

25 January 2008

Network Performance Group
Commerce Commission
P.O. Box 2351
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Wellington

By email: gas@comcom.govt.nz

Dear Paula

DRAFT DECISIONS PAPER – PRICING PRINCIPLES, GUIDELINES, AND REPORTING REQUIREMENTS

- 1 Orion welcomes the opportunity to make this submission in response to the *Pricing Principles, Guidelines and Reporting Requirements - draft decisions paper (the paper)* and the associated Meyrick report – *Gas Distribution Pricing Principles*.
- 2 We have no current commercial interest in natural gas distribution services, however we have chosen to respond to the paper because it canvasses issues that overlap with control of electricity lines businesses.
- 3 We also made detailed submissions during the *Form of Control* consultation in August 2006 and the *Authorisation for the Control of Supply of Natural Gas Distribution Services by PowerCo Ltd and Vector Ltd* consultation in November 2007. Those consultation rounds were of particular importance to us because of the parallel nature of issues faced by gas and electricity distribution, subject to the regulatory regime of Part 5 of the Commerce Act.

Meyrick report key issues

- 4 The Meyrick report considers four key issues:
 1. *Are pricing principles required?*

2. *If so, should pricing principles be proposed by the GDBs and approved by the regulator or specified by the regulator (after appropriate consultation)?*
 3. *How much detail should the pricing principles contain? Should they be:*
 - (a) *Highly structured and allow little flexibility (eg Australian Electricity Code Part E and PAWG Recommendations)?*
 - (b) *Reasonably detailed but allowing some flexibility (eg IPART 2004 PPM and Ergon energy pricing principles)?*
 - (c) *Relatively few in number with little detail (eg ESC and URF)?*
 4. *Are there issues that are important in the New Zealand context which have not been adequately covered in the approaches adapted by other regulators?*
- 5 We address each of these key issues below.

Issue 1 - Is there a need for pricing principles?

- 6 Orion agrees with Meyrick and the Commission that pricing principles¹ are required.

Issue 2 - Should pricing principles be proposed by the GDBs and approved by the regulator or specified by the regulator (after appropriate consultation)?

- 7 Our preferred approach is that pricing principles be proposed by the GDBs and approved by the regulator. In this way, companies can ensure consistent logic between asset management, pricing and other elements of their business.
- 8 We have developed the following five key principles to guide us in our pricing:²

¹ We note that Meyrick at times appears to treat pricing principles and methodologies (or options) as one and the same. For example, Meyrick suggests that PAWG's pricing principles are highly structured and allow little flexibility. While Orion does not endorse the work of PAWG, we note that PAWG's seven guiding principles are relatively 'high level' – it is PAWG's attempt to go beyond these pricing principles (to create a framework of options to meet the objectives of the guidelines) that is highly structured and allows little flexibility.

- *We aim to make a rate of return that is appropriate for the commercial risk of our business.*
- *We try to let customers know what it costs to deliver electricity to them at different times of the day and year.*
- *We give customers the opportunity to significantly reduce their electricity costs, if they reduce their electricity usage when costs are high.*
- *We do not include a fixed per day charge in our pricing to customers (except for major customers).*
- *Our pricing does not differentiate between rural and urban customers.*

9 Clearly, our key pricing principles differ considerably from the Commission's proposed pricing principles which are based on electricity distribution pricing principles produced by IPART.

10 We consider that pricing, whether in electricity distribution or gas distribution, is closely linked to asset management planning. Different businesses face different challenges, and respond and innovate through their asset management planning in different ways. To meet these challenges, businesses need to develop individual pricing approaches that complement their planning. Thus the priority given to each possible component of prices will differ from company to company.

11 The Commission's preliminary view is that it is appropriate for the Commission to propose pricing principles, subject to full consultation, on the basis of:

- the time-frames to implement the Authorisation; and
- the lack of regulatory precedent in New Zealand in approving gas distribution pricing methodologies.

12 Orion acknowledges that these issues are real, but questions whether they are sufficient reasons to reject the alternative approach.

² These principles are published in our *Pricing Guide*, a plain English guide to our pricing which we update annually and make available on our website: www.oriongroup.co.nz.

**Issue 3 – How much detail should the pricing principles contain?
Should they be:**

- (a) **Highly structured and allow little flexibility (eg Australian Electricity Code Part E and PAWG Recommendations)?**
- (b) **Reasonably detailed but allowing some flexibility (eg IPART 2004 PPM and Ergon energy pricing principles)?**
- (c) **Relatively few in number with little detail (eg ESC and URF)?**

- 13 If the Commission implements its preliminary view that it is appropriate to propose pricing principles, then we agree with Meyrick that any proposed pricing principles should be kept at a high level to allow flexibility and innovation.
- 14 While the Commission's proposed principles are structured at the lowest level that could be considered acceptable, when viewed together with the requirements of the tariff strategy report and the guidelines for the quantitative cost of supply model, the whole package is too prescriptive and highly structured and lacks the needed flexibility to meet local priorities.

Proposed pricing principles

- 15 It is worth noting that the Utility Regulators Forum (URF) review of nationally consistent pricing principles applying across Australia in 2005 concluded that:³

The following in particular appear to be common elements of the pricing principles currently being applied by most jurisdictional regulators:

- *that prices should lie on or between the upper and lower bounds for economically efficient prices; and*
- *that prices should signal efficient economic costs of service provision by:*
 - *being subsidy free;*
 - *having regard to the level of available network capacity; and*

³ Utility Regulators Forum, *Review of Nationally Consistent Pricing Principles Discussion Paper*, p 11.

- *signalling the impact of additional usage on future investment costs.*

A further common feature across jurisdictions is the requirement that pricing principles be accompanied by reporting requirements that place the responsibility on distributors to demonstrate compliance of their tariff structures with the pricing principles. Common reporting requirements can also be considered to form an important part of nationally consistent pricing arrangements. The principal elements of such reporting requirements could include, for example:

- *an overarching tariff strategy report covering the full regulatory period;*
- *reports on amendments to the tariff strategy report within the period;
and*
- *an annual tariff report providing information on prices for the current year and outlining variations from the tariff strategy report.*

16 As the Commission has adopted the IPART pricing requirements, it has mixed both pricing principles and reporting requirements together. We recommend that these should be separated for simplicity and clarity, as is outlined in the URF findings above.

17 We are particularly concerned about the Commission's third pricing principle, which relates to analysis of cost of service provisions. We consider that the level of prescription set out in this principle is excessive and in some cases unworkable.

18 We agree with the Commission that:⁴

There are different approaches to cost allocation and price development that can be considered valid, in that they are consistent with promoting improvements in economic efficiency.

19 We consider that these differences should be encouraged – it is through different approaches that innovative ideas can be applied to promote improvements in economic efficiency. However, as the Commission notes, it needs sufficient information from companies to assess whether their prices are efficient and transparent.

20 We note that the level of prescription in relation to the link between class of service and quality of service is excessive. In different areas of a network

⁴ Para 54 of the paper.

the quality of service may vary for the same class of service. However, this does not mean that it is appropriate or possible to reflect these differences through pricing.

- 21 We suggest that the Commission should delete the sub-clauses in pricing principle 3 (a) to (g), and leave it to the individual company to demonstrate that its particular cost of service model is sufficiently detailed for its network requirements.
- 22 We are pleased to see the principle relating to promoting price stability and certainty for customers.

Tariff strategy report

- 23 We are concerned about the level of prescription that is required in the tariff strategy report⁵. Much of this detail appears to be driven from the requirements of the third pricing principle which, as discussed above, is excessively prescriptive. We consider that a simpler and less onerous approach should be adopted, as suggested in the alternatives proposed in paragraphs 24 and 25 below.
- 24 On 15 June 2006 the Commission issued a draft paper to consult with the electricity industry on a new section in the information disclosure handbook on pricing methodology and line charges. Although submitters outlined many issues and concerns about the proposal, the Commission's descriptions of the content and analysis required for disclosure of the pricing methodology were more consistent and more appropriate than the tariff strategy report and the qualitative cost of supply guidelines proposed for gas. We suggest that the Commission consider a similar approach for disclosure of the gas pricing methodology.
- 25 Alternatively, given the Commission's time constraints, we consider that pricing methodology disclosure requirements similar to those in the electricity information disclosure handbook issued 31 March 2004 (including amendments in 1 April 2006) would be sufficient. Specifically:

Vector and PowerCo's pricing methodology disclosure must—

- (a) *Describe the methodology used to calculate the prices charged or to be charged; and*

⁵ Discussion document, para 77, Table 4.

- (b) *Include the key components of the revenue required to cover costs and profits of the disclosing entity's line business activities, including cost of capital and transmission charges, which must include the numerical value of each of the components; and*
- (c) *State the consumer groups used to calculate the prices charged or to be charged, including—*
 - (i) *The rationale for the consumer grouping; and*
 - (ii) *The method by which the disclosing entity determines which group consumers are in; and*
 - (iii) *For each of these consumer groups, the statistics relating to that group which were used in the methodology; and*
- (d) *Describe the method by which the disclosing entity allocated the components of the revenue required to cover the costs of its line business activities amongst consumer groups, which must include the numerical values of the different components allocated to each consumer group and the rationale for allocating it in this manner; and*
- (e) *Describe the method by which the disclosing entity determined the proportion of its charges which are fixed and the proportion which are variable, and the rationale for determining the proportions in this manner.*

Quantitative cost of supply model and audit requirements

- 26 The Commission's proposed guidelines for the quantitative cost of supply model⁶ appear to be intended to provide information on the calculations required to support the pricing methodology in the tariff strategy report. However it is difficult to relate these guidelines to the proposals, particularly to the pricing principles⁷, because of inconsistencies in terms and descriptions. Presumably, a 'class of service' is a group used for pricing/charging, which might be a group of customers, but could also be a group of connections? Is 'service level' the same as 'quality of service'?
- 27 Our overall impression is that this set of guidelines is poorly drafted and difficult to follow.
- 28 We also note that the cost of supply model must be independently audited and it must be certified that the model contains no errors. We assume that

⁶ Para 78 of the paper.

⁷ Para 46 of the paper.

this refers to errors in the actual spreadsheet, as opposed to errors in the underlying data (much of which will be based on forecasts or estimates and will inherently contain 'errors'). This issue needs to be clarified.

Issue 4 - Are there issues that are important in the New Zealand context which have not been adequately covered in the approaches adapted by other regulators?

- 29 We do not consider that there are issues that are important in the New Zealand context which have not been adequately covered in the approaches adapted by other regulators.

Concluding remarks

- 30 Confidentiality is not claimed for any of the content of our submission, including the attached papers.
- 31 Thank you for the opportunity to make this submission. If you have any questions, please contact Dennis Jones (Industry Developments Manager), DDI 03 363 9526, email dennis.jones@oriongroup.co.nz.

Yours faithfully



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