

Regulatory Alert

14 August 2009

Electricity market reform – the Technical Advisory Group reports back

In the throes of winter, when electricity usage is at its peak, the Minister of Energy and Resources, Hon Gerry Brownlee (“Minister”), has released a report that seeks to provide solutions to the perceived upward spiral in electricity prices.

This Alert considers the preliminary report to the Ministerial Review of Electricity Market Performance by the Electricity Technical Advisory Group and the Ministry of Economic Development, released on 12 August 2008 (“Report”). The Report is yet another milestone in the evolution of New Zealand’s electricity market, but it is not yet clear how significant and enduring the final outcomes of the Ministerial Review will be.

Background

In his first major speech as Minister on 24 February 2009, Mr Brownlee outlined the following key policy and regulatory challenges facing New Zealand’s electricity sector:

- (a) Progressing Transpower’s \$3.8 billion investment programme as a priority to address under-investment in effective and efficient transmission over the past decade;
- (b) Disentangling the overlap between Transpower, the Electricity Commission and the Commerce Commission to remove regulatory duplication and improve the investment environment (a Law & Economic Consulting Group report prepared for Business New Zealand on regulation and governance in the electricity sector had been favourably received by the Minister);
- (c) The issues of affordability and “how we can get off the escalator of price hikes that has typified the last five years”;

- (d) Responding to the then imminent Commerce Commission report on competition in the electricity industry. The Minister noted that “the Government will not hesitate to act if the report finds significant shortcomings in the operation of the market”.

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On 1 April 2009 the Minister released the terms of reference for the Ministerial Review, noting that “the government has concerns about security of supply, the affordability of electricity, and duplication of electricity sector governance”. The concerns were heightened on 19 May 2009 when the Commerce Commission released its market investigation report, based on the controversial “Wolak Report”, which found that over some six years generators had allegedly used market power to earn \$4.3 billion more than they should have. The Commission noted, however, that the generators had acted as any market participant would (and had not breached the Commerce Act).

The Minister’s response was immediate, suggesting that the findings “confirm the opinion of many that they have paid too much for their power bills over the last few years”. He noted that recommendations for improvements would be made by the Ministerial Review team after considered and measured study of the Commission’s report.

Summary of the Report’s Proposals

The Report contains proposals relevant to each of the policy and regulatory challenges identified by the Minister. On one view, however, the Report has gone too far. The Minister has quickly ruled out the options of creating a new SOE or transferring the Huntly power plant from Genesis to Solid Energy. He says that the Government will also need to be convinced about the proposal for Meridian and Genesis to swap the Manapouri and Huntly power stations. The Report

suggests this will achieve a better spread of flexible thermal and hydro resources and improve competitive rivalry.

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However, all of the Report's other proposals are on the table for public discussion. In comparison to the SOE restructuring proposals, the majority of the proposals can perhaps be described as tweaks to the existing arrangements, rather than proposals to change the fundamental market structure and design. Allowing lines companies to retail within their local areas (subject to arms length requirements) might be considered a significant step, but the recommendation was perhaps inevitable following recent legislative amendments that allow them to generate and retail without restriction outside their local networks. Other notable proposals include:

- (a) Requiring retailers to compensate consumers during a public conservation campaign. This could be in the form of a rebate, proportionate to the level of power saved. A minimum rebate of \$10 per week is recommended. A floor on spot prices during public compensation campaigns is also suggested;
- (b) Phasing out the reserve energy mechanism, and reassign Whirinaki to an SOE or sell it;
- (c) Any new decisions on climate change policy should provide for stability and predictability on the future cost of emissions to ensure that the costs of new generation are easily quantifiable. The RMA review should aim to facilitate investment in new generation;
- (d) Encouraging gas exploration and identify barriers to geothermal power development;
- (e) Establishing a clearer and simpler Grid Investment Test;
- (f) Introducing a transmission hedging mechanism to avoid price spikes at certain offtake nodes;
- (g) Improving price monitoring and transparency, and increasing use of smart meters and smart tariffs;
- (h) Increasing ease of consumer switching including providing a \$5 million contestable fund to encourage innovative programmes that promote customer switching; and
- (i) Disestablishing the Electricity Commission and establishing an Electricity Market Authority. This would also include a reorganisation of the roles of the Commerce Commission and Transpower.

Certain findings in the Report (whether intentionally or otherwise) may give the Government further comfort that significant intervention in the market is not required. In particular, the Report:

- (a) Downplays the supply crisis in the New Zealand electricity industry. It suggests that there is enough new generation;
- (b) Discusses criticisms of the Wolak Report and concludes that there is no clear evidence of long term exercise of market power in the wholesale market; and
- (c) Finds that retail price increases are largely justified due to higher costs of generation, although the retail market (and the wholesale market to a lesser extent) is not working effectively, as prices are still higher than they should be.

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Comment on the proposals

There are many proposals for stakeholders to consider, but none are particularly new or startling. The Report combines ideas from a number of other reports and reviews. Indeed, the terms of reference expressly required previous work by the Electricity Commission and Commerce Commission to be considered, with the aim of providing a consolidated approach to reform.

In considering their responses to the proposals, interested parties should bear in mind the Minister's focus, as highlighted above. The Ministerial Review has always been about security of supply, affordability and governance, in no particular order. It is therefore notable that the Minister's press statement of 12 August accompanying the release of the Report said that "the primary goal of the review is to tackle the steep price increase to the consumer power bill over the last ten years, and to examine ways to reduce vulnerability in dry years." The Minister was "especially pleased with the way [the report] tackles the pricing issues which trouble many homes".

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The proposals with the greatest prospect of immediately advancing that goal are likely to receive the Government's closest attention. That is evidenced by the Minister's

welcoming of the idea to offer compensation during power savings campaigns, and his rejection of options to restructure SOEs. The Government is looking for immediate and tangible results for households.

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The corollary is that the Government may be convinced that regulation is not needed in some areas if the industry develops its own solutions to address issues facing customers as identified in the Report. This could include, for example:

- (a) Addressing concerns that guidelines and standards for smart meters need to include functionality of greater value to the consumer;
- (b) Making tariffs available that provide incentives for consumers to better manage consumption; and
- (c) More aggressive campaigns to chase new customers.

Governance arrangements

It appears the governance arrangements for the electricity industry will be changed, including the disestablishment of the Electricity Commission. The Report favours the creation of a new Independent Crown Entity (the Electricity Market Authority) to make and enforce market rules (the Minister would no longer have a role), with Transpower assuming responsibility for operational functions such as contracting for market services and information and forecasting functions. The National Party was concerned at the time the Electricity Commission was created that it would not be independent from Government, and so is unlikely to have difficulty with this proposal.

The proposal for Transpower to be regulated by a single regulator is not new, although suggesting the Commerce Commission as the single regulator represents a change in direction from previous legislative provisions. Old section 57DB of the Commerce Act provided a mechanism to transfer the economic regulation of Transpower from the Commerce Commission to the Electricity Commission. Such a transfer was considered and rejected by the previous Government, primarily because the Commerce Commission was considering how best to control Transpower's prices at the time. Given that the Commerce Commission is currently heavily occupied implementing the new Part 4 of the Commerce Act, it will not

necessarily welcome any new responsibility for approving grid investment in the near future.

Ensuring the governance arrangements facilitate efficient grid investment will be one of the most important issues as the review progresses, and is likely to be a priority for the Government, as effective transmission has significant implications for wholesale and retail competition.

The proposed Electricity Market Authority would have the sole objective of ensuring the efficiency of the market, including reliability, for the long term benefit of consumers. This is similar to the objective for regulating markets under Part 4 of the Commerce Act, where competition does not exist and control is necessary. The functions and powers of the Electricity Market Authority to develop rules would therefore need to be carefully defined if this objective remains. It would need to be clear what role the regulator had with respect to market conduct to ensure no overlap with the Commerce Commission's regulatory duties under the Commerce Act.

Conclusion

The Minister's publicly expressed appreciation for the Report appears to be genuine. The Report provides options to tackle the key policy and regulatory challenges identified at the beginning of this Alert. It may be criticised by some as not being comprehensive or not going far enough. However, the Ministerial Review was never about a fundamental restructuring of the electricity market. It was about enhancing the current framework and getting some quick runs on the board for consumers.

Only time will tell if the Ministerial Review delivers on its primary objective. As noted in the Report:

Final prices to consumers are what counts for most people, and are the basis for their views on whether the market is working satisfactorily.

Achieving success in that respect will be difficult to measure, and it may be that the Ministerial Review is merely a small step in the difficult challenge of achieving electricity prices that are acceptable to the electorate.

The Report invites submissions on its proposals, which are due by **5.00pm Wednesday, 16 September 2009**. The Government expects to make final decisions on the reform package by the end of the year. It is also anticipated that legislation will be required to implement final recommendations.

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