The New Zealand Manufacturers Federation

Submission to:

The Ministerial Inquiry into the Electricity Industry

1. Introduction

1.1. The New Zealand Manufacturers Federation Inc (ManFed) welcomes the opportunity to contribute to the present Ministerial Inquiry into the Electricity Industry.

1.2. This submission is made on behalf of the New Zealand Manufacturers Federation. The Federation represents both regional associations and sector groups of manufacturers that support this submission.

1.3. ManFed has been involved in the development of a competitive electricity industry since the present reforms started well over a decade ago. The Major Electricity Users Group (MEUG) which has made significant detailed input into the reform process originated in the ManFed Energy and Environment Committee. ManFed is also involved in the Consumer Coalition on Energy (CC93) which was formed in 1993 to provide a wider base on behalf of the consumer in the reform process. The participants in CC93 are - ManFed, MEUG, Federated Farmers and the Consumers Institute. The fundamental purpose driving both these groups has been to see the benefits of the electricity reform process delivered to the end consumer. ManFed fully supports the submissions made by both groups.

1.4. Manufacturing as a sector consumes large quantities of energy, the latest available Census of Manufacturing showed $742 million being spent on electricity in 1995. With energy being such a large input into the cost structure of the manufacturing sector it is vital to the health of the sector and thus New Zealand's economy to have the benefits of the electricity reform process flowing through to the end consumer.

1.5. Much has been made of the need for New Zealand industry to be globally competitive in terms of its exports. Every opportunity must be taken to reduce the internal costs structures for exporters so that their competitive position is enhanced in global markets. Lower electricity costs for our exporters could be significant in their success or otherwise.

1.6. ManFed has consistently supported the proposition that competition should be the driving force in the electricity market wherever possible. Where competition has been effectively introduced it has been apparent that cost efficiencies have occurred. What continues to concern ManFed is that the benefits of the introduction of competition into the market are yet to be manifested in the pockets of the consumer. This is after many years of industry restructuring.

1.7. To date the stumbling reforms have almost reached completion. The introduction of competition in generation has seen input prices fall, similarly with electricity retailing the possibilities for competition are increasingly being seen. The monopoly lines and distribution businesses are not producing the desired outcomes for consumers however. Thus, this Inquiry is appropriate, particularly if it focuses on what must be the prime objective - a better deal for the end consumer.

2. Other Issues

2.1. While not raised in this context ManFed supports the proposal being put forward by CC93 for a Utilities Ombudsman to be implemented. The consumer throughout the reform process has had little power to influence the outcomes. With the introduction of greater competition and awareness by consumers, it is likely that disputes will increase between suppliers and consumers. Thus it appears to be timely to suggest a similar mechanism to the insurance and banking industries to assist in the resolution of those disputes.

2.2. Commerce Act Amendments, currently before Select Committee, needed to define the point at which anti-competitive levels of market power occur, should be passed. The definition should be harmonised with the level used in Australia; ie the threshold for abuse should be "a substantial degree of market power". Mergers and acquisitions that result in a "substantial lessening of competition" should be prohibited. This change is needed to prevent the re-aggregation of market power (similar to the old ECNZ) and the consequent ability to sustain higher pricing structures.

3. Specific Comment on Issues Raised

ManFed has the following comments on issues raised in the Ministerial Inquiry into the Electricity Industry Issues Paper (the Issues Paper)

Transmission and distribution

Identifying and constraining market power

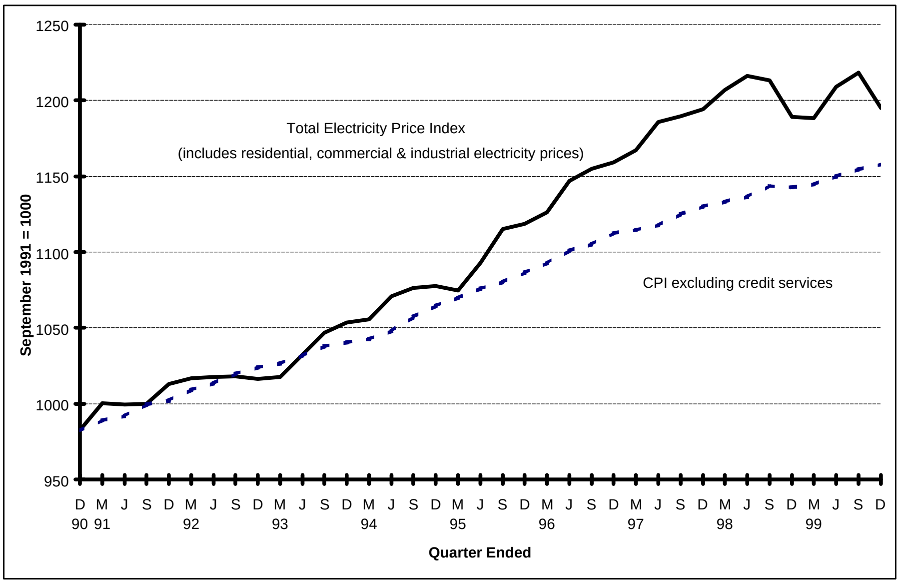
'Whether changes are required to the regulatory regime for transmission and distribution to ensure efficient prices and service delivery.'

The comments in the Issues Paper that the monopoly lines businesses both national (Transpower) and regional might face competition in forms such as bypass, embedded generation or direct supply may well be true in the future - at this stage however such competition is only at the fringes or only available to large consumers. The bulk of the consumers of electricity have to face the monopolistic charges imposed by both the national and regional lines businesses with little or no ability to negotiate costs and terms of supply.

In spite of cost savings being made by the generation and energy companies during the reform process the consumer has yet to see the benefit, with the savings apparently being captured by the lines businesses.

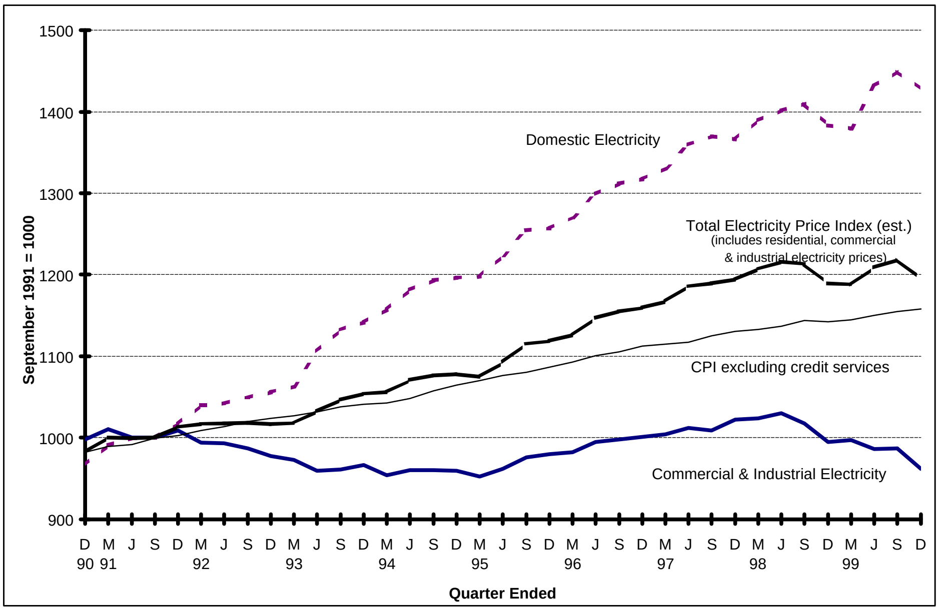
Statistics NZ data tracked by ManFed show the "Total Electricity Price Index" (Graph 1) increasing at a faster rate than the CPI.

Graph 1



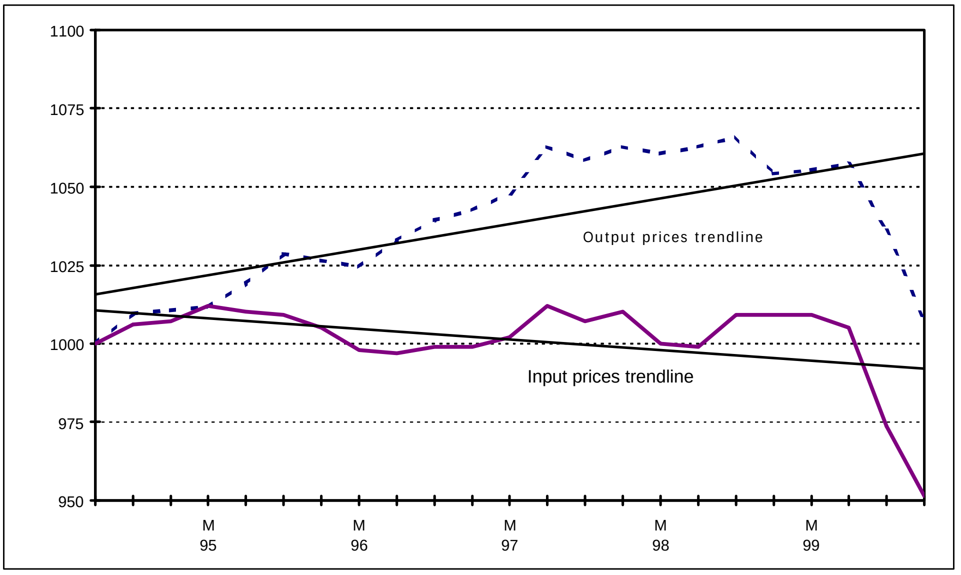
Graph 2 shows the split between domestic and commercial and Industrial electricity, the effects of rebalancing can be seen - regardless, the total electricity cost continues to rise.

Graph 2



Graph 3, the PPI for electricity, gas and water graphs the input and output prices (The electricity component of these statistics is the dominant part). This shows that while substantial reductions have been made in input prices (generation), the difference between that and the output price remains substantially constant. There have been no efficiency gains reflected through to the end consumer.

Graph 3



ManFed would suggest that the primary reasons for this are:

- Savings, eg when lines companies meters were sold, not being passed on;
- Lines companies seeking to earn high rates of return but avoiding all risk;
- Ever increasing asset valuations and thus the justification of higher charges.

ManFed recommends that as the monopoly lines and transmission businesses have captured cost benefits that should properly have flowed through to the consumer, and in the absence of any real competitive pressure on those businesses - that regulation in the form of price control be imposed immediately.

Any price control mechanism must have some stipulation that a reduction in quality of supply would be the equivalent of an increase in price.

The price control formula suggested is that of a Price Index - X, where X is a minus figure less than the rate of inflation. We note that the most commonly suggested Price Index is the Consumer Price Index (CPI). ManFed would like to suggest an alternative, more appropriate Index:

'Price Controls On Line Companies

The lines companies provide services to both commercial and residential customers so the CPI, which only measures price changes affecting households, is not useful for the implementation of price controls.

A better measure of inflation is the GNE deflator, which measures price change on all gods and services purchased in the New Zealand economy. It should be noted there has been a significant difference between the level of inflation shown by the two measures. The following example is based on a comparison of the two indexes between June 1992 and June 1999.

	Total % change between June 1992 and June 1999	**Annual average change (1992 – 1999)**
CPI excluding credit services	13.2	1.9
GNE deflator	5.9	0.8

The electricity industry has been using the CPI to deflate the price of electricity to the commercial sector but this is a misleading use of the data. Some of the factors that account for the differences between the two measures.

- Reductions in cross subsidies between business and households; and

- New central and local government charges. Between June 1992 and June 1999 central and local government charges rose by 35.7%, an average annual increase of 5.1%.

Measuring Price Increases

The Producers Price Index survey by Statistics New Zealand measures changes in input costs and output prices by industry sector. The input costs measure excludes labour costs and capital equipment costs since these are measured in other surveys.

The Department publishes a separate index for the electricity industry, which shows a consistent growth in the margin between input costs and output costs as a result of faster increases in output costs.

The Department is now able to produce an index for the generation sector as the split up of ECNZ has resolved concerns over confidentiality. The Department is also able to produce separate indexes for Transpower and the lines companies but has stopped work on this project due to lack of funding.

Funding for this work is essential to monitor the behaviour on firms in the lines sector since it appears most of the growth in profit margins in the sector has occurred in the lines companies. The indexes would also provide information on how well Transpower and the lines companies are managing their input costs. The use of a GNE deflator – x price control is likely to force companies to focus more strongly on reducing their input costs as well as limiting growth in profit margins.

The use of Statistics New Zealand to collect this data is favoured since they already have the powers to compulsorily collect information and have experience in constructing reliable inflation measures.'

New Zealand Manufacturers Federation

Asset valuations and efficiency assessments

'Whether asset valuations and efficiency assessments should form part of the regulatory regime.'

The most significant initial issue is to set the appropriate valuation of a monopoly business. The present valuations based on ODV are excessive arising from a biased interpretation of the ODV rules and a non-transparent process. These high valuations are one of the reasons the benefits of cost and efficiency improvements in the electricity industry have not been passed through to the end consumer.

The present regulatory disclosure regime does not allow for a lines company's ODV to be independently assessed for appropriateness thus allowing the present high valuations to persist.

It is essential then, that there be a mandatory revisiting of lines company's ODVs based on clear, standard guidelines applied uniformly and transparently.

Information disclosure

'Whether the existing information disclosure regulations provide adequate and reliable information for assessing the performance of transmission and distribution companies.'

With the present state of the information disclosure regulations, it is very difficult to benchmark the performance of lines companies. The uneven nature of the information makes this virtually impossible. The answer to the above question has to be - no.

MEUG has attempted to carry out an evaluation of the disclosures and has had difficulty with, variability in interpretation, presentation of the information and a degree of resistance from some of the lines companies in providing information that would assist in a comparison between businesses.

We note that the Issues Paper indicates that specifying externally the information required to determine performance is very difficult. We agree, but that should not preclude the effort.

ManFed supports the suggestion of "for companies to provide a core of common information in a standard format to allow comparisons of performance both between New Zealand companies and with similar companies overseas." We would also add the comment that to be effective information disclosure must be timely.

Ensuring system security

'Whether the present incentives for ensuring system security in transmission and distribution are appropriate.'

The arrangements contained within the MACQS agreement should provide confidence that system security is appropriately dealt with.

ManFed supports the MEUG suggestion for stakeholder agreements whereby levels of future network security and work programme with consequent liabilities are negotiated. Such agreements should assist in creating better incentives for line companies to perform and reduce the risk of inappropriate investment in line company assets.

Wholesale market

Does the voluntary nature of the market jeopardise its efficiency?

‘Whether the efficiency of the wholesale market is jeopardised by its voluntary nature and/or the extent of vertical integration between generation and retail.’

If the question is intended to ask whether participation in the NZEM should be compulsory or voluntary, ManFed is of the opinion that the option to bypass that market should stay.

It is important that the NZEM be exposed to competition though it is recognised that there may well be improved price signals to the dispatcher if the NZEM were to be made compulsory. We do not think that those benefits outweigh the cost benefits from the competitive tension imposed on the NZEM through it's voluntary nature.

It is apparent that the real time dispatch market must be compulsory - there may well be issues regarding how that process may be made more efficient.

Market governance

‘Whether market governance should allow for greater participation by smaller players and end users.’

In a word - yes. However, as always the difficulty is how can the end user effectively participate? There is the obvious imbalance in knowledge and ability to participate between end users and those directly involved in the industry.

It is likely that had the end user been more effectively involved in the process of change in the electricity market over the last decade then we may have arrived at a better outcome for the user and the New Zealand economy today.

The consumer organisations such as MEUG and CC93 were formed to try to provide a better voice for consumers in the market development process. Unfortunately, the offers to participate in the development process were often rejected, it is welcome to see the MACQS agreement providing for consumer representation on the GSC.

The focus from now on must be on improving the participation by consumer interests where they will be most effective in the determination of price, quality and delivery of electricity

Opportunities for demand-side participation

‘Whether opportunities for demand-side participation in the wholesale market should be increased.’

No particular comment.

Retail

"The Government's objective for the electricity industry will be achieved if consumer preferences are identified correctly and met efficiently, reliably and in an environmentally sustainable manner. In most industries, competition provides an important measure of performance against such an objective. By seeing what is available at what price, consumers learn considerably more than could be found out by examining the costs of one service in isolation. Better combinations of price and quality produced by competitors motivate firms to search and innovate to better meet consumer needs. Competition between retailers to meet consumer needs therefore has the potential to contribute significantly towards the Government's objective."

ManFed entirely agrees with this statement from the Issues Paper.

Barriers to entry

'Whether there are barriers to entry by new retailers that restrict the development of retail competition.'

ManFed has little documented evidence to support comments regarding particular barriers to entry that new retailers might have. Anecdotal evidence would indicate however that there are barriers in the form of the bureaucratic hurdles that they face. This is true particularly if the new entrant wishes to compete on the national level. The need to reach agreement with so many (31 lines companies) of differing size, complexity and willingness to promote competition within their regional areas is a large hurdle.

While ManFed was impressed by the effort made by the industry in putting in place switching arrangements under legislative threat, the actual process of consumer switching has not been as smooth, seamless and fast as expected.

We are of the opinion that the reluctance by the electricity industry to include the interests of the consumer in its processes will continue to frustrate the introduction of real competition for all consumers.

As an example - we understand that the industry is looking to revise the switching protocols, and that one of the suggestions is for a period of not more than 62 days be allowed for a switch to be implemented. This suggestion appears to be driven entirely by the needs of those in the industry and NOT the needs of the consumer. The end result of this type of approach can only be less, not more, incentive for consumers to consider switching between suppliers.

We would agree with the suggestion by MEUG that "the Government should signal to retailers that they have 3 months to agree complete and implement low cost switching rules. Otherwise the Government will consider intervening".

Standard use-of-system agreements

'Whether there is a need for the Government to facilitate or require the development of standard arrangements between retailers for consumer switching, and/or standard contracts between retailers and distribution line owners for the use of distribution networks.'

ManFed has no strong recommendation for standard contracts being implemented. We do however recognise the difficulties for new entrants when faced with the large number of differing contracts and negotiations required. This all adds to the cost structure that end users have to pay. The difficulty with standard contracts is that they become a de facto "lowest common denominator"

Fixed charges

'Whether the Government should constrain the use of fixed charges, taking into account economic efficiency, energy efficiency, interfuel competition, and equity considerations.'

ManFed would support any effective proposal by the industry (or Government) to reduce fixed charges to the absolute minimum.

Standard contracts between retailers and consumers

'Whether there is a need for the Government to facilitate or require the development of standard arrangements between retailers and consumers to promote consumers' interests.'

Again, ManFed has no strong recommendation for standard contracts or arrangements being implemented between retailers and consumers. We agree with the CC93 conclusion that:

- The inclusion of electricity in the Consumer Guarantees Act;
- The introduction of an Ombudsman, and;
- Enhancing competition at the consumer level

will best promote the interests of consumers.

4. Conclusion

ManFed members as consumers of electricity would like to see:

- Electricity delivered at the lowest possible price consistent with the quality of supply that is appropriate to their circumstances.
- This can be delivered through an electricity market where effective competition is introduced wherever possible and;
- Where competition is not possible effective constraints are placed on the monopolistic parts of the industry to curb the abuse of their monopoly power.

In the context of this Inquiry ManFed recommends:

4.1. An immediate introduction of an "INDEX - X" regime to the monopoly electricity lines businesses. The common suggestion is "CPI-X". ManFed suggests that "GNE-X" is better suited. Any reduction in quality to be considered as equivalent to a price increase.

4.2. An immediate review (recalculation) of all lines businesses ODV. Any recalculation to be based on clear, standard guidelines applied uniformly and transparently.

4.3. Improvements are made in the Information Disclosure Regulations such that direct and accurate comparisons can be made in a timely fashion of the performance of lines businesses.

4.4. More effective involvement of consumers in the decision making process.

4.5. A reduction in the barriers to entry for new entrant retailers, including improvements to the customer switching process. ManFed (along with MEUG and CC93) suggest that the industry be sent a signal that intervention will occur unless within 3 months there is an efficient and effective working switching mechanism in place.

4.6. That electricity be included within the Consumer Guarantees Act

4.7. That the electricity industry take up the suggestion of CC93 and implement a Utilities Ombudsman along the lines of the Banking and Insurance Ombudsman schemes.

4.8. That Statistics New Zealand produce detailed electricity industry statistics, particularly relating to the monopoly sectors i.e. the lines businesses and Transpower.