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Dear Dane

ERANZ submission on the default price-quality paths for electricity distribution businesses from 1 April 2020 (DPP3) issues paper

The Electricity Retailers' Association of New Zealand (ERANZ) welcomes the opportunity to provide feedback on the Commerce Commission's (the Commission) 15 November 2018 issues paper on the 1 April 2020 default price quality path reset (DPP3) for electricity distribution businesses (EDBs).

This is an important piece of work from the Commission – and we are supportive of the overall process being undertaken for the DPP3 reset.

Electricity distribution is critical for the electricity industry to meet the expectations of its customers . The consequences of EDB investment decisions are ultimately borne by end consumers, with sub-optimal investments manifesting as either higher prices or reduced quality over time. As the customer-facing part of the industry, retailers' reputation and brand, as well as costs, are tied to the quality and cost of EDB service provision.

The DPP3 reset coincides with increased scrutiny of the electricity industry. The Government Electricity Price Review (EPR) is underway – at a time when changes to the price path for EDBs under DPP3 could impact on the future costs faces by consumers. Customers are also facing potential cost increases as a result of upcoming EDBs investments to refurbish and replace aging network assets and strengthen distribution networks to meet the expected future needs of customers.

It is appropriate to review the current incentive scheme

We agree that the Commission should consider whether current incentive structures are appropriate and resulting in the best outcomes for consumers.

The current incentives under DPP2 do not appear to have driven efficiency improvements in EDBs.

To date actual capital and operating expenditure in DPP2 has been significantly higher than the forecast with only a quarter of capital expenditure being explained by higher than forecast prices. EDBs can recoup 85 per cent of additional capital expenditure and 67 percent of additional operating expenditure from consumers.

In addition there have also been some challenges with quality in DPP2 - with quality standards being broken eleven times.

The issues paper acknowledges that the incentive to constrain capital expenditure is weak and questions whether a capital expenditure retention factor of 15 per cent remains valid. It may be worthwhile for the Commission to investigate whether a higher capital retention factor, coupled with more stringent measures when quality standards are not met, would be beneficial.

Spending on aging networks could increase prices

MBIE data indicates that electricity price pressure over the last 5-years has largely been driven by both national electricity transmission and local distribution networks. There is a risk that these parts of the sector will continue to place upward pressure on prices.

The Commission itself considers that, given the age profile and normal life-cycle replacement of many distribution assets, there is increased need for network investment – stating in its EPR submission that "some individual EDBs will have significant capex needs within the next decade, putting material upward pressure on local prices".

The issues paper asks whether levels of investment in response to ageing assets are sufficient to deliver services at a level which consumers demand - raising the prospect that higher capital expenditure, and therefore prices faced by consumers, may be required to maintain current quality standards.

To provide the Commission with better information regarding what levels of investment are required to deliver services at the level which consumers demand, the Commission could require EDBs that have breached the standards to provide detailed explanations how they could have avoided the breaches.

EDB investment in new technologies needs the right incentives

In addition to maintaining the current aging network, investment is also required to ensure networks can meet consumers' future needs. All EDBs in their most recent Asset Management Plans (AMPs) are flagging increased future investment due to their predictions of consumer uptake of new technologies.

EDBs are actively investing in, and in some case promoting, emerging technologies. Almost all EDBs have invested in public EV charging, and a significant majority have invested in electricity generation, battery storage, or both.

Again, higher investment in new technologies will generally drive higher costs to pass on to consumers.

Some of this investment assumes that emerging technologies (distributed generation technologies such as solar PV systems and batteries, and electric vehicles) will be adopted en masse by consumers. Rapid adoption at scale - coupled with the uptake of applications enabled by emergent technology such as peer-to-peer trading, demand side response, and home energy management systems - would change traditional network demand patterns.

All businesses, including EDBs, need to prepare and invest for a future that looks different from today. What is important – particularly for monopolies – is getting the incentives right to drive the appropriate level of investment.

Most businesses facing the risk of disruptive technology change operate in a competitive market and therefore bear the risks – both positive and negative - of investing for a future that may or may not eventuate. This is not the case for lines monopolies. Consumers will pay for network upgrades regardless of whether the demand forecasts underpinning those investments eventuate.

The IM changes, in particular changing to a revenue cap and allowing accelerated depreciation, strengthen the ability for EDBs to recover their sunk investment following future asset stranding or underutilisation, effectively shielding them from the risk associated with technology uptake and shifting that cost to consumers.

These incentive settings could see consumers facing higher prices as a result in sub-optimal investment in specific new technologies based on EDBs' current expectations of future consumer appetite for these technologies.

Retailers are keen to help

Being the customer facing part of the electricity industry, retailers can provide valuable consumer insights. ERANZ and retailers are keen to be involved in the DPP3 decision process in order to help the Commission understand the price-quality preferences of our customers.

ERANZ commends the recent efforts of the Electricity Networks Association and its working group to review current and prospective new service measures. However we were disappointed that retailer representatives were not included on the working group, other than ERANZ in an observer role.

The Commission has a challenging problem to solve – assessing the appropriateness of current incentives that do not appear to have driven efficiency improvements in EDBs given DPP2 has seen higher than expected capital and operating expenditure and quality standards not being met. We are keen to help in any way we can to improve the incentive structures that apply to EDBs and ensure that the long term interests of end customers are promoted by the price path that applies in DPP3.

We look forward to continuing to work with the Commission for the benefit of the sector and the long-term interests of consumers.

Yours sincerely

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Electricity Retailers' Association of New Zealand