4 February 2016

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Commerce Commission
Wellington
By email: regulation.branch@comcom.govt.nz

Dear Keston,

Submission on the Commerce Commission's Emerging technology pre-workshop paper: 30 November 2015 (Workshop paper)

Introduction

Thank you for the opportunity to make this submission and participate in the emerging technology workshop held on 14 December 2015.

In order to ensure that input methodologies remain current and fit for purpose, section 52Y of the Act provides that:

> "The Commission must review each input methodology no later than 7 years after its publication and, after that at intervals of no more than 7 years."

The Commerce Commission (**Commission**) is currently in the process of conducting such a review.

As part of this review, we understand the Commission is keen to ascertain if there is a current, or future, problem with the regulatory treatment of the revenues or costs associated with emerging technology investments in the electricity distribution sector and, if so, what changes could be made to the current input methodologies to better promote the purposes of regulation under Part 4 of the Commerce Act 1986 (**the Act**).

In Contact's view, there is a problem with the regulatory treatment of the revenues and costs associated with emerging technology investments in the electricity distribution sector. A stronger regulatory approach is required to ensure that input methodologies facilitate the purposes of economic regulation and operate in the long term interests of consumers.

The electricity industry is changing

For many years the electricity industry was seen as having stable, predictable technology with reasonably clear delineations between the different segments of the supply chain, enabling a clear distinction between monopoly and competitive service providers.

This position is changing.

NZIER have described the changes to traditional business models as follows:

> "34. When the IMs were being developed prior to 2010, there was little prospect of the electricity industry being subject to the sorts of disruptive changes that are starting to emerge. The potential for change was talked about but the IMs were developed in an energy system where, for instance, nearly all electricity was generated far from the point of use, transported by the grids and offered for sale and purchased in the wholesale market. ..
>
> 36. This has now changed and will continue to do so, requiring a re-consideration of the risks and incentives for both networks businesses and for consumers of network services.
>
> 37. Declining demand growth for energy, climate change concerns, strong growth of renewable local generation of electricity, energy storage systems and demand management, as well as the use of smart technology in the operational management of grids have all combined to jump start what is now regarded as potentially the most profound changes to the energy industries since the initial development of the networks.
>
> 38. These changes appear to be neither short term nor cyclical. They are structural, long term and are changing the economics of the energy system."[1]

These structural industry changes are creating important issues for regulation of the electricity industry both in New Zealand and abroad. The key issue being that traditional monopoly conveyance services are now facing competition from new technologies.

Contact is keen to ensure that the regulatory settings for investment in new technologies promote the best long term outcomes for consumers. To this end we asked Castalia to provide us with an independent report on the regulatory settings that would maximise the value of these technologies for consumers: including batteries, load control systems, solar PV and other forms of distributed generation, as well as electric vehicle charging infrastructure and the various other energy technologies which will emerge over time. All of these technologies have one element in common: they provide an alternative to the traditional conveyance service and they provide other services including an energy service. Castalia's report is attached as an appendix to, and should be read as part of, this submission.

Castalia's overarching conclusion is that emerging technologies fall into a class of technologies that deliver fundamentally competitive activities and that, in relation to these investments, the dynamics of long term competition rather than economic regulation will deliver the best outcomes for consumers.

It follows that this current input methodology review is particularly timely.

Objectives of current review

In Contact's view the starting point for the assessment of whether current input methodologies are fit for purpose in the face of these significant market changes, is a clear understanding of the

[1] NZIER Report to MEUG, Commission review of the IMs: Identifying problems with the current IMs, page 6.

original purpose of the current regulation. In our view, the original purpose was to regulate monopoly services and not services which are subject to competitive market activity.

We think that both the legislative history and the text of Part 4 confirms that this was Parliament's intention. Our reasoning is set out in Appendix A.

The Castalia report advises that investment in emerging technology is fundamentally an investment in a competitive activity. This aligns with our market experience. Therefore we consider that one of the most important purposes of the current input methodology review is to recalibrate whether the purposes of Part 4 are still being met in the light of the changing market environment.

Current input methodologies lack necessary rigour for the new market conditions

After considering the Commission's workshop paper and participating in the associated workshop we have formed the view that the current input methodologies lack the necessary rigour for the new market conditions. Section 4 of the Castalia report describes the limitations which exist with the current input methodologies.

These include concerns arising from the fact that:

- Assets can be included in the regulated asset base if a **regulated business** considers they are required for regulated purposes,
- Regulated suppliers may not have incentives to realise the full value[2] of investments in emerging technologies for consumers,
- Regulated suppliers may be able to earn additional returns from assets included in the regulated asset base (e.g. from ancillary services) without consequential adjustments to the permitted regulated returns, and
- The *de minimis* thresholds and other flexibilities in the cost allocation input methodology will shift costs onto customers of regulated suppliers.

Castalia also note the significant practical difficulties which arise at the interface between regulated and unregulated businesses in relation to investments in, and contracts for, services from the various types of emerging technologies.

Castalia state on page 15 that:

> "While there are a number of possible ways to address these issues, we consider that assets providing a mix of regulated and unregulated services should be ring fenced from regulated businesses. This solution balances the desire to allow regulated businesses to invest with the need to ensure effective competition in unregulated markets."

[2] For example, if an investment in alternative technologies could provide services in addition to conveyance services the full value of the investment could be attributed to consumers and deny consumers the additional benefits that could be derived. This is inefficient and could be avoided by the competitive provision of all the services of the technology.

Other jurisdictions have reached similar conclusions

This recommendation aligns with the approaches being considered or already adopted overseas. For example, the Australia Energy Market Commission (**AEMC**) has undertaken extensive analysis on battery storage and its uses across the Australian energy sector.

In its Final Report, the AEMC stated:

> "Utilising the competitive market frameworks …will allow consumer preferences to drive how the sector develops. New business models will be tested and those that offer value to consumers will thrive while those that do not will vanish. The way consumers value storage and associated services will determine the deployment of this technology and competition between providers will keep costs low. A consumer led deployment is not necessarily orderly-but consumers are generally in the best position to decide what works for them. We are wary of proposals that seek to impose solutions or particular technologies on consumers at the expense of competition, especially when they result in consumers bearing the risk of the technology deployment".[3]

It concluded that storage should be considered as a contestable service outside the scope of economic regulation of monopoly networks. The same logic is applies to other types of emerging technology.

Amendments to the input methodologies

The Castalia report notes on page 16 that:

> "We think the IMs can be amended to include the required rules. Rather than specifying an approach to allocating costs, the IMs could instead require ring fencing and arms length dealing- directly ensuring a level playing field ….
> This solution will require regulated businesses to contract for the network benefits of storage through agreements with battery owners – which could be an affiliate or third party. This will require the right information being made available to other providers of emerging technologies"

Contact notes this approach could take the form of a number of changes to the IMs, for example to provide:

- New guidelines to ensure that there is a common understanding across the industry of the boundary line between the services properly regulated under Part 4 and services not intended to be encompassed by price-quality path regulation,
- Amendments to ensure that regulated suppliers are only able to include the costs of contracting for services from non-monopoly assets in their allowed operating costs, if they purchase those services on an arm's length basis,
- Additional incentives, if necessary, for regulated suppliers to contract for an alternative to traditional conveyance services from emerging technologies where that is more efficient than investment in traditional technologies, and

[3] AEMC Final Report on Integration of Energy Storage: Regulatory Implications, 3 December 2015 at page ii

- Rules and processes to ensure that all potential suppliers of services from emerging technologies have timely and complete access to information about available investment opportunities.

In summary

Contact thinks that the lines service regulated by the Act is the provision of a monopoly conveyance service. The permissive and flexible approach afforded to regulated suppliers in the current input methodologies is problematic as it creates a risk that investments in non-monopoly assets will be inappropriately included within the scope of the regulated service.

There are a number of ways this could be addressed but our preferred solution is that supply of services from emerging technology assets that provide multiple services are provided to regulated suppliers on an arm's length basis. This approach will ensure that the lines services regulated under Part 4 are the "basic services not subject to competition" as intended by Parliament.

Finally, we understand the Commission does not intend to seek cross-submissions on this matter. While we appreciate the tight time frame the Commission is working to, we believe the cross-submission process has an important role to play and we would strongly encourage the Commission to reconsider its position on this matter.

Should you wish to discuss any matter raised in this submission please do not hesitate to contact me.

Yours sincerely

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04 496 1567

Questions from the Workshop paper

134. Do you agree with the contents of this paper?
No. We think a more rigorous approach is required to ensure that regulation of the monopoly sector does not spill over to markets where there currently is competition and the likelihood of increased innovation and competition.
135. Do you agree with the current approach of relying on EDBs to determine if what they are doing is part of the electricity lines service is appropriate?
No. We think there is considerable "room for interpretation" about the need for particular network investments in emerging technologies, particularly investments which provide, or have the potential to provide, both regulated and unregulated services. We note that the regulated environment provides a greater certainty of cost recovery than the unregulated environment and, that this creates incentives for costs to be allocated to the regulated services rather than to the riskier unregulated services.
137. Do you think the flexibility provided by the availability of three different cost allocation methodologies is appropriate?
No. Our primary submission is that ring fencing investment in emerging technologies would be a sounder approach than fine tuning the cost allocation methodologies. However in relation to cost allocation approaches we think that a single approach is preferable and this should be the approach which most closely allocates capital and operating costs to the services to which those costs relate (e.g. ABAA).
138. Do you think that the results and processes for determining the circumstances in which OVBAA can be employed are appropriate?
No. OVBAA results in a greater proportion of costs being allocated to the regulated service than under ABAA. We do not think that cost allocation IM needs to provide a regulated cost advantage for investments in competitive activities by distributors. The purpose of Part 4 is to ensure that excessive prices are not charged for access to monopoly infrastructure.
139. Do you think the definition of capital contributions is appropriate?
Yes.
140. Are you aware of any revenues/costs that are currently treated as regulated (unregulated) when they may not and/or should not be?
As noted in the Castalia report we think ripple control is a contestable service as are many of the other services provided by emerging technologies which generate, store, use or transform electrical energy. We see the regulated service as being a conveyance service which uses monopoly infrastructure (poles and wires).
141. Are you aware of any EDB prices that bundle charges for both regulated and unregulated

services, or reasons why bundled charges may be offered in future?
No comment.
142. Are you aware of any arrangements where revenue from the supply of electricity lines services would best be treated as capital contributions?
No comment.
143. Do you think additional R&D or innovation incentives are needed? And if so, what?
No. We think there is currently a competitive investment environment for the provision of new electricity technologies and the Commission should not provide incentives or other arrangements which have the practical effect of favouring one group of market participants over another. This is not the purpose of Part 4 (including section 54Q).

Appendix A: Scope of Regulated services

Legislative history

The legislative history for Part 4 begins with the Commerce Amendment Act 2001 (No2), which introduced a targeted control regime with the goal of:

> "control all or any goods or services (and authorise the prices, revenues, or quality standards of those goods or services) supplied by a large electricity lines business in markets directly related to electricity distribution and transmission services, if it has breached a threshold set for control, after taking into account the purpose of the regime."[4]

This targeted control regime was substantially amended in 2008 with the introduction of a new Part 4 to the Act. The purpose of the 2008 amendments was not to expand the scope of the lines services being regulated but instead to improve the form of regulation and introduce a specific purpose statement for this part of the Act.

One of the key innovations in the 2008 amendments was the use of input methodologies to provide more certainty to regulated suppliers and other affected industry participants.

The following statements from the first and third readings of the 2008 Commerce Amendment Bill confirm the intended scope of the economic regulation and also explain the purpose of the input methodologies.

> "The replicability of the input methodologies will also benefit those in non-regulated sectors. For instance, it will ensure that those negotiating **with monopolies** can point to a standard model. [5]

> "This bill is a major improvement in the way we think about and **regulate basic services that are not subject to competition**. It applies best-practice approaches from around the world. I commend this bill to the House."[6]

> The provisions relating to the input methodologies are the most important provisions in this bill apart from the introduction of a purpose statement for this particular part. Given that these rules determine how financial statements should be prepared for regulatory purposes, they actually allow the Commerce Commission to identify whether **a natural monopoly business is taking monopoly rents.** So they are the fundamental part of any form of regulatory control under the legislation"[7]
> (*emphasis added)*

We think it follows from this legislative background that Part 4 is not intended to regulate services which are subject to competition.

This interpretation is reinforced by the scheme of the Act including:

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[4] Commerce Amendment Bill 2008: Bills Digest No 1608.
[5] Commerce Amendment Bill 2008 (as Introduced), see "Explanatory Note".
[6] (20 March 2008) 646 NZPD 15157.
[7] (2 September 2009) 649 NZPD 18539.

- The statements in section 52 that Part 4 provides for the regulation of services in markets where "there is **little or no competition** and little or no likelihood of a substantial increase in competition",
- Section 52A purposes are designed to "**replicate outcomes produced in competitive markets**",
- Section 54C(2)(a) – (d) which exclude from the regulated lines services lines services which are not used to provide a monopoly transport service , and
- Section 54C(2)(e), which **excludes** from the regulated service services that involve "conveying of electricity…by a **line or lines that are mostly in competition with a line or lines** operated by another supplier of electricity lines services that is not an associate of that person".

Scope of the definition of lines service

It was acknowledged at the workshop that the drafting of the definition of "lines services" in Part 4 was difficult to follow and suffers from a circularity problem.

However we think if you look at the section as a whole in the light of the purpose outlined above and in particular:

- Section 54C which defines the regulated services for electricity lines companies by reference to the "**conveyance of electricity by line**",
- The cross-reference to the definitions in the Electricity Act, which also define "lines" by reference to their conveyance function and specifically exclude appliances and other electrical works used for storage and generation from the definition of a "line",

it is clear that Part 4 is only intended to cover the monopoly conveyance service provided by lines companies and not any other contestable services lines companies might provide from time to time, including services from emerging technologies with multiple uses.

In reaching this view we have considered section 54Q of the Act, which requires the Commission to "promote incentives, and…avoid imposing disincentives, for suppliers of electricity lines services to invest in energy efficiency and demand side management and to reduce energy losses when applying this Part in relation to electricity lines services". We do not believe this section is intended to expand the scope of the regulated services to include activity in contestable markets.

Instead, our interpretation of this section is that the Commission needs to endeavour to apply its regulation of the conveyance service in a technologically neutral way whilst also adhering to the scope and purpose of Part 4.

We think, for instance, this obligation would be met if a lines company were able to include in its permitted revenues the operating costs, associated with acquiring energy management services on an arm's length basis if this was the most efficient way to deliver the monopoly conveyance service.