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Default price-quality paths for electricity distribution businesses from 1 April 2020

Genesis Energy Limited (**Genesis**) welcomes the opportunity to provide a submission in response to the Commerce Commission (the **Commission**) issues paper "Default price-quality paths for electricity distribution businesses from 1 April 2020" dated November 2018 (**issues paper**). We also support the feedback provided by the Electricity Retailers' Association on the issues paper.

Genesis recognises that, if New Zealand consumers are to continue to have access to affordable and reliable electricity, all sectors of the electricity industry must be functioning well. There is a growing spotlight on the industry in recent times and the Government is relying on electricity to be a cornerstone of New Zealand's drive towards a zero emissions economy, while new technology is disrupting the way electricity is generated, distributed and consumed.

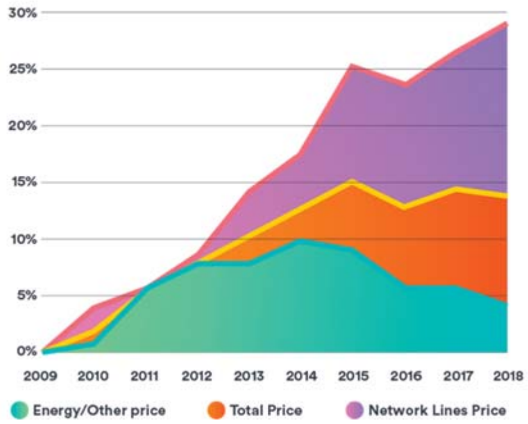
We consider the default price-quality path reset (**DPP3**) to be a vital tool to better align incentives for electricity distribution businesses (**EDBs**) and ensure they are making investments that are in the long-term interests of consumers. This includes encouraging EDBs to make efficient investments in new technologies, in addition to and in substitution of traditional asset management, which requires the Commission to ensure EDBs face competitive market disciplines and accountabilities. It also means driving for improvements in the performance of EDBs by focusing on: expanding quality measures; driving for better price outcomes from regulation (including risk of price shocks); stronger cost disciplines; increased transparency; and greater standardisation.

Poor distribution sector performance has financial impacts for consumers

The recent efforts by the Commission to shine a light on EDB performance through the creation of performance summaries is welcome.

Concerningly, it has uncovered rising costs, falling reliability and deteriorating assets, while prices for consumers have been rising. Households now pay 13 per cent more in real terms compared with 2009 and lines costs (transmission and network distribution costs), account for 82 per cent of these increases (refer to chart 1).

Chart 1: Change in Household Electricity Prices by Component (Real)



MBIE annual residential sales-based electricity cost data

We acknowledge the progress made by the Commission in providing transparency of EDB performance and encourage it to use DPP3 to put in place further measures to ensure EDBs can be relied on to deliver long term benefits for consumers.

In our view, this is an opportunity to put in place stronger incentives that will drive EDBs to invest in their networks at the lowest cost. A stronger level of scrutiny and control cannot wait until customised price paths (**CPP**) are developed - this will be too late. Stronger quality measures, challenging forecasts that deliver cost optimisation and improved transparency for all EDBs is essential.

DPP3 must focus on driving for long term reliability, while lowering costs and prices

Although lines prices have continued to rise throughout DPP2, this has not resulted in either improved reliability nor better asset conditions of distribution networks. In our view, the Commission needs to use DPP3 to drive a step change in the performance of EDBs to protect consumer trust and confidence in the industry. Focus should be on expanding quality measures; improving price outcomes from regulation, including risk of price shock; and driving stronger cost disciplines:

1) Expand quality measures to drive investment in assets and improve service

Genesis agrees with the Commission that reliability is critical for the distribution sector and setting suitable performance measures is central to its role as regulator of these monopolies. We are pleased to see more emphasis on this recently and especially the demonstration of an increased appetite to enforce the rules, which gives them more substance.

Our view is that DPP3 needs to expand the quality measures beyond SAIDI and SAIFI[1] and increase the revenue at risk to 5 per cent, to better incentivise EDBs to make investment decisions that deliver long term reliability. As noted above, the Commission's summary of network performance reveals many assets are in poor condition, especially substation assets (switches and transformers). Although this may not be resulting in outages in the current period, it does place future reliability at risk.

We believe that this points to underinvestment by EDBs, which is occurring due to strong incentives for short term profits reducing the signals to invest. In the Aurora Energy (**Aurora**) example, the owner (Dunedin City Holdings Limited) pushed for an annual dividend that could only be achieved by reducing asset investment, however, as the existing quality measures were not immediately impacted, it was not identified until raised by a whistle-blower[2]. We can also see similar short-term behaviour in trust and community owned EDBs where returning money to consumers via annual rebates and dividends "feels good"[3] and deviates focus from investment decisions that have long-term benefits for consumers.

DPP3 cannot continue to embed price increases for customers while leaving the door open for EDBs to underinvest in their assets. If EDBs are going to continue to receive higher than average returns they must be compelled to invest for future security of supply. Expanding quality measures to target asset health would ensure EDBs undertake routine maintenance and replacement of assets to deliver the future reliability expected by consumers. If this investment is not forthcoming, and we continue to see deterioration of assets, the very assumption for gifting high returns is invalidated and instead the level of weighted average cost of capital (**WACC**) should be reduced to levels more consistent with average market levels.

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[1] SAIDI: System Average Interruption Duration Index; SAIFI: System Average Interruption Frequency Index
[2] Deloitte Report December 2016: Review of Aurora Energy Limited / Delta Utility Services Limit – Network Safety Concerns
[3] Vector's August letter to customers on line loss rebate – "letting someone know about $30 they didn't they had is a pretty good feeling"

We are also supportive of the proposal in the issues paper to widen the quality measures to include metrics related to customer service. Essentially, we see a need for improved communication with retailers around outages so that we can support our customers during these periods and assist to manage expectations around power restoration.

2) Monitor price outcomes and mitigate the risk of price shock

Consumer expectations must feature more prominently in DPP3 than previously and reflect the expectation for flat or decreasing prices. This will require more analysis and reporting of pricing outcomes to ensure the impact on customer bills is fully understood. If there is justification for prices to rise - i.e. due to higher investment needs - EDBs should be required to provide full transparency on what these investments are and what benefits they are delivering for consumers. We wish to see more disclosure requirements for EDBs under DPP3, similar to the 'annual delivery report', required from Powerco in its CPP, as this would improve transparency and meet the requirement for low-cost regulation.

Further, with there being a number of regulatory initiatives targeting price, Genesis is greatly concerned about the risk of price shock and we are relieved that the Commission is planning to take steps to manage this risk as part of DPP3.

As highlighted in the issues paper, price outcomes for consumers are not just driven by the price path set by the Commission but are also impacted by pricing methodologies. For example, household prices have increased 79 per cent in real terms since 1990 but this is primarily a cost reallocation with overall prices only up 24 per cent over this period[4]. With the Electricity Authority (the **Authority**) concurrently pursuing changes to distribution pricing methodologies to drive more efficient pricing, is it likely this will culminate to negatively affect the price paid by some consumer groups.

In our view, to effectively mitigate the risk of price shocks, it is imperative to ensure alignment in the approach taken between the Commission and the Authority. Greater clarity of the role each regulator plays is essential to ensure the transition to a more efficient and resilient distribution sector is smooth and does not damage trust and confidence in the industry.

3) Drive enhanced cost management disciplines through low cost forecasting

We consider low cost operating and capital expenditure forecasts are critical to setting an appropriate level for price in the DPP3 period and we would encourage the Commission to utilise a range of tools to maximise their efficacy in achieving this outcome.

(a) The use of the step and trend models for setting operating cost (**opex**) forecasts relies heavily on the base year. Any inefficiencies in this base year, if not adjusted, will naturally be embedded in the future year forecasts. Genesis sees this as a significant risk for DPP3, especially given costs have been rising recently and the Commission is proposing to use the latest year of EDB opex as the base year.

(b) It is unfortunate that the Commission is prohibited from the use of competitive benchmarking to robustly assess base year opex and we encourage the Commission not to shy away from any other method that will provide comfort over the reasonableness of opex, such as deep dives and driver analysis.

[4] Electricity Price Review first report, Figure 5: Average electricity prices between 1990 and 2018

(c) Cost savings need to be embedded in the opex forecasts upfront to drive EDBs to employ cost management practices seen in the competitive market. In the Commission's consultation paper on Transpower's individual price-quality path for 2020-25 it was stated that there is an underlying expectation that costs should be reducing from the employment of new technologies and streamlining of business processes[5] and we believe this principle should also apply to distribution price paths. By including a cost optimisation expectation in the development of opex forecasts it will force EDBs to improve their procurement practices and develop 'shared service' models, where appropriate, to deliver their targets.

(d) It is essential that each EDB capex forecast is clearly linked to their asset management plans. This was noted as a deficiency and driver of significant underinvestment in the Deloitte review of Aurora[6]. Deloitte further noted the poor condition of distribution assets had in fact been identified in Aurora's asset management plans, however, sufficient capital had not been made available to ensure assets were maintained and replaced as required to deliver the ongoing service levels consumers expected.

(e) Genesis' view is that there needs to be an explicit expectation placed on the Boards of EDBs to ensure they have robust corporate governance practices, which includes risk based frameworks, robust business cases and transparent reporting on how funds are being spent. Investments should be procured on a competitive basis, i.e. in a competitive tender process and there should be greater disclosure of large asset investments and how they are delivering. This will ensure Boards are better held to account.

The Commission should continue to shine a light on EDB asset management plans

We support the focus the Commission has placed on EDB asset management and expect that there will continue to be scrutiny of how the sector is investing for the future. Technology disruption presents a real risk of either overinvestment, leaving stranded assets that customers pay for through higher prices or underinvestment, which reduces network reliability.

It is therefore vital for EDBs to have strong corporate governance, a risk-based approach to asset management and expert planning capabilities to provide appropriate oversight and business adaptability. As noted by the Commission in its consultation paper on Transpower's individual price-quality path for 2020-25, an asset-criticality framework for investments will ensure that these decisions are robust and defensible. In our view, this provides crucial transparency and accountability for a monopoly asset owner trusted with spending consumers' funds and, as such, should also be extended to EDBs.

Further, it is our view that EDB investment in new technologies as part of their regulated asset base (**RAB**) must be reviewed. No participant in the market should be allowed to use guaranteed cost recovery to make riskless investments in technology nor use a monopoly position to procure third party services from related parties. If EDBs wish to compete in contestable markets 'behind the meter', they must do so through a ring-fenced entity without reliance on their RAB. Given the issues that are arising with the Commission's current review of EDBs and their assets, we also call for external audits of RABs to assess that prudent and appropriate investments are being made.

[5] The Commerce Commission's consultation paper: Our process, framework and approach for setting Transpower's expenditure allowances, quality standards and individual price-quality path for 2020 to 2025
[6] Deloitte Report December 2016: Review of Aurora Energy Limited / Delta Utility Services Limit – Network Safety Concerns

The distribution sector is unnecessarily complex and does not provide an appropriate platform for the future

Although amalgamation of EDBs is made more difficult by current ownership structures, Genesis considers this solution needs to be considered in light of the challenges faced by the industry and whether the sector can be successful with 29 regional monopoly networks. The ability of all EDBs to leverage new technology, adapt to change, manage complex asset plans and accurately assess price impacts on end consumers is critical to the sector's success[7]. Rising costs also mean economies of scale are urgently needed to keep electricity affordable.

At a minimum, there should be standardised network access requirements and asset management plan reporting across all EDBs. Further, there should also be homogeneity of network pricing across EDBs. In our view, it is unacceptable for a country the size of New Zealand to have over 2,500 different distribution tariffs. We do not believe that there is sufficient evidence to justify the extent of the differences and it is unclear why time of use tariffs that are broadly similar across the country cannot be implemented. This would improve choice for consumers by better enabling retailers to provide more innovative offerings and it would reduce costs, by removing complexity.

Conclusion

Genesis looks forward to engaging throughout the DPP3 process. We support appropriate regulation as a means to deliver incentives for more efficient investment, cost reductions and simplification to enable better product and service outcomes. The disciplines that exist in the competitive parts of the market have delivered innovation in products and services whilst decreasing prices over the past four years; the Commission should pursue this degree of accountability for the EDB sector as well to ensure the best outcomes for consumers.

If you would like to discuss any of these matters further, please contact me by email: eleanor.briggs@genesisenergy.co.nz or by phone: 09 951 9350.

Yours sincerely

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[7] Energy policies of IEA Countries: New Zealand 2017 Review;
New Zealand Productivity Commission: Low-emissions economy;
Office of the Auditor General: Part 3: Our audits of electricity distribution businesses