meridian

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Submissions
Energy Markets Policy Team
Ministry of Business, Innovation and Employment
By email: energymarkets@mbie.govt.nz

Electricity Pricing Review proposed terms of reference

Meridian welcomes the opportunity to provide comments on the proposed terms of reference for the Electricity Pricing Review.

We believe, based on most available metrics and international benchmarks, that the New Zealand electricity market is delivering fair, equitable, efficient and sustainable outcomes for New Zealand consumers, whether measured in terms of:

- the level of competition and ease of customer switching;
- the overall cost of electricity to consumers;
- the reliability and security of supply; or
- the environmental sustainability of the sector.

The existing competitive market structure and regulatory frameworks in place (most recently modified with the introduction of the Electricity Industry Act and the Electricity Authority in 2010), continue to deliver substantive change and improvement. They have fostered increased competition in both wholesale and retail markets and contributed strongly to increased reliability and efficiency in the sector. The sector also sees an increasing proportion of electricity supplied from renewable sources. In short the sector, the sector's regulatory settings, and the sector's regulators (the Electricity Authority and Commerce Commission) have been set up for success and in our view are doing a good job.

That said, no market or regulatory framework is perfect, and there are areas of the market where there is room for improvement. We believe areas of focus for the review should include:

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1) **Future regulatory settings**: It is evident that (like many other technology-based industries) the pace and scale of change in the energy sector has never been greater than it is now. Improvements in technology and reductions in the cost of that technology – including grid scale technologies like wind and geothermal as well as solar panels, batteries and electric vehicles – promise to disrupt the traditional energy and transportation sectors and provide greater choice and cost savings to consumers. Coupled with this the entry of technology giants such as Google, Amazon and Apple into the sector through provision of home energy management and other services means the existing retail model will be increasingly challenged and will need to adapt to remain relevant to customers. These changing market dynamics will also create challenges and opportunities for the monopoly lines businesses that have to date been insulated from competition. A future-focused review of the sector will add value by ensuring that the current regulatory environment is keeping pace with changes in technology and market structure, and that regulatory settings remain appropriate into the future to enable all consumers to benefit from these changes.

2) **Reform of the Low Fixed Charge Tariff Option regulations**: These regulations were supposed to make electricity more affordable but for many people on lower incomes they have had the opposite effect. They are poorly targeted and are a major source of inequitable outcomes. The regulations also effectively double the number of tariffs retailers are required to offer adding significantly to the complexity of industry pricing and increasing costs to serve customers.

3) **Distribution pricing**: The 29 lines companies allocate the costs of running, maintaining and expanding their networks to customers in a range of different ways but the dominant methodology is to allocate network costs on a variable, per kilowatt hour basis. Variable charging like this is poorly aligned with the true drivers of network costs (which are based on peak demand) and is not providing realistic or efficient cost signals to customers, particularly the adopters of new technology. This means solar take up is over-incentivised and the pace of electric vehicle uptake is reduced, with potential costs to the country of billions[1] in inefficient expenditure and significantly increased greenhouse gas emissions. Research also indicates that current distribution pricing structures result in cost-shifting from wealthier to poorer

[1] See NZIER *Effects of distribution charges on household investment in solar* September 2015; Concept Consulting *Electric cars, solar panels, and batteries in New Zealand Vol 2: The benefits and costs to consumers and society* June 2016.

consumers penalising those who can least afford it. Efforts to improve the pace of change in this area should be cognisant that market-led reform of distribution pricing structures has been encouraged by the Electricity Authority and is already under way. An anticipated change in 2020 to the way many distribution companies' revenues are regulated by the Commerce Commission may provide the tipping point for widespread and sustainable adoption of more efficient distribution pricing.

We also believe the focus of the review should be not just on whether outcomes are fair and equitable but on whether they are fair, equitable, efficient and environmentally sustainable. The sector needs to deliver against all these measures to ensure the best long term outcomes for consumers.

Regardless of whether prices are fair, equitable, efficient and environmentally sustainable, we know that some customers struggle to pay their power bills. There are multiple reasons for this. They relate not just to electricity costs themselves but to factors such as income level, quality of housing and appliances, the customers' overall level of health, and the availability and cost of other household goods and means of meeting customers' energy needs. To address these issues any steps to improve regulatory settings in the energy sector must be progressed alongside broader social policies to ensure the best outcomes for all customers. Meridian therefore welcomes the Government's initiatives to improve the availability and quality of housing and to raise income levels, both in general and for those most in need. In particular Meridian welcomes the recently announced Families Package including a Winter Energy Payment to help with the cost of heating homes during the winter.

We have included some additional and more detailed comments as an appendix to this letter under the headings:

- Market performance
- Electricity prices, fairness, equity, efficiency and sustainability
- Scope definition
- Process and responsibility
- Relative financial performance of suppliers

We are happy to discuss further. Please contact us if you have any queries regarding this submission.

Yours sincerely

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APPENDIX

Market performance

New Zealand's electricity prices are 17 percent lower than the OECD average, calculated based on purchasing power parity of the relevant currencies. This is despite a complete absence of the subsidies prevalent in other countries and despite relatively high network costs, due to our geography and low population density. In 2017 the International Energy Agency described New Zealand as "…a world leading example of a well-functioning electricity market, which continues to work effectively."[2]

The World Energy Council ("WEC") uses the 'Energy Trilemma' to analyse the challenges and opportunities for different countries' energy sectors. The trilemma highlights the dynamic interaction of the different elements of a country's energy system. The three Energy Trilemma dimensions are:

- **Energy security** – the ability of the energy system to effectively and reliably meet current and future demand;
- **Energy equity** – the accessibility and affordability of energy across the population; and
- **Environmental sustainability** – achievement of energy efficiencies and the development of energy supply from renewable and low-carbon sources.

New Zealand scores highly on the Energy Trilemma. We are ranked 9th out of 130 countries reviewed by the WEC, with an overall balanced rating of AAB[3] ('A's for energy security and energy equity and 'B' for environmental sustainability) indicating that while there is room for improvement we continue to manage the trilemma well across all three dimensions. We are the only representative from the Asia/Pacific region, as well as the only non-European country, to be placed in the global top ten.

New Zealand is one of the easiest places in the world to compare and switch electricity suppliers and about 20 percent of consumers switch their retailer each year. In 2017 there were more than 440,000 switches between retailers - the highest level on record. There are an increasing number of retailers entering the market with now over 40 electricity brands offering a range of innovative and customer-centric services. The intense competition in the

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[2] International Energy Agency *Energy Policies of IEA Countries: New Zealand 2017 Review*
[3] World Energy Council *Energy Trilemma Index* https://trilemma.worldenergy.org/

New Zealand market forces electricity suppliers to innovate. The result is an array of retail offerings providing customers with a wide range of choice including pre-payment, smooth pay, spot price, and time of use pricing as well as different approaches to billing and usage tools. For example, Meridian offers plans for electric vehicle charging with low overnight rates and our online tools help customers track and manage their daily energy use. Meridian's subsidiary Powershop uses a mobile app to inform customers about the electricity they are using and how much it costs as well as enabling payment in advance, as you go, or set and forget.

There are some good examples of this retail innovation being exported with direct benefits to New Zealand. Meridian's Powershop technology has been exported to Australia where Powershop Australia now has 100,000 customers in Victoria, New South Wales and Queensland, and to the UK where nPower under the Powershop brand now has 22,000 customers. The Australian and New Zealand operations are supported by a call centre in Masterton and the Australian, UK and New Zealand operations are supported by Meridian's software development subsidiary – Flux Federation – which employs over 100 people in Wellington.

As well as driving innovation, intense competition is driving good price outcomes for consumers. Since 2011 the real price increase to consumers arising from the competitive parts of the electricity supply chain (generation and retail) has been close to zero.

The New Zealand market also delivers an extremely high percentage of generation from renewable sources and does this while maintaining security of electricity supply. Around 85 percent of the electricity generated in New Zealand is from renewable sources and this is growing. Meridian made a commitment to 100 percent renewable generation (wind and hydro) many years ago and we will continue to invest in new renewable generation projects as market demand grows. New Zealand has not had a country wide interruption to supply since 1992 (well before the establishment of the market) despite a number of record setting dry periods that severely reduced hydro generation and the New Zealand electricity sector has since 1999 delivered over 15,000GWh of new energy generation – an investment of over $7.5 billion. This investment has been diversified and has been undertaken by a range of different participants. It is not dominated by any particular technology or fuel source or by any single company or companies. The risks of these investments are borne by investors rather than, as historically, by taxpayers. As well as generation there has also been significant investment in transmission and distribution.

In summary on market performance there are a number of things working well in the sector. In developing areas of focus for the review this needs to be taken into account.

Electricity prices, fairness, equity, efficiency and sustainability

The proposed key focus of the review is on whether the price paid by end-consumers for electricity is fair and equitable. The terms of reference, however, also ask whether regulatory structures are delivering efficiency and fairness.

While efficiency is well understood as an economic concept, what is fair and equitable should be defined before it is analysed and measured. One person's idea of what is fair may differ from another's. At one end of the spectrum some might consider that fair and equitable pricing requires that all consumers receive the same price regardless of the costs to supply them. We encourage those drafting the terms of reference to provide a clear view of what is deemed fair and equitable in this context to ensure this review remains on track.

Better still, in our view, would be for the review to conduct a more holistic assessment of the performance of the New Zealand electricity industry and sector, and the outcomes for customers, by asking not only whether prices are fair and equitable but also whether they are efficient and sustainable. This would remove the current divergence between the criteria against which the review is to assess regulatory structures (are they efficient and fair) and the criteria against which the review is to assess prices (are they fair and equitable). We recommend the final terms of reference are amended accordingly.

Such an approach would be more consistent with the balanced approach taken by the WEC in the Energy Trilemma already mentioned. The key insight of the trilemma is that countries require an energy sector that delivers strongly on all three dimensions of the trilemma simultaneously – security, equity and sustainability (with the latter incorporating consideration of whether energy efficiencies are being achieved). The risk in focusing only on one dimension is that others are ignored, to the detriment of consumers in that country. All of this may be obvious to the drafters of the proposed terms or those leading the review and to that extent implicit, but we believe it would be helpful for the final terms to expressly direct the review to consider whether prices paid by end-consumers for electricity are not only fair and equitable, but also whether they are efficient and consistent with an environmentally sustainable energy system. The express reference to sustainability is particularly relevant given the Government's aim to encourage New Zealand's transition to a 100 percent renewable electricity system (in a normal hydrological year).

Scope definition

Sector wide review

Meridian agrees that if the review is to properly consider the prices paid by end-consumers it will need, at least initially, to consider the entire electricity supply chain (including generation, transmission, distribution, metering and retail) as each is an input cost that affects the price ultimately paid by end-consumers. Related to this we note that the draft terms say the review should:

> "Evaluate whether the regulatory structures that govern both the competitive aspects of the electricity market and the monopoly aspects (i.e. transmission and distribution that is regulated under the Commerce Act 1986) are delivering efficiency and fairness."

However they also say that the review will not consider:

> "Input Methodologies (IMs) that determine how Transpower and electricity distributors are regulated under Part 4 of the Commerce Act."

There is a potential conflict here and clarification of the intention is needed. Meridian submits that if the review is to properly consider electricity prices, then given that on average the largest part of a customer's bill is the combined costs of Transpower and the relevant electricity distributor (together accounting for approximately 36 percent of the bill[4]), the review's terms of reference need to allow for proper and full consideration of those costs and how they are determined by the regulator. This is particularly important at the current time given that a number of lines businesses are or may be anticipating cost increases for their customers in coming years as they move to replace end of life assets installed in the 1950s and 60s. Meridian is not suggesting that the review should attempt to duplicate or second guess the Commerce Commission's processes in setting the regulated cost of capital for lines businesses under the IMs. We are saying that as transmission and distribution costs contribute nearly 40 percent of an average bill, the scope for improvements (including improved cost and other efficiencies) in the transmission and distribution sectors needs to be fully considered along with the rest of the supply chain.

[4] Electricity Authority *My power bill* https://www.ea.govt.nz/consumers/my-electricity-bill/

Out of scope

According to the proposed terms of reference the review will not consider issues "that have already been subject to extensive scrutiny, consultation and litigation – such as the Input Methodologies that determine how Transpower and electricity distributors are regulated under Part 4 of the Commerce Act." Of course, other elements of the electricity market and regulation besides the Input Methodologies also potentially satisfy the test of having "already been subject to extensive scrutiny, consultation and litigation".

Foremost among these is the issue of the transmission pricing methodology or TPM. The TPM has probably been subject to more extensive scrutiny, consultation and litigation than any other issue in the industry. For its part Meridian has disputed the allocation of costs under the current TPM for most of the last 18 years. The Electricity Authority and its predecessor the Electricity Commission have investigated a wide-range of alternative options for the allocation of transmission costs including holding seventeen consultations between 2009 and 2017. The Electricity Authority has also successfully resisted an application by Trustpower for judicial review of the Authority's process relating to the TPM.

All of this suggests that the TPM is intended to be out of scope for the Review. At the same time the draft terms of reference specifically mention that the review should consider '…the regional distributional aspects of transmission pricing.'

Meridian's view is that the Electricity Authority's work to date has conclusively established that the current TPM is both unfair and inefficient. Further, the Authority has run an exhaustive process and is close to making final decisions. In Meridian's view it would not be in the interests of consumers for there to be a separate review of the TPM at this late stage.

Process and responsibility

The draft terms of reference state that the review will determine its own process but that it is expected to involve wide consultation on issues and draft findings. Meridian welcomes this as we consider that wide consultation is essential if the review is to deliver durable outcomes.

The draft terms also state the review may be undertaken in stages and include a report with recommendations to be delivered to the Minister of Energy and Resources by early 2019. Again, we consider this is a sensible timeframe and process for the review to adopt.

At this time it is not clear who will be leading the review. We believe that The Electricity Authority is the body with the most specialist expertise right across the sector and a statutory objective to act for the long term benefit of all consumers. It is well placed to facilitate the review. Alternatively the Ministry of Business, Innovation and Employment also has the requisite expertise. Either could, where necessary or appropriate, supplement their own expertise by calling on experts to support them in their analysis.

Relative financial performance of suppliers

Finally, Meridian notes that the review will collect information on and consider the financial performance of suppliers across the supply chain and in particular profitability of the different companies in the competitive and monopoly sectors of the electricity industry. Meridian recommends caution in such analysis. The draft terms mention gathering of information on gross and operating profits as well ROCE and ROACE. These and other ‘high level’ metrics or means of assessing profitability are well known to be fraught with difficulty particularly when the companies being assessed differ in nature. There are substantial differences between the companies operating in the electricity sector. Even within just the generation and retail areas there are companies that supply gas and electricity as a bundle whereas others sell only electricity, there are companies that operate as standalone retailers whereas others own generation also, there are companies with overseas subsidiaries and operations, companies with upstream oil and gas operations, companies making bundled electricity and broadband offers, some companies with charitable status and some operating on a ‘not for profit’ basis. Some companies already make substantial disclosure of financial information under listing rules whereas others are entirely privately owned businesses with little if anything in the way of publicly available information.

Comparing the financial performance of these companies on a truly ‘like for like’ basis is not straightforward. Meridian recommends that the metrics used to assess financial performance should be determined by the review and tailored to the specific problems or issues identified at an early stage as areas of focus for the review. We suggest the words in the draft terms of reference at bullet point 3 of point 2 should be amended to allow for this optionality rather than mandating the use of certain metrics.