BOARD STAFF INTERROGATORY #19

INTERROGATORY

Reference: p.16

Some distributors have made arguments that:

i) the Distribution System Code does not allow distributors to recover the full cost of customer connection (in part due to distribution rates not including the recovery contemplated in sections 3.1.4 and 3.1.5 of the Code)
ii) present distribution rates do not accurately reflect the cost of service.

If these arguments are true, is competition in the electrical distribution sector premature?

RESPONSE

These arguments are based on erroneous logic and even if they were true they would not justify delaying the benefits of open competition. The underlying premise is that if current rates do not accurately reflect costs, price signals will be distorted and customers may therefore choose a higher cost distributor in the belief that it is the lower cost distributor (adjusting for differences in the services offered).

This logic is erroneous for two reasons.

First, where a customer contribution is required any recovery shortfall in distribution rates will be recovered in the capital contribution. . If rates are higher than is cost justified, the required contribution will be lower than it “should” be. If rates are lower than is cost justified, the required contribution will be higher than it “should” be. These recovery discrepancies would occur in any case if the incumbent connects the customer. Introducing competition would ensure that the benefits of customer choice will be realized sooner.

Under either market approach, the total customer payments/distributor revenue (i.e., the present value of rates plus contribution) is the relevant price signal, not the distribution rate alone. By definition, this amount equals the value of the incremental costs recognized by the Distribution System Code. The split between rates and contribution is not relevant since any “error” in the distribution rate will, by definition, be offset by an equal and opposite error in the contribution requirement. Hence, the price signal is correct regardless of whether or not rates correctly reflect costs.

Since the rates (distribution rate plus contribution) are just a proxy for incremental costs, the price signals will only be misleading if:

a) no contribution is required, in which case the Report recommends that the incremental costs themselves be used to determine the lower cost distributor, if there is a dispute,

b) the mechanism for determining incremental costs in the Distribution System Code is flawed, in which case it would be appropriate to correct the flaw in the Distribution System Code.

Second, the relevant issue is not whether competition will produce perfectly efficient outcomes (it never does), but whether competition will result in more efficient outcomes than a regime that protects incumbents, regardless of how efficient they are relative to alternate distributors. Hence, even if the Board were to accept that the current price signals could result in inefficient market decisions, it would be inappropriate to prohibit competition since any flaws in the existing rates or economic feasibility test would continue to occur in the current market.

The harm of prohibiting competition is not only the lost opportunity in at least some cases to have customers choose a distributor that offers greater customer value than the incumbent, it also includes the lost opportunity due to the absence of competition forcing distributors to operate more efficiently and to be more responsive to customers.

Also, please refer to Wirebury's interrogatory response to VECC at Ex. J12, T11, S23.