19th October 2018

ABOUT VOCUS

1. Vocus New Zealand is the third largest fixed line telecommunications operator employing over 800 staff In New Zealand. Our retail operation includes a number of challenger brands - Slingshot, Orcon, Flip, CallPlus and 2Talk. We are also an active wholesaler of telecommunications services including access, voice and broadband over both fibre and copper.
2. Vocus has made significant investments in New Zealand. We are the largest copper unbundler with a presence in over 200 exchanges throughout New Zealand. In addition we operate 4,200km fibre optic network transits between virtually all major towns and cities, and connects directly into all major peering exchanges.
3. Our 200,000+ customers in New Zealand range from government agencies, integrators, large corporate, SME and residential households. We are committed to New Zealand's fibre future.
4. Vocus is committed to New Zealand and is one of the few large NZ telecommunications companies to base all its customer service call centres here in New Zealand rather than out-sourcing its customer service operations overseas.
5. Vocus is one of the fastest growing telecommunications companies in Australasia and a major provider of voice, broadband, domestic and international connectivity and data centers throughout New Zealand and Australia.
6. Vocus bought New Zealand electricity retailer Switch Utilities in December 2015 and since May 2016 has retailed electricity under the Slingshot, Orcon, Vocus and Switch Utilities brands. During this time Vocus has acquired some 16,000 ICPs through various marketing channels and upselling to our telecommunications customer base.
7. Thank you for the opportunity to make this submission. If you would like any further information about the topics in this submission or have any queries about the submission, please contact:

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19 October 2018

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Chair
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Electricity Price Review
c/o - Secretariat, Ministry of Business, Innovation and Employment
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Submission on Electricity Price Review first report

Dear Miriam,

1. Vocus welcomes the opportunity to submit at an early stage in the Electricity Price Review process, while the Advisory Panel thinking and analysis is still tentative. We appreciated the opportunity to meet and discuss our views on 21 September and look forward to future meetings and engagement as the review progresses.

2. Vocus supports the attention competition issues have been given in the first report.

3. Electricity networks are already price regulated, so improving competition will likely be the most productive avenue available to the Advisory Panel for delivering more affordable electricity.

4. The focus of our submission is on issues relating to how the large incumbent retailers are detrimental to the development of competition. This reflects where the barriers to competition and gaining scale predominently lie in the electricity market.

5. Resolving the structural issues of market concentration and retail-wholesale vertical-integration, as well as related problems with contract market liquidity, and the two-tier retail market, identified in the Panel Report, are key to achieving a healthy and vibrant competitive market.

6. Competition must exist at both the retail and wholesale levels for the best price outcomes for consumers to occur. Vocus believes a focus on the wholesale market is imperative to resolution of the core structural issues. Whilst wholesale market power reduced for a time it is becoming stronger again through tightening supply conditions, resulting in wholesale prices that are inefficient and high. This market power continues to effectively provide the generators with the ability to control retailer margins and protect the level of non-vertically integrated retail activity.

7. A more competitive electricity market would mean more affordable electricity for consumers and the opportunity for entrant retailers to compete on a more level playing-field. Vocus' interests are tightly aligned with consumer interests.

The Electricity Price Review should be ambitious for New Zealand

8. The incumbents continue to dominate the market. The Electricity Authority's market statistics show the market share of incumbent retailers remains high, with only modest reductions since the last round of electricity reforms and the establishment of the Electricity Authority.

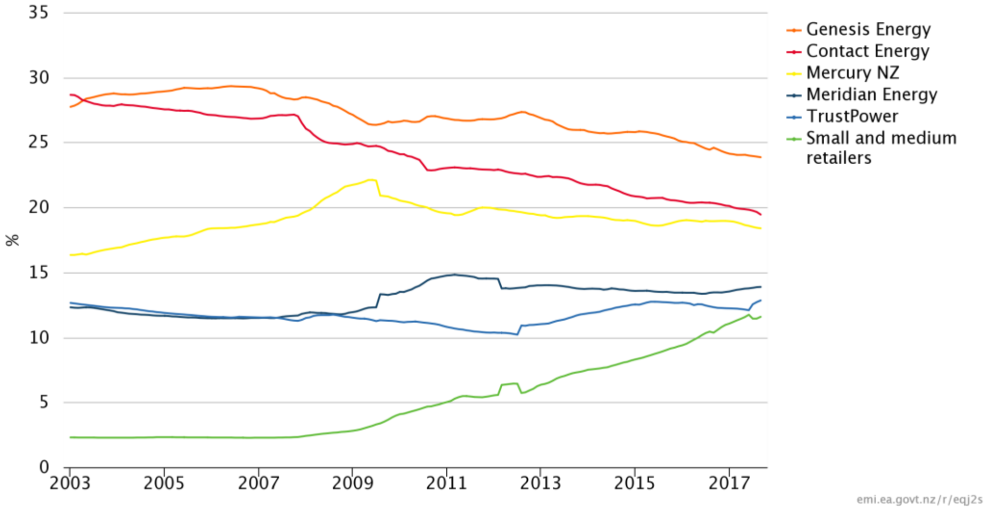
RETAILER	MARKET SHARE JAN 2003	MARKET SHARE OCT 2010	MARKET SHARE AUG 2018
Contact Energy	28.66%	24.3%	19.45%
Genesis Energy	27.74%	26.54%	23.86%
Mercury Energy	16.34%	20.72%	18.39%
Meridian Energy	12.31%	13.33%	13.88%
Trustpower	12.65%	11.27%	12.84%
Overall Share	**97.71%**	**96.16%**	**88.42%**

Source: Market Share Trends - emi.ea.govt.nz

9. The rate of change has been slow.

10. It took until March 2010 for the small retailers to gain more than 3% market share, after remaining stagnant for a long period of time.[1] Even now the market share of the small retailers is still under 12%.

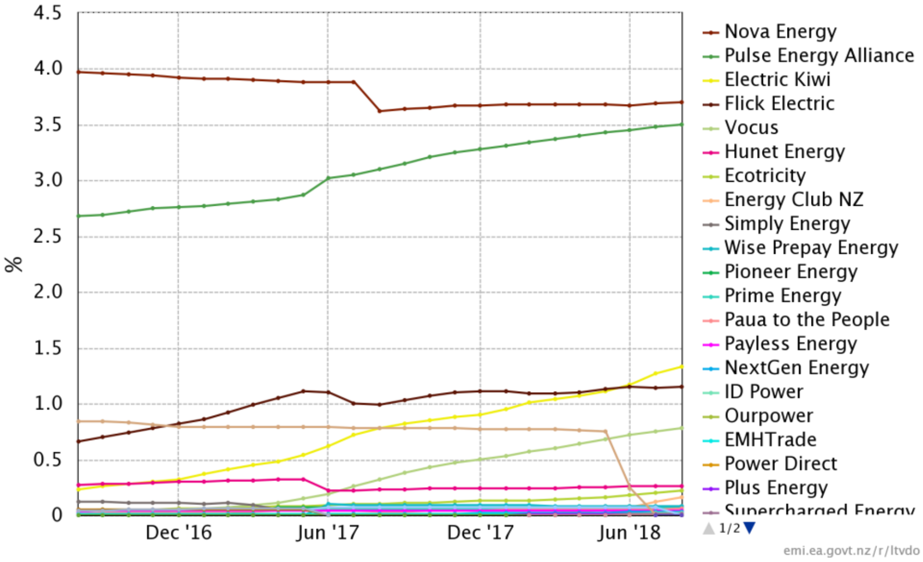
Electricity retail market share trends



[1] https://www.emi.ea.govt.nz/Retail/Reports/R_MST_C?Grouping=T5&Percent=Y&_si=tg|market-structure,v|3

11. Vocus is one of the fastest growing new entrants, but our market share is about 1% after two years of being in the retail market. Electric Kiwi and Pulse have made similar inroads, while other new entrants have flatlined or gone backwards.[2]

Electricity retail market share trends, excluding the 5 large incumbent retailers



12. We shouldn't be beguiled by the large number of retailers now in the market:

- Nearly a quarter have less than 10 customers;
- Over half (22 out of 40) have less than 100 customers; and
- Three-quarters have less than 10,000 customers (29 out of 40 have less than 5,000).

13. This compares poorly against the inroads entrant retailers have made in telecommunications.[3] A comparison of the rate of entrant retailer market penetration in telecommunications versus electricity is a good way of illustrating the challenges the Price Review faces in terms of delivering good outcomes and affordable electricity supply to consumers. Vocus, for example, now has 13% market share in broadband services, more than all entrant retailers in electricity combined.

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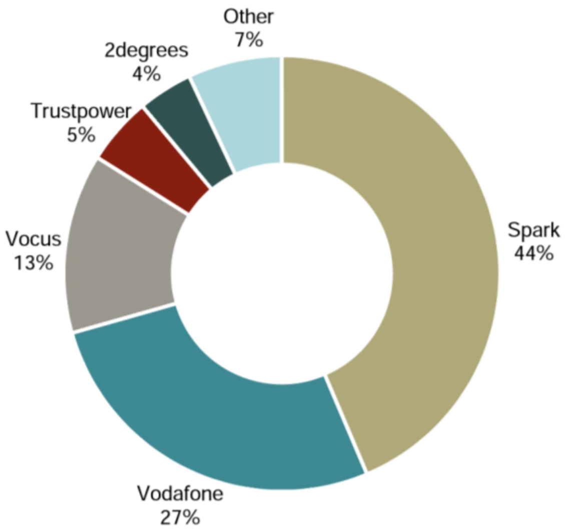
2 https://www.emi.ea.govt.nz/Retail/Reports/R_MST_C?DateFrom=20160901&DateTo=20180831&Percent=Y&seriesFilter=BCPL,TAOM,ECOS,ECOT,ELEN,ELKI,ENEL,EMHT,CLUB,ETRN,FLCK,HNET,IDPL,KEAE,KING,LITE,NEXG,SKOG,TODD,OPHL,ORSL,OURP,GIVE,PLEL,PION,PLUS,ORBS,PRME,CPPL,PUNZ,SIMP,STAK,SUPE,SWCH,WISE,YESP&_si=v|3

3 Commerce Commission, ANNUAL TELECOMMUNICATIONS MONITORING REPORT 2017 Key facts, 20 December 2017, figure 9.

Estimated broadband retailer market share by connections



What would success look like for the Electricity Price Review?

14. On the current trajectory, the five large incumbent electricity retailers will still have 80% market share in a decade's time. The oligopolistic nature of the electricity market remains stubbornly entrenched.

15. The currrent review can do better for New Zealand. Consumers should be able to expect to enjoy the benefits of a healthy-vibrant competitive market.

16. If the review is successful the five large incumbent retailers should lose their oligopoly status and there will be changes to who are the largest retailers. We would expect single digit market shares to be sufficient to be in the 'top 5' if the market is fully competitive. Only three retailers in the broadband market have more than 10% market share.

17. While this would be a good outcome for entrant retailers, it would, more importantly, result in more competitively priced electricity services that are affordable for most New Zealanders. Electricity prices could again be a source of competitive advantage for New Zealand businesses and exporters.

18. We don't think this is too much for New Zealanders to expect.

19. It will require changes some market participants won't like. This is nothing new. ECNZ objected to the creation of Contact Energy and its eventual full break-up. The electricity networks objected to vertical separation. Meridian opposed the physical asset swap in the last round of reforms.

20. The telecommunications industry provides useful precedent for the type of structural reforms that bring about genuine competition. Regulation evolved from financial separation of Telecom's wholesale and retail arms, then a corporate split and, eventually, full ownership separation. Chorus is now responsible for the wholesale business, and Spark (nee Telecom) has the legacy retail customer base. It was this final step to full separation of wholesale and retail which has delivered the biggest competitive benefits to the telecommunications sector.

21. These were all bold reforms that have delivered substantial benefits for consumers. Vocus recommends the Advisory Panel consider a structural split of the incumbent retailers' wholesale (including generation) and retail arms.

Questions 15 & 16: The two-tier retail market and Saves and Win-backs are part of the same problem

22. Vocus agrees with the Advisory Panel that *"A two-tier retail market appears to be developing"* where *"those who actively shop around enjoy the benefits of competition, and those who don't pay higher prices"*.[4] Non-switching customers retained by the incumbent retailers are on inflated legacy price premiums.

23. Powershop, a wholly owned subsidiary of Meridian Energy (a large incumbent retailer), noted *"existing retailers can and do [have different tiers of pricing for sticky and price-sensitive customers], because a negative pricing movement among the whole of a relevant segment of its customer base is significantly more expensive than just making [save offers] available to a few hundred customers"*.[5]

24. Vocus also agrees with the Advisory Panel's observation *"The average gap between the cheapest retailer's price and the incumbent retailer's price has increased"*.[6]

25. We had calculated, based on the Electricity Market Information (EMI) portal that he gap had increased, on average, by $43.09, from $164.38 to $207.47 between 2016 and 2017 alone.[7] We now understand from subsequent Advisory Panel analysis that this substantially understates the gap as depicted in the following table.[8]

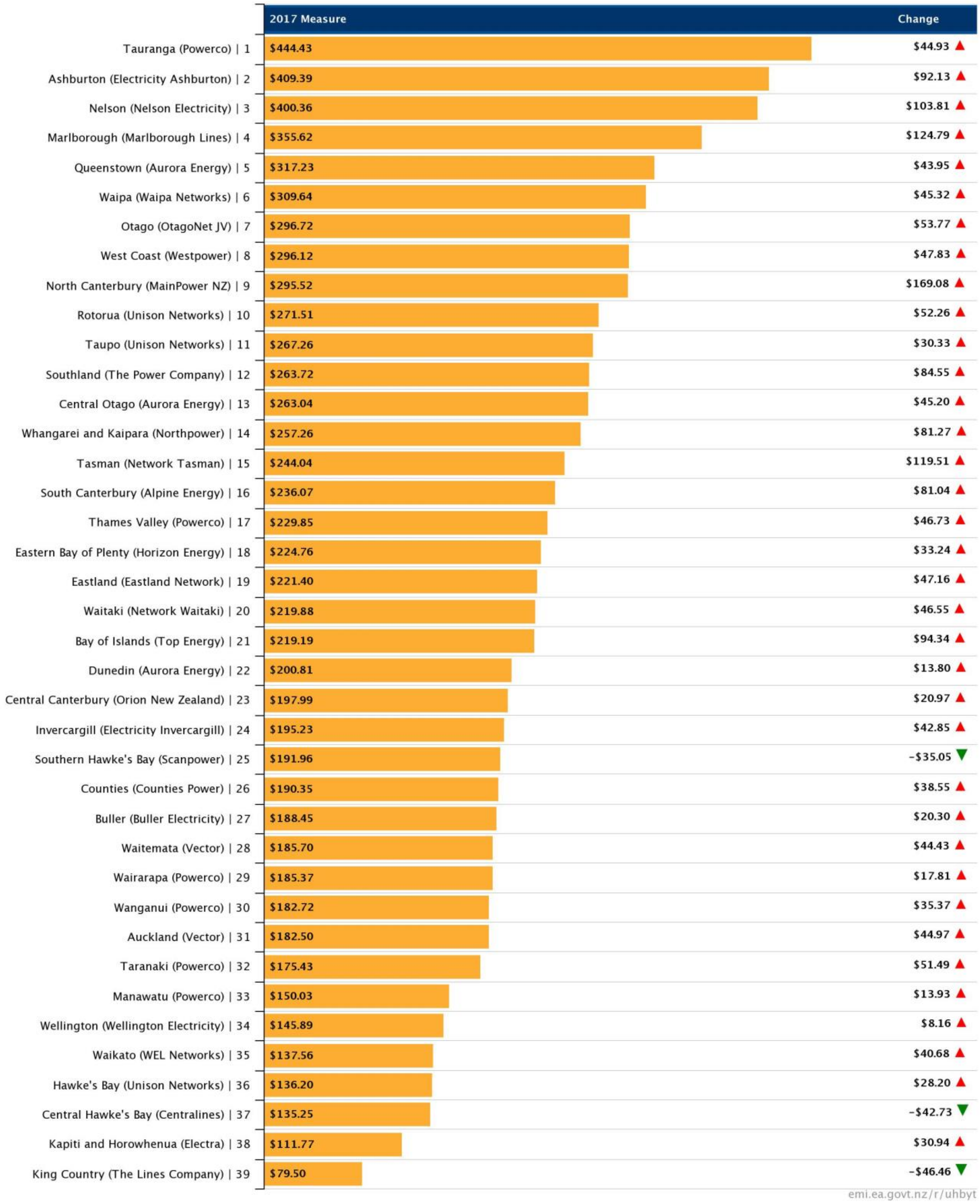
Table 1: Estimated average savings ($/year) available to consumers from switching

Region	Savings based on 'X'th percentile			Electricity Authority estimate
	10th	5th	1st	
New Zealand	240	280	400	
North Island	230	270	380	195
South Island	250	310	440	242

26. Behind those averaged figures there is a wide range of outcomes. Based on the EMI data, the largest increase was in North Canterbury at $169.08, and there were several other areas where the increase was also in excess of $100 or near $100.[9] There were only three regions where the gap between the tiers decreased over this period. It would be useful to replicate these calculations with the more accurate data the Panel now has, and look into why there is so much variation in the price gaps between the tiers.

[4] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 4.
[5] Electricity Authority, Competition effects of saves and win-backs, Decisions and reasons paper (2014), Powershop submission to Authority, Page 31.
[6] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 4.
[7] https://www.emi.ea.govt.nz/Retail/Reports/W4TZQL?RegionType=NZ&_si=v|3 and https://www.emi.ea.govt.nz/Retail/Reports/W4TZQL?RegionType=NZ&DateTo=20161231&_si=v|3
[8] Electricity Price Review, Hikohiko Te Uira, Initial analysis of retail billing data 15 October 2018
[9] https://www.emi.ea.govt.nz/Retail/Reports/W4TZQL?RegionType=NWK_REPORTING_REGION&_si=tg|residential-savings,v|3

Residential savings league table (EMI data)



27. Getting to the bottom of the two-tier market problem, including why the price gap between the tiers is getting worse, should be a key part of the next review steps.

28. The Advisory Panel noted the United Kingdom's Competition & Markets Authority and the Australian ACCC are also concerned about the emergence of a two-tier market and *"found that barriers included difficulties in comparing prices"*.[10] The level of price transparency scores poorly compared to the telecommunications sector, where price is much more of a prominent feature of competitor advertising.

29. Issues with pricing transparency, and lack of consumer awareness of the savings they are missing out on, are undoubtedly part of the problem, but don't explain why the gaps between the two-tiers have grown, or why they have grown by such large amounts in the last year.

30. Vocus doubts it is a coincidence the incumbent retailers stepped up the level of their Saves and Win-backs retention activity over 2016-17 as this was when there were the largest increases in the price gaps between the two-tiers.[11]

31. The prevalence of win-backs isn't just a barrier to new entrants expanding,[12] it is one of the key enablers of the two-tier retail market. Win-backs enable incumbent retailers to discriminate between households that are able to seek out the best deals, and households unable to do so. Win-backs mean the incumbent retailers are able to make selective offers rather than offering lower prices for all consumers. Absent this ability, there wouldn't be a two-tier market.

Early notifications and near-term win-backs enable the large retailers to preserve and increase the gaps between the two-tiers in the retail market

32. The Electricity Authority view was that restricting saves would *"increas[e] the incentive for retailers to **pre-emptively offer their existing customers a better deal**"* [emphasis added].[13] The problem though is that near-term win-backs, within 3 months of the switch, are close substitute for saves. This is why the Electricity Authority initially proposed to ban near-term win-backs as well as saves,

33. Given there is nothing in the Electricity Industry Participation Code which prohibits win-back related withdrawals, prior to the first bill being sent a withdrawal post-switch is just as easy as a withdrawal pre-switch.

34. The original Electricity Authority consultation paper on saves and win-backs summarised the problem well: -

> *"In most sectors, the incumbent supplier does not receive advance notice that a customer intends to change supplier. That information remains confidential to the customer and acquiring supplier until the switch is completed.*
>
> *By contrast, in the retail electricity market, **the incumbent retailer is notified that a customer intends to switch before the process is completed**. The incumbent may use this information to seek to 'save' the customer.*
>
> *The competitiveness of the retail market is driven in large part by acquisition activity*

[10] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 35.
[11] This can be observed from customer withdrawal statistics, available at: https://www.emi.ea.govt.nz/Retail/Reports/1D1AHX?_si=tg|consumer-switching,v|3
[12] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 42.
[13] Electricity Authority, Competition effects of saves and win-backs, Decisions and reasons paper (2014), Para. 3.4

> *and the **threat of acquisition activity**. Saves make acquisition activity less rewarding, because a proportion of customers cancel their switch before it is complete. Further, saves have a **disproportionate effect on the profitability of acquisition activity, because they reduce benefits without reducing campaign costs**. The same issue arises in relation to early win-backs.*
>
> *For small and new entrant retailers, **saves and early win-backs present a barrier to entry and expansion**. The effect on profitability is greater for such retailers as the costs of an acquisition campaign have to be spread across a smaller (or nonexistent) customer base.*
>
> *In some other sectors where retailers receive advance notice of impending customer switch decisions (such as New Zealand telephone landlines), saves are disallowed."*[14] [emphasis added]

35. It is worth noting that in general the losing trader controls the timing for the completion of the switch as they must send the relevant completion file. This gives a losing trader enormous power to subvert the regulated period by simply completing switches faster, only to withdraw them immediately after a successful save. Unsurprisingly, this is exactly what has happened. In most markets, the losing retailer would not receive any notification that a customer had changed service provider.

Question 25 (Part 1): What needs to be done to address the two-tier retail market problem

36. The Advisory Panel will need to resolve win-backs if it wants to resolve the two-tier market problem. We consider the two-tier market problem to be the most significant competition issue which cannot be resolved through structural reform.

37. The Advisory Panel's intention not to examine the matter of win-backs in detail, because the Electricity Authority is investigating the matter, puts the success of the Pricing Review at risk. The Advisory Panel wouldn't be able to provide surety to the Minister that its recommended reforms would address the two-tier retail market problem, if the Electricity Authority hasn't resolve the mater before then.

38. The Electricity Authority does not have any specified end-date for the Saves and Win-backs review, and hasn't commited to continue the review beyond the consultation MDAG has already undertaken. Further, entrant retailers are on record expressing lack of confidence in the MDAG review process which, from the outside, appears to be dysfunctional. The MDAG review process appears to have been subverted by the three incumbent retailers on the group and we note the Chair of the Advisory Group resigned mid-process.

39. Vocus has recommended the Electricity Authority investigate incumbent retailer pricing behaviour, with a focus on determining the size of the spread in pricing between switchers and non-switchers, by each of the incumbent retailers. The end-goal of this investigation should be understanding the extent to which incumbents are keeping non-switching customers on high pricing and using this financial advantage to cross-subsidise retention activities on switchers.

40. This information would be equally useful to the Advisory Panel, to get a better handle on the size of the two-tier retail market problem. The Advisory Panel should be able to leverage off the Electricity Authority's information gathering powers if it can't obtain this information itself.

[14] Proposed Code Amendment – Saves and Early Win-Backs Consultation Paper (24 June 2014), Executive Summary

41. Vocus considers electricity should take a lead from the restrictions in the telecommunications switching rules, which preclude saves and win-back. Vocus is of the view that in order for the two-tier retail market problem to be resolved, the following changes will be required:

    a) Amendment of the switching rules to reflect the Electricity Authority position "*retailers* ***should not withdraw a completed switch unless the original switch request was an error****.*"[15] *[emphasis added]*

    b) Amendment of the switching rules to prohibit information obtained from the switching process from being used for any other purpose than facilitating the switch (consistent with the rules in telecommunications). For the avoidance of doubt, switching information should not be allowed to be shared with the incumbent retailers' customer retention teams.

    c) Amendment of the Saves Protection Scheme to exclude win-backs for the first 45 days after a switch (consistent with the Electricity Authority's original proposals).

Questions 16 & 17: Market power problems and vertical-integration

42. When the Commerce Commission investigated the electricity sector it found *"each of the four largest gentailers - Contact, Genesis, Meridian and Mighty River Power - is likely to have held substantial market power on a recurring basis, particularly during dry years … Each of these companies has the ability and incentive unilaterally to exercise market power and* ***increase wholesale prices during certain periods****. The price increases in dry periods are well above any increases in input costs, including the higher opportunity cost of water when hydro storage is low" [emphasis added].*[16]

43. The subsequent changes in market concentration levels have not been material enough to suggest the substantial market power the Commerce Commission found isn't still an issue.

44. The ACCC's competition law expertise, and information gathering powers, also places it in a strong position to assess issues with market power and vertical-integration in the electricity generation and retail markets.

45. The levels of market concentration and vertical-integration in the Australian and New Zealand electricity generation and retail markets are very similar. Most of the problems the ACCC identified in its electricity affordability report are directly applicable to the New Zealand situation.[17] For example:

[15] Electricity Authority, Competition effects of saves and win-backs, Decisions and reasons paper (2014), Para. 4.2.7 and 4.2.8

[16] Commerce Commission, media release, Commerce Commission finds that electricity companies have not breached the Commerce Act, 21 May 2009: https://comcom.govt.nz/news-and-media/media-releases/archive/commerce-commission-finds-that-electricity-companies-have-not-breached-the-commerce-act

[17] Electric Kiwi has made this point in the context of the two-tier retail market – Saves and Win-backs issue, pointing out that the problem definition in the entrant retailer submissions to the Electricity Authority mirror closely the conclusions reached by the ACCC: https://www.ea.govt.nz/dmsdocument/23831-electric-kiwi-response-to-ea-saves-winbacks

WHAT THE ACCC HAD TO SAY	WHAT VOCUS HAS OBSERVED IN NZ
Issues of market power: The ACCC found high and entrenched levels of concentration in the wholesale market have driven up prices: *"the current wholesale market structure is not conducive to vigorous competition. In an energy-only bidding market, it is particularly important that there is sufficient competition between generators to deliver efficient prices"*.[18]	There is clear evidence generators, particularly Meridian, are using market power to raise spot prices. The Electricity Authority identified some of the more extreme examples of this.[19] The behaviour can also be observed by comparing spot prices, and peaks in spot prices, between 2017, which was a dry-year, and the high prices that have occurred during 2018. This warranties investigation by the Advisory Panel.
Hedge market liquidity: "Some … submissions acknowledged that liquidity and activity in these markets have decreased in recent years."[20] *"ERM Power suggested that increasingly illiquid contract markets have likely contributed to increased retail prices, and that improving contract market liquidity will be crucial in reducing retail prices."*[21]	We agree with the Advisory Panel *"Some aspects of the contract market's performance have faltered recently"*[22] and *"events during the winter of 2017 highlight the fragility of current arrangements"*.[23] It would be useful for the Advisory Panel to obtain an update from the Electricity Authority on bid-ask spreads. The Electricity Authority has provided this for 2017 but hasn't provided an update for 2018.[24]
"By market share, the vast majority of NEM retailers manage risk primarily through vertical integration. The big three … all own substantial generation assets …"[25]	Meridian is using its market power in the wholesale market as a tool for managing its retail price risk. This has been confirmed by the Electricity Authority's investigation into Meridian's spot market bidding practices.[26] Meridian has also been upfront *"Spot market volatility in the market is managed through vertical integration"*.[27] The gentailers also prefer to 'balance their books' by geographically matching their generation assets and retail customer bases rather than through hedging and contractual arrangements.[28]

[18] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, page 88.
[19] Electricity Authority, Market performance review: High Prices on 2 June 2016, 18 December 2017.
[20] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, page 107.
[21] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, page 107.
[22] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 44.
[23] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 45.
[24] Electricity Authority, final report, 2017 Winter review, 22 March 2018, figures 14 and 15.
[25] ACCC, Restoring electricity affordability and Australia's competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, page 110.
[26] Electricity Authority, Market performance review: High Prices on 2 June 2016, 18 December 2017.
[27] Meridian, INTEGRATED REPORT FOR THE YEAR ENDED 30 JUNE 2017, It's our future, page 29.
[28] The preference to use vertical-integration rather than hedging tools has been clear from the time ECNZ was split up. When Genesis, Mercury and Meridian were initially established as SOEs – some of the customer bases they ended up didn't match their generation portfolios, and a period of customer rebalancing occured. It happened again when the physical and virtual asset swaps were introduced which, again, resulted in mismatch between generation portfolios and retail customer bases.

WHAT THE ACCC HAD TO SAY	WHAT VOCUS HAS OBSERVED IN NZ
Vertical integration: *“As part of the Inquiry, the ACCC met with a wide range of small and medium sized retailers to discuss their experiences in the hedging market. A number of these retailers noted that they have trouble hedging. Hedging was identified as a significant differentiator between the relative competitiveness of retailers. Some stakeholders suggested that large, vertically integrated businesses are more able to hedge their wholesale risk effectively, and are able to do so at a lower price”.*[29] *“The impact of vertical integration on contracting markets is complex but, generally, vertical integration results in an overall decrease in contract market activity by that business. The degree of vertical integration in the NEM may also be limiting the ability of standalone retailers to aggressively win customers as any significant expansion of retail market share will require securing wholesale supply from a competitor.”*[30]	The incumbent retailers have incentives and ability to favour their own in-house retail businesses, and to discriminate against stand-alone retailers, in the provision of hedge contracting arrangements. These types of wholesale-generation vertical-integration issues haven’t received the level of attention that they have had in telecommunications, or in relation to electricity distribution vertical-integration. It would be useful for the Advisory Panel to review of pricing of fixed-price variable-volume (FPFV) contracts against ASX future prices to help establish the extent to which vertically-integrated retailers are able to make offers below commercial market rates which would otherwise be available. This is information which the Electricity Authority can readily supply to the Panel.

46. We note Entrust has laid a complaint to the Commerce Commission regarding potential collusion between Meridian and Contact, Genesis and Mercury in respect of Tiwai Aluminium Smelter.[31] What this seems to represent is a variation on the classic monopoly problem of profit maximising by limiting supply. The incumbent generators are financially rewarded when market conditions are tight; particularly Meridian given its retail customer base is substantially smaller than its generation portfolio.

47. Vocus is also concerned the arrangements are at prices well below those available in the market, and that the result of the arrangements is a tightening of market conditions, resulting in greater market power problems and higher (less affordable) spot prices. A comparison of the Tiwai price (circa $55) compared to the price retailers pay for hedging in the same region (circa $70) suggests independent retailers pay more than the true wholesale cost.

48. It is also worth noting that one of the reasons Meridian was left so much larger (more market power) than Genesis and Mercury, when ECNZ was broken up, was the Tiwai Smelter contract. Now that Contact, Genesis, Mercury and Meridian have entered into joint arrangements for supply of Tiwai, this justification would seem to no longer hold.

49. While the matter of potential breach of Part 2 of the Commerce Act may be outside of the scope of the Advisory Panel review, impacts on wholesale market conditions and affordability are not.

Meridian neglected its northern most customers when it was first established, and then put a concerted effort into gaining North Island customers after the asset swap with Genesis. Genesis pre-empted the asset swap by making a decision to enter the South Island retail market in Dunedin and planned to expand into Queenstown and Christchurch – based on the premise of the asset swap taking place. The physical and virtual asset swaps were effective at providing the incumbent operators with access to electricity at fixed prices in regions where they had little or no generation capacity.

[29] ACCC, Restoring electricity affordability and Australia’s competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, page 107.

[30] ACCC, Restoring electricity affordability and Australia’s competitive advantage, Retail Electricity Pricing Inquiry—Final Report, June 2018, page 128.

[31] https://www.entrustnz.co.nz/news/media-releases/entrust-calls-on-commerce-commission-to-investigate-potential-restrictive-trade-practices-and-collusion-by-electricity-generators/

Question 25 (Part 2): What needs to be done to address the market concentration and vertical-integration problems

50. Vocus agrees with the Advisory Panel *"improving the depth and resilience of the contract market should be given high priority"*.[32]

51. While Vocus also agrees *"An effective contract market is critical to mitigating the potential adverse effects of vertical integration and short-term generator market power"*[33] the best solutions to structural problems are structural rather than behavioural regulation.

52. The only assured way the Advisory Panel can guarantee its Price Review recommendations will deal with the interrelated issues of market concentration, vertical-integration, and contract market liquidity is through structural reform. The ACCC, for example, recommended break-up of Queensland generation assets, and prohibition on acquisitions and other arrangements to limit market shares to 20%.

53. Absent any structural reforms, the Advisory Panel is limited to second best options aimed at curbing the ability of market participants with market power to mis-use that market power, including rules relating to bidding behaviour (alternative wholesale market designs include generators having to bid in at cost of production such as being operated by PJM in Pennsylvania) and market conduct, arm's-length rules and financial separation of retail and generation, and hedge contract (market making) obligations.

54. Vocus recommends the Advisory Panel consider the following reform options:

    a) Full vertical separation is the 'gold standard' for regulation of retail and wholesale (including generation) services.

    b) If full vertical separation isn't adopted, then corporate separation with arm's length rules and financial disclosure requirements should be adopted.

    c) Horizontal separation of generation assets – the ACCC recommended break-up of the Queensland Government's generation assets, and prohibition on acquisitions and other arrangements to limit market shares to 20%.

    d) Market making obligations *"whereby generators must offer to buy and sell a certain amount of electricity contracts each day"* (ACCC recommendation).

Question 30: Low Fixed Charge Regulations

55. Vocus sees little or no merit in the Low Fixed Charge Regulations. The Regulations should be revoked. The Advisory Panel Retail Billing Analysis provides solid evidence the Low Fixed Charge Regulations should be revoked.

56. One of the anomalies of the regulatory settings for electricity and telecommunications is that a cap on residential fixed charges was introduced for electricity, but 100% fixed charges is required for residential telephony. In regions where water isn't metered there has also been hostility to the introduction of volumetric charges despite the clear benefits of water conservation. It would seem unlikely fixed charges are bad in one network sector, but desirable others.

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[32] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 45.
[33] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 45.

57. It appears that because increases in fixed charges and residential electricity bills happened at the same time, the two were conflated in consumer minds. If part of the tariff rebalancing that resulted in higher prices for residential consumers is unwound, as the Advisory Panel proposes, this would compensate consumers who may be disadvantaged by removal of the Low Fixed Charge Regulations. The Figure 30 graphic in the First Report highlights many consumers on low fixed charge tariffs may actually be better off if the Regulations were revoked, regardless.

58. Vocus doesn't consider the Low Fixed Charge Regulations rate well on any criteria, be it efficiency, equity and fairness, or affordability.

59. The Low Fixed Charge Regulations impose additional compliance costs on electricity retailers, and can constrain or make it more difficult to introduce, new, more innovative tariffs. For example, where a retailer offers 'free electricity', it makes compliance with Regulation 9(2) difficult, and dependent on the retailer's assumptions about what amount of electricity is consumed during the "free" period. Electricity distributors have raised similar concerns, including that the low fixed charges are an impediment to reforms such as introduction of peak-usage pricing the Advisory Panel and Electricity Authority are both advocating.

60. Concerns were raised about how well the regulations would target those most in need when they were first introduced. Aged Concern was worried *"some of the most vulnerable older people are not actually low power users" and "spend a considerable amount of time at home and require a large amount of heating"*.[34]

61. The Ministry of Consumer Affairs was similarly concerned about *"large consumers of electricity who are not rich, such as large families on low incomes, people with homes that are difficult (and costly) to heat, and low-income earners"*. The latter group included *"beneficiaries who may spend more time at home, Maori and Pacific Island people"*:[35]

> … it is sometimes argued that high fixed charges are inequitable in that they favour rich consumers who use relatively large amounts of electricity. However, there are other large consumers of electricity who are not rich, such as large families on low incomes, people with homes that are difficult (and costly) to heat, and low income earners (e.g. beneficiaries who may spend more time at home, Maori and Pacific Island people).
>
> Under a variable charging regime (with low or no fixed charges), large consumers would pay a larger proportion of the fixed costs of the electricity network, in effect subsidising small consumers of electricity. Conversely, it is sometimes argued that low fixed charges favour pensioners and other disadvantaged groups. But, there is only weak evidence that these are low-rate users of energy and, in any event, not all consumers of small amounts are in this category. Examples of small consumers who may be favored if a high proportion of the electricity charge is variable include batch/holiday homeowners (who are likely to be on high incomes).

62. While the regulations technically exclude holiday homes, the reality is that it has not been practical to differentiate between holiday homes and people's main place of residence. From time to time we have discovered customers will signup holiday homes with a different retailer to that of their main place of residence to avoid detection and benefit from low fixed charges on multiple properties. This is likely to be widespread but difficult to monitor given the lack of retailer visibility over properties held by other retailers.

The Low Fixed Charge Regulations are becoming increasingly outdated

63. The issues with the Low Fixed Charge Regulations are getting worse.

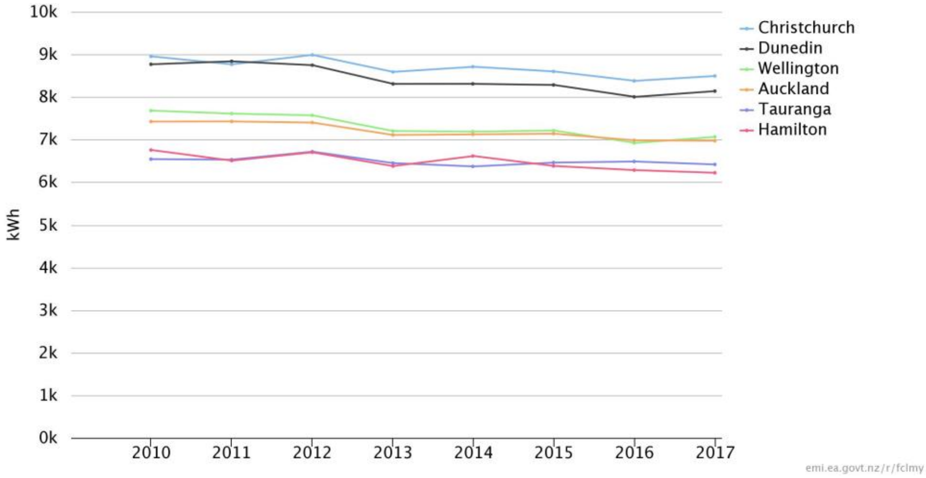
[34] Power changes may not help the needy, by Jo McKenzie-Mclean, The Press, 19 July 2007.
[35] Submission to the Ministerial Inquiry into the Electricity Industry, March 2000.

64. The level of the fixed charge cap has declined in real terms. 30 cents in today's dollars is worth the equivalent of 23 cents when the Low Fixed Charge Regulations were introduced in 2004.[36] The fixed charge needed to increase to 40 cents to keep up with inflation.

65. Changes in residential consumer demand for electricity is also making the regulations outdated. The "average consumer" thresholds in the Low Fixed Charge Regulations have never been in sync with actual consumption, and the gap between the thresholds and actual demand is getting worse.

66. The gap between the "average consumer" threshold of 8,000 kWh, in areas outside the Lower South Region, and actual average consumption is getting wider and wider. Average residential consumption in Auckland is now below 7,000 kWH, and 6,222 in Hamilton.[37]

Trend in the average residential consumption by main centre



67. It was probably a mistake to introduce a higher, 9,000 kWh, threshold for the Lower South Region in 2009. If any change was made to the thresholds it should have been to introduce a lower threshold for warmer/lower demand areas, which was proposed at the time, but not a higher threshold for colder/higher demand regions.

68. Residential demand in the Lower South Region is tracking closer to the original 8,000kWh threshold than 9,000kWh. Average electricity consumption by residential consumers in Dunedin was 8,004kWh in 2016 and 8,140 kWh in 2017.[38]

69. The comparison between the "average consumer" in the Low Fixed Charge Regulations and actual residential consumption is even more stark when the comparison is made with median demand rather than average demand. The relativity between "average consumer" and median

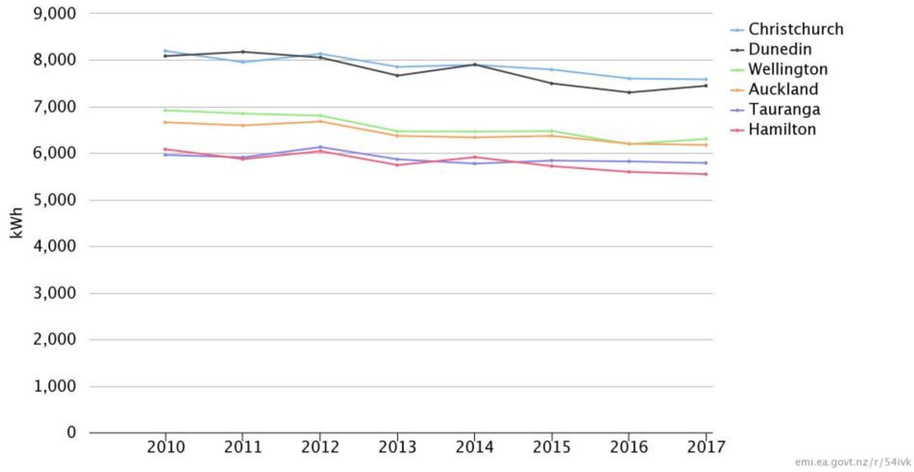
[36] Electricity Price Review, Hikohiko Te Uira, First report for discussion, 30 August 2018, page 35.

[37] https://www.emi.ea.govt.nz/Retail/Reports/0YUCE0?DateFrom=20100101&DateTo=20171231&RegionType=MAIN_CENTRE&Show=Avg&Timescale=Y&seriesFilter=&_si=tg|consumption,v|3

[38] https://www.emi.ea.govt.nz/Retail/Reports/0YUCE0?DateFrom=20100101&DateTo=20171231&RegionType=MAIN_CENTRE&Show=Avg&Timescale=Y&seriesFilter=&_si=tg|consumption,v|3

demand determines the numbers of consumers that benefit from being on the low fixed charge tariffs.[39]

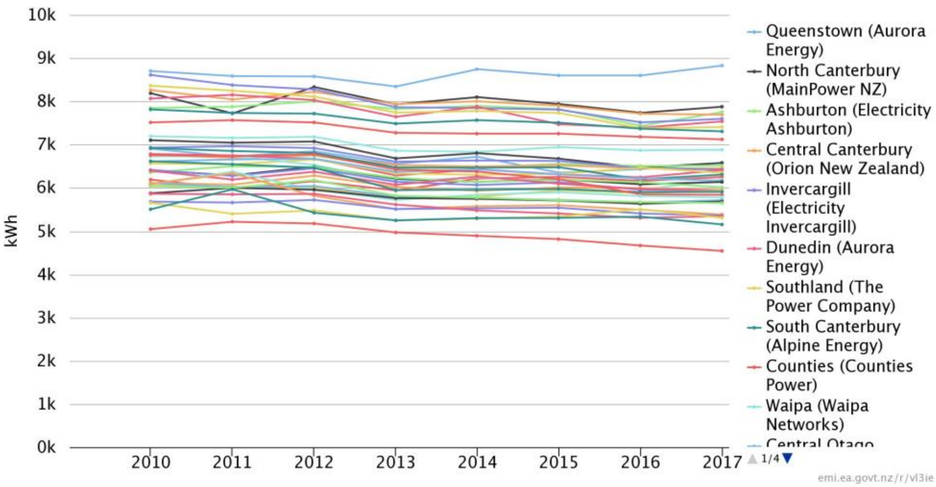
Trend in the median residential consumption by main centre



70. In 2010, there were only 6 network reporting regions, out of 39, where median demand was higher than 8,000 kWh, with none above 9,000 kWh.[40] These were limited to (from highest to lowest): Queenstown (Aurora), Invercargill (Electricity Invercargill), Southland (The Power Company), Central Canterbury (Orion), North Canterbury (Mainpower) and Dunedin (Aurora).

71. Now the only network reporting area with median consumption above 8,000 kWh is Queenstown (Aurora) at 8,830kWh.

Trend in the median residential consumption by network reporting region



39
https://www.emi.ea.govt.nz/Retail/Reports/0YUCE0?DateFrom=20100101&DateTo=20171231&RegionType=MAIN_CENTRE&Show=P50&Timescale=Y&_si=tg%7Cconsumption,v%7C3

40
https://www.emi.ea.govt.nz/Retail/Reports/0YUCE0?DateFrom=20100101&DateTo=20171231&RegionType=NWK_REPORTING_REGION&Show=P50&Timescale=Y&_si=tg|consumption,v|3

72. What this means is Queenstown is now the only area where consumers that should be on a low fixed charge tariff are in the minority (less than 50%). The "average consumer" threshold is now higher than the majority of residential consumers' consumption levels in all other parts of the country.

73. Buller is completely out of kilter with the thresholds in the Low Fixed Charges Regulation with median demand of 4,452 kWh, and 75th quartile demand at 6,571kWh. There would only be between 5 and 25% of residential consumers in Buller (closer to 5 than 25%) that would be better off on the standard tariff.[41]

74. The effect of the Low Fixed Charge Regulations in Buller is little different to imposing a requirement all consumers be placed on the low fixed charge tariff. In this type of situation there are very few higher use consumers to subsidise the low fixed charge rate. This would likely have the effect of raising the variable charges for low-users, relative to arrangements where there is a more even split of low and standard-use consumers. Drawing on observation made by the Advisory Panel: "In theory, if a network only served [low-use] consumers, transfers would be entirely between those consumers".[42] This example, in the extreme, is indicative of the distortions the Low Fixed Charge regulation produces across the market.

75. The issues the Advisory Panel has raised about current distribution pricing and solar are magnified by the low fixed charge tariff option. The Low Fixed Charge Regulations can result in bigger subsidies to consumers that can afford to invest in solar PV and batteries, and higher prices for consumers that can't afford solar. This situation will get worse as solar PV and batteries become economic for households. We do not consider this to be efficient, or fair and equitable.

Question 35: What needs to be done to address the Low Fixed Charge Regulations

76. Vocus' preference is for the Low Fixed Charge Regulations to be removed.

77. There may be merit in considering a transition phase to avoid price shocks during which the level of the low fixed charges are raised, and no new customers are entitled to the low fixed charge tariff option. The merit of a transition phase depends on a number of variables, including the impact of the next network price reset (reductions in interest rates could lower network charges) and if distribution businesses rebalance their tariffs in favour of residential consumers.

List of recommendations

78. We recommend the Advisory Panel consider the following reform options, including structural remedies where the underlying problems are structural:

    a) Amendment of the switching rules to reflect the Electricity Authority position "*retailers **should not withdraw a completed switch unless the original switch request was an error**.*"[43] *[emphasis added]*

    b) Amendment of the switching rules to prohibit information obtained from the switching process from being used for any other purpose than facilitating the switch (consistent with the rules in

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41 https://www.emi.ea.govt.nz/Retail/Download/DataReport/CSV/0YUCE0?DateFrom=20170101&DateTo=20171231&RegionType=NWK_REPORTING_REGION&Show=P50&Timescale=Y&_si=tg|consumption,v|4,_dr_DateFrom|20170101,_dr_DateTo|20171231,_dr_RegionType|NWK_REPORTING_REGION,_dr_Show|P50,_dr_Timescale|Y

42 Electricity Price Review, Hikohiko Te Uira, Initial analysis of retail billing data 15 October 2018

43 Electricity Authority, Competition effects of saves and win-backs, Decisions and reasons paper (2014), Para. 4.2.7 and 4.2.8

telecommunications). For the avoidance of doubt, switching information should not be allowed to be shared with the incumbent retailers' customer retention teams.

c) Amendment of the Saves Protection Scheme to exclude win-backs for the first 45 days after a switch (consistent with the Electricity Authority's original proposals).

d) New market and price monitoring provisions which *"includes the ability to observe retailer costs and gather information on the offers consumers are on, and what they are actually paying"* (ACCC recommendation).

e) Full vertical separation is the 'gold standard' for regulation of retail and wholesale (including generation) services.

f) If full vertical separation isn't adopted, then corporate separation with arm's length rules and financial disclosure requirements should be adopted.

g) Horizontal separation of generation assets – the ACCC recommended break-up of the Queensland Government's generation assets, and prohibition on acquisitions and other arrangements to limit market shares to 20%.

h) Market making obligations "whereby generators must offer to buy and sell a certain amount of electricity contracts each day" (ACCC recommendation).

i) The Low Fixed Charge Regulations should be removed, with consideration given to phase to avoid price shocks.

Concluding remarks

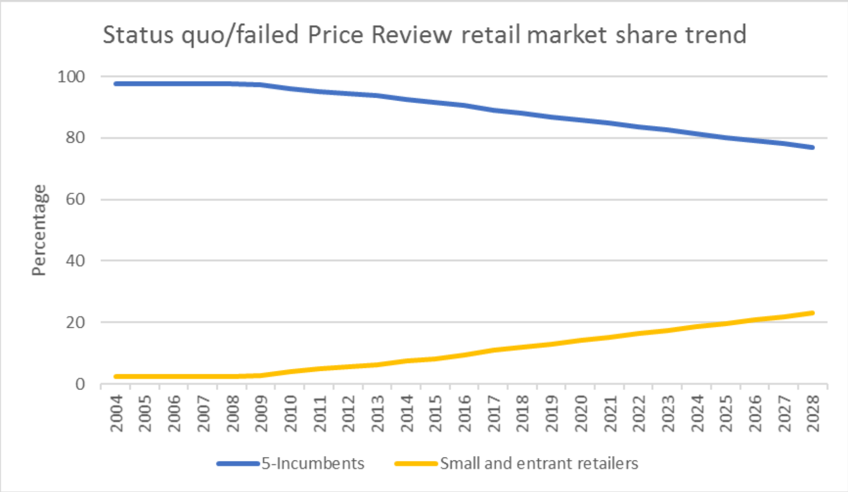
79. The competitive landscape in the electricity sector has improved following the last round of reforms.

80. Stakeholders wanting to defend the status quo tend to point to the number of retailers that have entered the market, and improvements in market concentration statistics.

81. The reality is that while there has been some improvement it has been very slow. There are a lot of retailers in the market, but the reality is that the market remains oligopolistic, and the gains in market share by entrant retailers remains low compared to other network industries.

82. What we would not like to see is need for another review in another nine- or ten-years' time, because the market is still oligopolistic and the five largest incumbent retailers market share has only decreased to 80%. This is where the sector is heading if the Price Review fails to improve competition.[44]

[44] https://www.emi.ea.govt.nz/Retail/Reports/R_MSS_C?_si=tg|market-structure,v|3



83. There is a lot more that could be done to make the electricity sector truly competitive, and to better ensure consumers are provided efficient and affordable services.

84. If the Advisory Panel review is successful it will be able to deliver substantial tangible benefits to consumers. The types of measures we will be looking at are whether the size of the gap between the two-tiers in the retail market halts its increases, and starts to decline, and whether there is an improvement in the rate of change in market concentration measures, such as HHI and the market share of the 3 largest (and 5 largest) retailers. We think it would be useful if the Advisory Panel set out projections of the outcomes from its proposals, in the next consultation. This will help make sure stakeholders can get an understanding of the benefits the Advisory Panel expects from its reform proposals.

Regards,

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