MARIA GOVERNANCE BOARD:
MODEL RETAIL CONTRACT PROJECT TEAM

DRAFT MODEL
ELECTRICITY RETAIL CONTRACT

COMMENTARY

7 May 2004

MRCPT PROCESS

Purpose

The Model Retail Contract Project Team ('MRCPT') was formed in July 2003 by the MARIA Governance Board ('MGB') to implement a request in the Government Policy Statement (GPS) of February 2002 for the MGB to prepare, in consultation with the Ministry of Consumer Affairs and consumer representatives, a model retail contract for domestic consumers.

Membership

The MRCPT comprised:

- An independent Chair:
  - Tony Baldwin

- Four retailer representatives:
  - Mel Orange (Meridian Energy)
  - Steve Rawson (Mighty River Power)
  - Bill Boyd, then Ian Burgess (Contact Energy)
  - Scott Harnett (TrustPower)

- Three consumer representatives:
  - Josephine Bartley (Ministry of Consumer Affairs)
  - Graham Pinnell (Fed Farmers - resigned on appointment to EC)
  - Paul Doocey (Consumers' Institute – replaced Graham Pinnell)
  - Peter Rutledge (Grey Power)

- A lines company representative:
  - Clive Bull (Vector)

The Electricity Complaints Commission (ECC) was invited to participate in an observer capacity, however the ECC was unable to make a person available due to other work demands.

Process

Working within the framework outlined above, the MRCPT followed four key steps:

- First, the team confirmed an overall policy framework, defined key issues for the retail sector in the context of the wider industry reforms, then agreed on a set of guiding principles;

- Second, the MRCPT reviewed all the existing electricity retail contracts and compared them against the Electricity Complaints Commission's code of practice;

- Third, the team distilled a set of core provisions into a 'Key Elements' paper, which the MRCPT reviewed on a clause-by-clause basis; then

- Fourth, the team reworked the 'Key Elements' paper into the attached (draft) Model Retail Contract, which the MRCPT also reviewed on a clause-by-clause basis.

In developing the draft model, the MRCPT has also taken into account:

- The model distribution contract developed by an MGB project team earlier in 2003;

- The Electricity Complaints Commission's Code of Practice and review of the code; and

- Model contracts developed in some Australian States.

GOVERNMENT'S POLICY REQUIREMENTS

2002 draft GPS

In the GPS of February 2002, the Minister of Energy asked the MARIA Governance Board to prepare, in consultation with the Ministry of Consumer Affairs and consumer representatives, a model contract for domestic consumers, which was to provide for:

- Transparency of charge components;

- Frequency of billing;

- Company-specific arrangements for dispute resolution;

- Arrangements for consumer protection with respect to outages;

- Arrangements in relation to prepayment meters to domestic consumers at reasonable cost; and

- Arrangements for an orderly transition for end users in the event of retailer insolvency.

2003 draft GPS

In September 2003, the Minister of Energy issued a new draft GPS requesting the Electricity Commission to prepare, in consultation with the Ministry of Consumer Affairs and consumer representatives, minimum terms and conditions for contracts with domestic consumers. The September 2003 draft GPS requires the *'minimum'* contract to provide for the same elements as required by the February 2002 GPS, but with four key changes:

- Arrangements for an orderly transition for end users in the event of insolvency of a retailer are to be addressed by the Commission more broadly, not just in the context of a *'minimum'* contract;

- The new draft GPS requires the *'minimum'* contract to address the use of bonds. It also asks that the Commission develop regulations setting fair and reasonable limits in relation to bonds, proposing a cap of one month's average consumption on the amount of any bond;

- The new draft GPS also asks the Commission to develop regulations to ensure that all retailers serving more than 25% of the market for domestic consumers in a line network area offer pre-payment meters to domestic consumers at reasonable cost; and

- Under the new draft GPS, the Commission is expected to take responsibility for ensuring that New Zealanders have access to an effective and comprehensive complaints resolution system.

The MRCPT's draft model contract has been developed with reference to the 2003 draft GPS requirements.

GOALS FOR MODEL RETAIL CONTRACT

Overall Government policy

The 2003 draft GPS sets out a broad statement of Government policy in relation to retail competition, which is relevant to the context in which the MRCPT has developed its draft model contract:

> *"The Government considers that competition between electricity retailers should, over time, help ensure that retailing costs are minimised, service quality is improved and downward pressure is placed on generation costs. Most consumers, especially in larger centres, have a choice of retailers, and the processes for consumers to change suppliers have steadily improved. However, the Government considers that retail competition is not as vigorous as it could be, and will look to the Electricity Commission to promote and facilitate retail competition…"*

Role of model retail contract

Effective competition in electricity retail markets relies on several elements. A model retail contract has only a small role to play, however it is part of the wider mix. MRCPT has approached its task with this in mind.

Other elements necessary to achieve effective retail competition include:

- Neutral access to lines;
- Availability of hedges to mitigate nodal price differentials;
- Availability of longer term wholesale electricity hedge contracts;
- Certainty in the regulatory environment;
- Demand from customers for competitive retail services, particularly in relation to price risk and reliability of supply;
- Real choice of retailers;
- Easy transfer of consumer data among retailers;
- No inefficient restraints on consumers switching;
- Clear and timely disclosure to consumers of changes in prices and other key terms; and
- Active and public monitoring of retailers' performance, particularly by independent agents.

Potential benefits of a model retail contract

Most of the barriers to more efficient retail competition are beyond the scope of the terms and conditions of retail supply contracts. However, a well-designed model retail contract could provide the following benefits:

- *Clarity:* Providing consumers with a clear and understandable description of their rights and obligations in relation to buying electricity;
- *Consistency:* Encouraging a more consistent approach among retailers in relation to retail contract terms and conditions, particularly for 'boiler-plate' provisions, with the benefit of reducing consumers' transaction and search costs, therefore lowering (to some degree) a potential barrier to the threat of switching;
- *Fairness:* Striking a fair balance between the interests of retailers and consumers;
- *Education:* Providing consumers with better information about how NZ's electricity system works, and the risks relating to price and quality which they need to 'insure' against;
- *Dispute resolution:* Promoting quicker, lower cost resolution of disputes between retailers and consumers; and
- *Competition and innovation:* Not impeding, but encouraging, innovation and competition in the retail market.

SUMMARY OF MODEL CONTRACT

Coverage

There are two draft model contracts attached. One relates to mass market (domestic and small to medium enterprise) consumers buying electricity on an interposed basis (where the lines company contracts with the retailer, not the consumer). The other is for mass market consumers buying electricity on a conveyance basis (where the lines company contracts directly with the consumer, not the retailer, for the provision of lines services). The conveyance contract was derived from the model interposed contract. The 'contract' referred to throughout this commentary is the model interposed contract. The contract is not expected to apply to time-of-use metered customers.

Structure

The model contract is structured in three levels:

- *Foreword:* This optional introductory section:
    - provides some simple key information about the electricity system (particularly the relationships between a retailer and other parties);
    - summarises the key promises made by a consumer and a retailer; and
    - points out some key questions a consumer may wish to consider in choosing a retailer.

- *Differentiated elements:* The opening sections of the model contract, which are likely to disclose any points of service and price differentiation between retailers. These sections cover:
    - The retailer's 'welcome';
    - How to become a customer;
    - The retailer's performance commitments;
    - The retailer's prices and fees (in particular the minimum duration of a price).
- *The rest:* The remainder of the model contract covers metering, access, interruptions, disconnections, liability, notices and the like. These are not likely to become points of competitive differentiation between retailers and would therefore benefit from becoming largely standard across all retail contracts.

The aim of this structure is to promote greater awareness among consumers of how electricity gets to households and things to look out for, and make it easier for consumers to compare how contracts differ on the key issues (pricing, service offerings and performance commitments).

Key features

Five key features of the draft model contract are highlighted below:

- The notice period required to change prices;
- An alternative approach to suspending the contract in extreme events;
- The amount of bond required from consumers;
- Methods for encouraging prepayment of electricity invoices; and
- The role of performance commitments in the model contract.

In considering some of these elements, it is useful to recognise that:

- At its conceptual core, a retail electricity contract is a hedge against changing spot prices. 'Price smoothing' is a key service retailers provide to consumers.
- It is therefore fundamental that the contract should provide certainty as to the range of spot prices within which the hedge applies.
- In a well functioning market, a hedge's parameters would be important points of competitive differentiation between retailers.

Notice for price changes

The draft model contract does not set out electricity prices or the details of any pricing plans. These are published by retailers in separate brochures and on their web sites.

However, a key issue for the draft model contract is the default period for which prices are fixed. The traditional approach has been to require one month's notice before prices can be changed. The effect is that prices are fixed under traditional retail contracts for one month. While in practice, all retailers change their basic residential prices *less* frequently, under most current contracts changes can be made every month.

A guiding principle in developing the draft model contract was that it should encourage competition and innovation among retailers. For various reasons, including the complexity of the supply chain, most customers' options for fixing their electricity price for longer than one month are limited. Demand and supply of such products is weak and therefore the market for longer retail hedges is not active. In other well-functioning retail markets, consumers can often choose from a variety of periods and prices.

A key technical limitation on customers with greater demand elasticity choosing more variable pricing (with shorter fixed periods) is the relative cost of time-of-use meter systems and efficient (near to real time) notification of price changes. However, reasonably low cost proxies could be developed.

With a view to encouraging more choice for consumers, the draft model contract proposes a two-tier regime for notice of price changes:

- If a retailer offered a 'fixed price plan' but the customer chose a 'flexible price plan', the retailer may change the customer's price by giving notice significantly shorter than one month. MRCPT has yet to specify what the shorter period should be, but it would be days not weeks;

- If the retailer did not offer a 'fixed price plan', the default period for notice of a price change would be one month.

The purpose of the two-tier approach is to encourage:

- Retailers to offer longer term price hedges at the domestic and small business level; and

- Customers, especially larger domestics and small businesses, to make conscious choices in relation to managing electricity prices.

Limits of price hedge

Current retail contracts allow retailers to change their prices if certain events occur, such as a serious 'dry year'. However, the thresholds or triggers for when prices may be changed are unclear.

Most retailers also protect themselves against events that cause electricity shortages by reserving the right to suspend the contract or physically cut customers' supply. This approach may have been appropriate in a pre-market environment. However, with the wholesale electricity spot market now in place, suspending contracts and cutting supply are inefficient responses to shortage. Indeed, these mechanisms are likely to weaken the market's capacity to deal with shortages efficiently. A market-based approach relies on contracts and pricing mechanisms to balance supply and demand.

The model contract therefore removes the traditional 'force majeure' approach to shortages and requires retailers to specify the spot price range within which their contract prices apply. This should provide much greater clarity and certainty for both parties. It could also help kick start the market for 'insurance contracts' covering shortage events, which is a key component in managing supply and demand risks efficiently.

Amount of Bond

The model retail contract does not specify the amount a retailer should obtain from a customer for any bond. The ECC Code requires that "the bond must not be more than the expected loss if a consumer does not pay". The MRCPT broadly agrees with this approach.

However, the draft 2003 GPS states that "the amount of any bond should be capped at the value of one month's consumption by an average household" (the draft 2002 GPS did not address this issue).

The purpose of a bond is to provide security of payment to a retailer for consumption by a customer who does not pay a proper invoice. It is not a penalty.

A range of factors need to be balanced in considering the amount of any bond, including:

- *Probability of non-payment:* It is often hard to know in advance whether a customer is unlikely to pay an invoice. Retailers base their decisions on whether to require a bond on customer category profiles and individual credit histories. However, not all customers who are required to provide a bond turn out to be unreliable payers, which makes bond review and return policies important;

- *Expected loss:* The bond should also reflect the amount of power a customer is likely to consume and not pay for before the retailer can disconnect the customer. This estimate must take into account (i) the time it takes for a retailer to determine that a consumer has not paid an invoice by the due date and (ii) the time it takes a retailer to follow due process before disconnecting a non-paying customer. Under the ECC Code, due process requires three separate notices over 14 days. In practice therefore, a retailer is unlikely to be able to disconnect a non-paying customer within two months;

- *Assumed consumption:* The 2003 draft GPS calls for bonds to be based on consumption by 'an average household'. This may not be appropriate as the consumption patterns of likely non-payers may be quite different from average consumption. A more tailored approach would be preferable;

- *Ability to pay:* The level of any bond may have serious implications for some consumers. Affordability is therefore a key issue; and

- *Fairness to other customers:* Costs created by non-paying customers tend to be spread across all other customers. Fairness issues may therefore be raised in relation to this cross-subsidy.

Another concern is that some retailers could use a bond as a way of trying to avoid supplying certain customers. Clearly, discrimination based on non-

economic criteria is covered by human rights legislation. However, it is also possible that some retailers may set the amount of any bond at a level that makes it impossible for some less well-off customers to contract for supply. This is discussed under pre-payment meters below.

Pre-payment Meters

The draft 2003 GPS requires the Commission to "develop recommendations for regulation to ensure that all retailers serving more than 25% of the market for domestic consumers in a line network area offer pre-payment meters to domestic consumers at reasonable cost".

Prepayment meters seem to be the Government' preferred mechanism for ensuring that customers with whom no retailer wishes to contract can obtain supply (in some contexts, this underlying question is referred to as the 'provider of last resort' issue).

This is beyond the scope of a model retail contract. However, the MRCPT notes that pre-payment meters have a relatively high up-front (capital) cost and (often) higher maintenance and installation costs. Furthermore the pre-payment meter equipment tends to be unique to each retailer and, as such, switching can be limited and/or expensive. These costs can make prepayment meters expensive in low-density areas and they may therefore be an expensive option for customers in such areas, when compared to a standard metered customer with no disconnection or reconnection costs included.

The MRCPT therefore recommends that further work be undertaken on other options, including direct payment of electricity invoices by welfare support agencies, or an automatic payment through the banking system of a regular, affordable amount.

Performance Commitments

The model contract requires each retailer to commit, on a contractual basis, to appropriate performance standards. The model contract contemplates that retailers will compensate customers for failing to meet these standards.

The model contract does not specify what these standards should be. The aim is to make these performance standards more prominent in the contract and, by competition among retailers and stronger awareness among customers, to encourage these standards to become more explicit and customer-responsive.

Another relevant feature of the model contract relates to compensation payments by a lines company to a retailer. Under the model distribution contract, lines companies are to pay retailers agreed amounts for any failure by a lines company to meet particular performance guarantees to the retailer.

The model retail contract notes that these guarantees are for the benefit of end consumers and, as intended under the model distribution contract, requires the retailer to pass these payments on (less reasonable administrative costs) to end customers connected to the relevant lines network.

NEXT STEPS

If you would like to make a submission on the draft model retail contract, please send your written comments to [ ] before [date].

The Electricity Commission will *[to come*]

CONTACT DETAILS

If you have any comments or queries on this commentary, or wish to make a submission, please contact:

[ ]
WELLINGTON

Email: