Major Electricity Users' Group

28 May 2021

Andy Burgess
Head of Energy, Airports, and Dairy Regulation
Commerce Commission
By email to regulation.branch@comcom.govt.nz

Dear Andy

Feedback on fit for purpose regulation

1. This letter is feedback by the Major Electricity Users' Group (MEUG) on the Commerce Commission open letter "ensuring our energy and airports regulation is fit for purpose" 29th April 2021.[1]

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Members may make separate submissions.

3. The open-letter and the earlier consultation at the start of the year on levy options set out in broad terms the various factors that are and will likely change the energy sector and the subset of that governed by the Commission in terms of Part 4 of the Commerce Act. These changes will bring both opportunities and risks to ensuring the best possible long-term benefit to consumers is realised. In summary the Commission must navigate two sets of disruptions:

    a) Market driven disruptions comprising:

        i) New technologies and business models that can increase the role of electricity prosumers in energy markets. This may alter the relationship of consumers with electricity and gas line businesses and hence be relevant to the regulatory governance of Part 4 and or the Electricity Industry Participation Code (the "Code") governed by the Commission and Electricity Authority, respectively. Put another way, there is the potential for widespread disruption in the relationship from most consumers having a passive take-it-or-leave-it role, to most consumers having and exercising choice of if, when and what regulated services to use. Part 4 and the Code should ensure there are no regulatory barriers for such a transition if technology and new business models are economic.

[1] Document URL https://comcom.govt.nz/__data/assets/pdf_file/0022/253561/Open-letter-Ensuring-our-energy-and-airports-regulation-is-fit-for-purpose-29-April-2021.pdf at https://comcom.govt.nz/regulated-industries/airports/projects/open-letter-ensuring-our-energy-and-airports-regulation-is-fit-for-purpose.

ii) New generation technologies further up the supply chain that can lower wholesale generation costs provided cost-effective back-up to an increasing proportion of new intermittent generation is built. The relationship between those generators and the line company they connect may change and hence Part 4 and or the Code may need to be adapted. In this submission "line company" could refer to either Transpower's grid or a local line network.

iii) New technologies that can be utilised by monopoly line and monopoly national or regional system operator businesses. As above this may require changes to Part 4 and or the Code.

iv) The above three disruptions facilitated by improved pricing of:

- The economic cost of greenhouse gas externalities through the NZ Emissions Trading Scheme (NZETS).
- More granular line charges to end consumers.

In the case of end prices to consumers the primary regulators are the Electricity Authority for line charges and the Ministry for the Environment for the NZETS. The Commission has a role to play to assist the Electricity Authority's objective to improve line charge price signals to end consumers.

Poor line price signals, including uncertainty on future line prices and whether and when they will shift to "efficient" pricing signals, can:

- Deter efficient investment, divestment, and operating decisions by consumers; or
- Lead to consumers making short term investment and divestment decisions that in the long run turn out to be inefficient; and or
- The above two factors can then lead to changes in demand that line businesses then under or over invest in relative to the level of services that would have been demanded with efficient line prices.

b) Political disruptions with the rise of distortionary interventionist policies[2].

4. The balance of this feedback suggests ideas for the Commission to assist it navigate and have a plan to manage the uncertainty of market driven disruptions. MEUG expects the Commission as an independent Crown entity to be conscious of the risks of political disruptions and will need to prepare for, but will not be an advocate for, interventionist policies that will undermine the long-term benefit of consumers of regulated energy services.

[2] Political disruptions, that is interventions that have been announced without prior consultation with affected parties nor a robust cost-benefit-analysis to justify the announcements, include the government's 2018 ban on petroleum exploration, the government's 2020 decision to invest large sums of the COVID-19 relief package into investigating the Lake Onslow pumped storage project, and various proposals in the Climate Change Commission draft report of February 2021 such as setting a date when no new gas connections are permitted quoted on page 3 of the Commerce Commission open letter.

5. The sub-paragraphs that follow suggest additional issues to those mentioned in the open letter that could be considered by the Commission. They are suggested for consideration rather than MEUG having considered pros and cons of each in detailed and reached a definitive view that they should adopted.

a) The analysis of the components of market driven disruptions in paragraph 3 a) above highlights that the Part 4 responsibilities of the Commission need to be integrated with the work of the Electricity Authority. Two aspects of that analysis are not mentioned in the open letter that MEUG believes should be considered in thinking about future disruption in the regulated line energy sector:

i) First there is no mention of the critical role that line prices for line services will play to drive the behaviour of lines businesses and consumers (refer paragraph 3 a) iv) second bullet point above).

The open-letter (p2) states, with underlining by MEUG:

> "The expectations of consumers, government and industry on both us and the sectors are also increasing – particularly in <u>the area of consumer engagement</u> and new technology."

MEUG would be concerned if the Commission were intending to rely on consumer engagement by way of consultations or surveys to uncover consumer needs to assist regulated businesses tailor their plans to meet those needs. In the view of MEUG, this is a poor second best option to using prices to signal to consumers the cost versus quality-of-service trade-offs.

If the reference in the quote above to "consumer engagement" is short-hand for facilitating direct consumer engagement with the line businesses by choosing price-service level from alternative offers by the line company, then MEUG has no concerns.

ii) Second there is no mention of an increasing number of consumers likely to have more choice about if, when and what line service they might want (refer paragraph 3 a) i) above).

There are already electricity prosumers that have invested in PV or EV and more will join them along with expected more integrated energy management systems for households and SME's and aggregator businesses. As prices better reflect actual costs and therefore there is more certainty underlying tariff designs will not be subject to ongoing change, more consumers will do the maths and decide more actively manage if, when and what line services they want.

b) An open question is whether the gas Default Price-Quality Path (DPP) reset should consider the risks of asset stranding? If so then an urgent review of Input Methodologies (IM), including allocation of risk including the Weighted Average

Cost of Capital (WACC) will be needed[3]. There may be insufficient time for such an urgent IM review. In that case should the gas DPP reset be for less than 5-years and a further reset undertaken after the planned IM review? Or perhaps there is a case for advancing the IM review?

MEUG has not considered which route, if any, should be taken to consider stranded assets. However, given the experience of when Southdown power station exited the gas market in 2015 and the resulting increased line charges incurred by remaining gas users', the question of reviewing the treatment of stranded assets is we believe critical.

c) The preceding sub-paragraph on treatment of stranded assets is part of a broader question on the allocation of risk between consumers and the regulated entity(es) and designing the best regulatory mix of incentives for line companies to innovate and improve productivity. As mentioned beforehand, WACC is an important aspect of that discussion and the use of the expected 67th percentile rather than mid-point WACC. Much has been discussed about allowing line companies latitude to experiment with innovative ways to adapt. MEUG is not averse to considering options in terms of the Part 4 regime provided outcomes are like those observed in workably competitive markets; namely where an experiment works then both the innovator and consumers benefit, and where an experiment fails, then the innovator bears the cost.

d) When an industry is disrupted the structure of the sector often evolves to adapt to those changes. MEUG suggests the Commission should consider if there are any barriers to what would, in a workably competitive market, be adaptions that could occur such as:

   i) Mergers and acquisitions (M&A) assist by less efficient businesses being taking over by more efficient businesses. There has been no M&A activity in the Electricity Distribution sector for several years. An open question is whether there are systemic barriers to M&A that need to be addressed? One indicator of whether there has been a systemic problem is to benchmark the performance, such as the year-on-year improvement in productivity, between different segments of line companies, e.g., listed versus unlisted, large versus small and Trust owned versus non-Trust owned. Another metric would be to benchmark the performance of New Zealand line monopolies with representative peer companies overseas.[4]

   There were analysis and evidence on barriers to line company amalgamations presented to the Electricity Price Review in 2018-19. A review of that evidence may assist the Commission undertake a desk top review of whether barriers to amalgamation is or is not a priority topic to consider.

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3 Refer MEUG submission to Commerce Commission, Levy consultations 2020, 5th February 2021, http://www.meug.co.nz/node/1119. The last paragraph on p2 of MEUG's submission discussed the need for a comprehensive review of WACC in the next IM review.

4 Ibid, the suggestion of benchmarking compared to overseas line monopolies was discussed in the second to last paragraph on p2.

ii) Splitting business functions. For example, would the future structure of the sector be better served by splitting out the natural monopoly system operator functions (nationally and regionally) from the economies of scale line monopoly functions? It appears that at the margin the traditional electricity line business will have increasing countervailing pressure from prosumers.

Not so the system operator functions where there is no choice to use an alternative system operator or opt out of having to have a relationship with the designated national or regional system operator.

The line and system operator services are quite different with different risk profiles. Splitting those for the purpose of having different regulatory regimes may improve the long-term benefit of consumers.

e) Whether there should be a path developed to facilitate the option of negotiate-arbitrate arrangements being implemented? In the future negotiate-arbitrate arrangements may be a more pragmatic approach, in terms of speed to adapt and lower transaction and implementation costs, as consumer choice at the margin of regulated energy line businesses start to make material changes.

f) Page 4 of the open letter notes:

> "We will also continue to work in close cooperation with other relevant agencies like the Electricity Authority the Energy Efficiency and Conservation Authority, and the Ministry of Business, Innovation, and Employment in these areas."

MEUG suggests the NZ Infrastructure Commission should be included as a relevant agency. The Infrastructure Commission's work on resource capability in the broader New Zealand infrastructure sector and risk-reward trade-offs in Private Public Partnership's relevant to New Zealand may provide useful insights.

6. MEUG looks forward to reading the feedback of other parties. As appropriate we will either provide follow-up comments and or request a meeting to answer any questions the Commission may have.

Yours sincerely

Ralph Matthes
Executive Director