EC080910 Submission retail

APPENDIX 1 (See especially Section 3)

Submission on Market Design Review Options Paper from David Close September 2008

Introduction

1.1 I wish to commend the Commission for assembling a large amount of information, especially that presented in the form of graphs, which enables observations to be made and conclusions drawn. The breakdown of residential charges into their various components is especially helpful. However, I have some concern with those parts of the paper that set out a wide range of options without any attempt to prioritise those that are easy to implement and likely to yield a significant benefit. Similarly, I have concern with some of the recommendations to carry out further investigation, as they appear to be a substitute for action.

1.2 My submission will be concerned mainly with measures to protect residential consumers. Commercial and industrial consumers have strong lobby groups to represent their interests to the Commission, and the pricing information in the paper indicates that both groups have benefited under the market. By contrast the pricing information indicates that residential consumers have been the losers under the market.

1.3 The Commission has an obligation under its principal objective to ensure that residential consumers are treated fairly. In the five years of its existence the Commission has expended most of its effort on issues relating to transmission, security of supply, and market operations and governance. Of necessity, the Commission's "constituency" on these matters has been industry participants, and by and large the Commission has acted in accordance with the views of industry participants conveyed through working parties and formal and informal consultation. However, when the issue to be considered is the retail market, the Commission's "constituency" is the small consumers, domestic and commercial, and it is their views and their interests that must be considered. It is entirely inappropriate to allow industry participants – whose commercial interests are not aligned with those of consumers – to dominate the debate or exercise a de facto veto on effective consumer protection.

1.4 In order to provide an effective voice for consumers, the Commission needs to develop suitable methods of consultation. The standard method of posting a discussion document on the Commission's website and calling for submissions via the Commission's electronic newsletter Update is obviously inappropriate. I am not sure whether the consumer issues group, which the Commission resolved to create in October 2007, has yet been established.

1.5 The resources (finance and personnel) allocated to a task are often a good measure of the priority the task is receiving. It would be reasonable for the Commission to allocate 4-5% of its budget to practical programmes to empower and protect small consumers.

Areas of Concern

2.1 Response to Question 1. As the wholesale market generally works well, and as the retail market has not resulted in effective competition or downward pressure on prices, an option which should be considered is the retention of the wholesale market and reversion to a single retailer in each distribution area, with retail prices to be related to the wholesale price. More will be said of this option later in the submission. Let it suffice to say at this point that the overheads of retailers competing in 38 distribution areas appear to outweigh any benefits to consumers.

Competition and pricing issues

3.1 <u>Trends in electricity prices for industrial, commercial and domestic consumers.</u> Figure 1 (Section 50) shows that, in the 1999-2006 period, inflation-adjusted costs increased by 28% for domestic consumers, 20% for industrial consumers, and only 3% for commercial consumers. It was therefore surprising that the paper concludes that "all major customer groups have experienced substantial price increases since 1999." It is not clear why the paper does not explore the reason for the major, continuing divergence between domestic and commercial consumers. It would appear that competition is effective for large commercial consumers, who negotiate contracts, at the expense of domestic and small commercial consumers.

3.2 It is to be expected that some commercial customers will have negotiated discounts from distribution companies in return for reducing demand at times of peak load. However, most domestic consumers in most areas have their water heating cut at peak times, so one would not expect the divergence to be explained by peak load shedding.

3.3 The Commission has analysed the components of the domestic electricity price (energy, network, retail) but has not attempted to identify the components of commercial charges. In the absence of such analysis, there is a strong suspicion that domestic consumers are now subsidising commercial consumers. The suspicion is strengthened by the refusal of retailers up to the present time (as far as I know) to separately identify, and make public, line and energy charges, as required by the GPS, the model consumer contract, and the resolution of the Commission.

3.4 It is worth recounting the history of this issue. When retailers were asked why they had not provided a breakdown of their charges on customer invoices in accordance with the model consumer contract, they pointed to the cost and time it would take to change the computer systems on which their billing depended. After some time had elapsed, the Commission enquired about the progress retailers were making in complying with the transparency requirement and hinted that it would have to consider making a regulation. The response of the retailers was that placing the breakdown of costs on invoices was difficult and instead they offered to post the information on their websites and include it in a letter to consumers whenever they were making adjustments to charges. The Commission agreed to this compromise. A recent letter to domestic consumers from Meridian informing them of a price rise did not provide a breakdown of the charges. Perhaps other retailers have done so, but I am not aware that they have.

3.5 It seems to me that the Commission has given ample time to retailers to comply and that the retailers have indicated, by their lack of action, that they have no serious intention of complying. This leaves the Commission with no option but to regulate. The Commission is charged with exerting downward pressure on prices, a task that is difficult and for which it has few instruments, which it makes it essential that it use those instruments which it does have, such as requiring transparency of charges.

3.6 **Submission:**

(i) That, in view of the failure of retailers to abide by the voluntary agreement to provide a breakdown of line and energy charges to consumers, the Commission proceed without delay to publish a draft rule requiring this information to be provided on all invoices from 1st March 2009.

(ii) That, in order to provide transparency of charging between residential and commercial consumers without breaching the confidentiality of contracts, a draft rule be published requiring retailers to provide a breakdown of line and energy charges for small, medium and large commercial customers by group.

3.7 <u>Retailers' margins.</u> Paragraph 65 of the Options Paper states: "There has been a sizeable increase in the estimated gross retail margin (i.e., retail operating costs and margin). This raises a question about competition in the retail market, or whether other factors can explain the margin increase."

3.8 The retail gross margin appears to be in the 20-25% range in most cases, but there are cases where it exceeds 30%. In Table 1 below a few representative examples are given. The percentages and dollar figures have been **roughly calculated** from Figures 9 and 12 in the Options Paper.

Table 1

Gross Retail Margin

Area	Medium Usage Residential		Low Usage Residential	
Waitaki	22%	$346	23%	$270
Christchurch	21%	$346	21%	$243
Auckland	25%	$423	20%	$243
Ashburton	25%	$423	29%	$351
New Plymouth	29%	$538	32%	$432
Greymouth	26%	$538	27%	$405
Otago	23%	$500	38%	$621

3.9 It is hard to find objective grounds for the large variations. Competition in the cities may be a factor, though bad debts are a greater problem there. The cost of meter reading may be higher in rural areas. However, Christchurch-based Orion includes rural Banks Peninsula and rural central Canterbury. The concentration of customers and economies of scale are also relevant. Nodal price risk has been mentioned as a factor, but Kaikoura, which regularly features in COMIT publications as having the highest nodal price in the country, and this is reflected somewhat in the energy cost, has amongst the lowest prices in total. Further enquiry is warranted. Just as a lines company is "investigated" by the Commerce Commission if its line charges are out of line, so there should be a mechanism for formal investigation of gross retail margins. It is the same consumer who needs protection.

3.10 In addition to a focus on the differences between gross margins in different retail areas, justification should be sought for the total sums being extracted from residential consumers for metering, billing and other servicing. For example, if one takes the Options Paper estimate of $170 for servicing a consumer per year, the yield from 130,000 customers in the Christchurch area amounts to $22m.

3.11 What sort of value-for-money benchmark might be applied to this? What other services are supplied for sums of this sort? The cost of supplying water to the same 130,000 households is about $11m – this includes the cost of reticulation, pumping, reservoirs, depreciation and metering (but not billing). Over New Zealand as a whole, $170 p.a. from 1.8m residential consumers would yield $306m – nearly half of Transpower's costs.

3.12 The international evidence provided in Figure 68 shows that a New Zealand retailing operating cost of $170 is very high. It is obvious that the manner in which retailers have spread their efforts over many distribution areas adds to their costs. It would appear that a token retail presence in many area may be a disbenefit to consumers overall.

3.13 Prior to deregulation the General Manager of Christchurch City Council's Municipal Electricity Department estimated that the cost of an electricity bill could be broken down into 50% generation, 20% transmission, 27% local network and 3% retail. The cost of retailing in 1990 was therefore about $39 per consumer – about $75 in 2008 dollars. (The cost of meters was probably regarded as a network cost.) This supports the international evidence that a cost of $170 is excessive.

3.14 Serious consideration needs to be given as to whether the costs of the competitive model are justified for residential consumers. The Options Paper suggests a simplification of network charges to increase the possibility of retail competition. Such a simplification will be difficult to achieve. In any case, serving a widely dispersed customer base is inherently inefficient. Instead a return could be considered to the early years of deregulation when retailers competed for commercial and industrial customers but a single retailer (in those days a power board or MED) supplied all the residential customers on the local network.

3.15 The current situation is that the incumbent retailer has over 50% of consumers except in three networks, so the change would be much less radical than it appears. Charges could be regulated by allowing retailers a gross margin over wholesale electricity costs of, say, 12-15%, the benchmark not to be exceeded on average over any three-year period. This model would restrict profits in retail, where there is not a competitive market, but allow the wholesale market, which is generally considered to function well, to continue.

3.16 There is some evidence that generator-retailers compete up to the point where they have a sufficient retail customer base to enable them to hedge their generation, but they do not want additional customers to the point where it could be expensive for them to buy supply from competitors in the event of dry years or extended plant failure.

3.17 Figure 16, which shows net retail margins of all retailers by distribution areas, shows the stance which different retailers take in the market. Mighty River Power operates in only 15 distribution networks, all of which are in the northern or central areas of the North Island. In all those areas where it competes, it offers the lowest or second lowest tariff. Trustpower is the incumbent in twelve provincial areas and in six of those has the highest charges. Contact is incumbent in eleven areas, is the dearest in three, the second dearest in six, and nowhere the lowest. Meridian, incumbent in five areas, is the lowest in three and the second lowest in two, but in other areas its prices range from lowest to highest. Mighty River Power appears to show the advantage of restricting its activity to certain areas. It appears that incumbents do not face genuine competition in some areas. Non-incumbents, in offering high-priced tariffs in some areas, may be doing so with the hope of shedding customers, and even where they offer low tariffs may not be actively seeking new customers. The paper makes a very valid point in Paragraph 114 that the New Zealand market is regionalised into sub-markets where there is potential for exercise of market power.

3.18 **Submission: That the Commission address the problem of the retail margin by:**

(i) discussing with the Commerce Commission ways and means of regulating the retail gross margin using methods akin to the "threshold" trigger used for distribution companies
(ii) investigating the transaction costs which the "competitive" model imposes on residential consumers
(iii) investigating an alternative market model which retains the wholesale market in its current form, and retains retail competition for commercial and industrial consumers, but provides for a single, regulated retailer for residential consumers in each distribution area.

Nodal prices

4.1 The Options Paper covers familiar territory with discussion of nodal price risk, zonal pricing and improvements to the hedge market. However, there is not a huge variation in the energy component of the prices. They range from $769 p.a for medium residential customers in Kaikohe, Kaikoura and Greymouth, to $615 in Waitaki. For low usage customers the difference is even smaller, from $555 in Kaikohe, Kaikoura and Greymouth, to $500 in Waitaki. No doubt additional transmission or local generation would narrow the difference further. What is inescapable is that the network charges and retail margin cause a much greater difference in tariffs. The incumbent net margin for medium usage residential ranges from $410 in Masterton to $65 in Christchurch, and for low usage residential from about $415 in Otago and about $265 in Masterton to about $35 in Christchurch.

4.2 It would be valuable for the Commission to study examples where additional transmission capacity has reduced nodal prices. (Blenheim still experiences high nodal prices – has the upgrade of the line from Kikiwa been completed?) However, the point I wish to underline is that there is more potential for downward pressure on retail prices through the retail margin than through the energy component. There is a mine of information in Figures 9-14 which demands action.

4.3 The outstanding nodal price issue in 2008 is, of course, the nodes throughout the South Island that have experienced very high prices in 2008 during the period of low lake levels. Although domestic consumers are protected to some extent by vertical integration of generators and retailers, the impact on industrial and commercial customers paying a component of the spot price is severe. This winter has underlined the importance of swift action to upgrade the HVDC link. However, in making the assessment of Transpower's proposal, the Commission must change the net market benefit test to include all pricing benefits to consumers. It is patently ridiculous to ignore the costs to the consumer because the supplier has profited in a constrained market. It is also ironic that South Island generators, judged by the pricing methodology to be the sole beneficiaries of the HVDC, have been unable to supply North Island consumers and have watched North Island generators profit from high South Island prices.

4.4 Submission: That the Commission adjust the net benefit test in the Grid Investment Test to include benefits to consumers.

Customer Switching

5.1 The rate of customer switching is low for the various reasons set out in the paper. One reform which would simplify comparison of tariffs would be to require retailers to make their annual adjustments in September. There would then be the orderly sequence of Transpower announcing prices on April 1st, distribution companies on July 1st and retailers on September 1st.

5.2 It makes good sense to make more use of Consumer New Zealand's Powerswitch. The proposal to have an 0800 helpline that would provide information from Powerswitch is an excellent idea. The higher cost of operating and promoting an 0800 line, compared with other initiatives, should not be a deciding factor. If 500,000 consumers were to save $100 a year, the total saving to consumers would be $50m a year. It would therefore be entirely reasonable for the Commission to spend $2-3m a year on this project. The Commission has been spending several million dollars a year at the industry's behest on the reconciliation project, which is unlikely to benefit consumers to any extent. It should devote comparable funding to facilitate consumer switching, which is the most direct way of promoting competition. The outcome might be a significant degree of consumer switching, which would in turn force the retailers that lose customers to reduce tariffs to avoid losing too much market share.

5.3 **Submission: That the Commission devote sufficient resources to promote and facilitate consumer switching.**

Energy Affordability

6.1 There is undoubtedly an affordability problem, of which I meet a good many examples. I do not think that it is difficult to define – Figure 34 shows clearly that it is the bottom decile of earners who are in the greatest need. Nor do I think it difficult to identify solutions. Such solutions should not include direct subsidy of electricity costs, since the Ministry of Social Development has the responsibility for benefits and income support. Direct subsidies of power bills could produce perverse outcomes of wasteful use of energy at a time when the nation is under an obligation to reduce consumption.

6.2 Instead the approach should be generous subsidy of insulation and energy efficiency and conservation. The subsidies should be available to landlords as well as homeowners and should be available, following an inspection from an assessor, for ceiling and underfloor insulation, low-flow showerheads, drapes and heatpumps. Such an approach would dovetail with the Commission's obligations to promote energy efficiency. The programmes could be carried out by distribution companies with funds from the Commission.

6.3 Submission: That energy affordability be addressed primarily through generous subsidies for energy efficiency and conservation in the home, and that distribution companies be considered as the Commission's agent in the programmes.

Disconnections for non-payment

7.1 It is pleasing to see that the rate of disconnections has dropped. It should be noted that the revised guidelines issued in mid-2007 did not differ greatly from those they replaced, but they were backed with a threat of regulation from the Prime Minister.

7.2 The Options Paper is right to say that a high rate of disconnection is an indicator of energy affordability issues. However, it is also a factor in making energy unaffordable, since the fees charged for disconnection and reconnection, and the surcharges on unpaid bills, may exceed a month's normal power charges.

7.3 I was alarmed to read the suggestion in Paragraph 268 that the reduction in disconnections might be unsustainable. I can see no reason why disconnection rates in New Zealand cannot remain at or below the levels in Australia and England. I was surprised to see that the paper did not contain disconnection statistics for the first two quarters of 2008.

7.4 **Submission**:

(i) **That the Commission publish the disconnection statistics at the end of each quarter.**
(ii) **That, following consultation, the Commission develop a performance standard for disconnections as a proportion of total connections and monitor retailers' compliance with it.**

Summary and Conclusion

8.1 The Commission is to be commended for the amount of useful statistical information which it has assembled on consumer pricing issues. Although some matters require further investigation, the Commission has ample information on which to act in a number of key areas.

8.2 This submission proposes or supports a number of straightforward measures, several of which the Commission has previously agreed to implement, which in combination could bring downward pressure on residential prices.

8.3 The submission contains a number of more radical proposals for change to the current regime. The Commission should give consideration to these also, with a view to regulating the market for residential consumers if the less radical steps to achieve competitive prices for residential consumers do not achieve the intended effect.

David Close

8 Seafield Place,
Christchurch 8062

david.close@xtra.co.nz

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