Response to the Electricity Price Review

The following is Paua to the People's response to the first report of the Electricity Price Review. The author of this feedback is Mark Hughes (Managing Director) who has held senior product, pricing and marketing roles in energy and telecommunications utilities in New Zealand and the UK.

Paua to the People consider that there are several key issues with industry structure and regulation that need to be addressed to ultimately deliver lower prices for all New Zealand households, which were not addressed in the review.

- Competition is not working to deliver low prices for all households. In fact, prices remain high for many households and the market dominance of generator/retailers continues unabated despite the plethora of new entrant retailers.
- The current imbalance of power between generator/retailers, distributors and MEP to smaller retailers is stifling innovation, stunting competition and holding up costs to serve.
- For the health of the industry the operations of an efficient generator, distributor, MEP or retailer should all be profitable and offer a fair return.
- That the consolidated accounts of the generator/retailers are masking cross subsidisation of generation profits to prop up unprofitable retail operations.
- A disproportionate level of risk is placed on new entrant retailers.

Vertical integration of Generator/Retailers causes a major issue that needs to be addressed

1. Contrary to the Electricity Price Review, we believe that the NZ retail electricity market is not competitive. Paua to the People believe that Generator/Retailers are stifling competition in the NZ residential retail market. Yes, there are lots of electricity retailers (39) in New Zealand but 26 or 70% of them do not even constitute 1% of market share. The vertically integrated generator/retailers continue to dominate the retail market with the 6 companies accounting for 88% at 31/8/2018. According to EA numbers the vertically integrated generator/retailers were only down a single percentage point for the last 12 months. It will take a very long time before the smaller retailers make any real in-roads to this market at this rate.

2. The Review identified that not all customers were benefiting from competitive rates. In almost all of these cases these households are customers of the Generator/Retailers. 100% of Paua to the People's customers are benefiting from lower prices.

3. To ensure that all households have access to competitor rates the Regulator needs to address the vertical integration of generator/retailers. We believe that generator/retailers are using their generation divisions, large inert bases and significant market power to distort the retail sector to the detriment of smaller retailers and consumers. We consider this anti-competitive activity and request that the regulator require more transparency to stop cross subsidisation by vertically integrated participants.

4. We were disappointed that the Review only considered generator/retailers and excluded all independent retailers. No attempt was made to establish if there was a difference between the two types of retailer.

Why are Smaller Retailers not making greater inroads?

5. There is little to no margin available for independent Retailers in the residential market at the price we must offer to compete against the acquisition and winback tariffs of Generator/Retailers.
    - A retailer's cost to supply (generation, distribution and metering) is at almost the same level as the price we need to offer to customers, and this leaves little or no margin for the retailer to cover overheads. In support of this point we highlight the losses that Flick were making each year, and they are not even the lowest priced retailer on Consumer Powerswitch.
    - Independent Retailers face costs and risks that the Generator/Retailers do not, including reducing the risk of the very volatile NZ wholesale electricity market and distributor prudential. In addition, because of their size their power generator/retailers can get favourable prices for services from MEP such as installing replacement AMI meters at no charge.
    - Smaller Retailers do not generally hold large inert bases than are available to exploit to subsidise unprofitably low winback and acquisition prices.
    - Because of the imbalance in power between Retailers and distributors, generators and MEP, the retail sector has been given some costs that do not logically sit with retailers such as managing faults identification for Distributors, tracking faulty meters for Metering and Conservation Campaigns to reduce demand for a generation sector that has already increased spot rates (significantly) to reflect their inability to meet that demand.
    - The retail operations of Generator/Retailers do not need to make a profit. We believe that the consolidated annual accounts of Generator/Retailers mask the lack of profitability of their retail divisions. Costs to serve of $400 per customer per year are unsustainable given market prices and low margins available for retailers (Flick's losses year on year likely forced their recent sale to Z).

    The price of electricity for consumers willing to switch is significantly lower than for inert households because of the independent retailers. We believe that the regulator needs to ensure that independent retailers can continue to compete while at the same time make a reasonable profit. If no action is taken to address profitability for our sector more retailers will need to seek buyers with deep pockets or fold.

6. Prudential is a massive handbrake for small Retailers. Paua to the People is holding the equivalent of 2 years of Gross Margin with the Energy Clearing House and Wellington Electricity (the only Distributor we trade over). We have so much money tied up in Prudential that we are unable to pay dividends or speed up growth in the size of our base (we turn customers away). The need for vast amounts of capital to hold as prudential stops us from growing very fast at all and we suspect is the reason independent retailers halt growth at a certain size or are sold.

    As a small retailer we fear the 3-day call for Prudential after a spike or a period of high spot rates. Having such a limited time to respond means we must maintain expensive banking facilities in place at all times. We have to pass these costs through to customers. Anecdotally we understand that a number of retailers faced severe cash flow issues over the last dry winter (2017). Prudential is the major factor we believe that will cause a retailer to become insolvent – ironically the very reason it exists in the first place.

Paua to the People have difficulty with the rationale of why distributors are allowed to demand prudential. A Distributor is not faced with any additional costs to maintain their network. We question why a distributor should benefit from zero risk.

Conveniently under the current prudential rules larger retailers and those owned by large companies do not have to maintain prudential with Distributors. This is a significant competitive advantage for the alternative brands (Energy Online, Powershop) of the big retailers. The same brands that are used to allow their parent brands to maintain higher prices for their inert customers.

Paua to the People also have difficulty with the rationale for calculating the prudential held by the Energy Clearing House. We can rationalise that Generators incur costs to generate energy so may be out of pocket if a retailer went insolvent. However as around 88% of electricity generated is renewable we argue that the costs of such generation is limited for the most part. We also struggle with the rationale for having two weeks added to Prudential for switching an insolvent retailer's customers to another retailer. Switches can be backdated, and is business-as-usual for retailers.

We again question why generators should benefit from zero risk.

We consider prudential in its current form a construct placed in the market to limit the growth of small retailers. If New Zealand is to ever achieve a competitive electricity market the issue of prudential must be addressed.

7. Winback from generator/retailers is subsidised by inert customers and generation profits. When Paua to the People acquire customers from the generator/retailers our new customers are immediately contacted with a very attractive winback offer. The issue is not the advantage the previous retailer has from knowing the customer's consumption and payment history, it is purely the attractiveness of their winback offer. Most offers include large credits and lower rates. We have seen credits of up to $400 which is 2.5 years of Gross Margin for Paua to the People. Generally, winback offers have a one-year contract, but we have seen some large credits with no fixed term offered on winbacks. While it is good that the consumer has "negotiated" lower prices, we question how generator/retailers can afford such unprofitable offers, especially if their cost to serve is $400 per customer. Even though we likely have the lowest cost structure of any retailer we often cannot compete with this level of offer.

   For any retailer with a large inert base it is far more expensive to reduce prices for your base (ie to offer competitive tariffs to all) than it is to use an "ambulance at the bottom of the cliff" strategy to retain customers. Without regulation and transparency of annual accounts, generator/retailers will continue to use their inert customers and generation activities to subsidise the part of their base actively seeking lower rates.

   Unfortunately, the Winback Protection scheme run by the EA is at best a minor inconvenience for the generator/retailers.

8. Retailers have all the risk of an end user not paying for consumption and daily charges. With the increase of energy poverty this risk is growing year on year. With the current prudential requirements distributors and generators hold zero risk of non-payment at all.

9. Retailers are even responsible for the energy consumption and the daily charges of vacant properties and for properties where we do not know who the householder is. There is a MEP cost to disconnect a property (even for AMI meters) when a customer moves out, so retailers

are forced to balance the cost of the vacant property versus the cost of disconnecting the property. Retailers are unable to recover these costs, but other suppliers (generators, distributors and MEP) are all unaffected and charge at normal rates for vacant properties unless they have been disconnected.

What else is holding up electricity prices and limiting innovation?

10. The EA has spent considerable efforts trying to build liquidity into the hedging market, but the reality is that the volatility of the market still adds significantly to a household's bill. With increasing renewable generation this is expected to worsen over time. We believe that changes must be made to the wholesale market as the reality is that the NZ Wholesale Electricity Market will likely never have any real liquidity.

11. While no expert concerning the mechanisms of the wholesale market, I struggle to rationalise why the spot rate for each kWh is the same for all generators regardless of what they were prepared to sell each kWh for. We can rationalise that it is expensive to bring some Peaker plant on-line to cover shortfalls but why are Peaker spot rates also awarded to baseload generation. Maybe it is time to consider a different model of wholesale market that stabilises returns for generators and prices for retailers. We do not need to add a required profit margin for energy speculators and forecasters to the electricity supply chain.

12. Paua to the People believe that with the current wholesale market structure there is little incentive for generators to ever allow a situation where an oversupply of generation maintains lower generation rates which can be passed onto customers.

13. Wholesale electricity rates are massively impacted by the energy demands of New Zealand Aluminium Smelters. Tiwai Point purchases 100% of the cheapest generation (hydro) so every NZ household is effectively subsidising their operations. We also wonder would our hydro lakes ever reach critical levels if Tiwai was not in operation?

14. Generator/retailers have a significant competitive advantage over retailers as they do not have to pass on (as higher tariffs) the risks of any volatility in the wholesale market. If the spot rates are low then for a generator/retailer collects the shortfall in their retail division, and when the spot rates are high any retail losses are covered by their generation windfall.

15. We noted your estimate of $400+ cost to server per customer per year for Contact Energy and some other retailers. We surmise that many of the generator/retailers with legacy systems are likely to have similar costs to serve. Paua to the People does not have anywhere near those costs and we suspect that many of the other retailers also run leaner operations. Allowing the generator/retailers to keep such a high percentage of the market is keeping the average cost to serve very high. In other industries the old dinosaur companies who cannot adapt to lower rates are replaced by the leaner operations of innovative start-ups. This natural evolution is being successfully stifled by the vertically integrated retailers.

16. Generation makes up around 40% of costs to supply so the lack of stability for purchasing electricity for our customers makes it very difficult for Retailers to deliver any innovation in tariffs. With Spot Rates so inconsistent across time periods we have found it difficult to send positive price signals to customers encouraging them to move load to non-peak times – a critical future focus for the industry. The hedging contracts also do not support Retailers structuring tariffs to encourage off-peak consumption.

17. The distributor component of our charges to customers is generally over 50% of the total bill. Making up such a high component of electricity bills, it will be essential that Distributor prices to residential properties be addressed if tariffs are to reduce in any meaningful way.

18. We were disappointed that your report did not consider the history of valuations of networks by distributors when assessing whether the sector is making excessive profits.

19. The very high component of distributor pricing in our cost to serve means retailers are essentially forced to follow whatever tariff structure the distributor sets. In Wellington the local distributor does not price to encourage off-peak consumption, so we are unable to either.

20. The non-standardisation of distributors and metering equipment providers (MEP) results in significant complexity being added to retail IT systems and processes. Each MEP has a different format for raw data and processes for connections and technical assistance. Each distributer has their own pricing, processes for faults identification, faults management and requesting retailers to contact their customers for planned outages. All the added complexity adds cost.

21. A primary purpose of Retail in the electricity supply chain is to collect payment from end users and to pay the other suppliers what they are owed. Time should be mandated by the Regulator to allow retailers to collect payments before they need to be paid to the other suppliers. Some distributors such as Orion charge retailers in advance (before the end user has even consumed it).

22. The regulator should be seeking ways to remove costs from the electricity supply chain to allow efficient operators from each sector (generators, distributors, MEP and retailers) to make a fair profit. We do not see this happening (generally we see them adding unnecessary cost) with the regulator so suggest that they are incentivised to do so.

23. We know that the speed of change is heavily influenced by the speed at which the generator/retailers are willing to make changes. Efficient operators in each sector would be able to make more changes faster but we believe that inefficient participants (likely with high costs to serve and legacy systems) are dictating the glacial pace of change. Other industries allow the giants who cannot change to wither but that is not the case in our industry.

24. The regulator has deliberately not regulated certain components of the commercial contracts between retailers and MEP or distributors. Unfortunately, both MEP and distributors have so much power in these negotiations that retailers are often forced to accept unfavourable terms including accepting responsibility for activities that should be funded by the other supplier. For example, retailers should be able to charge our suppliers for:

    - Contacting customers who are impacted by a planned network outage on behalf of a distributor
    - Paying distributor rebates to customers
    - Identifying faults on a distributor network for them to address
    - Identifying and requesting missing data from a MEP

We welcome any further discussion on the points we have raised above and look forward eagerly for progress towards making electricity prices fairer for New Zealanders.

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