Government Policy Statement on Network Pricing

To the Commerce Commission and the Electricity Authority:

This statement is given to:

1. the Electricity Authority by the Minister of Energy pursuant to section 17 of the Electricity Industry Act 2010 as a statement of government policy concerning the electricity industry; and
2. the Commerce Commission by the Minister of Commerce pursuant to section 26 of the Commerce Act 1986 as a statement of the economic policy of the Government on the electricity industry.

1. Background to this Government Policy Statement

1.1.1. A well-functioning electricity sector is essential for the well-being of all New Zealanders.

1.1.2. Across the sector new investment is likely to be required to accommodate an expansion of renewable energy and new energy technologies.

1.1.3. Transmission and distribution networks have strong natural monopoly characteristics and have an important role in the delivery of competitive, efficient, affordable and reliable electricity.

1.1.4. The way in which transmission and distribution services are provided and priced has an impact on all parts of the industry as well as the broader economy and the environment.

1.1.5. This makes it important that the Government sets out its policy expectations as to how these services should be provided and priced.

2. Government's future intentions in relation to the regulation of network pricing

2.1.1. The Government believes it is important that a single regulator is responsible for the way in which network services are provided and priced.

2.1.2. This will ensure a consistent and cohesive approach to regulatory decisions about each network company's:

a. regulated revenue requirements and how those revenue requirements are turned into prices for its customers;

b. network investment including its efficient deployment of alternative technologies;

c. desired network reliability, quality and service levels; and

d. network access arrangements including the obligations imposed on its customers.

2.1.3. The Government intends to pass new legislation which will:

a. transfer responsibility for the regulation of networks to the Commerce Commission with effect from [1 April 2020]; and

b. replace the processes and principles which currently apply for the regulation of network pricing with the processes and principles set out in this statement of government policy.

3. Government's views on the interests which need to be taken into account when determining network pricing

3.1.1. The Government considers that the Commerce Commission when making regulatory decisions about network pricing should take into account (and demonstrate how it has taken into account):

a. [the incentives to innovate] and the risks faced by investors in long life investments; and

b. distributional effects on end users of electricity service[1].

OR if the Government decides not to transfer the network functions to the Commerce Commission

3.1.2. The Government considers that it is both consistent with (a) the efficient operation of the industry and (b) the long term interests of consumers that the Electricity Authority when making regulatory decisions about network pricing should take into account (and demonstrate how it has taken into account):

a. [the incentives to innovate] and the risks faced by investors in long life investments; and

b. distributional effects on end users of electricity services.

4. Government's view on the need for sound transition arrangements in cases of significant network pricing reform

4.1.1. The Government's view is that the Commerce Commission when making regulatory decisions about network pricing should require:

a. Appropriate transitional arrangements where a revision of a network pricing methodology leads to large increases or decreases in current charges[2].

OR

b. That any significant change should be introduced incrementally, in a way that avoids price shocks, is sensitive to the impact on vulnerable regions or groups of consumers, and limits the potential for unintended consequences[3].

OR if the Government decides not to transfer the network functions to the Commerce Commission

4.1.2 The Government's view is that it is both consistent with (a) the efficient operation of the industry and (b) the long term interests of consumers that the Electricity Authority require:

a. Appropriate transitional arrangements where revisions of a network pricing methodology lead to large increases or decreases in current charges.

OR

[1] NB The transfer of network functions role to the Commerce Commission will require consequential amendments to the Commission's statutory objectives.
[2] Adapted from current clause 19 of TPM Guidelines.
[3] Transpower proposal in its draft GPS.

b. That any significant change should be introduced incrementally, in a way that avoids price shocks, is sensitive to the impact on vulnerable regions or groups of consumers, and limits the potential for unintended consequences.

Transmission pricing

5. Government's view on the purpose of network pricing principles

5.1.1. The Government's view is that Transpower's individual price quality path and information disclosure regulation under Part 4 of the Commerce Act will ensure that the overall costs of transmission services will be consistent with outcomes produced in competitive markets.

5.1.2. As a consequence the Government considers that the principal purpose of the transmission pricing methodology is to provide for the efficient and fair recovery of the Transpower's regulated revenues and to promote the nationally efficient use of the transmission network by grid users and consumers.

6. Government's view on respective roles of Transpower and the regulator in relation to the development and review of the transmission pricing methodology

6.1.1. The Government intends to amend the Commerce Act to provide that Transpower will:

a. have the principal responsibility of developing, for the approval of the Commerce Commission, any amendments to the current transmission pricing methodology required to implement the provisions of this Government Policy Statement;

b. be able to initiate operational reviews of the approved transmission pricing methodology if it identifies amendments which could subsequently be made to an approved methodology that would better achieve the purposes set out in this Government Policy Statement; and

c. be required to report to the Ministers of Energy and Commerce and the Commerce Commission every ten years on whether it thinks the principles in this statement of government policy need to be changed in any manner to achieve the Government's overarching objectives for the sector.

OR if the Government decides not to transfer the network functions to the Commerce Commission

6.1.2. The Government's view is that it is that it is both consistent with the efficient operation of the industry and the long term interests of consumers that:

a. the Electricity Authority permits Transpower to take the principal responsibility for the development, implementation and ongoing review of the current transmission pricing methodology in accordance with high level transmission pricing guidelines developed and published by the Electricity Authority having regard to this Government Policy Statement; and

b. following completion of the current transmission reform process the Electricity Authority should review the process currently set out in the Code to ensure that the process and decision-making criteria which apply to transmission pricing reform appropriately reflect the contents of this Government Policy Statement.

7. Government's views on transmission pricing principles

7.1.1. The Government considers that:

a. the transmission pricing methodology should allocate costs in accordance with the types of assets used, and in particular should provide that:

- the costs of connection assets should be recovered from those connected to them;
- charges for interconnection assets should be recovered from distributors and directly-connected load on a national postage-stamp basis; and
- charges for the HVDC link (as defined in Part 1 of the Electricity Industry Participation Code) should be recovered from generators who inject into the grid in the manner Transpower determines will least interfere with nodal prices;

b. the overall pricing structure should include a variable element that signals the impact of peak usage on transmission costs. This will promote the greater utilisation of existing assets by flattening demand and deterring peak demand growth, delaying or avoiding the need for further grid investment; and

c. the transmission pricing methodology should:

- be simple, understandable to a wide range of sector participants and readily able to be implemented; and
- take into account practical considerations, transaction costs, and the desirability of consistency and certainty.

OR if the Government decides not to transfer the network functions to the Commerce Commission

7.1.2. The Government considers that the following transmission pricing principles comply with the objectives in section 15 of the Electricity Industry Act:

a. the transmission pricing methodology should allocate costs in accordance with the types of assets used, and in particular should provide that:

- the costs of connection assets are to be recovered from those connected to them;
- charges for interconnection assets are to be recovered from distributors and directly-connected load on a national postage-stamp basis; and
- charges for the HVDC link (as defined in Part 1 of the Electricity Industry Participation Code) are to be recovered from generators who inject into the grid in the manner Transpower determines will least interfere with nodal prices;

b. the overall pricing structure should include a variable element that signals the impact of peak usage on transmission costs. This will promote the greater utilisation of existing assets by flattening demand and deterring peak demand growth, delaying or avoiding the need for further network investment; and

c. the transmission pricing methodology should:

- be simple, understandable to a wide range of sector participants and readily able to be implemented; and
- take into account practical considerations, transaction costs, and the desirability of consistency and certainty.

8. Government's views on the process which needs to be followed when reviewing transmission pricing

8.1.1. The Government's considers that changes to transmission pricing reform need to follow best practice regulatory processes.

8.1.2. For substantial changes to the transmission pricing rules the Government would expect that the decision-maker:

a. supports its views on the problems with the current arrangements and preferred solutions with those of independent experts and/or to the extent practicable empirical evidence;

b. avoids setting its reform objective in a manner which excludes any meaningful options analysis;

c. adopts a staged approach to consultation with separate consultations on problem definition, the evaluation of alternatives, implementation issues and risks, and rule drafting;

d. uses an independent firm to conduct cost benefit analysis of various preferred options to guard against the risk of confirmation bias;

e. uses advisory groups or workshops to assist it to both develop and test options and implement reform;

f. incorporates in its consultation processes:

- a cross-submission process so stakeholders have the opportunity to comment on the others views and refine their own views, and
- hearings so stakeholders have the opportunity to engage first hand with decision-makers; and

g. provides ongoing feedback to stakeholders on how their submissions have fared in the development of the decision-makers thinking.

Distribution pricing

9. Proposed repeal of LFC regulations on a phased basis

9.1.1. The Government has received advice from a number of stakeholders, including the Electricity Price Review Panel, that the New Zealand Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations 2004 (LFC regulations) are hindering the ability to change distribution pricing structures to more accurately reflect the costs of distribution networks.

9.1.2. As a consequence the Government proposes to amend the LFC regulations so the fixed prices distributors and retailers must offer low-use residential consumers would gradually rise over a specified period until the advantage enjoyed by those consumers compared with those on other tariffs is gone.

10. Government's views on distribution pricing reform

10.1.1. The Government expects distributors will reform their tariff structures to introduce more service-based pricing and reduce the current reliance on consumption based pricing.

10.1.2. This transition should occur in parallel with the removal of the price cap in the LFC regulations.

10.1.3. When distributors reform their tariff structures, they will:

a. Actively engage with consumers, retailers and other stakeholders and take into account their feedback on their proposals;

b. Ensure an efficient and fair allocation of network costs across all users of the network, acknowledging stakeholder views;

c. Take into account practical considerations, transaction costs, and the desirability of consistency and certainty for consumers; and

d. Manage transitions in a manner which complies with clause 4.1.1 of this policy statement.

BACKGROUND: The Minister of Energy has appointed an advisory panel (the **Panel**) to advise her on how regulatory frameworks could be improved to facilitate the delivery of fair and efficient electricity prices. The Panel is now consulting on a paper (**Options Paper**) which address the problems it identified in its First Report. Included in the package of reform options is a proposal to issue a government policy statement (**GPS**) on transmission pricing (**Option E1**) and on distribution pricing (**Option E2**). The Panel have invited stakeholders to, comment on a GPS Transpower drafted "for discussion purposes", and make suggestions on the content of a policy statement that would provide enduring guidance on distribution pricing. The Options Paper does not support a transfer of network rule-making functions to the Commerce Commission (**Comcom)** (see **Option F2**).

Trustpower supports Option E1 and Option E2 and disagrees with the Panel on Option F2. Trustpower is a member of a group of diverse stakeholders (**TPM Group**) who are concerned about the TPM reform which has been undertaken by the Electricity Authority (**EA**). The TPM Group support Option E1 and E2 and agree with Trustpower on Option F2. Trustpower is also aware that there are other companies outside the TPM Group that share its views. Therefore it asked Law+Policy Ltd **(L+P)** to draft a GPS on network pricing which could be endorsed in whole or in part by submitters on the Options Paper. This diagram accompanies that draft GPS and records L+P's advice. It has been prepared for Trustpower.

Legislative change will be required to implement a transfer of network rule-making functions and to make a GPS binding on the relevant regulator. Currently both the EA and Comcom are required to have regard to a GPS, but this obligation does not preclude them setting aside its guidance if they consider the GPS is incompatible with their interpretation of their statutory objectives. Nevertheless, a GPS under current legislation could be useful vehicle to (a) signal an intention to transfer network rule-making if the Panel changes its mind (b) set out how the Government thinks the EA should interpret its statutory objective in the context of transmission pricing and its preferences on the next steps in the TPM reform and (c) outline the Government's intentions in relation to the LFC regulation and expectations on distribution pricing reform including in relation to the desired degree of cost reflectivity, timeframes and how distributional impacts should be managed.

The annual reports of the EA (and its predecessor) show that attempts to reform price and non-price network access terms have been underway since industry regulation commenced and are still ongoing. There is also growing evidence of border issues between the EA and Comcom.

In the period from 2012 to 2017, the EA has developed nine different versions of an asset based beneficiaries pay TPM but no other options. A further option is on its way despite strong opposition to its proposals on economic, equity and workability grounds. At the heart of the EA's approach is its view that a more granular allocation of the cost of each transmission asset best aligns with its statutory objective. A GPS setting out the Government's views on how it interprets the EA's statutory objective could clarify if socialized or individualized pricing best aligns with the EA's operational efficiency objective and provide timely guidance on the next stages of the current reform process. It could also address the need for fair transitions for both investors and consumers and outline the respective roles of the regulator and Transpower in TPM reform.

Originally the focus in DPM refom was increased standardisation. More recently the focus has shifted to the lack of benefits based pricing. Distributor's ability to reform tariffs has been impacted by the LFC regulation. There are also concerns about the degree of rate shock associated with the EA's pricing preferences. A GPS providing guidance on these matters could avoid DPM becoming as costly and contentious as TPM reform.

Transfer of network regulation should be in the GPS

- The Panel think a transfer of network rule-making functions to Comcom would be complex and time-consuming to implement and could delay the resolution of transmission and distribution issues.
- However, the EA continuing down its present pathway is also likely to result in a multi-year delay (for the reasons noted on page 50 of the First Report).
- DPM reform may also prove problematic as the EA is seeking to deploy the same approach.
- A transfer to the Comcom will ensure that there is a consistent and coherent approach to the establishment of price-quality paths and price and non-price access terms.
- A GPS could:
  (1) Set out the Government's transfer intentions ahead of the legislation
  (2) mitigate risks of TPM/DPM delay by providing clarity on the desired methodology and implementation timeframes.

GPS should clarify TPM roles

- The EA's TPM reform process has involved very specific direction to Transpower about how the TPM should be structured.
- This direction appears to go beyond the "guidelines" provided for in the Code and has in effect involved the EA developing the TPM itself.
- Trustpower's experts have advised Transpower should have the primary role as it knows its assets and customers best.
- A GPS could clarify the respective roles of Transpower and the regulator so Transpower does not end up having to implement a methodology it considers impracticable and unworkable (which took the EA 6.5 years to design!)

GPS should require fair transitions

- The EA's (a) ability to change the Code at any time (including after long life investments have been made) and (b) view that it need not consider transition or distributional issues do not sit well with the Government's desire to electrify the economy whilst safeguarding the interests of consumers.
- A GPS could address these matters directly by (a) setting an intervention thresholds based on robust benefit assessment and (b) providing that the regulator was required to provide for appropriate transitions in the cases of significant reform.

GPS should set TPM pricing principles

- The EA believes its preferred cost allocation will improve investment efficiency (including in relation to network upgrades) and usage
- There are disputes about whether (a) network investment efficiency can be improved over and beyond existing processes administered by the Comcom and (b) the proposed approach will provide a clear enough price signal to impact other investment and usage decisions.
- There are also concerns about the equity of (a) providing price shocks each time the grid needs upgrading (b) applying the methodology to a selection of existing assets rather than just to new upgrades.
- Government's view on how a regulator's statutory objective should be interpreted in the context of transmission pricing would provide guidance on these issues.

GPS should outline preferred TPM process

- The Panel's First Report and Options Paper contain a number of references to the poor process which has been followed in TPM reform to date (see pages 49-50 of the First Report and page 22 of the Options Paper)
- Yet surprisingly the Panel's option did not include any suggestions as to how the EA might improve its rule-making processes in the future.
- Process is a very important *ex ante* accountability measure for a regulator with as wide a power as the EA and so it is recommended that the GPS sets out the Government's expectations on how TPM reform should be carried out.

GPS should confirm LFC intentions

- The First Report and Options Paper acknowledge that the regulated price cap on fixed charges for low users is impeding distribution reform.
- The EA believes reform can occur without repeal of the LFC regulations, but many in the industry disagree including those with legal obligations under the regulations.
- A GPS could provide clear guidance on the Government's future intentions and note that it would be consistent with the efficient operation of the industry if distribution pricing reform occurred in parallel with the phased removal of the LFC regulations.

GPS should set out DPM reform preferences

- Some distributors are concerned that the EA's preferred cost allocation is complex and will lead to difficult "bright lines" and equity issues.
- The Panel is presently undecided about whether it will recommend principles for a fair allocation of distribution costs between household and business consumers. Another equity issue is the allocation between urban and rural (which seems to have received less focus from the Panel but is of concern to some distributors).
- In this context we think it would be helpful if the Government expressed its views on the need for (a) more service based pricing and (b) distributors to engage with stakeholders, take into account practical considerations, and manage transitions when reforming their network tariffs.

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