MAJOR ELECTRICITY USERS' GROUP

26 February 2010

Mr Craig Foss
Chairman
Finance and Expenditure Committee
Parliament Buildings
Parliament

Dear Mr Foss

Submission on Electricity Industry Bill

1. This is a submission by the Major Electricity Users' Group (MEUG) to the Finance and Expenditure Committee (the "Committee") on the Electricity Industry Bill[1] (the "Bill").

2. MEUG comprises 19 individual companies and 2 trade associations. Collectively members of the group consume approximately 27% of total electricity demand in New Zealand. A list of member companies is attached in the appendix to this submission.

3. The purpose of the Bill is to improve competition and security of supply in the electricity sector. MEUG strongly support the key proposals in the Bill and agree that the Bill is likely to achieve its intended purpose.

4. There is one major caveat to our support of the Bill relating to the proposal to establish the System Operator as a statutory monopoly and to use the Code to manage its functions and accountability. MEUG recommend the purpose of the Bill would be better achieved if:

   a) The System Operator was a separate legal entity from the Transmission Asset Owner business;

   b) The Code was used to define functions that the Electricity Authority implements by way of a contract with the System Operator; and

   c) The Code and contract would be cognisant of the need to give the System Operator reasonable certainty in the near term and to provide incentives for efficiency gains including possible competition in the longer term.

5. Comments on specific clauses of the Bill including more details on the above substantial issue regarding governance of the System Operator are set out in the table on pages 2 to 10 of this submission.

[1] Refer http://www.parliament.nz/en-NZ/PB/Legislation/Bills/5/a/c/00DBHOH_BILL9726_1-Electricity-Industry-Bill.htm

6. Before considering the clause by clause comments, MEUG notes the following points in respect to the overall package of policy changes announced by Government on 9th December 2009[2]:

   a) The Ministerial Review was a comprehensive and independent review of the sector. Independence was facilitated by use of an Electricity Technical Advisory Group (ETAG). MEUG acknowledges the collective expertise of the members of ETAG. The contribution of ETAG to the final package has been very important as most of their recommendations formed part of the final decisions by Government. The Ministerial Review process took several months and considered a range of options and combinations of options. ETAG also consulted on a draft of its recommendations. One hundred and twenty eight respondents made submissions, including MEUG and several MEUG members. While not all of our submissions were accepted, we are satisfied that ETAG, officials and Ministers considered those submissions. This has not been a rushed review with a pre-determined outcome.

   b) The final package of decisions announced by Government needs to be viewed as a package. Fundamental changes to the package should be avoided because of unintended consequences elsewhere.

7. The specific clauses MEUG has comments on are listed below:

	Part 1 Preliminary Provisions
	No comments.
	Part 2 Electricity Industry Governance
s.7	This section is titled "References to electricity industry." The section states: s.7 "*In this Act, reference to the electricity industry refer primarily to businesses involved in the generation, transmission, distribution, and retailing of electricity, and not to retail consumers or those directly engaged in electrical work.*" <u>MEUG comment:</u> This definition defines the industry as primarily being the supply side. Retail consumers are specifically excluded. The definition is silent on whether large time-of-use consumers, and their representatives such as MEUG, are part of or excluded from the definition of "electricity industry." This omission creates problems, eg: (1) A major power consumer connected to the grid is defined as an Industry Participant pursuant to s.9 (1) (f) with all the responsibilities attached to being a participant but it's unclear if they are to be considered part of the "electricity industry." (2) Currently major power consumers both connected to the grid and connected to local distribution networks are important providers of ancillary services and demand side response. As meter and appliance technology improves, more consumers including households will become important sources of demand side response and ancillary services. However households, which are retail consumers, are specifically excluded from the definition of "electricity industry." The importance of demand side response as a new approach to provide better competition in the market is recognized by its inclusion as a specific new matter to be in Code, refer s.45 (2) (d). There is an anomaly between

[2] Refer Hon Gerry Brownlee, media release, Energy sector transformation to benefit consumers, 9th December 2009, refer http://www.beehive.govt.nz/release/energy+sector+transformation+benefit+consumers

	expectations that more consumer participation in demand side response is important and therefore is a specific new matter in the Code but consumers are not listed as part of the "electricity industry." (3) S.23 (5) lists the attributes of members of the Security and Reliability Council as "… appropriate knowledge and experience of the electricity industry". There is no mention of knowledge and experience of the current important contribution of major time-of-use consumers and the likely increasing importance of smaller sized consumers including households as smart grid, smart meter, smart appliance and smart pricing policies are implemented. One solution to the oversight in the latter point is to expand the attributes required of the Security and Reliability Council to cover consumer demand side response. The risk is that references to "electricity industry" in other parts of the Bill might make the same omission. MEUG therefore propose a change to s.7 to include consumers as follows (new text underlined and text to be deleted struck out): s.7 "*In this Act, reference to the electricity industry refer ~~primarily~~ to businesses <u>and consumers</u> involved in the generation, transmission, distribution, ~~and~~ retailing of electricity, <u>demand side response and ancillary services</u> and not to ~~retail consumers or~~ those directly engaged in electrical work.*"
s.10	This section establishes Transpower as a statutory monopoly System Operator. In addition to the usual functions of a system operator to match real time demand with real time supply, the Bill adds new functions comprising provision of information and forecasting on all aspects of security of supply and managing supply emergencies. The Electricity Authority will draft and implement the Code that will set out the functions and performance requirements for the system operator as set out in the Bill. <u>MEUG comment:</u> The System Operator function is the core of all electricity markets. The existing System Operator activity as a division of Transpower performs well in some aspects but has also had significant problems (eg time and cost overruns incurred in upgrading their market computer systems). Effective governance of the system operator functions is essential for an efficient market. Poor governance of the system operator activities can result in lack of innovation, higher costs and poor performance within the system operator and detrimental flow on effects to the market. MEUG notes four aspects of the proposed governance of the System Operator that improvements should be made: (1) Establishing the System Operator as a statutory monopoly we think is unnecessary. A better option would be to have an evergreen contract between the Electricity Authority and the System Operator with a right to give notice of expiry spanning several years. This gives the System Operator certainty for sufficient time to invest in new systems while at the same time allowing scope to introduce competition should that become a viable option. MEUG note: ▪ Establishing any new statutory monopoly needs to be an option of last resort. A statutory monopoly weakens incentives for efficiency and innovation. Having the threat of competition, even several years into the future by way of an evergreen contract, will create valuable incentives on the System Operator to be efficient and innovative. ▪ MEUG agrees that the option of creating an Independent System Operator and having the system operation function tendered as of today has high costs and risks. Nevertheless in the future changes in technology may allow competition for system operation services, or at least some portions

of that function. It will be costly and time consuming to have a legislative amendment to allow that competition when an evergreen contract is a viable alternative.

- An evergreen contract with long duration notice of expiry is not a novel idea. This is the type of contract the Electricity Commission currently agrees work and performance standards with the System Operator. MEUG is not aware of any undesirable outcomes from using this type of contract and therefore why it should be replaced by use of the Code in the future. In our view a contractual relationship is more flexible and therefore will be more economic welfare enhancing than a statutory monopoly.

(2) The International Energy Agency (IEA) has published several reports on the benefits of independent System Operators in many parts of the world. The proposal to embed our System Operator as a statutory monopoly not independent of the transmission grid owner appears to be a significant departure from the trend in other IEA countries.

One of the benefits of making this separation is to militate against the risk that the system operator may favour the interests of the grid owner. Chinese walls can help manage this; but in the heat of an emergency when the grid owner part of Transpower may be under financial or other stresses, the risk of the System Operator favouring a related party will be much greater than if the System Operator and Grid Owner were separate entities.

Another benefit is to ensure organisational focus. With over $2 billion of new transmission assets being built there is a risk that the Board of Transpower will be so focused on implementing that work programme that the system operator activities will become a second order priority. Building and running a transmission grid is a different business from being a system operator. While having two Boards of Directors will increase costs, we think the benefits in having both organisations with independent Board level expertise and input will be beneficial for those organisations and the market.

(3) The use of a regulatory mechanism (the Code) to govern the role and accountability of the System Operator will be less effective than a contractual mechanism. As noted above MEUG's proposal for an evergreen contract between the Electricity Authority and the System Operator provides for such a contractual relationship with the benefits that has of being more flexible and subject to normal commercial law precedents.

(4) There is ambiguity on the need for the System Operator in undertaking the new function of providing information on security of supply to do so within the Code and to be accountable to the Electricity Authority in performing that function. The Committee needs to ensure that the System Operator is clearly accountable to the Electricity Authority for these activities.

In conclusion MEUG propose s.10 be amended as follows:

(1) Remove the proposal in the Bill to make the System Operator a statutory monopoly and instead legislate for the System Operator to become a separate legal entity from the Grid Owner activities of Transpower.

(2) The first of two new clauses be inserted after s.10 (3):

"s.10 (3A) "*To avoid any ambiguity, the requirements of the Code in subsection (3) also apply to the new functions for the System Operator in subsection (2)*."

(3) The second of two new clauses be inserted after s.10 (3):

"s.10 (3B) "*The Authority and System Operator must enter into a contract to give effect to the functions and performance standards for the system*

	operator set out in the Code in subsection (3) cognisant of the need to give the System Operator reasonable certainty in the near term and to provide incentives for efficiency gains including possible competition in the longer term." If the above is implemented there will be supplementary changes to other parts of the Bill, eg listing the System Operator as an Industry Participant in s.9 (1).
s.16 (1)	Members of the Electricity Authority must not represent the view of "any particular industry participant or group of industry participants." MEUG comment: Industry Participants is a tightly defined set of parties listed in s.7. That list excludes large consumers currently providing demand side response and ancillary services. In the future smaller time-of-use consumers, including households, will also become important providers of demand side response and ancillary services. MEUG propose that s.16 (1) be amended so that Members of the Authority must not represent the views of consumers and other interested parties such as consumer representatives and load aggregators. This amendment would provide equal treatment for industry participants and other parties. This point is similar to the comments on s.127 (1) below regarding use of the defined term Industry Participants.
s.18 (g)	This clause lists one of the functions of the Electricity Authority as monitoring and undertaking reviews, studies and inquiries. MEUG comment: We support this function and the independence of the Electricity Authority to apply resources to those aspects of the market it considers most likely to result in better outcomes for the economy and consumers. Later in this submission we comment on the risk of overriding political direction in respect of issues that need monitoring and investigating – refer s.20 below. It is unclear from the wording of this clause whether the Electricity Authority is required as part of its functions to actively monitor the market in real time; or if this clause only refers to project based monitoring. MEUG notes that one of the problems with the Electricity Commission has been that it does not actively monitor the market in real time. For example there is a need to monitor the market to identify if one or more suppliers are starting to accumulate sufficient market power that they can dictate spot prices. Later in commenting on s.124 we note support for transferring Tekapo A and B power stations to Genesis though there is a small risk of anti-competitive behaviour in certain scenarios. It is essential that the list of functions required of the Electricity Authority include monitoring in real time the performance of the market. MEUG suggest after s.18 (g) a new subsection: "s.18 (g1) "*to undertake real time market monitoring to indentify and inform the market when competition may be limited*." Note that the Electricity Authority would develop the criteria for such monitoring but may contract with another party, such as the System Operator, to operationalise this work. This also reinforces MEUG submissions on s.10 for the System Operator to be an independent aggregator of market information with any analysis functions over and above standard system operator activities undertaken under contract to the Electricity Authority.
s.20	Provides for the Minister to request reviews by the Electricity Authority "on any matter relating to the electricity industry that is specified by the Minister."

	MEUG comment: The open ended scope for the Minister to request reviews is a risk to the independence of the Electricity Authority to undertake market-facilitation measures (s.18 (1) (f)), industry monitoring (s.18 (1) (g)) and the proposed new real-time market monitoring (refer new s. 18 (1) (g1) discussed above) as it sees fit. Having the Minister request a review compromises the ability of the Authority to manage its resources to meet its own objectives. A number of questions would arise should the Minister exercise this option, eg ▪ Why is the matter so urgent that it cannot be considered as an activity for the forthcoming year appropriation round? ▪ Of all the activities that the Electricity Authority is currently undertaking, which does the Minister suggest the Authority divert resources from in order that it can undertake a review? Or does the Minister intend to provide additional funding from Vote: Energy? ▪ Why can't MED undertake the review, or at least contract with the Electricity Authority to provide expertise, with the cost to meet from Vote: Energy? Overall MEUG has concerns with how s.20 is intended to operate and whether it undermines one of the primary objectives of the Bill to make the Electricity Authority more independent.
s.21	Any person is required to co-operate with the Electricity Authority in terms of providing information, interviews or any other assistance. MEUG comment: This provision is excessive as it applies to any person and allows discretion of the Electricity Authority to decide what is or is not reasonable assistance. S.51 already provides for investigative powers of the Electricity Authority in relation to compliance with the Code. We accept s.51 investigative powers are needed, but not the wider powers to acquire information in s.21. MEUG recommend s.21 should be removed.
s.23 (5) and s.24 (2)	Describes the attributes required of the members to be appointed by the Authority to the Security and Reliability Council (s.23 (5)) and other advisory groups (s.24 (2)). MEUG comment: While members of the Council and advisory groups need not be independent, MEUG suggests members be required to perform their as if they were independent. Suggested changes to the text of the Bill follow (proposed new text underlined): s.23 (5) "*The Authority must ensure that the members of the Council have between them appropriate knowledge and experience of the electricity* industry *to provide independent advice to the Authority, but members need not be independent persons*." s.24 (2) "*Every advisory group must include people who the Authority* considers *have appropriate knowledge of, and experience in, the electricity industry and consumer issues, and can provide independent advice, but members need not be independent persons*."
s.38	The Minister must certify a draft Code and make reasonable efforts to have the Code published at least one month before the Act comes into force.

	MEUG comment: Market participants will need certainty about the initial Code before the market starts operating under that regime. MEUG suggest the requirement to make reasonable efforts to have the Code published one month before the Code comes into effect needs to be strengthened into a firm requirement. If delays occur, then so to should the commencement of the new regime. The Bill is silent on the Minister consulting on a draft of the code before a final version is certified. In practice we expect a draft of the text will be available for comments. However to avoid any ambiguity we suggest the Bill require the Minister to consult on a draft of the Code before making a final decision on certifying the Code. As implementation of s.38 and the changes suggested above by MEUG need to be enforceable ahead of 1st October 2010, then the Bill will need to provide for s.38 to be enacted ahead of that date.
s.43	Allows the Electricity Authority to make urgent changes to the Code. MEUG comment: MEUG agrees the Authority may in some cases need to make urgent changes. The Electricity Commission has the same powers to seek changes to the Electricity Governance Rules. An important difference is that s.172E (3) of the Electricity Act requires the Electricity Commission within 6 months of the urgent rule change having been made, to publish an assessment (ie cost-benefit-analysis) justifying the change. MEUG suggests the Authority should also be accountable for publishing an assessment justifying the urgent Code change within 6 months of implementation. This could be achieved by adding into s.43 a requirement for a regulatory statement pursuant to s.42 (2) being published within 6 months.
s.46	Allows the Minister to amend the Code no later than 4 years after the Authority commences on five specific new matters: requiring retailers to compensate consumers for public conservation campaigns, a floor price on spot prices during supply emergencies, location hedge mechanisms, demand-side reduction mechanisms, standardised line tariffs and facilitating or providing for better financial hedge markets. MEUG comment: MEUG agrees that final decisions on these five specific new matters need to be progressed urgently. These are complex issues. MEUG's preference is for solutions that promote market mechanisms rather than regulating outcomes. In some cases regulations and or Code changes will be required; but those should be a last resort and we believe there is scope for non-regulated solutions. As drafted, s.46 allows the Minister to amend the Code as many times as she or he wishes within the four year window. For example the Minister could amend the Code each year for just one of the specific new matters. That is four Code changes within the four year window on the same issue. It may be better to restrict the ability of the Minister to amend the Code on any single specific new matter to only one change within the four year window.
s.47 (5)	Transmission agreements can be amended or replaced with the mutual consent of the parties. MEUG comment: MEUG supports the recent trend to shift the relationship between Transpower and

	its customers from a purely regulated arrangement to a contractual basis underpinned by regulated minima. Changing a Transmission Agreement might affect other parties with other Transmission Agreements entered into by Transpower. MEUG suggest additional text will assist manage this risk: s.47 (5) "*The terms may be amended or replaced, but only by mutual consent of the parties <u>and agreement by other parties with Transmission Agreements that are adversely affected</u>*."
	Part 3 Separation of distribution from certain generation and retailing
	No comments.
	Part 4 Industry participation and consumers
	No comments.
	Part 5 Miscellaneous
s.124	This section puts into place mechanisms for Ministers to give direction to SOE electricity suppliers with respect to the asset swaps and virtual asset swaps announced by Government on 9th December 2009. <u>MEUG comment (1) mitigating risks of unforeseen anti-competitive behaviour:</u> MEUG is a strong supporter of using structural changes to the market to improve competition. The pro-competitive benefits of asset swaps as a structural change to the market are not without costs and risks. The Ministerial Review has considered these in some detail. MEUG notes that there remains a residual risk that unintended scenarios will develop where less competitive outcomes might occur. For example MEUG members would be concerned if Genesis in a very dry year in the South Island were to withhold water from Tekapo while at the same time dominating marginal thermal power supply supplied from the North Island being transferred south. The overall likely benefits of the asset swap still make this policy very attractive; but MEUG is mindful that the Electricity Authority needs to have a much more vigorous market monitoring function compared to the Electricity Commission to identify these types of risks to competition. This reinforces the submission by MEUG beforehand to include a new clause s.18 (1) (g1) to ensure effective real time market monitoring by the Electricity Authority. <u>MEUG comment (2) ensuring adequate transparency on these transactions:</u> The asset swaps and virtual asset swaps are significant transactions. MEUG is concerned that the SOE will not disclose adequate information on these transactions thereby enabling market participants to take an informed view on how to manage risk. If SOE were to withhold material information, those SOE would then have an advantage compared to others in the market. The following detail problems in ensuring SOE will publish adequate information: ▪ If the SOE suppliers were listed, most if not all the details of these transactions would be disclosed as part of the NZX continuous disclosure regime. The Minister for SOE has instructed a change to require continuous disclosure; however MEUG believes it may take a while to bed this into practice and therefore consumers cannot rely on the continuous disclosure regime for SOE to publish all relevant information. ▪ SOE generators do have an interest in ensuring debt markets are well briefed but that information is not made public. Listed companies also provide significant additional information over and above the continuous disclosure requirements to share market analysts and investors as part of the competition for capital from equity markets. SOE suppliers have no

	such requirement or incentive to provide additional information. ▪ The Electricity Governance Rules provide for disclosure about risk management contracts. However the contract price disclosure requirements are only mandatory for contracts less than 10 years (refer Electricity Governance Rules Part G, Section VI, rule 3.4). As the virtual asset swaps will have a 15 year term, the SOE need not disclose the contract price. ▪ The Bill (s.124 (9)) requires the Minister for SOE to table in the House and publish in the Gazette all directions or notices given under s.124. There is no statutory requirement for the final details of the transactions, which may differ from that given in the direction or notice, to be made public except under the yet to be bedded in continuous disclosure requirements. The solution MEUG propose to the risk of SOE suppliers providing inadequate information on the asset swaps and virtual asset swaps is that the Bill includes a provision requiring the SOE after completion of these transactions to report back to the Minister for SOE on the details and reasons for any variation from the direction or notice. The Bill should require the report back by SOE to be made public.
s.126 (3)(c)	Allows levies to be set to cover EECA costs in relation to electricity efficiency work. The levies will be charged to all or some industry participants. <u>MEUG comment:</u> MEUG have opposed the current Electricity Commission levies that have under-written the Commission's electricity efficiency programme because it leads to energy efficient consumers subsidising less efficient consumers. It frustrates MEUG members that have spent their own money getting their plant as efficient as possible to pay levies to assist other consumers who have not put their money into doing the same. The Bill does not adress this problem. Instead s.126 (3) (c) retains the status quo, ie mainly highly efficient large consumers in competitive global markets subsidising other classes of consumer. MEUG recommend that if government wishes to fund electricity efficiency work then it should be funded from Consolidated account rather than levies involving cross-subsidies. Some parties have argued that reductions in demand as a result of subsidised electricity efficiency programmes have benefited large consumers because prices will be lower. This misses the point that on average prices are set by suppliers pricing just under the cost of new supply. If the Long Run Marginal Cost (LRMC) of the next tranche of generation is $90/MWh, on average spot prices will be just under $90/MWh. Reductions in demand from energy efficiency programmes do not affect LRMC or the longer term average pricing behaviour of suppliers. Average prices are not necessarily lower because of electricity efficiency programmes. MEUG recommends s.126 (3) (c) be removed from the Bill and ongoing electricity efficiency work by EECA be funded from Consolidated Account. The latter would then be consistent with EECA work on efficiency and conservation for the gas, coal, liquid fuels and other energy forms being funded from Consolidated Account.
s.126 (3)(g)	Allows costs of MED work to be levied. <u>MEUG comment:</u> The forecasting and modeling work by the Electricity Commission for the Statement of Opportunities is to shift into the broader overall energy sector planning and forecasting work of MED. The scale and detail of the work by the Electricity Commission is also to be wound back. The amount of monies MED will actually spend to be recoverable from levies is likely to be very modest and whether the additional cost or processes and bureaucracy to identify and charge for that is questionable.

	This also raises questions on accountability of MED to reasonably account for staff and other resources used solely for electricity sector modeling and not modeling say the gas sector. Ideally MED staff should be accounting precisely for time with an audit of that time-writing to ensure accuracy. If MED are not prepared to provide that level of accountability; then MEUG is very concerned about how a reasonable share of electricity industry related costs will be determined. Note that levy payers are not given any ability to make submissions on proposed MED levies, whereas s.127 of the Bill requires the Electricity Authority and EECA to consult on proposed appropriations. MEUG recommends s.126 (3) (g) be removed and MED should therefore fund any incremental costs associated with modeling and forecasting from Consolidated Account. If s.126 (3) (g) is not removed then protection for levy payers is needed by way of requiring MED to consult on proposed appropriations per s.127 and requiring MED to establish a time-writing or similar process to reasonably account for actual costs incurred and to avoid the risk of underwriting other related MED modeling and forecasting work.
s.127(1)	The Electricity Authority and EECA must consult industry participants on proposed appropriations that will lead to levies. <u>MEUG comment (1) in relation to only consulting industry participants:</u> Industry Participants is a tightly defined set of parties listed in s.7. That list excludes large consumers currently providing demand side response and ancillary services. In the future smaller time-of-use consumers, including households, will also become important providers of demand side response and ancillary services. Ultimately end consumers end up paying levies. It would be wishful thinking to believe "industry Participants" as defined in s.7 will scrutinize levy proposals to the same extent or with the same objectives as consumers. MEUG propose s.127 (1) be amended so that consultation is required with industry participants, consumers and other interested parties such as consumer representatives and load aggregators. This point is similar to the comments on s.16 (1) above regarding use of the defined term Industry Participants. <u>MEUG comment (2) in relation to justification for proposed appropriations:</u> The Electricity Authority and EECA are required to consult but s.127 (1) provides no guidance on the level of consultation that would be appropriate versus that which would be insufficient. This has been a bone of contention with the Electricity Commission consultation on their proposed appropriations for a number of years. Different parties have had different concerns. MEUG note two concerns. First, the time allowed for submissions has often been very short. Second, the quality of the justification for work programmes has ranged from poor to very good. The best justifications include a cost-benefit-analysis of possible outcomes. Those programmes with possible higher aggregate benefits can justify more and or earlier resources and attention than others. MEUG recommends an amendment to s.127 (1) to require consultation on proposed appropriations to allow at least 4 working weeks for submissions and each work programme be justified by a cost-benefit-analysis.

8. We would welcome an opportunity to present this submission and answer any questions directly before the Committee at any public hearing.

Yours sincerely

Ralph Matthes
Executive Director

Appendix: List of MEUG members

Ordinary members

ANZCO Foods
Auckland International Airport Limited
Carter Holt Harvey Limited
Dongwha Patinna NZ Limited
Fletcher Building Limited
Fonterra Co-operative Group Limited
Heinz Wattie's Australasia
Holcim (New Zealand) Limited
Lion Breweries
New Zealand Steel Limited
Norske Skog Tasman Limited
Oceana Gold Limited
Pan Pacific Forest Products Limited
Ports of Auckland Limited
Ravensdown Fertiliser Co-operative Limited
Rio Tinto Aluminium New Zealand Limited
Solid Energy New Zealand Limited
The New Zealand Refining Company Limited
Winstone Pulp International Limited

Industry group members

Business NZ
Wood Processors Association (WPA) of New Zealand Incorporated