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Facilitating Distributed Generation

The Ministry of Economic Development's Draft Regulations

Report to MEUG

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Preface

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1. Introduction

Section 172D(1)(10) of the Electricity Act 1992 (the Act) provides for regulating the "terms and conditions on which line owners and electricity distributors must enable electricity generators to be connected to distribution lines". The Government has decided to introduce regulations setting out such terms and conditions. The Ministry of Economic Development (the Ministry) has issued draft regulations and a discussion paper[1] and "is seeking feedback from stakeholders on whether the draft regulations give effect to the objectives [of the Government]."[2] The stated objectives of the Government are to:[3]

- provide greater certainty and clarity by specifying a process for obtaining approval for connection of distributed generation, including interconnection requirements, charges and fees, and a dispute resolution process;
- ensure that sufficient information is available on the terms and conditions of connection to enable investors to make fully informed decisions;
- ensure that connection charges to obtain interconnection are fair and reasonable; and
- provide regulated terms that apply to the connection of distributed generation in the absence of contractually agreed terms.

We have been asked by the Major Electricity Users' Group (MEUG) to provide it with a report on the Ministry's proposal to assist it with providing feedback to the Ministry. This paper is that report.

In the next section we make general points about the process by which the draft regulations have come about. In section 3, we outline and comment on the principles embodied in the draft regulations. Section 4 contains detailed comments on the drafting of the regulations. The final section contains a summary of our main points.

2. General comments on process

The draft regulations have been prepared by the Ministry and not by the Electricity Commission (the Commission). This is permitted under section 172E(1) of the Act. This provides: "The Minister may recommend electricity governance regulations under section 172D (other than the first regulations made under section 172(1)(10)) only if the recommendation

[1] Ministry of Economic Development, *Facilitating Distributed Generation*, September 2006. Both the draft regulations and the discussion paper are available at: http://www.med.govt.nz/templates/ContentTopicSummary____3847.aspx

[2] *Facilitating Distributed Generation*, para. 24.

[3] *Facilitating Distributed Generation*, para. 18.

implements the effect of a recommendation of the Commission and does not differ from that recommendation in any material way …". Section 172D(1)(10) relates to distributed generation.

No rationale for the first set of regulations relating to distributed generation being the only exception to the requirement that the regulations must be recommended by the Commission is given. However, it is likely that it was because the Ministry already had the development of regulations well advanced when the amendments to the Act incorporating the provisions relating to the Commission and governance regulations and rules were enacted. The Government signalled its intention to regulate in May 2003[4] and the Ministry issued a discussion paper on proposed regulations in September 2003. The Commission began operations on 15 September 2003.

Given that the Commission is now firmly established and operating, we believe the job of making recommendations on regulations for distributed generation should have been passed from the Ministry to it. The Act does not preclude this as the relevant provision is permissive and does not prevent the Commission from making recommendations for regulations under section 172D(1)(10); the provision merely permits the Minister to recommend the first regulations on this topic without a recommendation from the Commission.

The obvious rationale for requiring regulations under section 172D to be recommended by the Commission is to ensure they are consistent, have been developed using the Commission's specialist expertise and knowledge and are one step removed from the political process. This rationale applies equally to regulations relating to distributed generation. It is regrettable that an exception in the legislation, which was probably introduced to deal with a timing issue, has been used to produce regulations that have not had the benefit of the Commission's input.

If the Commission was recommending the distributed generation regulations to the Minister then the Commission would have to undertake and publish a cost benefit analysis of the proposed regulations and any practical alternative options.[5] The Ministry could have provided such an analysis but it has not done so. Instead, it has pointed to distributors generally having more information than distributed generators about the costs and operational issues imposed by connection and that connection requirements are not clearly defined for all distributors and vary across distributors. According to the Ministry these factors raise barriers to the connection of distributed generation. "The government considers that these barriers can be sufficiently large to warrant intervention through regulating terms and conditions for connection of distributed generation." This justification is an

[4] *Facilitating Distributed Generation*, para. 20.

[5] See Electricity Act 1992, s. 172E(2)(b)(i) and s. 172F.

extremely inadequate substitute for a cost benefit analysis of the proposed regulations compared with the practical alternatives, including no intervention.

We note that the Ministry does not provide evidence in its paper that the connection of any distributed generation has been delayed or prevented by the absence of regulations. We are unaware of any evidence of this kind. Moreover, even if it were established there is a problem justifying regulatory intervention, the proposed regulations are not the only potential solution. One alternative would be for the regulations to be used as a backstop to implement if distributors failed to reach sufficient industry agreement on standard processes for receiving and considering applications and on terms and conditions for connection. The Electricity and Gas Complaints Commissioner could potentially provide the dispute resolution process for small scale plants under this approach. Another option would be for the Commission to prepare model rules and promote their voluntary adoption by distributors.

As a matter of principle, all regulatory interventions should be assessed to ensure they contribute positively to economic welfare or, if they do not, they achieve other objectives considered worthwhile enough to warrant the overall loss in economic welfare. It appears from the reference to "the government considers" that intervention is warranted and the absence of any evidence of a proper appraisal of the proposal that the draft regulations are an *ex cathedra* "bright idea". We are further told "this consultation is not to debate the merits of whether or not to regulate as this decision has already been made. Nor will the consultation re-examine key policy decisions."[6]

No formal evaluation of policy options and no opportunity for public scrutiny is an approach that is almost certain to yield very poor regulatory and economic outcomes for New Zealand. This approach was pursued in the late 1970s and early 1980s to bring in "think big", almost universal wage and price controls and monetary and exchange rate policies. The outcomes in terms of economic performance were terrible. While regulations relating to distributed generation are unlikely to have a material adverse effect on the New Zealand economy, on their own, the abandonment of good regulatory practices with the current proposals should be of considerable concern to both producers and consumers.

If the government is determined to proceed with regulations relating to distributed generation then we suggest that the regulations should include a five-year review date and sunset clause.

[6] *Facilitating Distributed Generation*, para. 24.

3. Comments on principles

The draft regulations provide:

- a process under which those interested in connecting a distributed generator can apply to distributors for approval;
- for regulated terms that apply to the connection of distributed generation in the absence of a contractually agreed terms; and
- a dispute resolution process for disputes about whether a party has breached the regulations.

3.1 Approval process

The regulations relating to the process for applying for approval to connect applies to all distributors and a distributor cannot contract out of these provisions. The process is slightly different depending on the size of the distributed generator; the larger the generator, the more information is required to support an inquiry or application and the longer the time period available for the distributor to respond to an inquiry and to process an application.

The regulations impose an annual reporting requirement on the distributor. In the interests of efficiency and lowering overall compliance costs we suggest the information disclosure requirements in the draft regulations relating to inquiries and applications for distributed generation connections should be incorporated with the information disclosure requirements imposed on distributors through the Commerce Act 1986.

The regulations also set out how the distributor is to determine the priority among applications to connect to a similar part of the distribution network. If the applications are received within 10 working days of one another, the distributor may consider them together as if they were competing bids and must consider them in the light of the purpose of the regulations. If an application is declined the distributor must set out the criteria used to decide. If the applications are not received within 10 working days of one another then the priority is the order in which the applications were lodged.

It might be thought this last provision could lead to blocking of applications from legitimate parties. However, there are also time limits on applicants responding to the distributor agreeing to a connection and so the ability to block other applications will be relatively limited.

3.2 Regulated terms

3.2.1 Applicability

The regulated terms only apply to the connection of distributed generation in the absence of contractually agreed terms. Thus, they provide backstop or default arrangement to negotiated contracts in much the same way as the benchmark agreements provide a default arrangement for connection agreements between Transpower and transmission customers.

3.2.2 Comments

This structure has the advantage that it allows the parties to agree other terms if they wish, and can do so. The parties are only going to agree if they prefer the negotiated agreement to the regulated terms. The structure does not mean that a distributed generator will not end up with a contract that contains clauses they would prefer it did not contain. This is because the choice the parties will have to make is between a negotiated contract or the regulated terms and in order to get some negotiated provisions it wants a party may have to agree to accept some other negotiated provisions when for those aspects it would actually prefer the regulated terms.

If the framers of the draft regulations believe their passing will eliminate claims by distributed generators that distributors are not treating them fairly then they may well be disappointed. This is especially likely to be the case if the regulatory terms contain clauses that distributed generators would particularly like to avoid.

3.2.3 Proposed regulated terms

The regulated terms cover the areas discussed in the following subsections.

a) Liability

If a party breaches any of the regulated terms then the party is liable to the other for damages for any direct loss caused by the failure. Each party must also indemnify the other party for damages claimed by third parties where the cause of the loss is largely attributable to their own action or omissions.

b) Force Majeure

A party is relieved of an obligation to the extent that, and for so long as, the distributor or distributed generator is unable to perform the obligation as a result of a force majeure event. A narrow approach to defining a force majeure event is taken in the draft regulations.

c) Insurance

The parties must maintain general liability insurance for liabilities that may arise under these regulations. Self insurance is permitted if agreed to by the counterparty and the counterparty cannot withhold agreement unreasonably.

d) Meters

The distributed generator must install meters to record any inflow and exports of electricity to and from the network. The distributor is entitled to access to test meters.

e) Inspection and testing

The distributed generator must perform inspection and testing before connection and provide the distributor with a written test report and notice so the distributor can send an observer to watch the test.

f) Connection authorisation

The distributed generator will not be able to connect without authorisation from the distributor. The distributor will not be able to withhold authorisation once notified the generator has complied with all relevant requirements.

g) Right of access by distributor

The distributor is entitled to access to the distributed generators premises for any reasonable purpose upon providing reasonable notice and will have access at any time without notice in the event of an emergency or hazardous situation.

h) Interruption and temporary disconnection

Upon reasonable notice, the distributor may interrupt the connection or curtail generation and temporarily disconnect generation when necessary for maintenance, construction and repairs to the network. The distributor can disconnect without notice in the event of an emergency or hazardous situation. The distributor is required to make reasonable endeavours to co-ordinate outages with the generator.

i) Adverse operating effects

The distributor must notify the distributed generator as soon as reasonably practicable if it reasonably considers that operation of the generation plant may adversely effect the service to other network users, or cause damage to the network or other facilities, or present a hazard to any persons. If the generator does not remedy the situation the distributor can disconnect the generation. In the case of an emergency or hazardous situation, the distributor may disconnect without notice.

j) Pricing principles

The draft regulations do not provide a prescriptive pricing methodology but the regulations do set out in Schedule 4 the pricing principles to be applied under the regulated terms:

- For a distributed generator below 10kW capacity connecting at an existing point of connection, the distributor is expected to approve connection at no costs other than for processing the application and for any additional metering required.
- For distributed generators of 10kW capacity or larger the pricing principles allow the distributor to charge its incremental costs net of incremental benefits of providing the service. Costs that are shifted from the distributor to other parties are not to be included in the calculation.

The draft regulations also set out rules about how, if a subsequent distributed generator comes along and wants to use the assets being paid for or paid for by a distributed generator connected earlier, the earlier party is to be credited for part of the costs they have incurred.

3.2.4 Comments

Force majeure provisions are not popular among electricity sector consumers because they can be used to excuse failure to deliver at just the times when a guarantee of performance is most valuable to them. Even though the current draft regulations define a force majeure event quite narrowly, with the inclusion of such a provision in the regulated terms it is unlikely any distributed generators will be able to negotiate its removal from a contract. We believe it would be preferable if such a clause was left out of the regulated terms.

The insurance and liability provisions are likely to be material checks on the spread of small distributed generators; the cost of any insurance to cover the liability is likely to far outweigh the potential benefit from a householder installing such a device. We believe the insurance provision should be left out of the regulated terms. In regard to the liability provision we suggest that it needs to be very clear that if a small distributed generator acts prudently and follows the conditions laid down to operate by the distributor then it has no liability to the distributor.

The Commission is currently consulting on whether the unconditional service guarantee (USG) approach is the appropriate one to adopt in the context of the liability provisions in benchmark agreements for transmission services. Under the USG approach the party required to meet a service obligation is liable to pay a modest amount to the other party on each occasion there is a failure without the need to establish blame and the size of any damages. The rationale for this approach is that the USG liability incentivises the party delivering services to take steps to avoid failures and the need to make payments but since the liability is modest it does not lead

them to adopt excessively risk averse behaviour. The USG approach may have merit in this context and especially so if it is adopted for transmission because, in this case, it is likely the USG approach will spill over into the general liability provisions adopted by distributors.

The requirement that distributed generators should be charged on an avoidable cost basis is economically sound. The provision suggesting that a cost shifted to another party should not be treated as an avoidable cost is also sound. In its absence there is likely to be distributed generators claiming for avoided transmission charges merely on the grounds they have reduced the peak off-take of the distributor to which they have connected. In most instances this has not avoided any costs in New Zealand as a whole; it will merely shift the incidence of Transpower's charges between the various parties connected to Transpower. To be genuine avoided costs it is necessary that an investment or expenditure that would have otherwise been undertaken is avoided or deferred.

The pricing principles do not go far enough to remove the opportunity for on-going arguments and debates as they do not itemise how capital costs are to be determined when applying the avoided cost methodology. Are assets to be at historic costs or current costs? What weighted average cost of capital should be employed? How is optimisation of the asset base to be carried out? Etc. In the absence of principles to deal with these matters there could be on-going arguments between distributed generators and distributors over pricing and charges. Any dispute not able to be settled by the parties will have to be settled by the Commission or the Rulings Panel. It is doubtful whether either of these parties is well informed enough to make such decisions. In order to avoid the development of two forums in which disputes over pricing are dealt with it may be desirable to leave any pricing disputes under these regulations to be dealt with by the Commerce Commission under the standard Commerce Act provisions. This will reduce the risks of inconsistencies in the decisions arising.

3.3 Dispute resolution

3.3.1 Process

The dispute resolution process in Schedule 3 only applies to disputes as to whether a party has breached the regulations. The process does not apply to disputes arising out of contracts.

- If there is a dispute under the regulations then one party can give written notice and then the parties must attempt to resolve the dispute with each other in good faith.
- In the event this does not resolve the dispute, either party may complain in writing to the Commission.

- The Commission may appoint an independent qualified person to consider the complaint and try and find a solution.
- If the Commission cannot achieve a settlement the complaint may be referred to the Rulings Panel to arbitrate the matter.
- Parties to any dispute will be responsible for their own costs and the Rulings Panel may also impose reasonable costs.

3.3.2 Comments

This is a reasonable approach to dealing with disputes in a timely and efficient manner under the regulated approach.

4. Drafting comments

Schedule 1, Clause 4(2)

As currently drafted this requires "a certificate of compliance that is signed by … the electrical worker who installed the distributed generation …" before the distributor has decided to approve or reject the application. This means the distributed generator must have the device installed before the distributor has said it can be used. Most investors would prefer to know they can use plant before installing it.

Schedule 1, Clause 6(3)(a)

We suggest this should be amended so the last condition reads "…and the steps**, if any,** that the applicant can take to ensure the connection **is approved**; and"

Schedule 1, Clause 6B(a)

This should read "connect the distributed **generation** on the regulated terms; or"

Schedule 1, Clause 10(2)

We suggest this should read "A distributor must provide, if requested by a person making an inquiry, information that **it possesses or can be reasonably expected to know about and obtain** that is reasonably necessary for the person to consider and act on the information given by the distributor under clause 9." Otherwise the distributor's obligation to go out and find information for the applicant is nearly open ended.

Schedule 1, Clause 12(5)

Should be "subclause (4)" not "subclause (3)".

Schedule 1, Clause 15(1)

Insert “must” after “clause 12”.

Schedule 1, Clause 15(3)(a)

We suggest this should be amended so the last condition reads “…and the steps**, if any,** that the applicant can take to ensure the connection **is approved**; and”.

Schedule 1, Clause 15B(1)(a)

This should read “connect the distributed **generation** on the regulated terms; or”

Schedule 1, Clause 19

Insert “or before” before “1 April” in the second line and insert “calendar” before “year” in the next line.

Schedule 5, Prescribed fees

The prices for distributed generation of less than 10kW must be typos. At $500 per completed application there will be very few small distributed generators connected. The connection of such units should be a very small administrative matter imposing minimal cost on the distributor and any maximum charges should reflect this.

5. Summary

- Given that the Commission is now firmly established and operating, we believe the job of making recommendations on regulations for distributed generation should have been passed from the Ministry to it.
- The obvious rationale for requiring all other regulations under section 172D to be recommended by the Commission is to ensure they are consistent, have been developed using the Commission’s specialist expertise and knowledge and are one step removed from the political process. This rationale applies equally to regulations relating to distributed generation.
- Regulations relating to distributed generation are unlikely to have a material adverse effect on the New Zealand economy, on their own. However, the abandonment with the current proposals of the good regulatory practice of evaluating the costs and benefits of proposed interventions and allowing the rationale to be open to public scrutiny should be of considerable concern to both producers and consumers.
- In the interests of efficiency and lowering overall compliance costs we suggest the information disclosure requirements in the draft regulations relating to inquiries and applications for distributed generation

connections should be incorporated with the information disclosure requirements imposed on distributors through the Commerce Act 1986

- We believe it would be preferable if a force majeure clause was left out of the regulated terms because with its inclusion it will be hard to negotiate contracts which do not include one.
- The insurance and liability provisions are likely to be a material check on the spread of very small distributed generators; the cost of any insurance is likely to far outweigh the potential benefit from a householder installing such a device. We believe the insurance provision should be left out of the regulated terms.
- In regard to the liability provision, we suggest that it needs to be very clear that if a small distributed generator acts prudently and follows the conditions laid down to operate by the distributor then it has no liability to the distributor. We suggest consideration be given to distributors being subject to a universal service guarantee approach for the services provided to distributed generators.
- The requirement that distributed generators should be charged on an avoidable cost basis is economically sound. The provision suggesting that a cost shifted to another party should not be treated as an avoidable cost is also sound.
- The pricing principles do not go far enough to eliminate disputes as they do not itemise how capital costs are to be determined when applying the methodology. We question whether the Commission or the Rulings Panel is the appropriate place to resolve disputes about pricing and suggest the Commerce commission may be a more appropriate forum.
- The dispute resolution proposal is a reasonable approach to dealing with disputes in a timely and efficient manner under the regulated approach.