



12 November 2020

Hon Dr Megan Woods
Minister of Energy and Resources

Hon Dr David Clark
Minister of Commerce and Consumer Affairs

Hon James Shaw
Minister of Climate Change

Dear Megan, David and James

Briefing from the Major Electricity Users' Group

1. The members of the Major Electricity Users' Group (MEUG) congratulate you on your appointment to the Energy and Resources, Commerce and Consumer Affairs, and Climate Change portfolios, respectively.
2. This briefing introduces MEUG and discusses four policy themes in the electricity sector.
3. Members have appreciated Ministers attending our Annual General Meeting or monthly Executive Committee meetings to informally discuss energy and climate change topics. We look forward to continuing this engagement over the next three years.
4. This briefing considers four MEUG policy themes:
 - #1 - Electricity wholesale price competition
 - #2 - Climate change policies
 - #3 - Line monopoly costs
 - #4 – Impact on individual households and businesses matter.

The briefing concludes with background information about MEUG members and MEUG.

MEUG policy theme #1 - Electricity wholesale price competition

5. Wholesale electricity prices in New Zealand are, relative to other countries we compete with, high. We are concerned competition has stagnated in spot, hedge and retail markets and is not leading to good outcomes for consumers. The Electricity Price Review considered how competition in the wholesale and retail electricity markets could be improved and several useful recommendations were made and agreed by the Government. The Electricity Authority and MBIE are working on multiple projects to

deliver those work programmes and MEUG is engaged on those. This will all help but MEUG remains concerned that the pace of change will not see prices decrease for some time. Part of MEUG's role is to provide credible evidence to enable decision makers to facilitate efficient operating and investment decisions by small and large consumers and suppliers. For example, experience has shown the risks of prior governments picking winners or making decisions in the energy sector without independent expert advice and consultation.

6. MEUG cannot emphasise enough how the high wholesale electricity price environment we have been in since 2018 has eroded the confidence of our members that competition in the electricity market will improve. This will have a contracting effect on the economy as electricity intensive businesses that have little confidence they will in the future get a fair deal and competitive electricity prices will not reinvest or expand, or new end users elect to start up in New Zealand. Much has been written about a wave of lower cost technology supply options that will lower wholesale electricity prices. On the ground in MEUG member sites where day to day operational decisions are made, and in boardrooms where investment decisions are made, there is a massive gap between speculation by some that prices will fall dramatically and near-term prices actually offered in the market.
7. Some MEUG members and one non-MEUG member have taken the initiative of considering a power purchase agreement (PPA) to avoid possible market power holding up prices by the incumbent large vertically integrated suppliers. MEUG is also piloting an economic profit analysis of Meridian Energy over the last 20 years. Depending on the results of that pilot study it may be rolled out to consider other large suppliers to provide an evidence base as to whether the economic profits of the large vertically integrated suppliers are excessive and to monitor trends over time.
8. Improving competition using the levers available to the Electricity Authority and MEUG's own initiatives above could either be enhanced or undermined by other policies. For example, if the goal of having 100% renewable electricity generation by 2030 shifts from being aspirational to an absolute objective irrespective of cost, then electricity prices and the risks to security of supply may become untenable leading to major electricity users downsizing or leaving New Zealand.
9. The preceding example is one of many climate change driven policies that can have unintended consequences on the electricity market. There is a risk of policy making being undertaken at speed without adequate robust cost-benefit-analysis of the complex interaction between energy and climate change policies. The solution to avoid the risk of unintended consequences is to have early, adequate, and open consultation on policy options supported by evidence and robust analysis.

MEUG policy theme #2 - Climate change policies

10. MEUG appreciated the progress in climate change policy in the previous term of Government through the passing of the Zero Carbon Act and the Climate Change (Emissions Trading Reform) Act. The political consensus achieved, and the emissions budget frameworks, have the potential to assist in providing greater certainty for business planning.
11. For MEUG's emissions intensive trade exposed (EITE) members, the planned wide review of industrial allocation setting undermines these gains and has potential knock on impacts into the wider energy supply and demand balance, regional economies and the future characteristics of New Zealand's future industries.
12. Industrial allocation policy has been in place since July 2010 and was developed with the input of a Technical Advisory Group which included officials, industry experts and economists. This policy mechanism remains unchanged in current legislation.
13. Ministry for the Environment officials have signalled that all elements of the policy may now be subject to change, including eligibility, whether allocation should continue on an intensity (production) basis and whether the allocative baseline (units allocated per unit of output) should be updated.
 - One element of the review, the Electricity Allocation Factor (which forms part of the allocative baseline), is highly technical and MEUG is working collaboratively with Ministry for the Environment officials to develop a robust mechanism for its ongoing determination.
 - The remaining elements introduce significant uncertainty to EITE firms on the magnitude of NZ ETS costs that will have to be absorbed in the future.
14. At this stage, the Terms of Reference for the review remain unknown, as does the make-up of a proposed Independent Panel.
15. MEUG recommends that the Government be mindful that industrial allocation settings should not be viewed just through a climate change policy lens. Instead they should be assessed against wider economic and strategic imperatives for New Zealand.
16. Many industrial employers are struggling in challenging economic times, coupled with widespread disruption to international markets and supply chains. For many, their international competitors face little or no carbon costs. This is not to argue New Zealand should not progress climate change policies, just that decision-makers remain mindful that New Zealand does not exist in a vacuum.

MEUG policy theme #3 - Line monopoly costs

17. For an average household, the regulated line charges of their local Electricity Line Business (EDB) and Transpower average 43% of the total delivered power bill with transmission less than a third of EDB costs.¹ On average for MEUG members, regulated line charges are in the order of 15% to 30% of total electricity costs with transmission share ranging from around 25% to 100% of line costs. Some MEUG members are directly connected to the transmission grid and have no EDB charges. MEUG's focus is therefore primarily on the productivity and prices set by Transpower.
18. Both Transpower and EDB have had poor measured productivity for several years compared to most other sectors of the economy². A challenge for regulators, end consumers and the monopolies themselves is to adapt New Zealand's relatively light handed and low-cost approach to regulating monopolies to create more innovation by the monopolies and the parties they contract with. MEUG is optimistic solutions will emerge because there is good dialogue between parties including regulators and officials.
19. An evergreen contentious policy topic has been transmission pricing. One of the underlying problems has been that Transpower's charges include recovery of costs for assets that they cannot demonstrate any user of transmission services gains a benefit. As an aside we note a compounding issue to the problem of Transpower's balance sheet that includes assets that confer no value to any user of transmission services, is the regulated weighted average cost of capital (WACC) for Transpower is greater than the expected WACC (at the 50th percentile). The Commerce Commission have given Transpower and EDB an uplift in WACC to the 67th percentile.
20. If Transpower were in a workably competitive market the value of those assets that confer no benefit to a user of transmission services would be written off. In a well-functioning market, businesses do not get to charge consumers for assets that consumers do not use or do not benefit from in any way.
21. This issue of over-stated regulated monopoly asset values is not a material concern with EDB.
22. The inability of Transpower to demonstrate a reasonable allocation of costs has contributed to the conflicts within the sector on the allocation of transmission costs in the review of the Transmission Pricing Methodology (TPM). MEUG members have been materially affected such as Rio Tinto overpaying for transmission services even though it is located near its main source of power. In the North Island members such as NZ Steel will in the new TPM regime pay a "residual" charge that includes recovery of asset costs for which NZ Steel receives no benefit from.

¹ Refer Electricity Authority, <https://www.ea.govt.nz/consumers/my-electricity-bill/>

² Statistics NZ's Productivity Statistics, <https://www.stats.govt.nz/information-releases/productivity-statistics-19782019>, report the multifactor productivity index for the Electricity, gas, water, and waste services in 2019 (the latest year data is available) was lower at 938 compared to a starting year base of 1,000 in 1978. Over the last three reported years productivity was -3.5%, -3.7% and -0.3% over 2017, 2018 and 2019. The Commerce Commission in setting the Default Price-Quality Path for regulated EDB in 2019 assumed 0% productivity change for the next 5 years using the poor historic trend.

MEUG policy theme #4 – Impact on individual households and businesses matter

23. MEUG’s strategic objective and the statutory objectives of the Commerce Commission and Electricity Authority, as noted in paragraph 29 below, are intended to improve the long-term benefit of electricity consumers. MEUG welcomes the decisions following on from the Electricity Price Review to establish a Consumer Advocacy Council for small consumers and an Energy Hardship Group to improve how decision makers and the sector think about the effects on consumers.
24. An important step to improving understanding by consumers is clear articulation of the benefits consumers will receive from any decision, and the added costs they will face. By consumers we mean small, average, and large households, SME’s through to the largest industries. The sector has not been good at this. All decision-makers, including regulators and Transpower, should detail the costs and benefits across a range of representative classes of households, and appropriate groupings of commercial and industrial consumers, of any proposed action.
25. Complementing the conventional cost-benefit-analysis techniques with estimates of the incidence of benefits and costs on different consumers and regions is an evolving science across all of government. For example, the Climate Change Commission in reporting to Ministers on recommended Carbon budgets mid next year will include an estimate of distributional impacts. We have included this topic as a policy priority because like any new analytical method there will be some trial and error, correct and misleading interpretations of results. Some regulators and suppliers in the energy sector have started thinking about the distributional effects of policy and pricing changes and others have not.

Background information on MEUG members and MEUG

26. MEUG is a voluntary industry association comprising large industrial and commercial users of electricity as listed in the table on the next page.
27. Collectively members use approximately 28% of total electricity use in New Zealand and pay around \$900 million per annum for delivered electricity charges.
28. MEUG members are major employers, mainly in regions outside the main metropolitan areas, and significant contributors to the economy (2017 data).
 - 25,000 direct employees.
 - \$11 billion contribution to GDP and \$30 billion sales per annum.

<u>Company members ranked from largest to smallest demand with sector and location</u>		
Rio Tinto	Aluminium	Tiwai Point
New Zealand Steel	Steel	Glenbrook, South Auckland
Fonterra	Food industry	Multiple NZ wide
Oji Fibre Solutions	Wood products	Kinleith & multiple NZ wide
Pan Pac Forest Products	Wood products	Napier
Norske Skog Tasman	Paper	Kawerau
Woolworths (Countdown)	Supermarkets	Multiple NZ wide
Winstone Pulp International	Wood products	Karioi, Ohakune
OceanaGold	Gold mining	Macraes Flat & Waihi
Whakatane Mill	Wood products	Whakatane
Daiken NZ	Wood products	Rangiora & Maitara
Visy Glass	Glass	Auckland
Ravensdown Fertiliser	Fertiliser	Multiple NZ wide
Lion	Food industry	Multiple NZ wide
<u>Industry association members</u>		
BusinessNZ		
Wood Processors and Manufacturers Association		

29. MEUG's strategic plan is deliberately aligned with the statutory objectives of the Commerce Commission and Electricity Authority to achieve outcomes "for the long-term benefit of electricity consumers". Befitting MEUG's membership most of our work is in the upstream wholesale market and improving the performance of Transpower. Improvements upstream flow through to the retail mass market or household sector. MEUG rarely comments on policy changes in the retail sector.
30. The interconnected nature of policy, both vertically between upstream and downstream, and across sectors and policy areas including the gas sector and climate change, leads to MEUG maintaining an overview and engagement with a wide range of parties. Those include other consumer groups, other industry associations, line monopolies, generators, retailers, consultants, service providers to the sector, regulators, and officials.
31. An important role for MEUG is to maintain dialogue, be open to new ideas and have an opportunity for timely feedback to decision makers before decisions are made. We realise decisions must be made and not every change will achieve an industry wide consensus. We do though believe that before major policy decisions are made there should be adequate consultation and debate including credible cost-benefit-analysis evidence that the policy issue has been properly defined, all feasible options considered and the effect on different consumers, where appropriate, is understood.

Yours sincerely



John Harbord
Chair