



Electricity Governance Board Limited Authorisation Application

**Submission on the Commerce
Commission's Draft Determination
from Powerco**

22 May 2002

Abstract

The Commerce Commission has invited interested parties to make submissions on its draft determination regarding the Electricity Governance Board Limited Authorisation Application.

In summary, Powerco supports the Commission's draft determination. It is Powerco's view that the problems with the proposed governance structure and voting arrangements are symptomatic of the disjointed nature of the electricity sector.

Powerco's alternative regulatory model, outlined in our forthcoming submission to the Commission's discussion paper on regulation of electricity lines businesses, proposes a solution for these issues.

This paper outlines Powerco's response to the Commerce Commission's draft determination.

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Introducing Powerco

Powerco is one of New Zealand's largest electricity and gas distribution companies. Based in New Plymouth, the company has a service area covering much of the central and lower North Island.

The service area of over 28,000 square kilometers includes Taranaki, Wanganui, Manawatu, Wairarapa, the Hutt Valley and Porirua; making Powerco one of the largest New Zealand lines businesses. Powerco also owns and operates the second largest network, with more than 17,200 kilometres of lines and pipes.

Powerco is one of only two dual fuel (i.e. gas and electricity) operators in the country with 205,000 total connections, of which 157,000 are electricity consumers and 48,000 are gas consumers. This makes Powerco the country's third largest distributor in terms of customer connections.

Powerco listed on the New Zealand Stock Exchange on 4 December 2000, and has been active in mergers and acquisitions in the sector over the past decade, averaging one merger/acquisition a year for the last nine years. Powerco's ownership structure is representative of the broader cross section of distribution companies, with foundation shareholders including a local council, and two community trusts. Powerco also has more than 16,000 small shareholders spread throughout New Zealand and another 11,000 investors in senior bonds.

Powerco is New Zealand's third largest electricity and gas distribution business

Our ownership includes a council, community trusts and private shareholders





Competition in the sector

As a lines business, Powerco has been concerned about the dominance of the generation and retail sectors of the electricity industry, which has been a feature of the sector ever since the passing of the Electricity Industry Reform Act in 1998.

That statute required the split between electricity lines businesses and electricity supply businesses, that is, between lines companies and generators/retailers etc. In theory, this was meant to stimulate competition, improve efficiencies and lower prices in generation and retail.

After the split, lines businesses alone were subject to regulation in the form of a statutory information disclosure regime. Information disclosure was previously applied to both lines and retail companies, and was intended to make it transparent to consumers which elements are common to electricity delivered by all retailers and generators and how much those elements cost. In so doing, information disclosure was to ensure that retailers and generators were unable to exercise transitional or structural market power without being in detected doing so.

The reality has proven quite different. After an initial flurry of apparent competitive activity, retail competition has all but died away as vertically integrated retailer / generators seem to have achieved regional energy balance.

In the meantime, lines businesses such as Powerco have forged ahead with efficiencies and real price reductions despite the apparent monopoly characteristics of their business. But most lines businesses are unable to ensure the savings and benefits they create are passed on to the end users, i.e. the purchasers of delivered electricity. There is no regulatory threat or information disclosure to limit the ability of the generator-controlled retail sector to capture consumer value in the supply chain.

The regime applied to network businesses has delivered stable prices and improvements in service quality to consumers. Transparency delivered through the application of information disclosure has provided the surrogate competitive pressures to deliver these outcomes. A similar information disclosure regime should now be extended to generators and retailers so as to ensure that similar outcomes to these can be delivered consistently to consumers throughout the industry.

The dominance of the generators/retailers and their resulting control over prices, standards and efficiencies is reflected in the application by the Electricity Governance Board for authorisation to engage in restrictive trade practices under the Commerce Act 1986 ("Commerce Act"). In particular, the proposed voting arrangements would allow the generators/retailers to wield collective power disproportionate to their individual weighting in the industry.

Retail and generation dominance is a feature of the sector.

Lines businesses are unable to ensure the savings and benefits they create are passed on to end users.

The disclosure regime should be extended to generators, transmission and retailers.



Support for draft determination

Powerco supports the Commission's Draft Determination to decline the EGB authorisation application on the basis that the public benefits of the proposed arrangements are not likely to outweigh the competitive detriments.

In particular, Powerco shares the Commission's principal concern about the potential for desirable and pro-competitive rule changes to be voted down by existing market participants (and especially by vertically integrated generators).

In short, the voting entitlements under the proposed arrangement entrench supply-side dominance. As a result, the incumbent generators, who own and therefore generally control the voting rights of the retailers also, are provided with the clear opportunity to act in accordance with their commercial incentives rather than in the best interests of consumers. The result will almost certainly be less competition, less innovation, less efficiency and higher prices in the generation and retail of electricity. This is despite the best efforts of the lines businesses, which cannot force retailers to pass on savings in electricity distribution to the consumers.

Powerco supports the Commission's determination to decline the application



Response to specific parts of the application

Powerco wishes to respond to two areas in particular of the Commission's Draft Determination: the proposed voting arrangements under Parts A to I generally, and the proposed voting arrangements under Part F (Transportation) in particular.

We understand that the current voting arrangements are a concern for the Commission because of the misalignment between participant and consumer interests. Powerco's proposals in our forthcoming submission to the Commission on lines business price control, however, will demonstrate how lines businesses can be shown always to act "for the long-term benefits of consumers". In this case, there will not be competitive detriment to the Commission authorising the proposed voting arrangements in Part F. Applying a consistent regulatory and disclosure framework to generation and retail companies would equally ensure that there is no competitive detriment involved in the Commission authorising the voting arrangements in the other Parts A to I.

Powerco's proposed regulatory model will overcome Commission concerns regarding the voting arrangements

Proposed General Voting Arrangements

We refer to the proposed voting arrangement in Parts A to I (excluding Part F), which are set out in Appendix 1 to the Draft Determination.

The Commission pinpoints its concerns with the proposed voting arrangements to the blocking or delay of desirable, pro-competitive rule changes, rather than a problem with anti-competitive new rules or amendments to existing rules.

Powerco agrees that the opportunity clearly exists on every vote for participants to vote in the interests of their own sector of the industry. Because generators and retailers are vertically integrated they are likely to vote to further their integrated self-interest. On the majority of votes, generators and retailers collectively wield more power than any other sector. Consumers and others, including the distribution sector, are thereby disenfranchised. From Powerco's perspective, it is immaterial which way the anti-competitive incentives on the generators/retailers manifest themselves – whether by blocking competitive rule changes or supporting anti-competitive rule changes. Either way, the incentives and the opportunities clearly exist.

Under the current regime, the opportunity exists for participants to vote in their own self-interest.

On top of this, electricity lines businesses are currently singled out for extensive regulation by the Commission under Part 4A of the Commerce Act, in a way that generators and retailers are not.

So not only are lines businesses the most regulated by statute, they wield disproportionately less power under the proposed new industry arrangements. Yet arguably, given the current regulatory regime and potential for declarations of control, lines businesses have the least incentive to act in an anti-competitive manner.



The Commission itself recognises in relation to the counterfactual Crown Electricity Governance Board that the distribution sector is regulated under Part 4A of the Commerce Act and as a result “would largely be outside the interests of a Crown EGB” (paragraph 411).

Furthermore, the key problems in the electricity industry, such as increasing prices, poor customer service and switching related difficulties are primarily related to the generation / retail sector and not to the lines businesses. Powerco, for example, has switched to a totally variable pricing structure, which should have resulted in significant savings on the line charge component to small, residential consumers.

But the retail arm of the industry does not seem to be passing those savings on to these electricity consumers, and may not always be accurately or fairly representing line charges to consumers. In fact, Powerco has recently written to the Commerce Commission expressing real concerns in this regard.

Arrangements under Part F

The proposed arrangements under Part F allow transmission providers (Transpower) and their customers (generators and lines businesses) to develop and vote on their own grid investment arrangements. The Commission is concerned that these industry players could veto investments in the grid that would lead to greater competition in upstream and downstream markets. The Commission appears to have essentially the same concerns about industry capture in the transmission sector as it does in relation to the remainder of the electricity industry.

The Commission’s Draft Determination suggests that the commercial incentives on distribution businesses do not always align with those of end consumers (s441-444). Powerco believes that this is a failure of the disjointed regulatory framework across the entire sector and not necessarily a problem of voting rights allocation in part F. Our forthcoming submission to the Commission on lines business price control demonstrates how lines businesses will act in the interests of end consumers using a process of transparent investment discovery. Distribution investments are traded off against technical alternatives including transmission.

However, Powerco believes the Part F scenario is distinct from the difficulties with generator/retailer capture of the overall voting arrangements (as discussed above) for the simple reason that insufficient grid investment will ultimately result in the lights going out. This is a lose-lose scenario for consumers, the entire industry and the government. It would make heavy-handed government regulation inevitable.

Furthermore, it is far from clear that under the counterfactual used by the Commission, this scenario would be any different. Under the counterfactual, the Crown Electricity Governance Board would only step in, possibly even in favour of *inefficient* investments, where industry parties are unable to agree on whether or not the investment should proceed.

Concerns about the commercial incentives on lines businesses result from a failure of the current regime



Characterisation of the Counterfactual

Powerco is concerned that the Commission should distinguish the effects of independent governance from those of an independent discovery process in the counterfactual. We agree that a Crown EGB responsible for monitoring and approving industry processes consistent with the “long-term interests of consumers” would avoid the public detriment that the Commission has identified with the proposed rule book.

Our grounds for believing that the counterfactual would avoid public detriment are that its independent Governance would enable it to veto participant actions if it found them to be inconsistent with consumer interest.

We are concerned that the Commission’s counterfactual characterises the Crown EGB taking a pro-active role in discovering what outcomes are publicly beneficial. This puts the Crown EGB in the position of making decisions about how industry participants should run their businesses. This is neither necessary to prove the Commission’s case nor would it be desirable as an instrument of good public policy.

Powerco supports the approach embodied within the proposed rulebook that industry participants are best placed both to discover options available to meet consumer needs and to chose between them. The issue is that of the rules with which they carry these actions out and the transparency with which they disclose what they have done. We would strongly oppose any counterfactual in which a Crown EGB takes over the property rights within the industry.



The Commission's statutory purpose

Powerco notes that the Commission is specifically charged with promoting the efficient operation of markets for the long-term benefit of consumers, both as a general purpose under section 1A of the Commerce Act, and also more specifically in relation to electricity markets in section 57E, which provides:

57E. Purpose— The purpose of this subpart is to promote the efficient operation of markets directly related to electricity distribution and transmission services through targeted control for the long-term benefit of consumers by ensuring that suppliers—

- a) are limited in their ability to extract excessive profits; and
- b) face strong incentives to improve efficiency and provide services at a quality that reflects consumer demands; and
- c) share the benefits of efficiency gains with consumers, including through lower prices.

While section 57E relates to a specific subpart of Part 4A of the Commerce Act, namely declarations of control, it would be counterproductive for the Commission to act in a manner detrimental to achieving that purpose by, pursuant to a separate Part of the Commerce Act (Parts II and V), allowing the electricity industry to take on a shape and dynamic such as that proposed in the Electricity Governance Board application.

The Commission is correct in its Draft Determination to find that the proposed voting entitlements in favour of the vertically integrated generator/retailers could undermine the potential for desirable and pro-competitive rule changes. The Commission has no doubt considered that the proposed voting entitlements could also detract from the efficient operation of markets directly related to electricity distribution and transmission services, which the Commission is in fact required to promote.

It seems to us that the Commission could leave itself exposed to blame if the lights go out following approval of industry governance and voting arrangements that undermine the Commission's statutory purpose in relation to lines businesses.

The Commission's actions in relation to the EGB rule book must not undermine its ability to achieve its objectives under Part 4A of the Commerce Act.



Suggested course of action

Powerco's view is that the problems with the governance structures and voting arrangements under the proposed arrangements are symptomatic of the disjointed nature of the entire industry.

If the incentives on any industry participant are not to serve the long-term interests of end consumers, then it is unlikely that an industry governed rule book can be consistent with the Commission's objectives.

Just as Powerco has proposed that lines business price control must be considered as part of a wider industry framework, so must the governances and rules for the physical pool and wholesale electricity markets.

We believe that the Commission should decline authorisation of this rule book until an integrated regulatory framework exists to ensure that the needs of end-use consumers are addressed.

This is the Commission's statutory purpose.

Problems with the governance structures and voting arrangements are symptomatic of a disjointed sector.



Wider reform: Powerco's Power Plan

Powerco has recently published its *Power Plan* as a blueprint for reform of the regulatory regime governing parts of the electricity industry under the Commerce Act.

In short, Powerco believes that industry-wide, even-handed regulation is the key to success across the electricity supply chain. Only regulation across the whole industry will ensure that customers receive what they want: delivered electricity at a reasonable price. Lines businesses cannot achieve this on their own.

Powerco's *Power Plan* sets the scene for the reform debate. Powerco plans to develop these ideas further input to the industry debate over the coming months.

Powerco looks forward to addressing the Commission further on these issues at the up-coming Conference in June 2002.

Powerco believes that industry-wide, even-handed regulation is the key to delivering better results for consumers

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