14 March 2019

Entrust welcomes the Electricity Review Panel's reform package

Entrust applauds the work the Expert Advisory Panel has undertaken. The Panel has faced the twin challenges of managing a broad Terms of Reference and a tight timeframe to complete the review.

The analysis the Panel has undertaken, coupled with evidence from submissions, will help ensure the Panel's decisions are appropriately evidence-based. For example, the analysis undertaken in relation to the two-tier retail market has helped provide a better understanding of the previously understated size of the problem and has advanced the debate on saves and winbacks.

While we consider that the Panel's proposals could have gone further, the reform options the Panel favours to promote stronger competition and improvements to the wholesale market will deliver substantive and measurable benefits for consumers, both in terms of choice and improved affordability. There was a step change in the level of competition following the last electricity review, and we expect the same again once the Panel's proposals are implemented.

We would like to see timely implementation of the Panel's proposed reforms. Many of the issues the Panel's proposals would help resolve, such as hedge market liquidity and saves and winbacks, have been a problem for a considerable amount of time.

It should be recognised, if existing legislative provisions are relied on to fast-track implement various of the reforms, including the Electricity Authority's Code making powers, that the Authority is an independent crown entity, and there are limits on the direction that can be given by the Minister to the Authority.

A possible issue could arise if the Electricity Authority doesn't agree Panel's recommendations would benefit consumers. The Electricity Authority has already come out and warned of the purported high cost of mandatory hedge market arrangements, based on unspecified overseas experience. The Electricity Authority's typical review process time-tables, and prioritisation, also won't necessarily match the Panel or Government expectations. The Electricity Authority has been clear the TPM is its top priority.

Based on the analysis the Panel has released, each year the two-tier retail market issue remains unresolved will cost consumers, predominantly low income and vulnerable consumers, over $500 million in loyalty taxes. Resolving this issue alone will result in substantial improvement in energy affordability.

Summary of Entrust's views

- *Strong support for the Panel's views:* It is clear from submissions that the Panel's reform proposals have a high degree of stakeholder buy-in and support.

- A substantial amount of evidence has been provided in submissions that back the Panel's views about problems in the retail and wholesale markets. This is in addition to the Panel's Initial Retail Billing Analysis and subsequent analysis, which is yet to be released.

- We welcome the Panel's adoption of many of our recommendations.

- *The Panel's reforms will result in a step improvement in retail competition:* We consider a ban on winbacks, financial separation of the big-5 incumbent retailers, mandatory hedge market requirements and more stringent wholesale market disclosure obligations are key reforms for promoting a more competitive market, and better consumer outcomes.

- *Consumers are being misled by Prompt Payment Discounts:* While we support the ban on use of the term Prompt Payment Discount, Meridian continues to mislead consumers claiming it now offers a "guaranteed discount".[1]

- *TPM changes that result in large wealth transfers from consumers to suppliers need to be stopped:* The Electricity Authority's transmission pricing methodology (TPM) plans would undermine the benefits of the Panel's reform proposals and need to be stopped. The Authority's TPM plans would make electricity less affordable, by gifting substantial wealth transfers from consumers to South Island generators and the Tiwai Aluminium Smelter (NZAS).

- *The statutory objectives under Part 4 Commerce Act and the Electricity Industry Act need consistent application:* We note the Panel does not favour transferring responsibilities for network regulation from the Electricity Authority to the Commerce Commission. An alternative option, to promote greater regulatory consistency, would be to require the regulators adopt the same interpretation of their statutory objectives (promotion of long-term benefits to consumers).[2]

- *Timely implementation of the Panel's proposed reforms is critical:* It could be useful for the Panel to develop a road-map for fast delivery and implementation of the reform proposals. We also support the Panel's proposal for a 3-year implementation review. We consider this reflects regulatory good practice for any major reform initiatives.

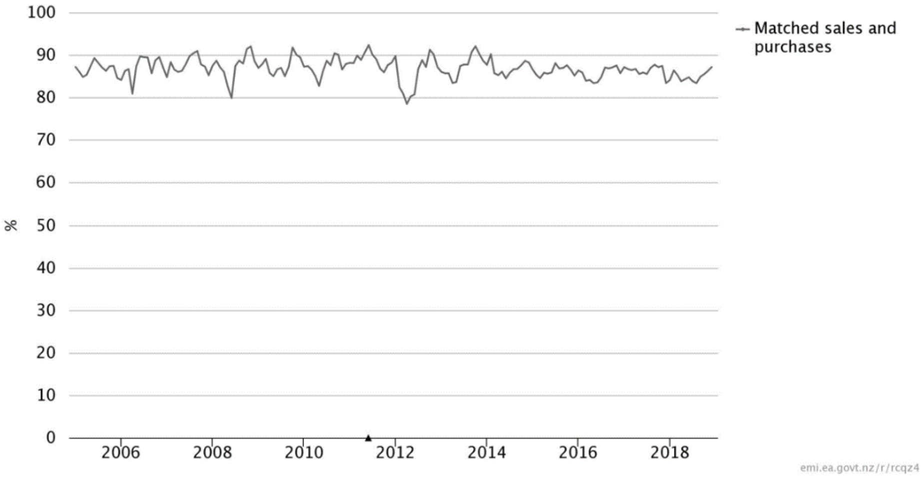
There is clear evidence of problems that need to be resolved

It is clear from the Electricity Price Review's initial consultation, and the submissions made in response, that there is a need for much greater attention to problems in the competitive parts of the electricity market.

Structurally, there are problems with market concentration and a high degree retail-generation vertical-integration (see figure below).

[1] https://www.meridianenergy.co.nz/news-and-events/meridian-to-replace-unfair-prompt-payment-discounts-with-guaranteed-discount-for-all-customers/
[2] We note Vector's commentary on interpretation of the statutory objectives: Vector, Submission to the Electricity Authority on Transmission Pricing Methodology: Issues and proposals, Appendix II: Interpretation of statutory objective, 1 March 2013: https://www.ea.govt.nz/dmsdocument/14445-vector#page49

Retail-generation vertical-integration trends[3]



It is also clear there are problems with the deteriorating health of the hedge market, the two-tier retail market (saves and winbacks), and spot market trading conduct. These issues should be prioritised for resolution.

Electric Kiwi, Flick, Pulse, and Vocus, who combined represent 86% of the market supplied by independent retailers,[4] and Vector also laid a complaint with the Electricity Authority about an Undesirable Trading Situation (UTS) late last year.

While the Electricity Authority decided the tests for a UTS were not met, a decision we disagree with,[5] the complaint highlighted several factors affecting the wholesale electricity market, including problems with the voluntary hedge market arrangements, and use of market power to raise spot prices. The matters raised in the complaint reflect problems with the state of competition in the wholesale market, particularly during periods of shortages, and inadequate regulatory settings for the hedge market.

High degree of industry support for the Panel's reform proposals

Based on submissions in response to the First Report, and submissions the Electricity Authority has received on related issues, we anticipate there will be a large amount of industry and consumer buy-in and support for the Panel proposals.

It is notable that while there was a large level of agreement about the need for reforms, amongst independent retailers and lines companies (and their trust-owners), the incumbent retailers and ERANZ weren't so unified in their views.

The incumbent retailers had mixed views about matters such as Prompt Payment Discounts (ban only supported by Meridian), financial separation (supported by Genesis) and mandatory hedge market requirements (supported by Genesis and Mercury).

Entrust welcomes adoption of many of our reform recommendations

Entrust welcomes the Panel's uptake of a large number of our recommendations, including:

[3] https://www.emi.ea.govt.nz/Wholesale/Reports/BLKL4U?_si=tg|market-structure,v|3
[4] Electric Kiwi, Flick, Pulse, and Vocus, Joint submission from independent retailers – delivering real competition for Kiwis, 23 October 2016: https://www.mbie.govt.nz/info-services/sectors-industries/energy/electricity-price-review/submissions/copy_of_submissions-received-epr/electricity-price-review-submissions-007.pdf
[5] Refer to Vector's submission in response to the Electricity Price Review Options Paper.

Reforms to improve competitive market outcomes

- Ban on winbacks and use of information from the switching process for any other purpose than facilitating the switch;
- Financial separation of the big-5 incumbent retailers' retail and generation businesses (which will require prescriptive cost allocation and related party rules);
- Introduction of more stringent market monitoring and disclosure requirements, including enforcement;

  It is clear from review of submissions in response to the First Report, particularly from those of independent retailers, that these reforms in conjunction with introduction of mandatory hedge market requirements, which we also support,[6] are key to unlocking a more vibrant and competitive electricity market.

Reforms to improve fairness and protect consumers

- Recognition of the need to transmission pricing methodology issues to be resolved;
- Ban on Prompt Payment Discounts, with allowance for cost-based late payment penalties;
- Strengthening the rules for protection of Vulnerable and Medically Dependent Consumers; and

Other

- Consistent with our recommendation for Post Implementation Reviews, the Panel intends to recommend a 3-year review on progress with the reforms it has recommended. The Panel could suggest that if the outcomes don't turn out as expected, the Government should consider further reforms, such as structural separation of the gentailers, which would help ensure industry participants are incented to facilitate successful implementation of the reforms in a timely manner.

The Electricity Authority's transmission pricing plans need to be stopped

Entrust agrees "the extent to which transmission or any other shared national infrastructure prices should vary between users or regions is best settled with clear guidance from elected governments". The last time the Government turned its mind to such matters was in relation to Chorus' broadband prices with the Government legislating for a nationalised price.

The Panel elegantly presented this issue as "whether it is generators or residential and business consumers in poorer regions, such as Northland and King Country, that should benefit from lower charges under the Electricity Authority's proposed transmission pricing methodology"? To put this in context, based on numbers provided by the Electricity Authority, the Authority's proposed TPM changes could end up costing Auckland consumers, alone, $60m per annum more than they currently pay.[7]

Applying the Commerce Commission's Part 4 Commerce Act tests, the 33% increase would be a substantial "price shock". The Commerce Commission has recognised this as an issue, in reviewing its approach to managing price shocks, noting that "if a new

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[6] Our proposals for vertical and horizontal separation of the large retail-generators may have meant that mandatory hedge market arrangements would have been unnecessary.
[7] Entrust, Submission to Electricity Authority re Transmission Pricing Methodology: Second Issues Paper – Supplementary Consultation, 24 February 2017.

transmission pricing methodology (TPM) is applied, the Transpower lines services recoverable cost could cause a significant price increase for some EDBs".[8]

While, some regions would benefit, to a degree, the largest beneficiaries would be the generators Meridian and Contact, and NZAS. Collectively, these three entities would benefit financially by approximately $90 million a year from the proposal – an amount that would be funded by New Zealand electricity consumers.[9]

We understand the Electricity Authority's plan would see 91% of Transpower's costs loaded onto consumers and only 9% allocated to generators. This compares to the current split of 80:20 between consumers and generators. This is despite generators clearly also benefiting from the grid in allowing them to transport their goods to market. There are no reasonable grounds for tilting even further the bulk of transmission charges onto consumers.[10]

The Panel has taken a prudent approach to Part 4 regulation and adoption of new technology

In the First Report, the Panel commented "Emerging technologies may well have the greatest bearing on the future of the distribution sector". The Electricity Authority has similarly commented "There are large changes ahead for the electricity distribution sector (distributors), which are being driven by emerging technologies. The outcome of how these technologies are adopted has the potential to lead to efficiency gains and lower costs for consumers".[11]

These observations support the Labour and Green Parties' respective energy policies which recognise "Lines companies can have a positive role to play in local energy solutions. Such solutions would enable them to better manage traffic across their network especially at peak times, and to avoid costly and avoidable upgrades" and lines companies should be encouraged to "use new technology to save their customers money".

The incremental, fine-tuning, of Part 4 Commerce Act settings should help ensure the Commerce Commission can continue to effectively operate Part 4 regulation, while also helping ensure lines companies "adapt to the impending technology change in ways that benefit consumers".[12]

Any changes to Part 4 of the Commerce Act, need to ensure the Commerce Commission is able to continue to "align the interests of EDBs with those of consumers"[13] and ensure incentive regulation is effective in "put[ting] the incentives in place for the electricity lines businesses to reduce their costs, similar to the incentives that are in place in competitive markets (but does so through price-quality paths)".[14]

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[8] Commerce Commission, Default price-quality paths for electricity distribution businesses from 1 April 2020 Issues paper, 15 November 2018, paragraph G29.
[9] Entrust, Submission to Electricity Authority re Transmission Pricing Methodology: Second Issues Paper – Supplementary Consultation, 24 February 2017.
[10] Entrust, Submission to Electricity Authority re Transmission Pricing Methodology: Second Issues Paper – Supplementary Consultation, 24 February 2017.
[11] Electricity Authority, Scope for the review of the distribution sector, undated.
[12] Electricity Authority, Scope for the review of the distribution sector, undated.
[13] Commerce Commission, Commerce Commission regulation of energy networks - key concepts, Prepared for IPAG, June 2018, paragraph 14.
[14] Memorandum from the Commerce Commission to the Electricity Pricing Review Expert Advisory Panel and MBIE, Response to May 2018 questions from Expert Advisory, 8 June 2019, paragraphs 34 and 35.

Concluding remarks

Entrust is a strong supporter of the Electricity Price Review and the work the Panel has undertaken. We look forward to the Panel's report to the Minister of Energy, and its reform recommendations being adopted.

The review has highlighted consumers are not yet seeing the full benefits of competition. It concerns us that while Vector continues to reduce its prices, the large incumbent retailers are increasing theirs.[15]

We are pleased the Panel's proposals will directly tackle most of the problems, identified in the First Report, with the wholesale electricity market and hedging arrangements, and the 'two-tier' market that is developing. The growth and scale of loyalty taxes clearly shows the incumbent retailers are using price discrimination, between switchers and stayers, to raise average prices for residential consumers.

We are also pleased the Panel intends to recommend a ban on the misleading use of the term Prompt Payment Discount to describe late payment penalties. While Meridian has received positive comment for its decision to stop using the term, and to stop using late payment penalties, it continues to mislead customers by using the term "guaranteed discount".[16] We also note Meridian's decision to increase its retail prices, including in Auckland despite Vector's announcement it would be reducing its network charges, will more than offset the $5m loss in revenue from late payments.

The Panel has limited itself to reforms which are incremental in nature and have a large amount of buy-in from industry and stakeholders. The type of submission content we and others have provided, including the UMR consumer survey and analysis of the competitiveness of the electricity market, mean the Panel can have confidence its recommendations will be evidence-based and not overly reliant on subjective judgement. These factors should make it easier for the Government to adopt the Panel's reform package.

We reiterate our closing comment, in response to the First Report, that "A good outcome for the review would be ensuring regulatory arrangements provide for open competition, where everyone, be they electricity generators and retailers, lines companies and other alternative market entrants, able to embrace and use new technologies to offer consumers greater choice and drive prices down. It is important regulation and policy do not obstruct the sector's natural evolution and ability to innovate and embrace new technology".

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[15] We highlighted this concern in our letter to the Expert Advisory Panel, Genesis' price-hike bad for consumers and energy affordability, 20 December 2018.
[16] https://www.meridianenergy.co.nz/news-and-events/meridian-to-replace-unfair-prompt-payment-discounts-with-guaranteed-discount-for-all-customers/

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Kind Regards

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