

Submission

by



to the

Finance and Expenditure Select Committee

on

'The Electricity Industry Bill'

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PO Box 1925
Wellington
Ph: 04 496 6555
Fax: 04 496 6550

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Appendix: About Business New Zealand

1. INTRODUCTION

- 1.1 Business New Zealand welcomes the opportunity to comment on the Bill before the Finance and Expenditure Select Committee (the 'Committee').¹ Business New Zealand believes that many of the changes proposed will contribute to the delivery of a more secure, competitive electricity market and we largely support them.
- 1.2 It is important that consumers, particularly in the productive sector, are assured that electricity prices are reasonable and that the operation of the electricity market is efficient. This is more likely to result from the changes than in their absence. In particular, Business New Zealand strongly supports the changes to the governance arrangements. These changes are broadly consistent with the direction of the work undertaken on behalf of Business New Zealand by LECG.² In particular, Business New Zealand welcomes the new regulator's increased independence from political interference. The constant threat of regulatory intervention raises basis risk and deters investment.³
- 1.3 Business New Zealand also supports the focus of the new regulator's highest priorities. Fundamentally, a well functioning retail electricity market is based upon a competitive generation market with new generation being built in the right location, at the right time, for the right cost and with security of supply risks being managed within a framework that assesses the cost of new generation against the risk to supply. The new regulator's priorities are aimed at achieving this.
- 1.4 However, the outcome of the review, as reflected in this Bill, is a pot pourri of moving parts involving both market, and non-market interventions. Business New Zealand understands that there is no single magic bullet that will assure downward pressure on electricity prices but by the same token the sheer breadth of changes assumes that they are the right mix of tools and create mutually reinforcing incentives to best deliver on this assurance.
- 1.5 Business New Zealand asks that the Committee carefully assess the nature and magnitude of the risks and benefits before proceeding with the Bill. To aid in its consideration of Business New Zealand makes a number of suggestions (generally on matters of detail) that it considers will assist in this regard.

¹ Background information on Business New Zealand is attached in the Appendix.

² Report prepared for Business New Zealand by Kieran Murray, Graham Scott, Toby Stevenson (LECG) entitled 'Determining outcomes or facilitating effective market processes: a review of regulation and governance of the electricity sector', dated 4 February 2009.

³ While a number of factors contribute to investment decisions (such as uncertainty around demand and approval processes) regulatory opportunism also is contributing factor. The Electricity Commission's most recent security of supply assessment signals increasing concern regarding future investment plans.

1.6 The following table summarises Business New Zealand’s view of the nature of the amendments proposed.

<u>General Issue</u>	<u>Business New Zealand Position</u>
The new electricity market governance arrangements	Agree with overall direction but have some concerns such as the extent to which the Minister may still influence the work programme of the new regulator, the levy making powers and some transitional matters.
The separation of lines companies from generation and retail	Agree but concerns regarding the prohibition on procurement on retail bases and whether the new regulator is best placed to administer the new provisions
The use of evolutionary and fine-tuning measures	Many proposed changes are welcome incremental improvements to the electricity sector and can be described as a part of the on-going evolution of market mechanisms. But some, such as mandatory vesting hedges cannot. A high burden of proof is necessary for non-market interventions such as these.

1.7 Business New Zealand’s detailed comments are set out in sections two to five below.

2. IMPROVING GOVERNANCE OF THE ELECTRICITY SECTOR

2.1 Business New Zealand welcomes the proposed establishment of a new electricity market regulator (the ‘Authority’) but has the following specific comments:

- a. Clause 16: having determined that an independent Crown-entity is the preferred governance model, Business New Zealand supports the approach set out in the Bill to determining the independence of the membership of the Authority. It is vital that that the appointment process should be considered in connection with agency independence, since the government may change the policies of an agency not by micro-managing it, but through the appointment of its members. This potential to taint the independence of the new Authority needs to be carefully avoided;
- b. Clause 18(2)(a): this clause provides for the ability of the Authority to perform the functions of the market administrator while other market operation services can only be undertaken by the Authority on a temporary basis. In order to ensure that the Authority remains small and narrowly focused on achieving competitive market outcomes, Business New Zealand considers that the market administrator functions should be undertaken on the same basis as all other market operation services. This clause should be deleted;

c. Clause 20: this clause gives the Minister the power to request the Authority to review and report on any matter relating to the electricity industry that is specified by the Minister. Putting aside for the moment the sheer breadth of the power (“any matter relating to the electricity industry”), Business New Zealand considers that this clause potentially acts:

- i. contrary to the desire to give the Authority independence from the Government, by providing for a power that could effectively reverse the appropriately diminished status of the Government Policy Statement; and
- ii. to defeat the laudable objective set out in the explanatory note to the Bill which states:

“Making the Authority independent from Government provides greater certainty and predictability about how the market will be governed and operate, reduces incentives for lobbying by industry participants and improves investor perceptions about risk.”⁴

A significant element in the uncertainty surrounding the governance of the industry was the lack of clarity surrounding the boundaries between the Electricity Commission and the Ministry of Economic Development (in terms of the appropriate split between core policy development and operational policy [i.e. working out how to deliver on a policy once determined]). Business New Zealand considers that this clause effectively entrenches this uncertainty and is likely to be distracting to the Authority and its focus. Business New Zealand recommends that this clause be deleted, and the Minister instead rely on his advisors in the Ministry of Economic Development to undertake these reviews. They can, of course, utilise the skills, experience and knowledge that will reside in the Authority but the primary accountability for undertaking them should rest with the Ministry of Economic Development;

- d. Clause 21: the powers contained in this clause are disproportionate to the functions of the Authority and, in any case, are largely provided for in clause 51;
- e. Clause 22: Business New Zealand considers that the advisory groups should be renamed working groups. This was the nomenclature used by the Ministerial Review Team and it is unclear why it has reverted back to advisory groups in the Bill. Much of the perception of distance between the Electricity Commission and its stakeholders was its insistence in constantly reminding its stakeholders that it had no obligation to take any notice whatsoever of the advisory groups. This barrier, even if only a perception, needs to be broken down by the Authority;

⁴ Electricity Industry Bill, explanatory note, page 4.

- f. Clause 39: while the Minister must make reasonable endeavours to ensure that the draft code is released one month before the Act comes into force there is no guarantee that this will occur. Business risks facing the uncertainty of having to operate under a new and in some circumstances novel Code without having the opportunity to fully understand its implications. Business New Zealand considers that a practical means to relieve this is to state that the Code will not come into force until one month after it has been published;
- g. Clauses 41(3)(b) and (c): this provides for the Authority not to comply with the obligation to prepare and publicise a regulatory statement where there has been adequate prior consultation. As a matter of principle, Business New Zealand considers that regulatory impact statements are needed for all changes. Given the diverse range of stakeholders it is important that consultation through an advisory group be seen as a proxy for the need to undertake rigorous analysis, including the provision of a regulatory impact statement. Business New Zealand recommends that the exclusion set out in (c) be deleted on this basis, while (b) can be deleted on the basis that a change for which there is widespread support is also likely to be non-controversial (subclause (b));
- h. Clause 46: this clause should be deleted. While Business New Zealand welcomes the priority given to the new matters set out in clause 45, this clause signals the willingness of the Minister to second-guess the outcome of the work of the new regulator, thereby undermining its independence and providing industry stakeholders with the incentive to lobby the Minister. The three year timeframe effectively being given to the Ministry of Economic Development to continue to work on these matters is also likely to undermine investment confidence. If this clause is retained, Business New Zealand recommends that:
 - i. the Minister should publish a report setting out how the Authority has failed in its duty to promote competition in, reliable supply by, and the efficient operation of the electricity industry for the long-term benefit of consumers; and
 - ii. limit the further time available under the clause to an additional one year;
- i. clause 47: stipulated access agreements are generally required in those circumstances where access seekers to a natural monopoly service are unable to exert sufficient countervailing power in negotiating contractual terms and conditions. Business New Zealand considers that clause 47 should be reoriented to require access to the grid on the terms and conditions that are specified in the code or, if requested by the access seeker, required to negotiate alternative arrangements subject to certain standard criteria (such as good faith bargaining);
- j. clause 126: this clause sets out the levy making powers. Business New Zealand has the following suggestions regarding this clause:

- i. in light of the impending strategic review of the Energy Efficiency and Conservation Authority ('EECA'), the costs able to be recovered by it initially should be capped at the level of the Electricity Commission's appropriation for the same outputs (or some lesser amount);
 - ii. the ability for EECA to recover its costs via a levy should be set out, once the review has been undertaken and the case for continued levy funding made, in the Energy Efficiency and Conservation Authority Act 2000, and not in the Electricity Act; and
 - iii. subclause (g) should be deleted. The extent to which the work undertaken by the Ministry for Economic Development will assist investment planning by industry participants is likely to be extremely minor (in fact no investor is likely to rely on this output), and the marginal additional cost of this new work is likely to be extremely small given that Ministry for Economic Development already undertakes energy forecasts. As the levy is ultimately paid for by consumers this Bill should not be used as an indirect means to tax consumers;
- k. clause 127: while laudable, Business New Zealand considers the obligation to consult as drafted to be ineffective. In general, the extent of information provided by the Electricity Commission in its consultations on its appropriations was grossly inadequate. This often gave the impression of an agency going through the motions rather consulting in a meaningful way. The dearth of information generally meant that stakeholders were generally unable to draw any linkages between such basic elements as budget, spend to date, forecast out-turn and the following year's proposed spend. Views on the trade-offs between quality and quantity were also unable to be made. Should this clause be retained, Business New Zealand strongly recommends that:
 - i. the obligation to consult be fulfilled in a way consistent with the principles set out in the Wellington Airport case; and
 - ii. minimum expectations of the nature of the information that must be provided be included such as the basic elements set out above; and
- l. clause 131(1)(f): this clause sets of the requirement that on the new Authority's commencement date, every employee of the Electricity Commission becomes an employee of the Authority. Business New Zealand appreciates that this clause is likely to be aimed at avoiding a serious discontinuity in the commencement of the work of the new Authority, particularly given its list of priorities. However, it is as important that the transfer of staff does not defeat the change of emphasis driven by the creation of the Authority. The Authority's new Chief Executive must be given the opportunity to get the culture of the new organisation 'right'. This is likely to require a significant shift in behaviours as opposed to a rebranding exercise. The Authority's 'home' culture of seeking a vibrant, competitive market needs to be reflected in the skills required to

implement competitive market policies. Business New Zealand recommends that clause 131(1)(f) be deleted on the basis that clause 133 ('transferred employees') provides a sufficient balance between protection of the Electricity Commission's staff and the needs of the new Chief Executive.

3. THE SEPARATION OF LINES COMPANIES FROM GENERATION AND RETAIL

3.1 As pointed out in its submission to the Ministerial Review, Business New Zealand sees greater advantages to freeing up the entry of lines companies in the generation market than freeing up the entry into on-network retailing. Efforts by lines companies to out-compete other generators in the delivery of the marginal unit of electricity are, in Business New Zealand's view, more likely to contribute to downward pressure of retail prices. This, combined with transparent disclosure or discovery of information, the non-discriminatory connection arrangements that apply to all lines companies that retail on their own network, and an unconstrained ability to retail off-net, is likely to result in an outcome that best contributes to the objectives of the reforms.

3.2 In light of these introductory comments, Business New Zealand has the following suggestions on the line company aspect of the reforms:

a. clause 74: Business New Zealand considers that the purpose of Part 3 of the Bill could be strengthened by amending 74(1)(b) to read:

“.....retailer, where those relationships may not otherwise be at arm's length and could:

- (i) inhibit competition in the electricity industry; or
- (ii) create incentives and opportunities to cross-subsidise generation or retail activities from electricity lines activities.”

b. the entire Part has transferred responsibility for the oversight of lines company separation from the Commerce Commission to the Authority. Business New Zealand recommends that references to the Authority in this Part be deleted and replaced with the Commerce Commission. Business New Zealand recommends this for the following reasons:

- i Business New Zealand sees the administration of the corporate separation and arms-length requirements as closer in function to other roles and responsibilities of the Commerce Commission than to the new Authority;
- ii Transfer of these functions to the Authority potentially perpetuates the confusion around boundaries that a number of the reforms changes seek to correct. Clearer boundaries will hopefully not only contribute to minimising the opportunity for 'regulator-shopping' but should also lead to greater certainty and predictability. Doing so

can be expected to lower basis risk and keep downward pressure on prices;

- iii the functions conferred on the Authority by this Part will potentially act as a serious distraction from the business of encouraging the development of markets in those areas where competition is possible; and
 - iv it minimises the potential risk of the Authority becoming a de facto competition watch-dog. This should be the sole preserve of the Commerce Commission; and
- c. clause 80: this clause appears to be inconsistent with the overall intent of the changes freeing up the ability of lines companies to participate more activity in the retail market. While primarily aimed at seeking to ensure that swapping retail asset bases does not become a ‘backdoor’ means by which lines companies enter into the retail market, its focus on lines companies also, by default, constrains the commercial options of other, non-lines retailers. If a retailer wishes to sell its retail base then there should be no constraint to whom they wish to do this. This clause prevents, for example, a financially distressed retailer from selling its retail base to a lines business, even where that may be the most financially advantageous thing to do. This clause should be deleted, or at a minimum, time bound to apply, for example only in the next two years.

4. EVOLUTIONARY AND FINE TUNING MEASURES?

4.1 The conclusion of the explanatory note to the Bill states that:

“The Bill makes wide-ranging changes, but of *an evolutionary and fine-tuning nature*, to put in place improved governance and regulatory provisions for the electricity industry.” (emphasis added)⁵

4.2 Business New Zealand agrees that for the majority of changes, this is indeed the case. However, some of the changes cannot be so described. The two primary measures which would not, in Business New Zealand’s view, fall into this category are the proposed asset swaps and the virtual asset swaps (or more accurately described – mandatory hedges between the SOEs).

4.3 As a matter of principle, Business New Zealand prefers the use of competitive market tools to deliver more competitive market outcomes. Business New Zealand considers that forced changes are less desirable than business outcomes that emerge organically from within a pro-competitive regulatory framework.

4.4 Clearly this does not preclude the use of direction where pursuit of certain outcomes (in this case a more competitive retail market) is believed to be warranted. Undoubtedly, both the asset swap and the mandatory SOE hedges will change the retail market landscape, and Genesis Energy has

⁵ Electricity Industry Bill, op cit, page 17.

already announced a new aggressive move into the South Island. Such a move is welcome.

4.5 However, Business New Zealand remains unconvinced from the analysis provided by the Ministry of Economic Development that either of the two above mentioned proposals will deliver enduring benefits that cannot be delivered by the other proposals being considered. It would also appear that the Treasury is similarly unconvinced as can be implied from the following comment in the Regulatory Impact Statement, which states:

“The Regulatory Impact Analysis Team has reviewed this Regulatory Impact Statement and considers it partially adequate, with the following qualifications:

- The RIS should have included a more comprehensive discussion of the risks associated with proposed options.
- The RIS should provide a better idea of the magnitude of costs and benefits of the options discussed in comparison to the problem they are trying to address.
- The RIS should have better reflected the range of views received during consultation.
- There should be a discussion of whether or not the options proposed have been tried overseas and, if so, what their impact was.”⁶

4.6 The risks of unintended outcomes and the need for further interventions that could eventually stifle retail market competition also need to be assessed. In particular, the mandatory hedges:

- a. only assists the SOEs;
- b. could undermine the liquidity being sought from a traded market;
- c. will not sufficiently address basis risk arising from locational problems;
- d. will not encourage the participation of new independent retailers; and
- e. are time bound.

4.7 In addition, the broad range of initiatives being implemented mean that success cannot easily be determined.

4.8 Public policy makers face the unavoidable fact that they operate in a world of uncertainty. Moreover, an incorrect decision by policy makers may potentially impose very large costs on firms and the economy. Such costs occur through distorted resource use and reduced investment and innovation (that is, they impair allocative and dynamic efficiency). Reduced investment results in a compounding loss of value that may become quite substantial over a long period. If initial policy responses are inadequate, the original intervention can

⁶ Cabinet Paper: Ministerial Review of the Electricity Market. Regulatory Impact Statement, page 2.

be intensified or additional measures can be deployed. If instead multiple interventions are applied now to the same problem, then it will not be possible to assess which intervention to intensify if responses are inadequate because the effects of the different measures will not be separable.

- 4.9 Where interventions cause market changes that are uncertain but irreversible, policy design should set a higher cost benefit threshold. Holding off intervention until there is this higher level of benefit is often referred to as recognising the option value of waiting in making irreversible interventions.
- 4.10 Clearly there are strong pros and cons on both sides of the arguments and the Committee needs to be assured that the benefits of them are going to outweigh their costs. Ultimately, the proof of the pudding will be in the eating. If the Committee wishes to proceed with clause 124(2)(a) and (b), clear and *on-going* evidence of different commercial behaviour in response to the new incentives faced is needed. Business New Zealand would strongly recommend that the Committee insert into the Bill a provision to review the effectiveness of these particular changes in two years time. Such an ex post review would be intended to inform future policy actions.

5. MISCELLANEOUS MATTERS

- 5.1 Business New Zealand has one miscellaneous matter it wishes to raise, this being the need for an ex post review of the performance of the market to be hard-wired into the Bill.
- 5.2 Business New Zealand considers that a 'state of the market' report should be required under the legislation to be completed within three years of the establishment of the new Authority. The purpose of such a review would also be to test whether the expectations of the current review have, in fact, been delivered, if not, why not and what further action needs to be taken to deliver on those expectations. This, as much as any other change proposed, is critical to regaining the confidence of business consumers.

APPENDIX: ABOUT BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.