Entrust
Majority shareholder of Vector

18 DECEMBER 2024: SUBMISSION TO ELECTRICITY AUTHORITY REGARDING DISTRIBUTION CONNECTION PRICING

Distribution pricing reform needs to help deliver affordable electricity

Entrust supports distribution pricing reform that encourages more efficient network usage and helps keep electricity prices down.

The Electricity Authority's (Authority) proposed cap on capital contributions could instead have the twin negative effects of exposing households and other consumers to increased network investment risk and higher distribution charges.

The price increases the Authority has indicated would be needed for Auckland consumers would harm energy affordability, particularly for low-income households and vulnerable consumers.

These would be in addition to the network price increases from 1 April 2025 and price increases at the retail level.[1] They would also compound the harm caused by the Authority's ban on electricity distributors passing loss rental rebates (LRR) on to consumers. In 2023 the LRR was $30 for each Auckland consumer. The Authority's ban has resulted in each Auckland electricity consumer missing out on a $59 rebate in the last twelve months alone.

Summary of Entrust's submission

- Distribution pricing reform should be designed to make consumers better off.

- Entrust is concerned the Authority's proposals would make small businesses and households worse off. This would be contrary to the Authority's consumer protection objective.

- If the Authority imposes a cap on capital contributions, part of the capital investment required for new connections would need to be funded by other consumers, including households. Entrust does not support requiring existing consumers to fund new connections or changes that would require the Commerce Commission to set higher network revenue allowances to enable electricity distributors to recover their costs.

- The proposed cap would also expose households to additional network investment risk. If the new connection customer closes without fully paying for its connection, households and other consumers would end up paying the cost. The consultation paper from the Authority doesn't mention this risk in its assessment of the proposals.

- The approach the Authority is proposing to determine the "incremental cost" of supplying new connections could understate costs and result in higher charges for households and other existing customers.

- Charging new connections their incremental cost would not be theoretically optimal. This would result in households having to contribute more to the cost of electricity distribution. It is important new connection customers contribute fairly and proportionately to all network costs they benefit from.

[1] https://www.rnz.co.nz/news/business/532853/another-power-price-warning

Entrust's submission

If electricity distribution pricing reform is well managed, it should result in lower electricity prices. The increase in demand from new connection customers should result in network costs being spread over a wider group of customers.

Entrust is supportive of pricing reform which improves network utilisation and helps avoid unnecessary investment.[2]

We welcome that the Authority has clarified it is "not proposing to subsidise business network connections at the household consumers' expense".[3] Changes will be needed to the Authority's proposals, including in relation to the capital contribution cap and how incremental cost is determined, otherwise it appears that cross-subsidies will be unavoidable.

The Authority has not demonstrated capital contributions are a problem

Entrust does not consider that the Authority has demonstrated capital contributions are too high or should be regulated.

If the Authority is going to impose a cap on capital contributions it needs to determine what would be an excessive level for capital contributions. The CEPA report (section 2.1) purports to demonstrate the harm caused by excessive capital contributions but the stylised example CEPA use could be applied to any sized capital contribution not just large ones.

Our view is that 100% capital contributions is the safest way to ensure existing customers don't end up paying for a proportion of new connections costs. This would be particularly harmful for consumers that happen to be on networks where there is high growth such as the Vector Auckland network.

Consideration should also be given to what would happen if capital contributions are unregulated at the transmission level but capped for distribution. This could result in an artificial bias for new customers to connect at the distribution level even when it would make sense and be more efficient to connect to Transpower.

Entrust does not support requiring households to help fund large new connections

The Authority's proposals would require part of the capital investment required for new connection customers to be funded by households and other consumers.

Entrust does not support network pricing methodology changes which would require the Commerce Commission to re-open some distributor price-paths and increase prices to enable electricity distributors to fully recover their costs.

Based on the Authority's calculations the cap it is proposing would result in Auckland consumers paying $28.25m more over the next regulatory period alone. The Authority has been silent on what the impact would be after this, but the impact on distribution charges is likely to grow substantially. Based on guidance from Vector this could result in the addition of $100s of millions of capital expenditure needing to be funded by consumers.

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[2] See our recent submission in relation to the barriers to investment in batteries and competition caused by the existing transmission pricing methodology: https://www.entrustnz.co.nz/media/ezlhfv2q/entrust-submission-re-tpm-and-batteries_13-september-2024.pdf.

[3] https://www.linkedin.com/posts/vector-limited_youwatt-customer-energyfuture-activity-7271569229642919937-u5MT?utm_source=share&utm_medium=member_ios

If price increases are needed because of the Authority's proposals this should be seen as a red flag.

The changes could expose households to risk from new connections

The Authority's proposed cap on capital contributions would not only result in higher prices for consumers, including small businesses and households, but would also expose them to network investment risk.

This is because instead of requiring the new connection customer to fund all the cost of connecting to the network upfront, the Authority is relying on the new customer contributing to these costs over time. The problem this creates is that households and other consumers will have to bear this cost if the new customer closes before the cost of the asset is repaid.

The consultation doesn't mention this risk in its qualitative discussion of the costs and benefits of its proposals, or its discussion on consumer protection, even though it is a major adverse consequence of the Authority's proposals.

Entrust does not consider it would be efficient or desirable for existing consumers to be exposed to network investment risk because of new connections. Unless existing consumers are compensated for the additional risk through lower prices, they would end up subsidising the new business ventures. Entrust considers that new connection customers are best placed to take on the risk of network enhancements they need.

Clarifying the definition of "incremental cost" would help ensure subsidy-free pricing

Entrust is concerned the Authority's proposals could result in understatement of incremental costs and result in subsidies from existing customers to new connection customers.

The definition of "incremental cost" the Authority has specified[4] is vague at best. For example, how should the "cost of specific operating costs" be measured, what is meant by the reference to "specific" and when is the cost "applicable"? The definition also doesn't include whether a short-term incremental cost approach (implied by the exclusion of transmission costs) or a long-run incremental cost approach (implied by the expectation pricing should be subsidy free) should be adopted.[5] There are various different "incremental" cost concepts that could potentially be applied, including: (i) the definition in Part 1 of the Code that applies to the application of pricing for distributed generation under Part 6 of the Code; and (ii) Total Service Long Run Incremental Cost in the Telecommunications Act.

The Authority has said it intends to exclude transmission charges from the calculation of incremental costs. This would result in under-estimation of incremental costs. For example, an electricity distributor's transmission residual charges are adjusted annually on the basis lagged volume. The new connection customer's network usage will feed into this calculation of residual charges and should be included in any incremental cost

[4] Incremental cost is defined as "the capital cost of a connection plus the cost of specific operating arrangements if applicable".
[5] The same issue was pointed out in relation to earlier versions of the distribution pricing principles which used the term marginal cost without stating whether it meant short-run marginal cost or long-run marginal cost.

calculation.[6] Entrust considers the reference that incremental cost "include any reasonable additional transmission costs", in the Part 1 definition, is appropriate.

The Authority's "neutral point" may not be neutral for existing consumers if incremental costs are understated or the increased risk exposure for existing customers is not taken into account.

A neutral or subsidy-free position would require either that new connection customers pay the full upfront cost of connection through capital contributions and/or existing customers are compensated for the increase in risk through lower network charges. The Authority's proposals would not achieve either of these outcomes.

Fixed and common costs should not be loaded onto captive household customers

Entrust does not support the Authority's suggestion that existing customers should pay the bulk of fixed and common network costs.

This would result in households having to contribute more to the costs of electricity distribution networks to the benefit of large new customers such as data centres, electric vehicle charging stations, and property developments.

We do not agree with the Authority that only charging new connection customers their incremental cost would be theoretically optimal. Just because a pricing option might satisfy a particular economic or theoretical perspective doesn't mean it benefits consumers. We instead agree with the Authority's subsequent comment that if "fixed costs are spread across more network users" it "would lower power costs for all consumers", including both business and residential customers.[7]

Fixed and common costs should be shared fairly and proportionately amongst existing and new customers.

The proposals are inconsistent with the consumer protection objective

Entrust welcomes the assessment of the Authority's proposal against its consumer protection objective.

It is unclear though how the Authority reached the conclusion that its proposal supports the consumer protection objective for domestic consumers and small business consumers.

Domestic consumers and small businesses would be exposed to increased investment risk and higher distribution charges without any clear countervailing benefits. If the Authority considers there are benefits to existing consumers, including small businesses and domestic consumers, it should be able to quantify these benefits.

The focus of the consultation paper seems to favour new connection customers rather than protect domestic consumers and small businesses. The Authority's consultant, CEPA, discusses consumer protection but it is principally oriented towards the interests of new connection customers.

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[6] Transpower has provided a worked example of how a transmission customer's increase in electricity volume flows through into residual charges: https://static.transpower.co.nz/public/uncontrolled_docs/TPM%20Information%20sheet%20on%20residual%20charges%20v3.pdf?VersionId=o6F2KqOt_tMGMC_3L3uugo1P8WzvaVM9.

[7] https://www.ea.govt.nz/news/press-release/feedback-welcomed-on-faster-simpler-electricity-connections/

Jurisdictional barriers

Entrust is concerned about the jurisdictional boundary issues that the consultation highlights. The Commerce Commission undertook a 21-month process to determine the regulated price paths for 2025-30. If the Authority adopts distribution pricing changes that require the price paths to be re-opened this will create uncertainty about revenue paths and electricity distributor cash-flows.

Entrust considers that the Authority should be cautious about setting regulated pricing methodologies in a way that impacts both cost allocation (the role of pricing methodologies administered by the Authority) and the required revenue allowance (administered by the Commerce Commission). At best, the Authority's proposals highlight there are jurisdictional boundary issues which need to be addressed.

Next steps

Entrust is of the view that the Authority should consider:

- how to ensure that distribution (connection) charging changes do not result in unintended subsidies from existing customers to new connections;
- the efficiency and wealth transfer impacts if existing customers, including small businesses and households, have to bear an increased share of the investment risk of capital upgrades for new connection customers;
- options that would avoid the need for regulated distribution price-paths to be re-opened and increased;
- the boundary between the Authority in setting pricing methodologies and the Commerce Commission in setting revenue allowances, if Authority policies impact both cost allocation and the required revenue allowance;
- the impact of having different pricing rules for connection for transmission and distribution networks; and
- quantifying the costs and benefits of its proposals.

Concluding remarks

Entrust wants to ensure electricity is supplied in an efficient and affordable way to all consumers and its beneficiaries, including the 365,000 households and businesses in its area of central, east and south Auckland.

Entrust is supportive of measures to make it easier and more efficient for new connections at both the distribution and transmission levels. New and emerging technologies will increase the diversity and types of connections which will be required in the future, including for electric vehicle charging and grid-scale batteries.

This does not mean that regulation should require households to fund network investment required for new connections or be exposed to additional network investment risk, nor does this mean that households should pay more than their fair share of fixed and common network costs.

Kiwi families and small businesses would be worse off financially if the Electricity Authority reforms for distribution connection pricing go ahead.

We are also concerned an unintended consequence of the Authority proposals is that new customers could prefer connecting at the distribution level rather than transmission, because of the cap on capital contributions and the way fixed and common costs would be allocated.

Kiwi families and small businesses should not have to contribute towards the connection costs for big businesses. The Authority should ensure that those that create the need for new investment should pay for it, and that other customers, including households, are not underwriting new businesses such as data centres. Any reforms aimed at removing barriers to new connection customers, if appropriately designed, should make all consumers better off.

Kind Regards

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Chair of Regulation and Policy Committee