

23 October 2018

Electricity Price Review
Secretariat, Ministry of Business, Innovation and Employment
15 Stout Street
PO Box 1473
Wellington 6140

Commerce Commission submission on the Electricity Price Review's first report

Overview of our submission

1. We appreciate the opportunity to submit on the EPR Expert Advisory Panel's (Panel) first report as part of the Electricity Pricing Review. The report's focus on delivering the best outcomes for consumers amidst the uncertainty around technological change is consistent with our own aims. We remain available to assist the Panel as it moves towards the next stage of the review.
2. We concur with the report's view that the fundamental market and regulatory mechanisms of the electricity sector are working relatively well, given the challenges in balancing the different objectives of the energy trilemma. However, we acknowledge there are some areas where improvements can be made and we recognise the concerns raised by the Panel.
3. Our comments focus on the topics most relevant to our specific role in the electricity sector and are summarised below. We are also providing a separate joint submission with the Electricity Authority (EA) on key areas where our responsibilities interact.

Role of the regulators

4. The Panel has rightly considered our role and that of the EA as the two regulators in the sector. We consider our separate functions provide clear benefits to electricity consumers as we bring specific expertise to different elements of the industry. There are known areas where we have intersecting responsibilities, but we work hard to communicate across all levels of the organisations to achieve agreement on key issues.¹
5. More generally, the significant role of regulators in the electricity sector is essential given the monopoly elements, complexity, importance to the New Zealand economy and the potential for technological change. The use of tertiary instruments like codes and rules, rather than primary legislation, means more flexible responses to industry developments are possible. Significantly, all of our rules are subject to robust legal

¹ For example, we are working with EA on options for distribution network access.

and consultative processes, in order to provide appropriate scrutiny, without the risk of outdated and inflexible legislation that can result in potential consumer harm.²

Promoting network efficiency

6. One of our key roles in the sector is to promote the efficient operation of, and investment in, electricity networks. We have therefore carefully considered the report's view on how the incentives for distribution network efficiency could be improved.
7. Our focus to date has largely been in designing and implementing the rules and incentives of the price-quality regime for electricity distribution businesses (EDBs). The input methodologies underpinning the regime weathered a full merits review and have since been through a seven-yearly review. The stability of the regime has been recently confirmed through an independent assessment by Standard & Poor's Global.
8. Now that we are nearing the end of the first full five-year regulatory period, without a mid-period reset, it is an appropriate time for us to consider the effectiveness of the incentives in the regime. This is something we highlighted earlier this year when we published an open letter setting out our 2018/19 priorities for our work regulating EDBs, which included a focus on increasing our understanding about the investment levels and associated incentives of EDBs. Since then we have initiated asset management and emerging technology reviews to better understand the investments EDBs are undertaking.
9. The report suggests that price-quality regulation could be extended to the 12 community owned EDBs that are currently exempt from revenue constraints. It is not clear to us that applying price-quality regulation, by itself, would produce better efficiency outcomes (or indeed that they are the 12 least efficient EDBs). For example, it is not clear that they are strongly profit driven and would therefore respond better to price path incentives than other approaches. Other factors may have a greater influence on their performance (eg, governance).
10. In the first instance, we favour exploring lower cost, more iterative responses, given the costs associated with introducing price-quality regulation for both us and the EDBs, which ultimately falls on consumers. Benchmarking, in particular, is a tool that we think has potential to be used more widely across the distribution sector. The growing amount of information we have on individual networks is likely to increasingly allow us to identify specific efficiency concerns.
11. However, there is value in considering whether to broaden our range of tools in responding to concerns about the performance of exempt EDBs, where our existing tools are ineffective. For example, having the ability to introduce enforceable quality standards could help to ensure exempt EDBs are providing appropriate service levels

² For example, the report identified how the low-fixed charge tariff regulations help some households but raise costs for others.

Emerging technology

12. We agree with the Panel's view that technological advances have the potential to profoundly alter the way the electricity sector works, and provide benefits to New Zealanders. It is important for us to understand the opportunities and challenges that these technologies present to the sector, and that the regime remains sufficiently flexible to prevent barriers to competition arising, and the potential loss of benefits that competition provides, in electricity markets. It would be worth considering how this flexibility can be achieved, while balancing the certainty that a stable regime provides to market participants.

Issues covered in our submission

13. We have attached the submission template to this letter, which provides our views on the following specific issues:
 - 13.1 Barriers to greater distribution network efficiency
 - 13.2 Access to distribution networks
 - 13.3 Competition issues related to win-backs
 - 13.4 Information on distributor investment in emerging technologies
 - 13.5 Costs of customised price-quality paths

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Sue Begg', is positioned above the typed name.

Sue Begg

Deputy Chair, Commerce Commission



ELECTRICITY PRICE REVIEW

SUBMISSION FORM

How to have your say

We are seeking submissions from the public and industry on our first report into the state of the electricity sector. The report contains a series of questions, which are listed in this form in the order in which they appear. You are free to answer some or all of them.

Where possible, please include evidence (such as facts, figures or relevant examples) to support your views. Please be sure to focus on the question asked and keep each answer short. There are also boxes for you to summarise your key points on Parts three, four and five of the report – we will use these when publishing a summary of responses. There are also boxes to briefly set out potential solutions to issues and concerns raised in the report, and one box at the end for you to include additional information not covered by the other questions.

We would prefer if you completed this form electronically. (The answer boxes will expand as you write.) You can print the form and write your responses. (In that case, expand the boxes before printing. If you still run out of room, continue your responses on an attached piece of paper, but be sure to label it so we know which question it relates to.)

We may contact you if we need to clarify any aspect of your submission.

Email your submission to energymarkets@mbie.govt.nz or post it to:

Electricity Price Review

Secretariat, Ministry of Business, Innovation and Employment

15 Stout Street

PO Box 1473

Wellington 6140

Contact details

Name	9(2)(a)
Organisation	Commerce Commission
Email address or physical address	9(2)(a)

Use of information

We will use your feedback to help us prepare a report to the Government. This second report will recommend improvements to the structure and conduct of the sector, including to the regulatory framework.

We will publish all submissions in PDF form on the website of the Ministry of Business, Innovation and Employment (MBIE), except any material you identify as confidential or that we consider may be defamatory. By making a submission, we

consider you have agreed to publication of your submission unless you clearly specify otherwise.

Release of information

Please indicate on the front of your submission whether it contains confidential information and mark the text accordingly. If your submission includes confidential information, please send us a separate public version of the submission.

Please be aware that all information in submissions is subject to the Official Information Act 1982. If we receive an official information request to release confidential parts of a submission, we will contact the submitter when responding to the request.

Private information

The Privacy Act 1993 establishes certain principles regarding the collection, use and disclosure of information about individuals by various agencies, including MBIE. Any personal information in your submission will be used solely to help develop policy advice for this review. Please clearly indicate in your submission whether you want your name to be excluded from any summary of submissions we may publish.

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Summary of questions

Part four: Industry

Retailing

16 *What are your views on the assessment of barriers to competition in retailing?*

- 16.1 The Panel has highlighted that the EA has done a lot to reduce the barriers to competition in the retail market. However, some submitters have suggested that barriers remain. In particular, new entrants to the retail market have cited win-back discounts as a barrier to expansion.
- 16.2 A competition concern could arise where the use of win-back discounts result in customer foreclosure and raising rivals' costs – increasing the costs of customer acquisition and making it more difficult to achieve minimum efficient scale. This, in turn, means there is potentially less competitive pressure on incumbent retailers and higher prices in the future. In addition, discounts may be targeted at the high value customers, so that challenger retailers end up with disproportionately low value customers.
- 16.3 Enforcement action might be possible under part 2 of the Commerce Act, where the use of these discounts results in a substantial lessening of competition. It is possible that any enforcement under the Commerce Act may be limited to aggregating the offers across a single retailer, as we may not be able to aggregate across multiple retailers and customers. If we are limited to taking enforcement action against a single retailer, rather than aggregating across multiple retailers, it might make it more difficult to find a substantial lessening of competition.
- 16.4 Banning all selective discounts such as win-backs could be counter-productive – the discounts may only be profitable to the retailer because they are targeted at particular customers. If retailers were forced to make all discounts available to all customers, they may not make the offers at all. This is what the CMA found in their review of experience with the Ofcom rules in the UK and the ACCC declined to ban all such offers due to concerns that they might be counter-productive.
- 16.5 We also consider that it is important to distinguish between “save” and “win back” discounts. Saves are offered during the notice period for switching, when the incumbent has access to specific information regarding customer intentions as a result of the regulatory regime surrounding switching. Saves seem particularly problematic and have been the focus of attention by both the EA and the ACCC.

Distribution

20 *What are your views on the assessment of distributors' profits?*

- 20.1 The Panel has concluded that, while some EDBs are making profits above their WACC, for most it is only a marginal amount. We have undertaken our own analysis, and agree that EDBs are not earning excessive profits. However, we would like to highlight that the upfront rules allow EDBs to outperform their allowance and earn above normal profits by responding to the incentives that exist under price-quality regulation, for example, by finding cost efficiencies.
- 20.2 The Panel also highlighted that some stakeholders have questioned the methodology we used to determine asset values. We agree with the Panel that there is no merit in reopening the methodology we used for setting those values. Setting a starting asset valuation involved the exercise of judgement. As highlighted by the Panel, our approach was subject to extensive consultation, expert analysis and was tested in the High Court. We also note that there are costs, in terms of investment certainty, to trying to unwind historic revaluations.

21 *What are your views on the assessment of barriers to greater efficiency for distributors?*

- 21.1 The Panel has identified seven areas where it considered that greater incentives could be created to reduce electricity distribution costs.

Price structures

- 21.2 We agree that pricing structure (within the EDB's revenue cap) is an important tool to influence customer behaviour, and therefore reduce the need for increased transmission and distribution capacity, and send the right signals for investments by consumers (eg, in solar panels). These issues are within the EA's remit and we support the direction of the work they are undertaking.

Efficiency pressures

- 21.3 From our anecdotal observations it is not clear that applying price-quality regulation by itself would produce better efficiency outcomes in the 12 exempt EDBs (or indeed that they are the 12 least efficient EDBs). For example, it is not clear that they are all profit driven, and would therefore respond to price path incentives, or that there are not other factors that more greatly influence their performance (eg, governance). In the first instance, we favour exploring lower cost, more iterative responses, (eg, more benchmarking as part of our ID summary and analysis) given the costs associated with introducing price-quality regulation for both the EDBs and us.
- 21.4 However, there is value in considering whether to broaden our range of tools in responding to concerns about the performance of exempt EDBs, where our existing tools are ineffective. For example, having the ability to introduce

enforceable quality standards could help to ensure exempt EDBs are providing appropriate service levels.

- 21.5 We also agree that allowing benchmarking to be part of setting default price-quality paths could be useful, but we would expect to use it cautiously, as one input into price setting.
- 21.6 Regarding some stakeholders' views that the complexity of the price-quality regime "deadens" incentives to cut costs:
- 21.6.1 We agree that evaluating the effectiveness of the incentives we put in place is absolutely the right thing to do. Our focus to date has largely been in designing and implementing the rules and incentives. The input methodologies underpinning the regime weathered a full merits review and have since been through a seven-yearly review.
- 21.6.2 Now that we are nearing the end of the first full five-year regulatory period (ie, without a mid-period reset) it is an appropriate time to do this evaluation. We have started some analysis of this which is informing our early views on expenditure and quality incentives for the setting of DPP3.
- 21.6.3 The incentives we put in place are a means to an end. They are intended to better align the firm's incentives with consumer interests and thereby alter firms' behaviour to produce the desired outcomes. Firm behaviour is also influenced by a variety of other drivers, not just our incentives. Therefore, should the evaluation conclude that existing incentives are not driving the right behaviour, we should consider what changes (including but not limited to our 'traditional' incentives) are most likely to be most effective in driving behaviour change.
- 21.6.4 We are aware of the possibility that, while the design of our incentive regime is likely appropriate in principle, it may not be well understood by all the firms we are trying to influence. Better outreach, education and communications may well be a solution worth considering. Other potential solutions may include better use of ID such as league tables, more proactively shining a light on right or questionable behaviours, workshops with interested parties to work through issues.
- 21.6.5 One advantage of these solutions is that for the most part they are tools we already have at our disposal and do not require rule or legislative change.
- 21.6.6 We note that the existing Commerce Amendment Bill would add enforceable undertakings to our range of enforcement tools under the Commerce Act. However, there would be value in considering whether the penalties under the Commerce Act are sufficient to deter some contraventions of price-quality requirements, particularly by the larger EDBs. Aligning the penalty provisions for contraventions of price-quality paths with the maximum penalty for contraventions of Part 2

of the Commerce Act might provide a more effective deterrence to EDBs contravening their price-quality path.

Business size

- 21.7 We agree that economies of scale may be available in relation to some EDB costs. It is less clear to us that, in aggregate, bigger is always better for EDBs. We have seen examples of low cost innovation from smaller EDBs. This may, for example, drive higher opex, but allow a deferral of renewal capex.
- 21.8 It is our intention to perform and publish further benchmarking work in relation to EDB costs despite currently being precluded from using the results in price-quality regulation. While this still needs to be developed further, we see it as an important basis for having discussions about improved efficiency with EDBs, and potentially for promoting more efficient behaviour and structures. In our view creating this type of pressure is more likely to lead to better and more durable outcomes than mandating a particular behaviour.
- 21.9 The Panel has also asked for views on encouraging alternative business models and more collaboration between EDBs. We support collaboration between EDBs, where it creates efficiencies, cost savings and supports innovation. However, there are risks with such collaboration. For example, collaboration can reduce competition in the long term if it reduces innovation or the number of competitors in the market, in particular by EDBs collaborating to enter into a long term contract with one supplier.
- 21.10 When undertaking collaboration, EDBs have to be particularly aware of provisions under Part 2 of the Commerce Act. This is especially relevant where they may well be competitors now or in the future, or where there may be incentives to use their market power to exclude competitors in downstream or related markets. Where EDBs are proposing entering into any agreement with cartel provisions as part of a collaborative activity, they can apply for clearance for the agreement. In the event that the collaborative activity does not qualify for clearance, the parties may seek authorisation for the agreement. Ultimately, we encourage collaboration, so long as EDBs are aware and comply with the provisions of the Commerce Act.
- 21.11 We also note the suggestion by a stakeholder that smaller EDBs might be discouraged from amalgamation by the costs of price-quality regulation. We would like to highlight that amalgamations can be structured in such a way that they do not lead to the introduction of price-quality regulation. The Power Company, Electricity Invercargill and OtagoNet amalgamating through management company Powernet, provides an excellent example of efficiencies that can be achieved without price-quality regulation being imposed on The Power Company.

Metering data

- 21.12 We agree that any actual barriers to accessing metering data are problematic. Aspects of this data are valuable to EDBs for network planning, and in

responding to specific circumstances, for example, large outages.

21.13 Access to the data is through metering service providers. They have a commercial interest in selling the data. We would not expect that EDBs would get this data for free.

21.14 At this point it is not clear that there is an intractable data problem, requiring regulation, compared with, commercial behaviour and parties seeking a better deal.

Governance

21.15 We agree that good governance of EDBs is important, and will contribute substantially to the quality of their long-term planning and their response to new technologies in the sector.

21.16 Our anecdotal understanding of the sector is that there are examples of both good and poor governance, and that no one ownership or investment model clearly leads to better governance. The success of joint ventures or collaborations (being recommended by some submitters) will likely be due to specific circumstance and behaviours, rather than an inherent advantage of these structures.

21.17 We are actively using our tools to create more incentives around the governance of EDBs, for example, publishing more accessible EDB performance information, and looking to engage more with the trustee owners of consumer owned EDBs, to enable them to better hold EDB Boards to account.

Asset management and planning

21.18 We understand the report's comments on planning horizons for EDBs and agree that they should be looking beyond ten years, particularly with the potentially greater uncertainty in the sector at the moment. However, we do not think that simply extending our existing specific disclosure requirements to a longer horizon would be of significant benefit (given our understanding of forecasting uncertainty). Instead, we will consider how we can encourage distributors to make their longer term strategies more transparent. This will better reveal the appropriateness of their ten-year investment plans because the value of the investments is expected to last well beyond ten years.

Aging assets

21.19 The report notes that the scale of investment required by EDBs to replace ageing assets appears manageable. We would like to highlight that although the aggregate investment need appears manageable, different EDBs are at different points in their investment cycle, so some individual EDBs will have significant capex needs within the next decade, putting material upward pressure on local prices.

Part five: Technology and regulation

Technology

26 *What are your views on the assessment of the impact of technology on consumers and the electricity industry?*

- 26.1 We agree with the Panel's view that technological advances have the potential to profoundly alter the way the electricity sector works. We have been developing our understanding of the potential impacts that emerging technologies might have on the sector by gathering information from EDBs. Amongst other things this work provides a check on EDBs using their core monopoly position to create a competitive advantage in new adjacent contestable markets.
- 26.2 We are in the process of reviewing the information we have gathered from EDBs. From our initial observations, we have questions about whether some EDBs may be inappropriately recovering the costs of their investments in emerging technologies, resulting in consumers paying more for their lines services than they should be or potentially impacting competition in related markets. Where EDBs are including the cost of emerging technologies in their regulated cost base, we want to ensure that consumers of services are benefiting from those technologies.
- 26.3 As part of our process we have also published the information gathered from EDBs, giving interested parties an opportunity to use the information to support their submissions to the Panel.

Regulation

31 *What are your views on the assessment of gaps or overlaps between the regulators?*

- 31.1 We recognise that the topics covered by this part of the report pertain to both us and the EA. As a result, we have prepared a joint submission, which we have provided alongside this submission.

33 *What are your views on the assessment of other matters for the regulatory framework?*

- 33.1 The report notes that some EDBs have indicated a reluctance to apply for customized price-quality path regulation, given the compliance cost. The perception is not new to us. We have considered this matter in our IM Review, where we made changes to reduce costs. In addition, we highlighted in our 2018 priorities letter that we want to reduce the costs of price-quality paths – this was a feature of our Powerco and Wellington Electricity CPP processes.
- 33.2 It is not evident at this time that further work on refining the CPP framework is a priority given the small number of intending applicants that we are aware of

and their expected timings, and our existing ability to vary an applicant's requirements.