Pricing Principles align with the Authority’s statutory objective and with outcomes that would be expected in a workably competitive market (market-like approach) with the qualification that Principle (b) should be amended to require any revenue shortfall is recovered in a way that minimises distortions to pricing signals, rather than requiring adoption of Ramsey Pricing. Vector is not aware of any EDB that has adopted Ramsey Pricing as part of its EDPM. The Authority’s Distribution Framework Paper provides a sufficient basis to reconfirm the Pricing Principles and any fine-tuning that may be desirable
49. Vector also reaffirms the view that the current Electricity Distribution Pricing Regulation (voluntary general Pricing Principles, mandatory distributed generation Pricing Principles Information disclosure and consultation requirements) is the appropriate form of regulation of EDPMs, and there is no need to overlay this with a requirement for EDBs to apply the Distribution Pricing Framework; particularly given compliance with the Framework is not needed for compliance with the Pricing Principles.

### **Recommendations**

50. Vector’s recommendations are repeated in full below, for the convenience of the reader.

### **Application of the Distribution Pricing Framework to the distribution Pricing Principles**

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<sup>24</sup> As originally proposed in conjunction with 9,000 kWh in colder areas. The amendment regulations were made on 15 September 2008 and come into force on 1 April 2009.

51. Vector **notes** we consider the Pricing Principles to be broadly consistent with the Authority's statutory objective, the proposed Distribution Pricing Framework and, specifically, a market-like approach.

***Amendment of the Pricing Principles***

52. Vector accordingly **recommends** Pricing Principle (b) be amended to read "Where prices based on 'efficient' incremental costs would under-recover allowed revenues, the shortfall should be made up by recovering any revenue shortfall in as least-distortionary manner as possible ~~setting prices in a manner that has regard to consumers' demand responsiveness, to the extent practicable~~".
53. If the Authority accepts Vector's view that Principle (b) should be amended, Vector additionally **recommends** the Authority discuss with the Commerce Commission whether it would consider making the same amendment to the Pricing Principles in the Gas Input Methodologies.

***Consideration of the distributed generation Pricing Principles***

54. Vector **recommends** the evaluation of the Pricing Principles include the Pricing Principles for distributed generation and their exclusion of common costs.

***Role of the Distribution Pricing Framework beyond reconfirming the Pricing Principles:***

55. Vector **notes** that we do not consider it necessary or desirable to overlay current electricity distribution pricing regulation (voluntary general Pricing Principles, mandatory distributed generation Pricing Principles information disclosure and consultation requirements) with a Distribution Pricing Framework that EDBs must also adopt.
56. Vector **notes** that we would support the Authority adopting the ENA's proposal to amend the Pricing Principles to require they are interpreted consistent with the Authority's statutory objective. Vector considers this simple amendment would help allay the Authority's concerns.
57. Vector **recommends** that if the Distribution Pricing Framework is applied to EDBs for distribution pricing:
- a. Adoption of the Framework be on voluntary basis;
  - b. The Authority make it clear the Pricing Principles take precedence over the Framework; particularly where conflicts arise (if applicable); and
  - c. The Authority specify, for the avoidance of doubt, that EDBs can rely on its own assessment of the practicability of the approaches under the Framework.

***Impediments to efficient pricing:***

58. Vector **recommends** the Electricity Authority work with the Ministry of Economic Development on a review of the Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations 2004 including consideration of revoking the Regulations or otherwise making the following amendments:
- a. The low fixed charge of 30c is set solely by EDBs, rather than EDBs and Retailers both being able to set 15c; and
  - b. A lower 7,000 kWh per annum threshold is adopted in warmer parts of New Zealand; and
  - c. The 30c per day cap is raised; including periodic review to reflect inflation etc.

Kind regards

Bruce Girdwood  
**Regulatory Affairs Manager**

## Appendix: Responses to the Authority's Questions

Question		Vector response
<b>Q1</b>	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.	<p>Vector reiterates that the statutory objective should be interpreted as giving dynamic efficiency precedence over static efficiency.<sup>25</sup></p> <p>Vector also reiterates our view on the interpretation of "promote competition":<sup>26</sup></p> <p>Section 15 of the Electricity Industry Act 2010 states that "[t]he objective of the Authority is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers." Section 52A(1) of the Commerce Act similarly states that the purpose of Part 4 of the Commerce Act "is to promote the long-term benefit of consumers ... by promoting outcomes that are consistent with outcomes produced in competitive markets". The distinction between promoting competition and promoting outcomes consistent with competitive markets reflects that Part 4 of the Commerce Act regulates markets where competition is not possible or unlikely to emerge.</p> <p>Where the Authority is dealing with regulation in markets where competition is not practicable it should either interpret "promote competition" and/or "efficient operation" to mean "promote outcomes that are consistent with outcomes produced in competitive markets".</p>
<b>Q2</b>	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?	<p>This aligns well with the Pricing Framework preference for market approaches, where practicable, and market-like approaches (approaches that replicate workably competitive market outcomes) where market approaches are not practicable.</p> <p>Our views on interpretation of "long-term benefit of consumers" differs from the Authority's interpretation. Refer, for example, to Vector's comments on the treatment of wealth transfers in our submission to the Authority on the Distribution Pricing Framework for electricity transmission.<sup>27</sup> For the avoidance of doubt, our views are not limited to wealth transfers "where the impacts of wealth transfers cause inefficiencies or outweigh efficiency gains".<sup>28</sup></p>
<b>Q3</b>	Do you agree that a market-based distribution pricing methodology would	Vector agrees that a market-based EDPM would tend to promote efficiency more than

<sup>25</sup> For example, paragraphs 39 - 47, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review (24 February 2012) and paragraphs 6 - 17 and 4 - 10, Vector, Cross-Submission to the Electricity Authority on the Decision-Making and Economic Framework for Transmission Pricing Methodology Review (12 March 2012).

<sup>26</sup> Paragraphs 31 and 32, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review, 24 February 2012.

<sup>27</sup> For example, paragraphs 64 - 70, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review (24 February 2012) and paragraphs 6 - 17 and 55 - 86, Submission to the Electricity Authority on the TPAG Transmission Pricing discussion paper (14 July 2011).

<sup>28</sup> Paragraph 34, Electricity Authority. Decision-making and economic framework for transmission pricing methodology, Decisions and reasons, 7 May 2012.

Question	Vector response
	<p>administrative pricing options.</p> <p>While we agree with the Authority that a market approach is unlikely to be practicable a market-like approach is practical and is broadly consistent with the current Pricing Principles.</p> <p>No subsidies, no monopoly pricing, sending appropriate signals for future investment cost etc, linking prices to service levels, limiting prices where competitive bypass or substitution is possible and Ramsey Pricing) are characteristics of prices one would expect from a market-like approach.</p>
<p><b>Q4</b> 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?</p>	<p>Consistent with this, Vector has previously suggested “an ETPM which mimics or replicates workably competitive market outcomes may well be more practicable than charges established by the interaction of buyers and sellers”.<sup>29</sup></p> <p>Vector was surprised the discussion of market-based approaches in the Distribution Framework Paper<sup>30</sup> only included market-approaches and made no mention of market-like approaches such as the adaption of LRMC pricing (or LRMC type pricing such as LRIC and LRAIC), which was instead discussed under exacerbator pays.<sup>31</sup></p>
<p><b>Q5</b> 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?</p>	
<p><b>Q6</b> 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</p>	<p>The Distribution Pricing Framework lists the market approach as first priority, market-like approach as second, exacerbator pays as third, beneficiary pays as fourth and alternative approaches as fifth.<sup>32</sup></p> <p>If Vector’s assessment is correct that the Pricing Principles broadly comply with the market-like approach then EDBs would not need to make assessments of exacerbator pays and beneficiary pays rendering their ranking moot.</p>

<sup>29</sup> Page 29, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review, 24 February 2012.

<sup>30</sup> Section 5.3, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

<sup>31</sup> Section 5.5, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

<sup>32</sup> Figure 1, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

Question		Vector response
	disagreeing?	
<b>Q7</b>	Do you agree these actions can exacerbate investment? Are there any other actions and, if so, what are they?	The Authority cites a “generator that was considering whether to locate in an area not connected to the network” as an “example where a party’s actions or inactions led to a need to augment a distribution network.” This example is somewhat academic given the pricing of network access for distributed generation is governed by clause 6.9, Pricing Principles, in Part 6, Connection of distributed generation, Electricity Industry Participation Code 2010. EDBs do not have discretion over whether to apply exacerbator pays, beneficiary pays etc.
<b>Q7 – Q 12</b>		If Vector’s assessment that the Pricing Principles broadly comply with the market-like approach is correct then EDBs would not need to make assessments of exacerbator pays and beneficiary pays rendering these questions largely moot.
<b>Q9</b>	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.	LRMC and LRMC type prices (eg LRIC and LRAIC) are consistent with both market-like approaches and exacerbator pays.
<b>Q13</b>	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.	Vector agrees with the Authority that where there is a revenue shortfall (eg market-based, exacerbator pays or beneficiary pays does not enable full recovery of costs) it is desirable to spread the charges over a broad base as this “...lowers the charge per unit...” etc. <sup>33</sup>  This is why Vector has advocated that “consideration is warranted as to whether “incentive-free” charges should be imposed entirely on consumers or shared by generators” <sup>34</sup> and “It is generally the case that the broader the tax base the less distortionary the tax will be.” <sup>35</sup>  The Authority has not identified all the alternative charging options that warrant consideration. An

<sup>33</sup> Paragraph 5.4.16, Electricity Authority, Decision-making and economic framework for distribution pricing methodology review, 7 May 2012.

<sup>34</sup> Page 51, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review, 24 February 2012.

<sup>35</sup> Page 53b, Vector, Submission to the Electricity Authority on the Decision-making and economic framework for transmission pricing methodology review, 24 February 2012.

Question		Vector response
		obvious option, which has practical difficulty in electricity transmission but would be straightforward in distribution, is the adoption of two-part tariffs (with fixed charges). The use of two-part tariffs makes it possible to avoid distorting marginal cost pricing, while allowing full recovery of costs and is superior, from an efficiency perspective, to the use of Ramsey Pricing.
<b>Q14</b>	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.	Vector believes the appropriate role of the Distribution Pricing Framework(s) is to determine whether the ETM should be changed, and if so how, and to confirm the Pricing Principles for electricity distribution are appropriate.  Vector believes the Pricing Principles are broadly consistent with the Distribution Pricing Framework, subject to our comments on Principle (b). <sup>36</sup>
<b>Q15</b>	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.	
<b>Q16</b>	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.	No.  Principle (b) should be redrafted to state "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" but it does not currently state this.  Principle (b) instead states that Ramsey Pricing should be adopted. <sup>37</sup>  The use of two-part tariffs (fixed charges) is the first best approach to minimising distortions to pricing signals. Ramsey Pricing is a second best approach where fixed charges are not practicable (which obviously is not applicable in relation to electricity distribution where the use of fixed charges is the norm).  Vector believes principle (b) should be amended to align with the intent of question 16:  <del>"Where prices based on 'efficient' incremental costs would under-recover allowed revenues, the shortfall should be made up by recovering any revenue shortfall in as least-distortionary manner as possible setting prices in a manner that has regard to consumers' demand</del>

<sup>36</sup> Refer to question 16.

Question	Vector response
	responsiveness, to the extent practicable".
<p><b>Q17</b> 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.</p>	<p>No. The Distribution Pricing Framework(s) should only be used to establish an ETPM and confirm the Pricing Principles for electricity distribution are appropriate.</p> <p>Vector does not believe it is necessary for EDBs to comply with the Distribution Pricing Framework in order to comply with the Pricing Principles. We do not believe there would be additional benefit in overlaying the current Electricity Distribution Pricing Regulation (voluntary general Pricing Principles, mandatory distributed generation Pricing Principles, information disclosure and consultation requirements) with a requirement for EDBs to apply a Distribution Pricing Framework.</p>
<p><b>Q18</b> 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?</p>	<p>Yes. If the Authority proposes to make any amendments to the pricing principles, information disclosure guidelines and assessment criteria it should consult on them before they are implemented. Paragraph 2.3.1 of the Consultation Paper indicates there would be no further consultation.</p> <p>Vector also seeks clarification of when (or whether) the Authority will undertake a cost benefit analysis of its proposals. The Distribution Framework Paper does not provide a quantitative or qualitative assessment of the Authority's proposals. Changes should not be made to the EDPM regulation unless it is demonstrated this would be to the long-term benefit of consumers.</p>
<p><b>Q19</b> 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?</p>	<p>If EDBs are required to apply the Authority's proposed Distribution Pricing Framework, rather than just comply with the Pricing Principles, a substantial amount of work could potentially be required; particularly around assessments of exacerbator pays and beneficiary pays. Vector would not expect any EDB to complete such a major process this year.</p> <p>The process of complying with the Distribution Pricing Framework would be more perfunctory, however, if EDBs took the Authority's position that market-based approaches are not practicable for electricity distribution as given and interpreted the Pricing Principles as satisfying a market-like approach. This would mean they would not need to consider exacerbator pays etc.</p>