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MAJOR ELECTRICITY USERS' GROUP

2 July 2008

Maree McGregor
Electricity Commission
By email to info@electricitycommission.govt.nz

Dear Maree

Submission on appropriation proposal for reserve energy

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Commission ("Commission") consultation paper "*Proposed appropriation change: Reserve Energy and Emergency Measures*" released 24 June 2008.

2. Our detailed response in the format requested by the Commission is attached. In summary:

   a) We do not support the proposed increase in appropriation for fuel at Whirinaki of between $55m to $110m. The Commission should rescind its decision to cap prices because to continue a policy of allowing the Commission to offer Whirinaki prices unrelated to its marginal cost of production is extremely distortionary and in the near and longer term will hurt the economy and most consumers.

   b) We do not support the proposed increase in appropriation for purchase of additional generation or demand response reserves of up to $50m. This policy needs very detailed consideration because of the risk of gaming by potential service providers. The consultation document explanation falls well short of an adequate justification. In any case we believe the risk to security of supply is rapidly abating and there is no need for this response.

   c) We do not support the proposed increase in appropriation to cover the costs of a possible Commission conservation campaign of up to $5m. As noted above the need for such a campaign is abating. Even if the risk were to re-appear and as a last resort the Commission needed to fund a campaign, then the Commission should provide more detail than in the consultation paper on how it arrived at the requested $5m appropriation. Furthermore the Commission should demonstrate that all possible savings in other work undertaken by the Commission have been made first.

3. The unilateral decision by the Commission to cap offer prices for Whirinaki at below its marginal cost of production along with these requests for additional appropriation are, in our view, seriously flawed. We don't think that decisions that involve such large sums of monies and will unfairly penalise consumers should be made solely on the basis of this single rushed written consultation round. MEUG request a workshop where the rationale of the Commission can be tested and the concerns of affected parties can be tabled in an open forum.

Yours sincerely

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Increase in the Reserve Energy and Emergency Measures—Variable appropriation proposal

Support / don't support	Comment
Do not support any of the three proposed increases in appropriation.	Refer comments below.

Comments on potential courses of action

Additional Reserve Energy resources

1. The Commission proposes an increase in appropriation of up to $50m for additional reserve energy resources, being either additional generation supply or firm demand response. In anticipation of appropriation being approved, the Commission on 20 June issued a RFP for reserve energy offers, which closes on 7 July. The Commission is vague about how it might decide to contract with possible reserve energy providers and when to exercise any option for supply to commence.
2. The Commission intends to recover the cost of any contracted reserve energy in the same manner that Whirinaki costs are recovered, i.e. from end consumers in proportion to annual consumption.
3. MEUG does not support this proposed increase in appropriation because:
   - There is a high risk that potential providers will rort the process. For example, how will the Commission evaluate a claim by a generator that they had planned maintenance of a plant but will for a payment defer that until after the risk to supply abates further? That generator may well have a risk position as a retailer that would have led to delay of that maintenance anyway. Unless the Commission understands all the incentives on that generator it will be very difficult to assess offers to supply additional generation that are genuinely over and above business as usual.
   - The Commission has failed to consider alternative policy responses. In particular if the Commission had not capped the offer price from Whirinaki and did not propose to continue that price cap, then we believe the market response to managing risks to security of supply would be more effectively managed.
   - The risk of blackouts is abating. Paragraphs 10 to 13 of the consultation paper describe the very low inflows recorded this year and the relative position of lake storage to the Commission calculated Minzone and Emergency Zone. Figure 1 in the consultation paper illustrates inflows for the last 3 months to 9 June.

     Fortunately a combination of the following events has resulted in there being very little chance of blackouts this year:

     - The rain events of 13 to 16 June and 23 to 28 June;
     - The re-calculation by the Commission of the Minzone and Emergency Zone on 17 June;
     - Demand side reductions;
     - Additional generation; and
     - Improved southward transfer capability on the HVDC compared to that expected at the beginning of the year.
4. Some indicators in the market already reflect the significantly diminished risk to security of supply compared to early June. For example there was no or minimal output from Whirinaki between 25 and 29 June.
5. Therefore there is no need for the Commission to make a decision on whether to contract for additional reserve energy at this point in time. The Commission should go no further than obtaining binding expressions of interest from providers of reserve energy. The Commission could also ask these potential providers whether or not they are prepared to contract with their current supplier.
6. If the risk of blackouts returns, then the option of procuring additional reserve energy should be considered, provided the Commission clearly communicates to market participants and stakeholders

the basis on which it will make a decision on when to exercise that option. This should include a clear indicator or set of indicators that will trigger the Commission publishing a RFP. If the Commission is vague about this basis, then uncertainty will influence possible service providers on whether to go to the expense of responding to a RFP.

7. Finally, MEUG note that the Minister of Energy announced on 7 June an option of "negotiating with other major industrial users to buy-back load." We made a request on 10 June to the Minister, in terms of the Official Information Act, for certain information regarding this announcement. One of the reasons we lodged this request with the Minister was uncertainty as to whether the Minister was referring to market driven buy-back arrangements or some other arrangement approved by Cabinet. A reply to our request has yet to be received.

Operation of Whirinaki

8. The Commission proposes an increase in appropriation of between $55m and $110m to provide it with the ability to continue offering Whirinaki into the market at a price less than Whirinaki's short-run marginal cost (SRMC). The Commission's only justification for this offer strategy in the consultation paper is[1] "to ensure there is a stable offer into the market."

9. The Commission intends to recover the cost of any contracted reserve energy in the same manner that Whirinaki costs are recovered, i.e. from end consumers in proportion to annual consumption.

10. MEUG does not support the proposed increase in appropriation to be used for this purpose, as we believe that capping the offer price from Whirinaki is a poor economic choice.

11. The initial decision by government to build Whirinaki in 2003 was a very poor decision. In the absence of government acknowledging that its decision to build Whirinaki was flawed and selling it, the next best policy is to ensure its operation in the market is least distortionary. The Castalia review prepared for the Commission last year recommended Whirinaki be dispatched at SRMC. We supported this recommendation on the advice of NZIER for MEUG[2].

12. On 7 June the Minister of Energy announced government had authorised $40m of cap the offer price from Whirinaki. On 9 June MEUG lodged a request, in terms of the Official Information Act, for details of this government approval. A reply from the Minister has yet to be received. The comments in this submission may require revision once we understand the details of the Minister's statement. MEUG is also interested in a number of aspects of how the decision to cap Whirinaki offers was made including:

    - How the Electricity Commission reportedly transferred profits from Whirinaki power sales prior to the cap commencing to offset revenues below SRMC once the cap was in place; and

    - What were the factors the Commission considered in deciding to implement a cap and if those were the same or different from the Ministers statement that government had approved a cap. We are also interested in knowing if the Commission considered the views of any party prior to making its decision. As far as MEUG is aware, no end consumers were consulted.

13. The Commission's decision in April to cap Whirinaki prices from 30 May has resulted in the following outcomes:

    - Generation being dispatched inefficiently. This will happen whenever another generator could have produced electricity at a cost below the true marginal cost of Whirinaki but is knocked out of the stack by the subsidised offer of Whirinaki.

    - Inefficient electricity consumption due to the market price of electricity generation being below the marginal social cost of electricity generation.

[1] Refer Commission consultation paper, paragraph 27
[2] For a summary of the MEUG position last year on the review by Castalia, refer MEUG submission to the Electricity Commission, *Submission on Reserve Energy Review Consultation paper*, 15 October 2007.

- Creates uncertainties and inefficient incentives to hedge, invest or change behaviour to offset price risks by altering the financial consequences of not doing so.
- Advantages those that have been imprudent in managing their financial derivates and spot exposure at the expense of the prudent. Those that are fully hedged still have to pay for the subsidy to reduce the exposure of those that have under-hedged. This applies in particular to the vertically integrated hydro generators-retailers that are short.
- The Commission decision to set offer prices for Whirinaki below SRMC without any explanation increases regulatory uncertainty for potential investors. New Zealand can ill afford to be known for ad hoc interventions by regulators; but that is exactly what the Commission's decision to cap prices is.

14. MEUG therefore does not support the decision to cap the offer price from Whirinaki or the proposal to continue the ability to flexibly apply a price cap. The experience over the operation of Whirinaki this year demonstrates that the cost recovery policy for Whirinaki and any additional reserve energy needs to be reviewed.

15. In the General Comments section of this submission (paragraphs 20 to 23) we explain why a review of the existing Whirinaki levy structure including who should pay these costs is needed.

Conservation campaigns

16. The Commission proposes an increase in appropriation of up to $5m to[3] "be able to initiate a conservation campaign (as distinct from the industry campaign currently running) at short notice if this is required later in winter."

17. As with the costs of contracting additional reserve energy and the costs of Whirinaki, the Commission intends to recover the cost of any conservation campaign in the same manner that Whirinaki costs are recovered, i.e. from end consumers in proportion to annual consumption

18. MEUG does not support the proposed increase in appropriation for this purpose because:

- The risk of supply shortfalls causing blackouts is abating;
- The Commission has not justified this level of expenditure. In seeking appropriation for a sum as large as $5m, the Commission should provide an approximate breakdown of its constituent parts (e.g. the cost of newspaper, radio and television advertisements, or other activities the Commission plans to undertake). As a minimum, the Commission should give information on the costs of similar campaigns. Simply saying the cost will be $5m, without any explanation, is poor regulatory practice.
- MEUG understands that government departments and crown entities seeking additional appropriations should demonstrate off-setting savings if possible. The Commission has potential discretionary expenditure that is related to an energy conservation campaign, by virtue of the additional $5.1m for the electricity efficiency programme voted this year. MEUG suggests that the Commission should not commence any additional spending on that energy efficiency programme until it is absolutely certain that there will be no need for a Commission-funded energy conservation campaign.
- The Commission should be focused initially on ensuring the effectiveness of market-driven energy conservation signals, such as generation offers reflecting the underlying cost of generation and ensuring suppliers increase their conservation campaign efforts if needed. It is likely a conservation campaign managed by suppliers would be more effective than a Commission campaign because retailers will have a better understanding of consumer behaviour.

[3] Ibid, paragraph 28

General comments

Comment
More consultation is needed
19. MEUG members find it distressing that the Commission could on the basis of a consultation paper that lacks any detail and allows only one week for responses, potentially increase the levy on consumers this year by another $165m. This is in addition to the $94m appropriated in the budget just over a month ago[4]. This is not a trivial decision and, as a minimum, we believe that the Commission should conduct a conference of affected parties to make verbal submissions, answer questions from the Commission and allow cross-submissions.
The levy structure is distortionary
20. While consumers, as the end beneficiaries of delivered energy, should ultimately pay for reserve, the manner in which this occurs need not be uniform. Some consumers may enter into contracts where the price of delivered energy, including the cost of reserve, is included, while others may not. Under the Commission's levy arrangements for reserve energy, the former group of consumers are disadvantaged.
21. Take the example of a consumer who has entered into a fixed price contract for the supply of electricity. It is the responsibility of the supplier to ensure that it meets its contracted supply obligations. If the supplier needs to procure reserve energy in order to meet those obligations, then the cost of doing so is borne by the supplier. The supplier would be expected to factor the probability and cost of procuring reserve energy into the electricity price agreed with the consumer.
22. Under the Commission's levy arrangements, in the example above, the consumer is being forced to pay for the reserve energy required by the supplier to meet its contractual obligations, even though the consumer has already paid for this in its contract with the supplier.
23. Under the Commission's current approach to procuring reserve energy, the associated costs should be levied on the electricity market's supply side, not its demand side. At the extreme, if all of the demand side has in place fixed price contracts for delivered energy, the full cost of reserve energy will be borne by the supply side. To the extent that variable price contracts exist in the marketplace, then the supply side will have the opportunity to reflect the cost of the Commission's procured reserve energy in its prices to the demand side.
The need for a wider policy review
24. As this submission notes, there are serious public policy flaws in the decision to cap the offer price from Whirinaki power station and the rushed and information-light request for additional appropriation. This points to the need for a wider review of policies such as: ▪ Are there better policies to manage dry-year risk? ▪ Who should pay the existing Whirinaki levy and any future costs for new reserve energy or a conservation campaign? ▪ Should Whirinaki be sold?
25. On the first point, MEUG note that NZIER in its report to the Commission entitled "Market Design Report – The Way Forward?", August 2005, recommended: *The introduction, by voluntary agreement with retailers, of contracts aimed at consumers which have them responsible for some of the management of dry-year risk in return for lower prices in other years. Again, if the approach suggested succeeds more heavy-handed solutions will not need to be considered and the risks they would bring will be avoided.*
26. This suggestion and other options need to be urgently considered in light of experience with the current policy settings this year.

[4] Refer Electricity Commission, *Statement of Intent 2008-2011*, May 2008, p25, Total budget revenue 2008/09 excluding interest and other revenue is $94.345m