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Electricity Review Panel
C/- Ministry of Business, Innovations and Employment,
Wellington

By email to energymarkets@mbie.govt.nz

Unison Submission on the Electricity Price Review First Report

Introduction

1. This submission addresses key points that Unison wants to make in response to the Electricity Price Review Panel's First Report ("First Report"). We do not seek to cover every item raised in the First Report, but focus on areas where we think the electricity market is working well and where further work is required. We appreciate that there is likely to be a substantial volume of submissions, so have sought to be succinct. We are happy to discuss our views in more detail, if useful.

Unison's Key Points

2. Our key points are as follows:

   a. New technologies are reshaping electricity markets and their development around the world. We think it is timely to review the performance of New Zealand's electricity market, to ensure that regulatory and policy settings are right. We also think it is important to recognise the problems being experienced in other markets where well-intentioned policy interventions have caused major long-term challenges. For example, the use of subsidies to promote renewable investments, which is now leading to concerns about reliability and affordability for those not benefiting from the subsidies. Political remedies to these issues do not appear to be working and are eroding confidence in those markets. Prices have increased substantially in Australia as a consequence of poor policy and regulatory design, for example.

   b. New Zealand is well-placed to meet the decarbonisation challenge facing the broader economy. It is widely expected that new generation to meet greater electrification of the economy will be met with renewables that have similar costs as existing generation. Distribution prices are not expected to increase significantly from current levels, with the important caveat that network pricing reform needs to proceed to ensure that costs are fairly and efficiently recovered from consumers. Network investment requirements are lifting as old assets are replaced, so there needs to be realism that there will continue to be pressure on network prices. New technologies will help to ameliorate some of this pressure, particularly if there is regulatory and policy support to migrate customers in more remote areas from conventional grid solutions to alternative technologies. Distributors have local presence and are best placed to undertake the necessary coordination of energy requirements across multiple customers than retailers or third parties in such areas.

   c. We do not think it is appropriate to compare prices today with those in 1990. Residential prices were heavily subsidised by commercial users, ratepayers and/or taxpayers. In our view, more relevant comparisons should be made against other countries or from 1999 onwards, than prices pre-corporatisation and commercialisation of the sector.

   d. In our view, the New Zealand electricity market is well-designed, well-regulated and delivering good outcomes for consumers in aggregate with prices benchmarking well against international comparators. This is despite geographic isolation and a relatively challenging environment within which electricity is produced and delivered (low density, difficult terrain). Policy-makers, regulators and energy companies from other jurisdictions regularly visit New Zealand to research our implementation of what is known as the "standard market design" for electricity markets:

i. Contestable generation and retail;
ii. Regulated network infrastructure;
iii. Independent regulators charged with looking after the long-term benefit of consumers.

e. Notwithstanding the core planks in place, there is of course always room for improvement. No market is ever static. We think that there are four important areas where industry, policy and regulatory focus can deliver better outcomes for consumers over the longer term:

   i. Network pricing reform will help to protect consumers who do not have access to new technologies. NZIER has estimated that power prices will increase by 10% over ten years if network pricing reform does not effectively reward consumers for how they use the network[1]. Network pricing reform needs to be supported by:

      - substantial reform of the "Low Fixed Charge Regulations", if not their removal;

      - retailers developing their systems to enable distributors to bill their new pricing approaches, including ensuring timely smart meter roll-outs and provision of data for billing; and

      - carefully designed transition plans to allow consumers to prepare for and respond to new pricing approaches.

   ii. A supportive regulatory environment to allow for effective integration of new technologies into the electricity market. New technologies, particularly battery storage, are still very expensive compared to conventional solutions. Their most immediate use is where network replacement or reinforcement is most expensive, such as in remote rural areas. We think that Part 4, sub-Part 3 of the Electricity Industry Act 2010 needs to be reviewed to ensure that consumers cannot unduly hold-up use of alternative technologies where these are more cost-effective.

   We understand that third-parties want to provide alternatives to network solutions and therefore network businesses will need to have commercial and technical platforms in place to enable those solutions to effectively substitute/complement for traditional investments. The 2020 DPP reset provides an opportunity for stakeholders to engage with the Commerce Commission on how those platforms might develop and associated funding requirements. There needs to be good coordination between the Electricity Authority and Commerce Commission on these matters.

   iii. There should be ongoing focus by the Electricity Authority in monitoring and improving the performance of the wholesale and hedge markets for electricity. It is critical that there is confidence in these markets to ensure that new entrant retailers can provide discipline on the major retailers.

   iv. Developing a clear framework for addressing energy hardship concerns. This is a complex area. Energy hardship does not stand-alone from other challenges facing households on low incomes. Industry has some role to play, as does Government. A process should be

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1 NZIER (2015) *Effects of distribution charges on household investment in solar* Report to the Electricity Authority (https://www.ea.govt.nz/dmsdocument/20059-nzier-effects-of-distribution-charges-on-household-investment-in-solar)

established to define the problem more tightly and to identify appropriate solutions. We comment on this area further in the next section.

Looking after consumers in energy hardship

3. The Panel's major focus appears to be on affordability and those in energy hardship, though the terms are not inter-changeable. We accept that energy hardship is a real issue for some New Zealanders. But we also think that concerns about electricity affordability and hardship should not simply be equated with an electricity supply chain that is "broken" or in need of radical reform. The Panel has identified that there is no evidence of excessive profits in aggregate or in any elements of the supply chain and average prices compare favourably with OECD countries. Therefore, interventions that seek to arbitrarily reduce prices or that have not been well-conceived, might have short-term benefits, but cause significant long-term costs that are ultimately borne by consumers.

4. The long-term interest of consumers is served well where the regulators and competition authority ensure that contestable parts of the electricity market are competitive and efficient and, for network businesses, that economic regulation is effective in promoting efficient investment and ensuring profits are reasonable. As we discuss later in this submission, we think that Part 4 Regulation is working well and has the necessary flexibility to address emerging challenges.

5. For those consumers who face energy hardship, we think it is important that the Panel and Government look at their issues holistically. Those in hardship are very likely to face challenges across a range of essential goods and services, including housing affordability (rents are high), housing quality (cold, damp, poorly insulated, with inefficient heating), transport costs etc. We agree with the Panel's findings on the factors causing hardship,[2] but think a wider view is required, including how socio-demographic factors impact on people's energy choices or their ability to engage with the market. We support the ENA's submission that an Energy Ambassador position should be explored and that better information and resources be made available to help consumers.

6. Social welfare interventions and targeted initiatives to improve housing and rental stocks are likely to have a far bigger impact on these consumers than conceivable reductions in electricity prices. Even if electricity prices could drop by 10%, say, this would only put around $250 a year in the pockets of such consumers, but better insulation and more efficient heating would have far more substantial impacts on electricity bills, as well as improving quality of life and health outcomes. The Panel and Government's recommendations and responses need to take a wide view on the solution set to address affordability concerns.

7. We recommend that the Panel recommend to the Government that it should:

   i. review the winter energy payment, which is not effectively targeted at those in energy hardship;

   ii. work with electricity retailers to review arrangements around vulnerable consumers to assess whether additional mechanisms can be put in place to reduce disconnections caused by inability to pay. This could involve better information sharing and coordination with welfare agencies;

   iii. Ensure a whole-of-Government approach to assisting low income households manage energy hardship.

   iv. Consider funding for an Energy Ambassador role and increased measures to inform and advise consumers to make good energy choices.

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[2] First Report, page 29.

Retail market

8. We are not experts in the retail (or wholesale/hedge), markets so have no comment on the actual performance of those markets. Nevertheless, we do observe that the Electricity Authority is a specialist regulator in these areas and has invested significantly in developing and improving those markets. Interventions in the wholesale and hedge markets to improve risk management for new entrant retailers and other purchasers are likely to be complex and potentially carry risks of un-intended consequences. We support the Authority continuing to take the lead role in continuing to monitor performance of those markets and to take steps, if necessary, to make further improvements. It is critical that there is confidence in these markets to provide reliable, cost effective risk management tools for new entrant retailers and other large purchasers.

9. Although the Panel has identified that there is a two-tier retail market, further analysis is required to better understand the factors behind it. What is stopping consumers from switching and are there any common characteristics of the consumers who have not switched?

10. We note that the Electricity Authority has ensured that the process of switching is relatively quick and easy, and that new entrant retailers can enter relatively quickly as demonstrated by the growing number of retailers who have been able to establish themselves in the New Zealand market. Highly visible campaigns have been used to promote the ease of switching and the value that consumers can achieve from switching.

11. The fact that some consumers are unaware of, or chose not to switch, needs further investigation. On the face of it, the level of prompt payment discounts seems excessive compared to credit risks. But we also recognise that interventions to force retailers to compete in a different way or set prices differently could have un-intended consequences or stifle innovative pricing approaches that consumers may prefer. We favour the Authority continuing to examine competition in the retail market and for it to determine appropriate solutions.

Networks

12. The Panel has assessed profitability performance and factors impacting on distributor efficiency, including the impact of scale on efficiency and capability to manage the changing electricity market environment in light of new technologies.

Part 4 Regulation

13. By way of background, we note that Part 4 of the Commerce Act was reformed in 2008, with the introduction of Input Methodologies and Default Price-Quality and Customised Price Path regulation. This followed a long period of unsettled regulation, where rules could be changed quickly, with few accountability mechanisms. We recommend that the Panel does not lose sight of the factors that had caused significant problems in the economic regulation of network businesses under the previous Part 4A regime and the high value of regulatory certainty, stability and predictable regulatory processes.

14. The Commerce Commission and industry have invested heavily in developing a detailed set of Input Methodologies and are about to embark on the third regulatory reset for EDBs. Rigorous, open consultation processes have been followed to arrive at the Input Methodologies, which have also been tested and validated in the Courts. As the Commerce Commission stated in its note to the Panel, a consequence of the more stable regulatory environment is that Ratings Agencies now rate regulatory risk as low, which ultimately flows through into lower costs of borrowing for regulated EDBs.

15. In our view, there should be a high threshold for change to Part 4: it provides a balance of predictability and stability in regulatory settings, with flexibility to make changes (through appropriate processes) in light of changing market circumstances and experience with the rules.

16. We think the Part 4 regime is effective in regulating the non-exempt EDBs. It is appropriately tailored to the number and scale of EDBs, and avoids the heavy regulatory costs incurred in other jurisdictions, whilst delivering similar outcomes in limiting profits, but providing incentives to improve efficiency and meet standards for reliability. We note that the 2015 DPP reset was the first five-year regulatory period. The 2020 reset provides an opportunity to learn from experience. The Commission has the opportunity to strengthen existing incentives and introduce new incentive mechanisms, building on extensive overseas experience.

17. We note the Electricity Authority's recommendations (reproduced in Appendix A) to the Panel on changing Part 4 to achieve more collaboration or to force network businesses to outsource more of their procurement. These matters have been addressed by the Commerce Commission within its existing framework and further changes can be made, if required. The Commission has already made changes to Information Disclosure rules on cost allocation and related party transactions to strengthen transparency, which are due to impact on disclosed information in the coming financial year. In that light, the Authority's recommendations should not be given weight.

18. The Commerce Commission has stated (para 78 of its note to the Panel) that it thinks the prohibition on use of benchmarking to set prices could be removed. We are strongly opposed to removal of the benchmarking prohibition. Benchmarking is a good idea in theory, but in practice, unless it is comparing production efficiency of a homogenous good (e.g., "steel of a certain quality"), the benchmarking methodologies are unable to apply accurately to network services. There are always factors of production which cannot be measured, which end up being confused with "inefficiency". Businesses subject more to those unmeasured factors that are beyond their control end up being penalised.[3] The Commission states it would use benchmarking "cautiously". But using results of benchmarking studies that are little more than lotteries in a "cautious" manner does not solve the underlying problem that the benchmarking methodologies cannot be robustly applied to network services.

19. One area we think the Commission could improve incentives is in the area of rewards for mergers and acquisitions. A short window of five years exists for EDBs to capture the benefits of amalgamation, but this window is too short to offset the risks and costs involved in bringing companies together. In our view, the Commission needs to revisit this aspect of its incentive schemes.

Network pricing reform

20. We agree with the Panel that network pricing reform is an important enabler of protecting affordability for those in energy hardship over the longer term. Pricing reform will better ensure that technology "haves" are not implicitly subsidised by the "have-nots." Price reform is, however, not simple and if poorly executed or without appropriate transitions could be unduly disruptive to customers.

21. The ENA is leading significant analysis to identify new pricing options, measure their impacts on consumers (including analysis of impacts on deprivation deciles) and to help with design and implementation issues. While reform needs to be timely, before material numbers of consumers make significant investment decisions (e.g., in batteries), it also needs to be well-communicated and explained to consumers. We think there is a significant downside risk to moving too quickly than taking a transition approach, but agree with the ENA's submission that from 1 April 2020, there is merit in widespread availability of new pricing options. Full implementation is likely to be staged over time, particularly because retailers are still rolling out smart meters.

[3] For example, Unison faces additional costs in providing its network services in Rotorua due to the corrosive geo-thermal environment. Benchmarking studies cannot readily accommodate, nor directly measure this impact, so the cost consequences of the corrosive environment become conflated with deemed "inefficiency".

22. To support network pricing reform, we strongly support the view that the Low Fixed Charge Regulations are past their use-by date and are in need of significant reform, if not out-right removal. The requirement to offer a 15c per fixed charge option is problematic, as it requires distributors to recover significant fixed costs through high variable charges which distorts consumers' energy choices. But there are other problems too including that the thresholds for "low user" are too high and prohibitions on stepped and tiered charges make the design of new pricing options very difficult. We think an urgent focus on removing or reforming the Regulations should form part of the Panel's recommendations.

Cost allocation

23. We support a review of network cost allocation models, to provide confidence that network costs are fairly and efficiently allocated. Concept Consulting has undertaken a high-level analysis of this issue, but a much more sophisticated and comprehensive analysis is required to identify whether current allocations are appropriate, as well as identify what other options exist to ensure allocations are reasonable. Cost allocation is a zero-sum issue as lower residential costs would be equally offset by higher commercial and industrial prices. These in turn would be reflected in prices back to consumers, and higher inflation if this is spread over time. Residential consumers would not necessarily better off, and arbitrary allocations to business customers may harm business confidence in the market. In price sensitive industries, higher commercial or industrial prices may lead to inefficient bypass or exit, to the ultimate detriment of the economy.

24. Cost allocation approaches also need to be viewed through a lens of sustainability and durability. By virtue of comparatively lower volume requirements, residential users are likely to find it more economic than larger users to invest in small-scale distributed generation, leading to reductions in volumes consumed, but not their requirement for network capacity (for example, if the sun isn't shining, battery is exhausted or wind not blowing). Using volume as an allocation approach for non-load-related costs may lead to inequitable outcomes for commercial and industrial users shouldering an increasing burden of paying for the networks.

25. It is also important that the Panel recognise the difference between price (the cost per unit of consumption) and charges (price multiplied by quantity) when considering the allocation of network costs. Residential consumers have high peak demands, but relatively poor utilisation (total volumes consumed) compared to most industrial and commercial users. The following chart shows Unison's average charges for different user types in Hawke's Bay. It demonstrates that commercial and industrial customers pay significantly higher charges, because although their prices are lower, their volumes are substantially higher:

User type	Average annual charges ($) (including transmission)
Residential	926
General (smaller commercial)	1,293
Commercial	4,844
Large Commercial	36,260
Industrial	114,247

26. Overall, we think an ENA-led process to review the cost allocation Guideline produced by the ENA’s Pricing Approaches Working Group in 2005 would be an appropriate approach. We do not believe that a mandated/regulated approach would be appropriate as it would carry high risks of un-intended consequences. EDBs are best placed to make the right decisions for their local communities. We believe the timing of this process would be completed in time to be reflected in prices from 1 April, 2020.

Transmission pricing

27. We support the timely conclusion of the TPM review process. It has created significant uncertainty for the industry.

Concerns about distributor capability and scale

28. Unison notes the concerns that have been raised about distributor’s capabilities to manage an increasing complex environment, particularly those with small scale. As has been recognised, Unison’s Management Services Agreement with Centralines and the “Powernet model” are effective in overcoming small scale as a barrier to performance or capability to respond to emerging technologies, or indeed other threats such as growing cyber-security risks.

29. It is very difficult for the Government to intervene in EDB ownership or management arrangements, as local ownership is valued highly by communities. We think that there are however, some natural drivers for increasing collaboration and out-sourcing amongst EDBs. At a governance level, there is growing pressure on businesses to be able to demonstrate capability. Those businesses under price-quality regulation, face the threat of fines and other sanctions if they do not meet their quality targets and cannot demonstrate effective asset management practices. One way for Trustees and Boards to gain assurance on asset management capability is to ensure their organisations are certified to ISO55001, the standard for asset management.

30. Similarly, almost any global risk report will highlight cyber-security as a significant strategic and operational risk. As life-line utilities, communities will rightfully expect Trustees and Boards to be seeking assurance that systematic cyber-security programmes are in place to prevent, detect and recover from cyber-security issues. “Information assets” are just another type of asset that EDBs need to manage carefully. ISO 27001 provides a framework for implementing a systematic approach to cyber-security management.

31. Unison’s experience is that such systems are resource-intensive to implement and maintain, but provide valuable assurance and benefits of a systematic approach to Management. Small companies would likely struggle to adopt them and therefore would need to collaborate with others or outsource to achieve their benefits. We don’t think that regulation is required to force companies to adopt such systems, as this is ultimately a governance matter. The Commerce Commission is undertaking work to shed light on best-practice, particularly around asset management. It highlights that it is using its “Summary and Analysis” function to provide information to governing authorities and we think this is a good way to promote improvements in capability and industry collaboration. The ENA has also proved a highly successful vehicle for fostering collaboration among network businesses, with an extensive list of working groups covering a wide range of issues.

32. With the DPP reset approaching, the ENA has obtained a report which will be released to the Commerce Commission shortly on how overseas regimes have dealt with the creation of incentives for network businesses to undertake research and development. These incentive schemes have included approaches that involve contestable processes to development funding, with requirements on businesses to share the results of their R&D initiatives with other networks. We think that such mechanisms could be useful in the New Zealand context and can be used under DPP regulation to achieve scale economies and collaboration.

33. Overall, our main comment on economic regulation of non-exempt network businesses is that the Commerce Commission has appropriate tools that it can use to create the right incentives on EDBs to improve efficiency, collaborate and effectively integrate new technologies, including through out-sourcing. The 2020 reset provides an appropriate opportunity for stakeholders to engage in the process of defining the types of activities that they want EDBs to pursue and to develop appropriate funding or incentive arrangements.

Integration of new technologies to provide network services

34. The Electricity Authority's note to the Panel[4] raises concerns about EDB's involvement in new technologies. The Electricity Authority thinks that new technology is likely to have rapid impacts and uses this to argue for interventions in the current regulatory framework (e.g., 3.11):

> *In summary, we think the scope for contestability will continue to expand rapidly as the capability of emerging technology continues to expand and their costs decline.*

35. Unison notes that the Commerce Commission takes a more cautious view on these matters, noting that it already has the tools to address the matters raised by the Electricity Authority, and if necessary can strengthen their use of these tools (e.g., incentive mechanisms) to address issues as they arise. We consider the Commerce Commission is best placed to address the integration of new technologies into the sector, via incentive mechanisms of Part 4 Regulation. In particular, Unison notes the following:

    i. With the coming 2020 price path reset, the ENA will be engaging with the Commission on ensuring that revenue allowances and incentives are in place to facilitate the efficient utilisation of non-traditional investments to complement or substitute for network investments. This will involve:

        a. Development of the commercial and technical platforms to integrate new technologies with networks;
        b. Revisiting the incentive arrangements currently in place which arguably create a bias towards network investment against procurement of alternatives;
        c. Development of incentive schemes which appropriately encourage network businesses to invest in research and development, including consideration of collaboration models which have been used successfully overseas to avoid duplication of effort and sharing of research findings.

    ii. All of these matters can be addressed within the Commission's regulatory toolbox. Our hope is that the Electricity Authority, as an interested stakeholder, contributes constructively to these processes rather than seek prescriptive approaches.

    iii. We also note that the Commission has strengthened cost allocation rules and related-party transaction rules over the last two years to provide additional assurance that there are mechanisms in place to ensure contestable and non-contestable activities are treated appropriately. These rules will be reviewed as part of the routine reviews of Input Methodologies and, if required, out-of-cycle reviews.

Concluding comments

36. The New Zealand electricity market has been developed over a lengthy period, with regulator-led improvements being developed through often lengthy consultations and corresponding consideration by the decision-makers. The Panel faces a challenging task of concluding its review over a very short-timeframe in comparison. We think that it is important that any recommendations from the Panel do not over-reach. Where appropriate, more enduring outcomes are likely to be reached through further

[4] EA Paper 1# Opportunities for improving the regulatory framework for electricity (2018, undated)

processes that can take the appropriate time to ensure that all necessary information and options are considered.

37. In Appendix A we have summarised the recommendations made in this submission. If the Panel would like to discuss our views further please contact Nathan Strong on 06 873 9406.

Kind regards,

Nathan Strong
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APPENDIX A : SUMMARY OF UNISON'S RECOMMENDATIONS

Affordability The Panel should recommend development of a clear framework for addressing energy hardship concerns (including defining the problem more tightly). The Panel should encourage Government to take a whole-of-Government approach to addressing the needs of low income households experiencing energy hardship, including measures to support improvements in access to affordable housing and housing quality. We support the ENA's submission that an Energy Ambassador position should be explored and better information and resources be made available to help consumers. The Panel should recommend to the Government that it review the winter energy payment, which is not effectively targeted at those in energy hardship.
Retail and wholesale markets The Panel should recommend an ongoing focus by the Electricity Authority in monitoring and improving the performance of the wholesale and hedge markets for electricity. It is critical that there is confidence in these markets to ensure that new entrant retailers can continue to provide discipline on the major retailers. The Panel should recommend that the Government support the Electricity Authority's ongoing work to examine competition in the retail market and for it to determine appropriate solutions, if required. Further consideration should be given to factors leading to the presence of a two-tier retail market as well as other mechanisms used by retailers to win customers, such as substantial prompt payment discounts that appear disproportionate to credit risk.
Networks The Panel should promote network pricing reform to ensure fair recovery of network costs. The panel should recommend substantial reform or removal of the "Low Fixed Charge Regulations" to support effective network pricing reform. Part 4, sub-Part 3 of the Electricity Industry Act 2010 should be reviewed to ensure that consumers cannot unduly hold-up use of alternative technologies where these are more cost-effective than conventional network investments. The Panel does not need to recommend changes to regulation of EDBs in regard to investments in new technologies. The Commerce Commission has the necessary tools and powers to foster innovation amongst EDBs and to create incentives for procurement of alternatives to traditional network investments. It has made changes to cost allocation rules and related party transaction rules to enhance transparency in these areas. The Panel should adopt a high threshold for recommending any change to Part 4: it provides a balance of predictability and stability in regulatory settings, with flexibility to make changes (through appropriate processes) in light of changing market circumstances and experience with the rules. The panel should not recommend removal of the prohibition on use of benchmarking for price setting under the DPP.

The panel should recommend that an ENA-led process be used to review the guideline used by EDBs for allocating costs between consumer groups. EDBs are best placed to determine cost allocations that work for their local communities. This process should be complete in time for prices effective on 1 April 2020.