



MAJOR ELECTRICITY USERS' GROUP

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By email to anton.murashev@castalia.fr

Dear Anton

Submission on Security and Supply Issues Paper

1. The Electricity Commission (the "Commission") has appointed Castalia to undertake an independent third party review of the reserve energy policy as set out in paragraph 65 of the Government Policy Statement (GPS). To initiate the review process Castalia have published a paper, *Security of Supply Review Issues Paper – Relevant Issues and Questions to facilitate information gathering*, (the "Issues" paper) published 8 December 2006. Feedback on the Issues paper will assist Castalia prepare a Discussion paper.
2. The paragraphs below set out MEUG comments on the Issues paper.
3. The fourth paragraph of section one of the Issues paper, titled "Introduction", states:
"Although the review will need to be undertaken within the context of the Commission's broader work on security of supply, the review is specifically focussed on the role of reserve energy in helping ensure security of supply."
4. MEUG suggest it is essential the broader security of supply policy review is comprehensive. Within that broader view the role of reserve energy should then emerge. It would be a poor outcome if we assumed at the outset, for example, that we must always have Whirinaki or similar plant and the purpose of the review was to assess how that reserve energy plant was run and who pays for it.
5. Therefore MEUG suggest there is a key high level question about the broader policy that should be at the beginning of the discussion paper:
Can the market determine the optimal level of security relating to supply?
6. Question 6 of the Issues paper asks this question in a round-about-way although it is in the context of other questions about reserve energy. Question 37 is also along the same lines although it's right at the end of the Issues paper (which has 39 questions). MEUG suggest the above key high level question and discussion of the answer needs to be at the beginning of the Discussion paper.
7. The above suggested key high level question treats determination of security of supply as an optimum in the sense of the best economic outcome. Some modification might also be needed to the first of the key issues in section two and question 1 of the Issues paper that focuses on the "definition of security of supply" rather than considering security of supply in terms of an economic optimum.

8. Two follow on questions arise from the suggested new question in paragraph 5 above:
- a) ***If the market cannot determine the optimal level of security relating to supply then what is the nature of the market failure?***

MEUG suggest the Discussion paper examines this question in some detail because the nature and extent of the market failure should assist in identifying what, if any, interventions are likely to be welfare enhancing.

When the GPS was first promulgated the government stated its' view of detriments with respect to security of supply. Those were described in paragraph 35 of the GPS as:

"... inconvenience and disruption, and may have affected the attractiveness of New Zealand for business investment, especially for sectors using relatively large quantities of electricity."

The discussion paper needs to consider if those detriments are still relevant and what economic "cost" New Zealand might incur for different security of supply policies.

There were political costs and risks from the prolonged high spot price events during winter 2001 and autumn 2003 and MEUG believes those were as much to do with the setting of the security of supply policy in the GPS as the detriments stated above. The Discussion paper should explore these and other political costs and risks and couch those in economic terms when considering the nature of the problem and different solutions.

- b) ***What solutions are there to the market failures identified?***

In the penultimate section (section 2.4) of the Issues paper Alternative Arrangements other than reserve energy generation are considered. MEUG suggest this section and the question above needs to be towards the front of the Discussion paper.

Other alternatives are likely to emerge through the consultation phase. One obvious alternative that needs to be explored in the Discussion paper is the use of a mix of the alternatives listed in the Issues paper and disposal of Whirinaki. A combination of alternatives plus the changes to the market since Whirinaki was first commissioned (eg two new peaking plant commissioned plus anecdotal reports of higher levels of "hedging") make this a feasible option. The more measured performance of the market over the very prolonged high spot price event of late 2005 through to the end of autumn 2006 illustrates how different the market is compared to the shorter duration but much sharper spot price events in 2001 and 2003; notwithstanding the contribution of Whirinaki reserve energy plant.

9. As well as investment in and operation of generation and demand side initiatives, an optimal level of security of supply can also require consideration of transmission and distribution investment and operations. In other words meeting the level of security of supply consumers want can require consideration of the whole supply chain. The contribution of transmission and distribution to security of supply is recognised in the fourth bullet point of paragraph 36 of the GPS. Therefore MEUG suggest the Discussion paper should include a new question:

Are there policies affecting transmission and distribution that might be detrimental to or could be modified to assist the objective of achieving an optimal level of security relating to supply?

Yours sincerely



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