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2013 Review  
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Energy and Communications Branch  
Ministry of Economic Development  
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Too whom it may concern,

## Review of Section 62 of the Electricity Act 1992

### Introduction

1. Thank you for the opportunity to make a submission on the Ministry of Economic Development's (MED's) Discussion Paper "*Review of Section 62 of the Electricity Act 1992 'Continuance of Supply'*" (2013 review), dated August 2007.
2. No part of Mighty River Power's submission is confidential and we are happy for it to be made publicly available.

### Observations about the obligation to supply

3. There are effectively two key drivers for considering whether an obligation to supply is warranted:
  - a. Economic – whether there are particular customers who would be uneconomic to supply, but the national benefits of supply outweigh the costs; and
  - b. Market Power – whether a supplier has sufficient market power to prevent supply or an alternative supplier from entering.
4. The regulatory regime for electricity presently takes a somewhat contradictory approach to electricity lines businesses' obligation to supply.
5. Section 62(2) of the Electricity Act 1992 requires electricity lines businesses to continue supplying line function services, where that line function service was provided on 1 April 1993.
6. Key implications of section 62(2) are that electricity lines businesses are required to continue supplying line function services, even if the service is commercially non-viable (i.e., uneconomic), and they do not have the option of supplying equivalent services through alternative means.

7. The obligation to supply is not recognised by the Electricity Information Disclosure Requirements though; in particular, the requirement to disclose ODV valuations and financial performance measures based on the ODV valuations.<sup>1</sup>
8. The ODV valuation methodology is based on the premise that electricity lines businesses' valuations should reflect the value of the network as if the market for line function services was workably competitive. In a workably competitive market firms cannot sustain (or recover) the value of excess (or gold-plated) assets, hence the optimisation component of ODV. Likewise, in a workably competitive market firms cannot sustain the value of assets supplying commercially non-viable consumers or where there is a lower cost means of supply, hence the Economic Value component of ODV.
9. Recovery of the cost of suboptimal or uneconomic assets will show up as excessive profits under the Electricity Information Disclosure Requirements. The problem is though, in contrast to a normal workably competitive market, electricity lines businesses do not have any choice but to continue supplying commercially non-viable consumers. What the Electricity Information Disclosure Requirements identifies as excessive profits can simply be recovery of the cost of meeting section 62 obligations.
10. The combination of section 62 and the ODV requirements, in affect, impose an obligation to supply and a requirement that the cost of doing so be borne by electricity lines businesses' shareholders. In reality though regulation of electricity lines businesses (presently Part 4A of the Commerce Act 1986) allows electricity lines businesses to use cross-subsidies from commercially-viable consumers to recover any losses from supplying commercially non-viable consumers. The discussion below is premised on the ability of electricity lines businesses to continue to rely on cross-subsidies.

### **Obligation to supply and pricing**

11. The Discussion Paper states that *"A key assumption is that current policy requiring line charges to rural and urban areas to be pegged will remain."*<sup>2</sup> Mighty River Power believes that MED needs to consider how the obligation to supply, alignment of rural and urban prices and operation of Part 4A of the Commerce Act interact. Depending on the policy options for the obligation to supply it may not be appropriate to maintain the rural-urban pricing alignment policy. Consideration of the obligation to supply in isolation of the other policies, or assuming the other policies will remain unchanged, is not conducive to producing the best policy options.
12. Consider the following:
  - a. The obligation to supply means that some (remote-rural) customers may be supplied line services even though it would be more economic to supply them through alternative means, e.g., diesel generators.

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<sup>1</sup> The same is true for the Electricity (Information Disclosure) Regulations that preceded the Electricity Information Disclosure Requirements.

<sup>2</sup> Page 4 of the Executive Summary of the Discussion Paper.

- b. The requirement to align rural and urban prices means that there will be a larger group of rural customers that are also commercially non-viable because electricity lines businesses are required to price below cost.
13. The operation of the threshold regime under Part 4A of the Commerce Act 1986 means that electricity lines businesses can potentially increase their profits (while staying under the price thresholds) by reducing costs. If the obligation to supply was removed, electricity lines businesses could improve their profitability by ceasing to supply commercially non-viable consumers, regardless of whether they are non-viable because there are lower cost supply options, or because of the subsidy requirement. The maintenance of the rural-urban price alignment requirement would act to exacerbate the number of commercially non-viable consumers electricity lines businesses would have incentives to disconnect.
14. Consequently, it may not be in the interests of rural consumers for the rural-urban price alignment requirement to remain intact, if the obligation to supply is removed. Effectively, the Government would be telling electricity lines businesses that it is acceptable to remove cross-subsidies through disconnection of rural consumers, but not acceptable to remove them through tariff rebalancing. From the perspective of a rural consumer, however, the latter would be preferable compared to no supply. (If the tariff rebalancing results in prices that are too high, the rural consumer could always self-disconnection, and find alternative means of supply, anyway.)
15. The other consequence, of the removal of the obligation to supply is that if electricity lines businesses could reduce their costs by ceasing to supply their most expensive (uneconomic) customers then the price thresholds under Part 4A would need to be lowered; otherwise electricity lines businesses would be able to increase profits simply by disconnecting customers, as opposed to actually making efficiency improvements.
16. What this illustrates is that it would not make sense to consider removing the obligation to supply without reviewing the rural-urban price alignment requirement and the operation of Part 4A.

#### **Socialisation of the costs of supplying uneconomic regions**

17. The point should not be lost that electricity lines businesses are natural monopolies.
18. In a normal workably competitive market, any particular firm would not be able to sustain cross-subsidies from urban to rural consumer groups with lower prices. If they tried, alternative suppliers could enter the market and target urban consumers. Electricity lines businesses do not face competition and therefore do not face any such constraints on the ability to cross-subsidise. The status quo of individual electricity lines businesses maintaining cross-subsidies, whether such subsidies are desirable or not, is sustainable.
19. Mighty River Power was accordingly surprised to see option f in the Discussion Paper. It is not apparent to Mighty River Power why the Government would consider that an alternative funding mechanism (from the status quo) could be needed for commercially non-viable consumers. Mighty River Power strongly opposes option f.

20. The Discussion Paper is light on details of how the proposed subsidy regime would work. It does, however, appear that it would resemble the Telecommunications Service Obligation (TSO) funding mechanism in Part 3 of the Telecommunications Act 2001. The TSO funding mechanism is currently used to fund Telecom's Kiwi Share Obligation and the Telecommunications Relay Service<sup>3</sup>, provided by Sprint. Industry participants are required to contribute to the cost of these services based on their revenue (which roughly reflects their market share).
21. The difference between a TSO like the relay service provided by Sprint and provision of electricity line services by electricity lines businesses to commercially non-viable customers is that Sprint is not providing a natural monopoly service. Without the TSO funding mechanism the relay service would not have been established, as it could not have been supplied profitably. This is clearly not a problem for electricity lines businesses. They can fund any costs from their commercially-viable (e.g., urban) consumers.
22. As well as there being no need for such a subsidy regime, there would be substantial costs in administering the regime. As is the case with the TSO funding mechanism, some entity (the Commerce Commission?) would need to annually determine what the net cost of supplying commercially non-viable consumers is in each electricity lines business area. Just looking at a single TSO determination process by the Commerce Commission provides a good illustration of the large amount of work and resources that is required to do this.<sup>4</sup> Fortunately, for the Commerce Commission it only has to make two TSO determinations annually (one for Telecom's KSO and the other for Sprint's Relay Service<sup>5</sup>), whereas analogous arrangements in electricity would necessitate up to 28 such determinations.
23. Further, any subsidy regime would result in wealth transfers and a different allocation of the cross-subsidy. At present, any subsidies are internalised in each electricity lines business area. In the Marlborough network area, for example, Marlborough consumers would subsidise other Marlborough consumers. The subsidy regime would mean consumers in more economic network areas (such as that of Auckland) would end up subsidising consumers in Marlborough. Mighty River Power does not believe this would be efficient or equitable, particularly when the RERC subsidies that have already been granted are considered.<sup>6</sup>

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<sup>3</sup> <http://www.nzrelay.co.nz/>

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<http://www.comcom.govt.nz/IndustryRegulation/Telecommunications/TelecommunicationsServiceObligations/2001-2002tsodetermination.aspx>

<sup>5</sup> The determination of Sprint's Relay Service is made easy by the fact that the subsidy level was determined by the Government through a competitive tender process for the service i.e., the entity that bid for the lowest subsidy got to provide the service.

<sup>6</sup> The Commerce Commission would need to ensure the pricing thresholds included any revenue to electricity lines businesses from such subsidies. Otherwise, the electricity lines businesses could

24. All this needs to be considered in the context that the electricity lines businesses' ODV disclosure statements imply "... that any portion of their network deemed to be uneconomic cannot be more than 1% of each company's total asset valuation."<sup>7</sup> It is difficult to see how it could be worth establishing a subsidy funding mechanism for such small amounts.

### **Concluding remarks**

25. MED should consider the interrelationship of the obligation to supply with the rural-urban price alignment requirement and Part 4A of the Commerce Act. It may not make sense to continue the rural-urban price alignment requirement if the obligation to supply is removed.
26. Mighty River Power can see little benefit in removing the obligation to supply and the current mode of cost recovery. Whilst it implicitly results in a cross-subsidy between economic and uneconomic customers, this is fully internalised within each electricity lines business.
27. Mighty River Power would support allowing electricity lines businesses to maintain their obligation of supply through alternative supply mechanisms where this is lower cost. The Commerce Commission's Part 4A thresholds regime should then act to reward lines businesses for providing more economic solutions to uneconomic customers so as to reduce the adverse incentive associated with price pegging.
28. The true cost of uneconomic supply should be identified within the Electricity Information Disclosure regime, irrespective of how much is allowable from a recovery perspective. Transparency of the subsidy overtime would be a useful indicator of the costs associated with any given policy mix being utilised for obligations to supply.
29. Mighty River Power would also like to voice our concern over the policy option f to impose a subsidy funding regime on the electricity industry. Mighty River Power does not consider such an option has any merit. It is unnecessary, would have substantial administrative costs and would result in funding that is neither efficient nor equitable. Option f is not needed to extend the obligation to supply beyond 2013.
30. If you have any queries regarding Mighty River Power's submission, or would like further information, please do not hesitate to contact me.

Yours sincerely,

Robert Allen  
**Regulatory Manager**

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maintain the existing internal cross-subsidy and use revenue from the subsidy funding mechanism to increase their (monopoly) profits.

<sup>7</sup> Paragraph 27 of the discussion paper.