

Regulatory Alert

15 December 2009

Electricity Industry Bill introduced

The Electricity Industry Bill ("**Bill**") recently introduced to Parliament by the Minister of Energy and Resources, Hon Gerry Brownlee ("**Minister**"), heralds major changes to the design of the electricity market in New Zealand. The Bill largely follows the recommendations of the Electricity Technical Advisory Group ("**ETAG**"), which conducted a review of the performance of the electricity market earlier this year culminating in a preliminary report released on 12 August 2009 ("**Report**").

The objectives of the reforms (improving competition and security of supply) are similar to those that led to the breakup of ECNZ over a decade ago. However, different solutions are now considered necessary; some reversing what was previously put in place (for example, allowing lines companies into retailing).

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Problems with the electricity market identified in the Report and of concern to the Government are that retail prices have risen too fast (although price increases were noted to be largely justified) and conservation campaigns are too frequent. These issues have a political dimension and the Government will want to be seen to be taking action. Nevertheless, the Minister has been clear that, although the Bill will help curb the rate at which electricity prices are increasing, it is unlikely to lead to a drop in prices.

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The Bill is due to have its First Reading this week with the aim of passage and implementation by October 2010. Interested parties will have an opportunity to submit on the Bill once it is referred to the Finance and Expenditure Committee, although the ability to achieve any significant change to the Bill may be limited due to the consultation already undertaken during the ETAG review.

This Alert outlines the significant (but not all) changes introduced by the Bill.

Overview

The ETAG review largely concurred with the finding of an earlier investigation by the Commerce Commission: that, although individual companies had not acted anti-competitively, the market design could nevertheless be improved to promote competition for the benefit of consumers. Changes recommended by the Report and carried through to the Bill fall within the three key policy and regulatory challenges identified by the Minister in his first major speech on 24 February 2009:

- a) improving competition in the wholesale and retail electricity markets to reduce prices for consumers;
- b) increasing security of supply by facilitating investment in effective and efficient transmission; and
- c) addressing the governance structure of the electricity industry to remove regulatory duplication and encourage investment.

Notable changes proposed in the Bill include: significant asset reallocations between northern and southern state-owned enterprises ("**SOEs**"); removing restrictions on retailing by lines companies; the replacement of the Electricity Commission ("**EC**") with a trimmed-down and more independent Electricity Authority ("**EA**"); provisions for the creation of a liquid hedge market; and facilitation of measures that enable consumers to better manage demand (for example, smart meters). Consumers may directly benefit in the event of a public conservation campaign, with retailers being required to make compensatory payments.

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Some of these requirements will be implemented via a new Electricity Industry Participation Code (“**Code**”) to be made and administered by the EA. Initially the Code will be comprised of the existing Electricity Governance Rules 2003 (and specific parts of other regulations) with modifications to reflect the changes in the Bill. Certain “new matters” must then be addressed by the EA in the Code within a year (for example, the provision of compensation by retailers to consumers during public conservation campaigns).

The Bill also incorporates the Electricity (Continuance of Supply) Bill reported back by the Commerce Committee in July 2009 which requires continued supply in rural/ uneconomic areas post 2012.

Improving competition

Asset swaps

Asset swaps are a proposal to address a perceived lack of competition in the wholesale and retail electricity markets. The Report highlighted the imbalance in asset holdings between North and South Island SOEs, which translated into a lack of retailing in the island in which they did not hold assets. The Report outlined three options for restructuring SOEs, all designed to stimulate retail competition by giving SOEs a more equitable holding of northern and southern assets. Although the Minister initially rejected the more radical Options One and Two, the Bill now adopts a blend of these together with virtual asset swaps, namely:

- » Meridian is to transfer Tekapo A and B power stations to Genesis Energy, in exchange for receiving the Crown-owned Whirinaki reserve plant. The swap will give Genesis a generation presence in the South Island for the first time, enabling it to provide more retail competition to approximately 20 per cent of South Island customers due to lower transmission risks. It will also reduce Meridian’s vulnerability to dry years by providing an alternative source to hydro.
- » In addition, the Bill requires “virtual” asset swaps to facilitate competition. These involve one-off, 15-year term, financial hedge contracts between generators, allowing them to offer electricity at competitive prices in areas where they traditionally have had little or no market presence due to transmission risks. The hedge contracts involve Meridian selling “South Island” electricity to

Mighty River Power and Genesis, in exchange for purchasing “North Island” electricity from the two SOEs.

In order to achieve these outcomes, a temporary one year legislative power (overriding the SOE Act and Companies Act) will enable the Minister to direct the SOEs to undertake the sale(s), set terms and conditions and to enter into virtual asset swaps (if the SOEs are unable to conclude the necessary contracts). A similar power was introduced on a temporary basis in 1998 to achieve the breakup of ECNZ.

Hedge market

The Bill also requires all electricity retailers who hold more than 500 MW of installed generation capacity to implement an accessible electricity hedge market by 1 June 2010. The hedge market aims to facilitate greater retail competition and encourage risk management by industrial users through making electricity available on standardised, tradeable contracts.

An assessment of the market’s liquidity will be undertaken by 1 June 2011, requiring each market participant to offer 3,000 GWh of electricity that is not matched by any offsetting obligations.

Other measures

Other measures introduced by the Bill to encourage competition include:

- (a) allowing lines businesses back into retailing electricity within their own network areas, subject to the retention of existing corporate separation and arms-length rules;
- (b) giving the Minister the power to make rules for standardising line tariff structures and contracts of the country’s 39 monopoly electricity networks, in order to encourage retailers into new geographic areas; and
- (c) establishing a three-year, \$15 million, contestable fund to encourage innovative programmes that promote the benefits of customer switching. This measure follows the Report’s estimate that customers are on average paying \$100 more per year for electricity than they would be if they switched to the cheapest available provider.

Increasing security of supply

While the Report found there was sufficient new generation being built to maintain adequate security of supply, there was a perception that New Zealand had a vulnerable electricity supply system.

The key measures proposed are to phase out the Government-run reserve energy scheme and transfer the Whirinaki reserve plant to Meridian. The Report found that

the reserve scheme discouraged generators from managing their own risks during dry periods, and from investing in greater generation capacity.

A further measure is to require retailers to make compensation payments to consumers in the event of a conservation campaign. This is intended to improve incentives on generator-retailers to better manage supply risks and make conservation campaigns more acceptable to the public.

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Governance structure

The Bill proposes the disestablishment of the EC, and its replacement with an Independent Crown Entity, the EA. As a Crown Agent, the EC is required to act on policy directions from the Minister, rather than merely have regard to them. The change in entity is expected to address concerns that the EC was insufficiently independent from Government and is more in line with international regulatory best practice principles. The EA's objective will be to promote competition for the long term benefit of consumers (akin to purpose provisions under the Commerce Act and Telecommunications Act). It has a narrow set of functions, which include:

- (a) making and administering rules governing the electricity industry through a new Electricity Industry Participation Code ("**Code**"), replacing the Electricity Governance Rules 2003;
- (b) monitoring compliance with, and enforcing, the Code; and
- (c) promoting the benefits of switching retailers to consumers.

As part of the rationalisation, the Bill aims to have the EA focus on pro-competition rules and requirements, with the Commerce Commission focusing on economic regulation. This is intended to reduce perceived functional overlap. However, this could prove to be illusory rather than real. The Bill will create two regulators with similar objectives to promote competition, which each regulator could interpret and implement differently in practice. There also appears to be nothing to prevent the scenario which occurred over the last 2-3 years, where the Commerce Commission investigated potential anti-competitive conduct under Part 2 of the Commerce Act at the same time that the EC was considering market design and competition issues more generally. The EA will now be responsible for enforcing the remaining Electricity Industry Reform Act restrictions. The

Commerce Commission takes over the process of approving major grid upgrades, and addressing the Report's concern that Transpower could "forum shop" when seeking approval, due to regulatory oversight being split between the EC and the Commerce Commission. The function of promoting energy efficiency is transferred to the Energy Efficiency and Conservation Authority ("**EECA**").

Another feature of the Bill is that the Code will not require Ministerial approval before coming into force. This reflects the independent status of the EA, and mirrors the approach taken in Australia and the UK. It also makes the Minister less susceptible to lobbying by interest groups, and removes a layer of government accountability for the rules. However, the Minister may make requests to the EA to undertake reviews of particular issues and report back, which suggests an ability to point the EA in a particular policy direction. An initial Code composing existing regulations is expected to be published at least one month before the Bill comes into force.

"New matters"

Several "new matters" are required to be in the Code, including provision for compensation by retailers to consumers during public conservation campaigns, and mechanisms to help wholesale market participants hedge against price risks caused by constraints in the national grid. If the EA fails to incorporate these matters, the Bill gives the Minister the power to amend the Code (provided any amendments are made within three years of the Act coming into force).

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Conclusion

Overall, the proposed reforms are wide ranging and, given their untested nature, carry risks of unintended consequences and cost. In order to be effective, the reforms (taken together) will have to place the right incentives on the right players at the right time. It may take a review in another decade before the success or otherwise of the proposals ultimately introduced are fully understood. In that sense, it remains to be seen whether this round of reform will complete the process started by the National-led Government in 1998, or whether it is simply one further step in an ongoing effort to achieve the objectives of establishing a competitive electricity market.

The Bill is large and there will be devil in the detail. Interested parties should take time to familiarise themselves with the Bill and make submissions in due course.

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