

## UPDATE ON CURRENT ISSUES

Dr Helen Brookes, Chairman, Waitaki Power Trust

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### A. INTRODUCTION

At the ETNZ conference in May this year Energy Minister, Judith Collins, and ETNZ's Executive Officer, Alan Jenkins, introduced us to a report by the International Energy Agency (IEA Report).

That Report was commissioned by government with, I believe, significant oversight by Ministry of Business, Innovation and Employment (MBIE), as well as input by two Crown entities, the Electricity Authority (EA) and the Commerce Commission (ComCom).

Main findings by the IEA Report include.

1. An increasing amount of new and emerging technology is coming on stream, that will change the way in which electricity distribution networks, are operated and managed;
2. There will also need to be significant changes made, to ensure that consumers, as the end users of distribution services, benefit from the adoption and implementation of new technology;
3. Business practices, by EDBs in New Zealand, currently fall under one or other of two descriptions – they either operate primarily as 'platform service providers', focussing on providing distribution services, or as providers of value adding services which not only distribute electricity, but also operate a range of other types of business.  

“to promote additional revenue streams to supplement their regulated cash flows” (IEA Report, p. 141).
4. The IEA Report recommends that all EDBs, across New Zealand, become providers of neutral platform services only.

Also in May this year, a hugely significant consultation document – “Enabling Mass Participation in the Energy Market” was released by the EA.

The content of that document clearly shows, that the EA has its own agenda and that its agenda includes, implementing a number of recommendations from the IEA Report.

Accordingly, the EA states

“The focus of this [Mass Participation] paper is the 'gaps' in that programme and .... [in particular] what, if any, changes to the rule book ... may be needed to promote

competition in, reliable supply by and the efficient operation of the electricity industry for the long-term benefit of consumers” (EA, 30 May 2017, page ii).

In other words, the EA’s “gap-filling” consultation process is primarily aimed at developing

“a regulatory framework that makes sure networks provide **open access** and a **level playing field**” (ibid, page 23).

According to the EA, those changes to existing present distribution practices, would enable consumers to benefit from a competitive rollout, of new and emerging technological products and services.

My purpose today is to talk about the fallout from the Minister’s presentation, the IEA Report, EA’s consultation document and the content of specific submissions to it.

Going forward, I will identify and discuss issues as I see them, focussing on the extent to which EDBs, trustees as shareholders, and consumers, will be affected, in the event that changes sought by the EA are implemented. I then identify some options trustees may want to consider, as a way of mitigating and/or resolving the challenges we face.

The release by EA of its ‘Mass Participation’ document, is subtitled, “how can we promote innovation and participation?”.

The Executive summary states clearly, why the EA is consulting on electricity market participation,

“The Electricity Authority wants your views on **changes to regulation** that may be needed for consumers to benefit from the changes in technology and innovation happening now in the electricity industry”

In essence, the EA has set its own agenda. Its work stream currently includes, among other things, making changes to enable

“third parties to help maintain and enhance network reliability by using batteries or demand response” (ibid, page iii).

In the consultation document EA acknowledges two types of ‘**service platforms**’.

The first is

“a set of market arrangements for matching buyers (Transpower and distributors) with sellers (suppliers of required services)” (ibid, page ii).

The EA also attributes a ‘**platform for services**’ role, to **electricity lines networks**

## B. THE FALLOUT – CHALLENGES, ISSUES AND CONCERNS FOR TRUSTEE/SHAREHOLDERS OF EDBS

### ISSUE 1

#### Protecting and/or benefitting the long term interests of consumers – who is ‘fit for purpose’ to fulfil that role?

I anticipate that the majority of Trustees present would be in agreement, that from what we already know, new and emerging technology will be of benefit, to distributors and consumers, alike.

The question is – from a ‘fit for purpose’ perspective, who is best equipped to ensure that whatever happens, the long term interests of consumers **will be upheld**?

The Electricity Authority has assumed that role, almost as of right.

Nowhere, in all the material I have recently read, did I see mention that Trustee/shareholders could also have a role to play in ensuring that consumers do benefit, in the longer term, from access to services based on new and emerging technology.

As Judith Collins advocated, it is valid to ask some questions.

So: **Can** a case be made, and put to the Minister which shows that ‘consumer benefit’ needs to be uncoupled from policy and regulation relating to competitive markets, to enable Trustee/shareholders of Electricity Consumer Trusts to be involved, in the discussions?

After all, I am confident that we, as Trustees, know far more about consumer interests and what our consumers see as ‘benefits’ than both ComCom and EA. And, I am sure that you will agree, that not all consumers think the same!

### ISSUE 2

#### A Regulatory Approach to Ring-Fencing – Effects for EDBs and Trustee/shareholders

What ComCom will require in the future is more likely to be objective evidence that the **distributor’s related businesses** have not received favourable treatment from the company’s **regulated business** activity.

The IEA however advocates a much stronger approach. The absence of effective regulatory constraints could simply “open the door”, for distributors to abuse their natural monopoly.

It is obvious that the EA agrees. The Authority comments that ‘accounting separation’ is a **weak form** of ring-fencing.

And notes that

“stronger forms of ring-fencing are also used in New Zealand” (EA, 30 May 2017, p. 24).

A second option is “functional separation”.

That arrangement permits distributors to broaden the range of their business activity, as is provided for by the 2010 Electricity Industry Act, but only under certain specified conditions.

The third ring-fencing arrangement – ‘legal separation’ – entails that distributors cannot **directly** participate in a particular competitive market, at all.

The reasoning behind EA’s contention that current ring-fencing arrangements “might need strengthening” is clearly stated. It is

“the prospect of more participants requiring (access to) **a distribution network service**, to compete in markets where distributors might also be active” (ibid, p. 24, emphasis added).

Therefore, to promote competition the EA adds to its work stream the following task,

“to develop a regulatory framework **that (also) makes sure** networks provide **open access** and a **level playing field**” (ibid, 5.5, page 23, emphasis added).

At this point, the only conclusion we can draw, is that the overall effect of ring-fencing, by complete structural separation would result in the establishment of all distribution companies being transformed into **neutral platform service providers – by default**.

To help understand the full effect of complete structural ring-fencing arrangements, it is important to ask:

1. What would the status of an EDB’s **unregulated network repair, maintenance and upgrade division**, be;
2. Who would be responsible for the overall governance, management, control and operation of other **unregulated** businesses, currently held by EDB companies;
3. Which side of the fence would capital contributions, called up to help fund eminent up-grade work be lodged on, since, after all, capital contributions which in some cases are referred to as ‘development levies’, are not regulated for, either.
4. To what extent, if at all, would structural ring-fencing benefit consumers in the longer term and if not, why not?

### **ISSUE 3.**

#### **One size fits all, or does it?**

The IEA Report, along with the EA's consultation document on 'mass participation', as well as the Electricity Retailers' Association submission, are all based on the same unstated assumption. It is that the recommendations/proposals advanced by each party need to apply **across the board**, to all EDB companies.

The example above of the EA's heavy handed solution to ensuring that a one-size-fits all approach is to apply, comes across as a significant change by the EA, from more accurate comments the Authority has made earlier, that

“Every distribution area is different so a one-size –fits all approach will not be successful”

(EA, December 2015, p. 6).

Network Waitaki's regulatory analyst did some work on the **comparative effects** of a range of network variables on operational and capital performance.

The variation in EDB rankings from year to year with respect to the two performance indicators used in our analysis, clearly confirmed EA's earlier position that every distribution area is different.

Trustee/shareholders and the EDB companies they own really do need to take that point on board before the regulators, MBIE or government decides that all EDBs are to be fitted into the same mould.

### **ISSUE 4**

#### **The Drive for Efficiency – Economy of Scale**

The view that 'bigger is better' has been out there for some time now, as has the contention that efficiencies result from economy of scale.

According to Energy Minister, Judith Collins, the fact that

“a country 'our size' has 29 electricity distributors is a 'real issue' and creates 'some inefficiencies' [as well as showing that] the cost of distribution is clearly quite high” (Felicity Wolfe, Energy News, 3 and 18 August 2017).

Further the IEA Report, specifically notes that

“Concerns have been raised about the (distribution) sectors capacity to effectively harness efficiencies associated with economies of scale” (IEA Report, p. 148)

But in fairness to affected parties, the considered opinion of the International Agency is that because

**“no official empirical analysis** has been undertaken on economies of scale in New Zealand’s distribution businesses ... there is **little evidence that small firms are less innovative or perform less well than large ones”** (IEA Report, p. 150)

Clearly the jury is out. We leave the matter there.

## ISSUE 5

### Governance and Trust Ownership

When presenting to the ETNZ Conference in May, Judith Collins queried whether

**“the trust model** is a constraint on getting the benefits of greater scale in distribution businesses” (Judith Collins, 11 May 2017, p. 2, emphasis added)

In the same presentation the Energy Minister also asked whether trust

“arrangements are still fit for purpose and **whether consumers will continue to see value in the future”** (ibid, p. 2, emphasis added)

The IEA Report is more forthright, noting that investigation ‘reinforced’ the IEA’s

“concerns about the on-going effectiveness of a corporate governance model based on community ownership” (IEA Report, p. 153)

Clearly the IEA’s comments are based on a number of assumptions.

The key to identifying the more important of these, and probably putting a finger on the reasons for the Energy Minister’s queries as well, is the tension the IEA hints at above, between the dual role the same person, has as both trustee and shareholder

As we no doubt are all aware, the tension between the two roles, trustee/shareholders, have, not only requires the wearing of two different hats, but two different ways of considering the same issue, are required. Corporate business principles need to be upheld to ensure that the company is a successful business. The further question is, will proposals by the company be in the long-term interests of consumers?

The unifying factor, is our overall responsibility, to uphold the long-term interests of our consumers.

## ISSUE 6

### An Un-level Playing Field – is it possible conflicts of interest could be involved?

The way in which issues raised by the IEA Report and EA's 'Mass Participation' document, are to be resolved, looks at first sight, to be to a large extent, in the hands of government, MBIE and EA.

In terms of the issues raised by these two documents, MBIE, EA and government have a raft of common interests. That is hardly surprising, given the more or less circular relationship between the three parties.

I consider, it would be beyond belief to assume that MBIE **does not take into account** the Crown's shareholding in the electricity gentailer companies, owned by the Crown, when making recommendations to government on policy, regulatory and legislative matters. In cases where objectivity is questionable, the conclusion is that a conflict of interest exists.

To those who would deny that conclusion it suffices to point out that according to a former Auditor General, Kevin Brady, the term 'conflict of interest' covers both real and **perceived** situations where objectivity is threatened. (Brady, Kevin, Managing Conflicts of Interest: Guidance for Public Entities, June 2007).

It appears initially that the EA does not have a conflict of interest. After all, what the EA does is mandated for, by the statutory objective of the Electricity Industry Act 2010.

But I am not so sure.

In its submission the Electricity Retailers' Association makes a telling comment. It is that

"This consultation largely captures all the questions and issues that ERANZ **have been raising** on the concern of the blurring of the line between what is a contestable service and what is a monopoly service" (ERANZ, 11 July 2017, p. 6, emphasis added).

Could it be, that the Electricity Retailers have the ear of the EA and could it be reasonable to conclude that **there is an** element of bias in the EA's 'Mass Participation' document? I believe that there is!

## ISSUE 7

### Ensuring Consumer Benefit – Competition and Regulation versus Collaboration, Co-operation and Trustee Duties

For trustee/shareholders to be comfortable that an EDB company **will** operate in a manner which benefits consumers in the longer term, involves collaboration and co-operation, between the trustee/shareholders and the company's board of directors.

That step in the process generally occurs, during discussions relating to the company's Statement of Corporate Intent. What trustee/shareholders are looking for, is sympathetic director ears, towards recommendations trustee/shareholders may make, on changes to the SCI.

In the case of consumer benefit resulting from competition and regulation, consumer behaviour is the sole determinant, of whether consumers do benefit. The essential pre-requisite is that consumers must make choices. How consumers will benefit and the extent to which they do, having made a choice, are unknown variables which potentially could operate to distort, or even undo, the effects of any further regulations, EA may impose.

It is, therefore, valid to ask, in reality, to what extent will EA's planned work programme benefit consumers.

### C. THE WAY FORWARD – ISSUES AND OPTIONS

In my view, the first step required to be made, is a decision by all Trusts affiliated to ETNZ on what their response will be to issues raised by the IEA Report and the EA's follow-up consultation document.

We are faced with adopting one or other of at least, three general types of option.

**The first** is that we do nothing.

This is not an option I would support.

**The second** type of option is based on endeavouring to fore-stall, or make changes, to what the EA will propose, by lobbying parliamentary ministers on the view that any changes to current EDB practices need to be legislated for.

It is a scary thought that ring-fencing would result in EDB companies losing management and control of both the **regulated** electricity distribution network and the **un-regulated** part of the company's business activity.

Interposing a tender/contract relationship between a distribution network and its network servicing branch, would significantly raise operational costs for both parties, impact adversely on reliability, efficiency, and **timeliness of response**, in the case of **significant network damage** resulting from extreme events, such as large fires, major weather events or earthquakes. Recall that when the Kaikoura earthquake occurred, **Mainpower had network service and maintenance staff in Kaikoura later the same night, to secure public safety.**

None of the above outcomes of strict ring-fencing are in the best interest of consumers.

**The third** type of option has a legal focus.

In the presentation to the ETNZ conference in November 2010, Tony Molloy QC considered the opportunity Trustees have under Section 66 (1) of the Trustee Act 1956, to put a case to the High Court.

“Any trustee can go to the Court for directions concerning any property subject to a trust, or respecting the management or administration of any such property, or respecting the exercise of any power or discretion vested in the trustee” (Tony Molloy QC, Trustees of Public Utility Trusts – No job for the fainthearted, 5 November 2010, pp 18-19).

Taking some form of legal action raises a number of possibilities. One is, seeking a declarative judgement from the High Court, based on whether the EA can usurp the legal right of trustees, to **protect** the current management and control of EDB company business, on the grounds that the changes would **devalue the assets and reduce company profit**. Such a case presumably, would need to focus on the best long term interests of consumers.

There will be other options I am sure! But I leave these to be thought about by someone else!

#### **D. TO SUMMARISE:**

There are several take home messages. A Trustee colleague and I, have identified the following:

- One of the most important responsibilities Trustees have, is always to remember that the interests of the consumers we represent must be paramount.
- We all need to be part of any discussion about the long term interests of consumers.
- Additional ring-fencing regulations, will result in EDB companies losing control and management of every type of business activity they currently are engaged in.
- They will be told how electricity networks are to be operated and what network service companies are to do.
- What's more those rules, could be advanced and/or put in place by public entities which can be regarded as having at least a perceived conflict of interest.
- And the new regulations will apply across the board, to all EDB companies in New Zealand, to the detriment of consumers.

Trustees need to become energised. We really don't have to take everything lying down.