

Speech Notes for Address to ENA – 18 October 2017

Distribution pricing reform

The Authority believes that distributors have strong incentives to reform their pricing structures so their charges are more service-based and cost-reflective.

If distributors do not, then consumers will make inefficient decisions to bypass paying for their services. This will add further costs to other consumers and result in more consumers bypassing paying for distributor's services.

Distributors can't do much to stop *efficient* bypass, but by adopting service-based and cost-reflective pricing they can avoid *inefficient* bypass and asset stranding.

The strong connection between distributors and the communities they serve means that they are likely to better understand what will work well and suit their communities than a central regulator. It will also mean that they will have more credibility with consumers when they say that changes are needed.

The best role for the Authority is to support you with getting on with the job. It is more than an interested observer, however. It has a statutory role to promote the efficiency of the electricity industry for the long term benefit of consumers. It thinks that the

industry taking the lead is the best approach but, if that looks like it will fail or not be effective, it has an obligation to review its approach.

The Authority is appreciative of the efforts distributors put into the roadmaps they presented to the Authority. This provided us with useful information and also, we hope, provided you with useful pointers on how your fellow distributors were planning to make changes in this area.

One concern is that a number of distributors think that work on reforming distribution prices can be left for a number of years. We think planning and signalling the need for change and introducing changes need to be addressed. We are well aware of how long it can take to introduce service-based and cost-reflective prices.

Some points of advice in the context of setting charges are:

1. The service-based aspect is as important as the cost-reflective aspect, if not more important.

Some customers may want to buy only a limited capacity back-up service for their own PV/battery installation. Others may want a large capacity full energy delivery service giving them access to wholesale prices. Some customers will want high reliability and prioritised reinstatement. Others will be happier with lower costs and lower reliability and priority.

The key is to ask what customers want to buy from you. This can be hard for organisations that have enjoyed a strong market position for a standardised service. Monopolies not only enjoy power in relation to pricing above competitive levels. They also have the luxury often of telling customers what service or goods they can have, irrespective of what they actually want. Changing the culture to provide customers with choice can be hard. Some banks struggled for a very long time with this.

The fact that most of you have a retailer interposed between you and the ultimate consumers of your services also adds a layer of complexity. However, this situation is far from unique. Every time you go to the supermarket or a department store you see literally thousands of products for which a retailer is interposed between the consumer and the producer. The retailers and producers of the service manage to work together on pricing points and strategies quite successfully.

2. Try to set new charges that are based on sound principles but are pragmatic in application.

3. Peak pricing seems to many to be a good idea but you should be cautious about it. 'Peak' is not really an economic or cost-reflective idea. What drives costs is the need to expand capacity, and peak use can relate to the need to increase capacity—but it may not. RCPD is a very good example of a poorly designed peak charge.

4. Grandparenting favourable charges is often short-term gain for long-term pain. The incumbents who are grandparented are happy but other parties are not, and often the prices they have to face to ensure revenue adequacy for the supplier are not efficient.

Having a transition period to allow parties to adjust may be a better approach or you might look for an opportunity to make changes when the negative impacts can be moderated. Will 31 March 2020 provide distributors, subject to price-quality paths set by the ComCom, and others that use them as a guide, a good opportunity to introduce changes?

The impact of new technologies

The rise of photovoltaics, batteries, electric vehicles, automated control systems, etcetera. is likely to have a big impact on the industry and on distributors in the next few years.

I attended an OECD meeting in June about the impact of radical innovation on the electricity industry.

At the meeting only two parties spoke up against the ring-fencing of distributors from involvement in providing the new technologies to the industry. The assumption of most was that the “monopoly” character of distributors meant that they should be

excluded from any participation in the deployment of these new technologies.

The two parties in the minority were the New Zealand Commerce Commission and the Electricity Authority.

In other travels and meetings the situation was the same:

Norway has about 150 distributors. The five largest are currently subject to ring-fencing but they are proposing to impose this on all distributors.

In the UK, Ofgem has recently announced plans to exclude distributors from providing batteries.

In Australia, the AER assumes that ring-fencing is the obvious policy.

The key issue is to ensure that the markets for the provision of services related to batteries, photovoltaics, electric vehicle charges etcetera remain or become level playing fields. That potential entrants into these markets are not scared away by distributors and that distributors do not overtly or covertly self-deal.

Ring-fencing is one approach but, when you do not know what business models may work and what technology may turn out to be best suited to local

conditions, it may not be the best approach. Moreover, in more remote areas of New Zealand the local distributor may be the only efficient and willing provider of some of this new technology.

Maybe a better approach for us is to have lines companies establish enforceable policies relating to access and self-dealing that ensure the markets remain workably competitive. These will need to be of a high standard and be enforceable by interested parties wanting to access networks and provide services in competition with the lines companies to be effective.

The Authority has recently accounced membership of its Innovation and Participation Advisory Group (IPAG). One of the things it has decided to ask IPAG to consider is whether the Authority needs to undertake any initiatives to improve investor confidence in the provision of these services.

Study of lines company efficiency

For the Authority, the study is not motivated by reasoning along the lines that there are 29 lines companies in a small country and surely it would be cheaper to have fewer.

The Authority is interested in cost efficiency of arrangements and models of lines companies cooperating to reduce operating costs. Graeme Peters has provided the Authority with very good information about the significant cooperation that is

increasingly occurring between distributors. Our Board-to-Board meetings have also highlighted these developments.

However, from the Authority's perspective, the bigger fish is the dynamic efficiency of the arrangements. Whether distributors have the capacity and incentives to facilitate the adoption of new technologies on their networks, and allow an open contestable process for this to occur.

In this context, good progress with reforming pricing would be a very positive sign, as would progress in establishing enforceable policies relating to access and self-dealing. We are aware of thinking in other jurisdiction about the introduction of DSOs and have started to think about whether nodal pricing extending deeper into distribution networks might bring further efficiency gains.

Default distribution agreement

The Authority is continuing to work on this and will be consulting on a revised proposal late this year or early next year.

Avoided costs of transmission

The Authority has never been opposed to consumers paying for avoided costs of transmission (ACOT). Its objection has been to consumers paying for ACOT when there has been

no savings in transmission costs to consumers as a group.

I suggest you wait for the release of our draft decision for the lower South Island and carefully read the ComCom's response to ENA's letter about pass-through, before you jump to any conclusions about the likely costs to some distributors.

Extended reserve

We are working with NZX and Transpower on a project to implement an extended reserve scheme to replace AUFLS in the North Island.

We have run into some data-related and technical issues, and information about the events in September last year in South Australia has lead us to reassess the way forward. A paper on this is scheduled to come to the Board in December.

Extended reserve is, hopefully, rarely if ever needed. But it is essential the scheme works very well when it is required to do so.

Outlook

Forecasting the future is fraught with difficulties but there are plenty of positive signs for the New Zealand electricity industry generally, including distributors.

Climate change commitments are not likely to go away for any country soon. New Zealand's electricity system is well placed in a world where parties are trying hard to reduce greenhouse gas emissions:

Approximately 85 per cent of our electricity already comes from low emissions sources (hydro, geothermal and wind) and further increase appears very likely.

There are lots of opportunities to expand capacity from wind and geothermal, and to some extent hydro, at costs not much different from current average wholesale prices.

There is going to be a lot of pressure to convert a good proportion of New Zealand's light vehicles and low-grade process heat to electricity. Demand for electricity should shift upwards.

We have avoided a large influx of PVs as a result of too high feed-in tariffs, and the low operating costs of much of New Zealand's current capacity should restrict the abandonment of existing hydro, wind and geothermal generators as a result of competition from falling PV costs.

We have well-functioning wholesale and retail markets that should allow us to integrate batteries, increased PV, EV, wind and

geothermal without too many economic or reliability problems.

Prices in New Zealand for residential consumers are relatively low compared with many other OECD countries. We are 11th lowest and several of those with lower prices have subsidies and/or retail price controls.

Reliability issues and high and rising retail prices for electricity greatly increase the risks of ill-considered policy developments. We should be able to escape both these triggers if we keep working together.