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Dane Gunnell (Acting Manager, Price-Quality regulation)
Electricity Authority
PO Box 10041
By email: regulation.branch@comcom.govt.nz

meridian

2020-2025 Distribution default price-quality path – Issues paper – Meridian submission

Meridian appreciates the opportunity to submit on the Commerce Commission's "*Default price-quality paths for electricity distribution businesses from 1 April 2020 Issues paper*" (the **Issues Paper**). We also appreciate more generally the well-signalled process the Commission is following for the DPP3 reset and its intention to give interested parties multiple opportunities to contribute.

Introduction and general comments

As we understand it, the purpose of Part IV regulation under the Commerce Act is to promote outcomes "…that are consistent with outcomes produced in competitive markets…".[1] The periodic resetting of prices and quality targets via the DPP Reset is a once-in-five-year opportunity to check whether actual outcomes in the distribution sector are achieving such consistency and, to the extent they are not, to recalibrate those price and quality targets. In particular and from a consumer perspective, it is an opportunity to ensure that any efficiencies achieved by distribution businesses in the previous five years are shared with consumers via lower prices being set for the next 5 years.

As the Court remarked in *Wellington International Airport Ltd & Others v Commerce Commission* [2013] NZHC 3289:

> *[27] Thus the purpose [*of section 52A / Part IV regulation*] is to promote the s 52A(1) (a) to (d) outcomes consistent with what would be produced in workably competitive markets. For example, suppliers of regulated goods or services are to have incentives to innovate and invest, but consistent with the manner in which suppliers in workably competitive markets have incentives to innovate and invest.*
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> *[28] When s 52A speaks of promoting outcomes, the question arises: what actions does the regulator take to promote such outcomes? Part 4, in providing for regulation of the price and quality of goods or services in markets where there is little or no competition and little or no likelihood of a substantial increase in competition, envisages that regulation of price and quality will promote those outcomes.*

[1] Section 52A of the Commerce Act 1986.

[29] A key output of Part 4 regulation is prices, the prices that regulated businesses charge for their services. In workably competitive markets, prices are the manifestation of market outcomes: that is, the outcomes of the process of competitive rivalry and of the interaction between supply and demand. It is prices that provide signals to suppliers to innovate and invest. It is prices that determine profits. In each case, of course, prices interact with demand and expected demand. Markets where there is little or no competition do not produce price outcomes that are consistent with the outcomes to be promoted in the s 52A(1) purpose. It is the difficult role of Part 4 regulation to produce prices that generate the s 52A(1)(a) to (d) outcomes[2], consistent with the outcomes produced in workably competitive markets. Prices are, therefore, at the heart of Part 4 regulation.

In the light of this and as a general comment Meridian is concerned that the Issues Paper does not place sufficient emphasis on alignment of distribution sector outcomes with those occurring in competitive markets. The Issues Paper states the Commission will balance the section 52A(1)(a) to (d) outcomes and exercise judgment in doing so,[3] but does not appear to acknowledge that each of those outcomes needs to be pursued to a degree consistent with that which occurs in competitive markets. In other words, it is not enough, for example, that distribution businesses have some degree of incentive to pursue efficiency, or that they have some incentive to share efficiencies, or that they face some limitations in their ability to make excessive profits. The Commission's task – a difficult task as the Court observed - is to ensure those incentives and limitations are sufficiently strong that they produce outcomes consistent with what would be observed in competitive markets.

There also seems little discussion on whether there is scope for efficiencies achieved over DPP2 (if any) to be shared with consumers in DPP3. As we understand it the Issues Paper information on capital and operating expenditure by distribution companies over DPP2 suggests that, at least at the aggregated sector level, few efficiencies have been achieved. It would have been useful for the Issues Paper to discuss this and what it might mean for prices over DPP3.

The Issues Paper refers to the Government's 'Electricity Price Review' as an important aspect of the context, or wider issues affecting the electricity sector, in which the DPP3 Reset is taking place. Specific reference is made to two aspects of the Commission's submissions to the Electricity Price Review as 'relevant to our approach to the DPP3 reset' namely:[4]

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[2] Namely: "that suppliers of regulated goods and services: (a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; (b) have incentives to improve efficiency and provide services at a quality that reflects consumer demands; (c) share with consumers the benefits of efficiency gains in the supply of the regulated goods or services, including through lower prices; and (d) are limited in their ability to extract excessive profits."

[3] Paragraph 2.8.2

[4] Paragraph 3.7

- whether the incentives put in place by the Commission are sufficiently well understood by distributors to influence their behaviour; and

- whether current service levels reflect the level of reliability that consumers want.

These matters are certainly important but it is not clear that, as formulated by the Commission, they go to the heart of the concerns driving the Review. The Review, as its name suggests, is to a large extent about prices. The Review's First Report summed up its preliminary views on areas in need of improvement for the distribution sector as follows:[5]

> *We found factors that may hold back distribution efficiency, including outdated distribution pricing structures; the questionable effectiveness of incentives to reduce costs and improve performance; the small size of some distributors; access to meter data; the quality of governance; ageing assets; and short planning horizons.*

Meridian's submission to the Review observed[6] that since 2011 the rise in distribution costs to residential consumers has been relatively modest and that the larger contributor to real cost increases over this period has been from transmission. However real residential distribution prices have nevertheless increased steadily, in contrast to the competitive parts of the electricity sector where residential prices have fallen in real terms.

Against this background we suggest it would have been useful for the Issues Paper to comment more directly on the issue of prices and particularly the anticipated distribution prices over the period covered by the DPP3 reset as compared to prices observed over the years covered by the DPP1 and DPP2 periods. For example, it would have been useful for the Issues Paper to identify a range of anticipated prices that might apply during DPP3 and the key decisions that the Commission will make as part of the DPP3 reset that will drive prices towards the upper or lower ends of the identified range. This would greatly assist those not versed in Part IV regulation to understand and participate in the Commission's processes. We note that at 3.29 of the Issues Paper the Commission recognises the value of such an approach so it is not clear to us why it has not been employed more fully in the Issues Paper. It may be simply that it is too early in the Commission's process for it to start to give indicative prices and that the Commission will address this in the Draft Decision Paper and Updated Draft Decision Paper that it issues next year.

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[5] Electricity Price Review, First Report for Discussion, 30 August 2018, page 5.
[6] Page 13

Specific issues raised by the Commission

In relation to some of the specific issues raised by the Commission or specific points made by the Commission our comments at this stage are as follows:

Reference	Issue or comment	Initial Meridian feedback
Paragraph 3.51.2	Commission does not intend to focus on changes in approach to efficiency and productivity as part of this reset.	We disagree and ask the Commission to reconsider. The effectiveness of current incentives to drive efficiency has been questioned by the Electricity Price Review and the Commission's stated intention seems at odds with that. We are not sure we follow the explanation given by the Commission at 3.54 for why it believes its current approach to efficiency remains sound. Is this because there is evidence that distribution businesses have been successful in finding efficiencies? There is no evidence to this effect in the Issues Paper. On the contrary, if we have understood the discussion at A23 to A25 correctly it seems the Commission has assumed deteriorating productivity for DPP2 and that this may be weakening incentives to improve efficiency. Further, the Commission speculates at A27.1 that productivity may have in fact been worse than assumed over DPP2 with this contributing to the fact that operating expenditure exceeded the forecast figure.
Attachment C	Reliability standards and incentives	Meridian's initial views: - It supports the current weighting and treatment of planned interruptions (C 6); - It does not support a relaxation of the current one standard deviation buffer (C 7); - We would support changes to the reference period or reference dataset to ensure extreme outcomes do not have disproportionate effect (C 8); - We query whether 'two out of three' should be a necessary precondition of breach or whether other methods might produce better outcomes (C 9); - We strongly support additional reporting requirements (C 10 and C 51); - We query whether the current revenue at risk or any reasonable increase in the level of revenue at risk is or would be sufficient to provide a meaningful reliability incentive – we suspect requirements to publicise quality breaches and steps being taken to address these may be more effective (C 11 to C 13); - We agree with the Commission's emerging views on normalisation (C 15 to C 17); - We agree with the Commission on the Other issues at C 18 to C 20.

Reference	Issue or comment	Initial Meridian feedback
Attachment D	Other measures of quality of service	Meridian's initial views: - We support the additional measures proposed by the ENA QoS working but suggest they be included in the quality standard used for compliance purposes; - We support an additional measure of quality relating to voltage stability as part of the quality standard; - We do not believe UoSAs are generally effective in supporting service quality – this may change if and when the Electricity Authority is successful in mandating a default distribution agreement.
Attachment E	Incentives to improve efficiency	Meridian's initial view is that while in principle it would make sense for the opex and capex retention factors to be more closely aligned, for this to happen the Commission would need to be confident that EDB capex forecasts for DPP3 are likely to be materially more accurate than they have proved to be for DPP2.
Attachment F	Energy efficiency, demand-side management, and reduction of losses	Meridian agrees with the Commission's preliminary views. We consider the Commission should promote line loss reduction through summary and analysis of information disclosed by EDBs and targeted new disclosure requirements.
Attachment G	Implementing changes from the IM review	Meridian agrees with the Commission's preliminary view that volatility in forecast quantities does not need to be addressed through a control. In relation to changes in Transpower costs as a result of changes to the TPM the EA's most recent proposal for amendments to the TPM provided for price shocks to be addressed via the proposed new TPM methodology. We see no need for the Commission to also implement measures to address this.

Please contact us if you have any questions regarding this submission.

Yours sincerely

Jason Woolley
Regulatory Affairs Manager

DDI **04 381 1206**
Email jason.woolley@meridianenergy.co.nz

Alannah MacShane
Regulatory Affairs Analyst

DDI **04 381 1378**
Email alannah.macshane@meridianenergy.co.nz