Submission

by

BusinessNZ

to the

Ministry of Economic Development

on

'Improving Electricity Market Performance'

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

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IMPROVING ELECTRICITY MARKET PERFORMANCE: A PRELIMINARY REPORT TO THE MINISTERIAL REVIEW OF ELECTRICITY MARKET PERFORMANCE
SUBMISSION BY BUSINESS NEW ZEALAND[1]

1. INTRODUCTION

1.1 Business New Zealand welcomes the opportunity to comment on the discussion paper entitled ‘Improving Electricity Market Performance’ dated August 2009 (the ‘discussion paper’). This is the first substantive transparent review of the market since 2001 and is long overdue.

1.2 There is no other market in which such mistrust and suspicion of its operation is so palpable. Consumers – both large and small - have no confidence that the price of electricity they face is an efficient one.

1.3 Business New Zealand welcomes many of the proposed changes. While modest, they head in the right direction and, if delivered, should go some way towards restoring confidence in the electricity market.

1.4 The use of competitive market tools to deliver more competitive market outcomes is the right response. A competitive market is more likely than the alternative to deliver sustained downward pressure on prices. However, Business New Zealand considers that these proposals should not be seen as the final tranche of improvements needed, but a further step in the governance and design of the electricity market.

1.5 Businesses, many of whom form the backbone of New Zealand’s export economy, are under extreme pressure from rising electricity prices. Business urges that the Government’s strategic goals of maintaining high levels of employment and increasing New Zealand’s productivity growth should be central to what the review seeks to deliver, and not peripheral to it.

1.6 The business community looks to be assured that the changes proposed will deliver more than just a workably competitive electricity market. It will look for evidence that the treadmill of price rises will cease. If this is not forthcoming, more aggressive regulatory action is likely to be warranted.

2. SUMMARY OF RECOMMENDATIONS

2.1 The following table summarises Business New Zealand’s view of the overall package of recommendations from the Ministerial Review.

Review Recommendation	Business New Zealand Position
Recommendations 1 – 7 to improve the management of dry-years.	Support. But more thought needs to be given to where the boundaries should rest with regard to security of supply. See Section 4 below.

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

Review Recommendation	Business New Zealand Position
Recommendations 8 – 14 to help restrain the costs of generation.	Strongly support. See Section 5 below.
Recommendations 15 - 16 to improve procedures for upgrading transmission services.	Mixed support. Further work needs to be done before settling on the improvements to the grid upgrade processes. Business New Zealand also considers that the process for the development of grid upgrades needs to be more transparent. See Section 6 below.
Recommendations 17 - 25 to improve wholesale and retail competition and help restrain prices.	Mixed support. Business New Zealand considers that while further work on the proposal to swap assets is warranted, implementing such a proposal may be premature in light of other proposals. It is also unclear how the performance of the market should be monitored, or by whom. This lack of clarity needs to be resolved. See Section 7 below.
Recommendations 26 - 29 to improve the governance of the electricity sector.	Support the disestablishment of the Electricity Commission and the reallocation of a number of its functions to other agencies. But Business New Zealand does not consider the proposed Electricity Market Authority to be well matched to its residual functions. The expansion of roles of the System Operator also needs careful consideration. See Section 8 below.

2.2 Overall, Business New Zealand considers the recommendations to be a good start and it is important that those proposals with broad support be implemented quickly. While many of the proposals – even those with broad support – have matters of detail that must be resolved, it is important that the market not get bogged down in endless debate on the minutiae. At this stage in the market's development it is critical that the behavioural incentives are changed. Ex post monitoring by the new regulator can address any residual outstanding issues of effectiveness.

2.3 Greater transparency is also needed around such issues as how the transition will be managed in a practical sense, when it will occur and the timetable for and extent of legislative change.

2.4 Business New Zealand's detailed comments are set out in sections three to nine below. Business New Zealand's key recommendations are:

a) **consistency with the Government's new strategic economic priorities**: Business New Zealand seeks clearer evidence that the review team has been cognisant of the Government's strategic priorities for the economy and business, particularly those relating to export growth, narrowing the income gap with our trading partners and increasing productivity;

b) **proposals that deliver on a vision**: Business New Zealand recommends that the review team's expectations of what the electricity sector of the future looks like be made more explicit. This will be a helpful guide to the conversation around the nature of the changes required;

c) **'form follows function'**: while the governance proposals are a positive step, it is unclear, given the remaining functions, that the regulator, as described, is appropriate. Business New Zealand recommends that further work be done to define who should do what, particularly regarding the proposed boundaries of the functional reallocations. Clear accountabilities and 'ownership' of the outputs are important to incentivise and empower improved performance;

d) **thinking about the next step**: the set of recommendations outlined may be sufficient to lift the performance of the sector, but should this not be the case, easy access to a more complete 'toolbox' of regulatory powers could provide future options. Business New Zealand recommends that any amended legislation allows for the use of such powers, should they prove necessary;

e) **another consultation round**: in light of the high-level of analysis provided for most of the proposed changes, Business New Zealand recommends that a follow-up discussion paper be prepared. While setting out the decisions taken (as it is important that the sector not be allowed to drift), its primary focus must be to outline how they are to be implemented. Key to this is the formation of an transitional unit and a description of how it will interface with the industry and stakeholders; and

f) **an ex post review**: Business New Zealand recommends that a review be undertaken by the Ministry of Economic Development no later than the end of 2012. The purpose of the review would 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 consumers.

3. ARTICULATING A CLEAR VISION AND STRATEGY

3.1 Paragraph ten of the discussion paper summarises the objective sought:

> "A well-functioning market should provide a reliable supply of electricity at efficient or competitive prices, that is, prices which

are as low as possible consistent with ensuring reliable supply over the long term"[2]

3.2 This is a good objective, if delivered, and one that Business New Zealand welcomes.[3] But on its own, it lacks context. Business New Zealand has concerns that there is no clearly articulated set of attributes that would define its achievement nor a clear strategy to deliver it. The changes mostly appear to be taking the sector in a generally consistent direction, but there is no clarity about what that direction is.

3.3 A more competitive electricity market is a desirable objective, and an implicit strategy of mostly using competitive tools to deliver on it an appropriate one. However, for a review of this nature and magnitude, Business New Zealand expected a clear set of market outcomes to have been developed. The absence of a clearly enunciated set of outcomes greatly reduces the ability of consumers to:

a) debate their merits, and the merits of an alternative set of outcomes; and

b) know whether the market is delivering the desired/agreed set of outcomes and therefore whether the objective is being achieved.

3.4 Business New Zealand would like to see a future electricity market that is consistent with the following:

a) a market-based framework where generators and retailers of any size are competing vigorously over a robust transmission network, and businesses and residential consumers are trading in a way that enables them to manage their risks at efficient prices;

b) a focused, stable regulatory and governance framework delivering an investment climate where local and international firms feel comfortable enough to risk their capital to invest in the right generation technology, at the right cost, and at the right time;

c) a market where the participants are more willing to use the electricity market, rather than the political market to resolve their issues, and where politicians are willing to set policy but rely on market outcomes; and

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[2] 'Improving Electricity Market Performance, Volume One, A Preliminary Report to the Ministerial Review of Electricity Market Performance by the Electricity Technical Advisory Group and the Ministry for Economic Development, dated August 2009, section one, page 11, paragraph 10.

[3] It is Business New Zealand's expectation that this objective (or some close variant to it) will become the new regulator's legislative objective. Business New Zealand suggests a potential variant in paragraph 8.18 below.

d) an industry where transparent information about the state of its health is regularly delivered in a form that facilitates understanding and debate about the sector's performance.

Putting the Productive Sector at the Heart of the Reform Agenda

3.5 Prior to assessing the merits or otherwise of the proposals contained in the review, it is worthwhile briefly considering the strategic context within which the assessment sits.

3.6 Fundamentally, a modern economy needs an efficient electricity system. An efficient electricity system is vital for a competitive, growing economy. Electricity is a key input into the production and use of goods and services in both industry and households, and their electricity demands need to be satisfied in a manner which is at least cost to the economy, so that scarce resources are not wasted.

3.7 The achievement of the Government's overall energy policy objective is therefore important to both New Zealand's international competitiveness, and the quality and standard of living of New Zealand's population.

3.8 Paragraph three of the terms of reference states that:

> "….the Government is particularly concerned to ensure that the electricity sector contributes to economic growth by providing for security of supply and efficient prices."

3.9 This appears to be the only specific link to the new Government's broader strategic approach to strengthening business and revitalising the economy.

3.10 The new Government has three key economic objectives, which together will result in improved and enduring economic growth. Two of these are increasing New Zealand's productivity growth and maintaining high levels of employment.

3.11 In a recent speech, the Prime Minister noted that society must always be conscious that New Zealand's wealth is generated by the private sector – by the small firms, the big companies, and the sole traders who generate the jobs, the profits, and the return on investment that drives our economy.

> "In the end, New Zealand's economic prosperity relies on the hard work and inventiveness of our businesses and their employees." [4]

3.12 Over 90% of New Zealand's exports come from just under 5% of exporters. However, it is unclear whether, at a strategic level, the messages from the Prime Minister have made any tangible difference

[4] Prime Minister's speech to Cullen Law business breakfast, 15 July 2009.

to the review's recommendations. When considering the submissions, it is critical that the review team and the Ministry of Economic Development consider, in a non-superficial way, the relative economic contributions of the use to which electricity is put and the extent to which electricity market improvements can benefit New Zealand as a whole.

3.13 In essence, investors and consumers must be able to make decisions which seek to maximise the value they receive from each extra unit of electricity, while producers and suppliers are forced to innovate and find the least-cost solutions over time.

3.14 The real issue for Business New Zealand and the businesses it represents is what the Government's strategic priorities mean in practical terms. From a policy perspective, it is important that some basic, relatively uncomplicated 'tests' for regulatory change are met. Business New Zealand considers that the following basic criteria would be a useful starting point:

Do the proposals enhance society's overall well-being by:

a) making businesses more productive;

b) providing incentives for innovation in the production, use and consumption of electricity; and

c) enhancing the quality of life of consumers.

3.15 Business New Zealand has applied these 'tests' in developing its response to the review's proposals. It would be helpful to understand the extent, if at all, the review team and the Ministry for Economic Development have done likewise.

4. SECURITY OF SUPPLY

4.1 This section outlines Business New Zealand's views on the review's recommendations on security of supply.

4.2 While Business New Zealand has a range of comments on the details of the proposal, it supports the recommendations. It is fundamentally important to the efficient operation of the electricity market that, consistent with the Winter Review, all participants face the right incentives to appropriately manage their dry-year risk. Specific comments on the recommendations follow.

Review Recommendation	Business New Zealand Position
1. Require retailers to make payments to consumers in the event of a public conservation campaign or enforced power cuts, with a graduated scale reflecting the level of nationwide savings (as determined by the System Operator), and with a minimum payment of, say, $10 per week.	Agree. But this form of compensation is only warranted if used as a final backstop and only appropriate if targeted to suppliers' (be they retailers or generators) dry-year risk profile. In other words, it should be used in the context of scarcity pricing (e.g. in concert with a scarcity pricing solution, rather than as the primary solution), and it would be inappropriate to force generator-retailers who are in a balanced, or 'long' retail market position and who therefore would not benefit from an enforced savings campaign to face this cost. It needs to be targeted at suppliers who are unhedged in a conservation campaign (in other words hedged participants should not face an incentive they cannot react to). An added advantage of greater targeting of this penalty cost would be an increased inability for the supplier facing this cost to simply pass it on to their customers. This would likely be the outcome were all suppliers to face it. Irrespective of whether all suppliers or some subset faces this cost, its clearly punitive, penalty-based focus suggests that all of their consumers without exception should be eligible to receive it. This would: a) ensure that the strength of the incentive to avoid another conservation campaign was maximised; and b) provide a financial signal to major users who have mostly already undertaken efforts to improve energy efficiency that prudent early action has a value. Should a threshold be necessary, Business New Zealand considers that it should be set on a value of energy used rather than on households versus non-households, in order to capture low electricity using SMEs. Finally, it is important to consider the costs associated with its implementation (i.e. monitoring and enforcement). It is important that the costs of the cure do not overwhelm the cost of the problem it is seeking to fix.
2. Put a floor on spot prices during any public conservation campaign or during any enforced power cuts in a dry year of, say: 2.1 $500/MWh (50c/kWh) when a public conservation campaign is activated. 2.2 $1,000 - $5,000/MWh ($1 - $5/kWh) if and when	Agree. Scarcity pricing is likely to drive more efficient behaviours with respect to the management of dry-year risk and as such, is likely to be in the long-run interests of businesses and consumers. This mechanism was proposed in the Electricity Commission's Winter Review and its intent is best captured in the following statement from the Winter Review report: "security robustness is best gained through

Review Recommendation	Business New Zealand Position
forced power cuts are activated.	the actions of individual participants, rather than relying on active intervention by the Electricity Commission"[5] This proposal is likely to achieve this and should be implemented as a priority. As acknowledged in footnote 5 of the discussion paper, further analysis of this mechanism and how it would be implemented is required. In particular, the extent to which these prices will fall on major electricity users who have for legitimate risk management reasons, decided not to be fully hedged, specifically those who have limited operational flexibility to shift production in a way that reduces energy off-take from the grid. Without careful consideration of this and other factors, the use of scarcity pricing as a mechanism aimed primarily at generators could simply destroy economic value in the productive sector. Business New Zealand suggests that exemptions could be appropriate in this situation at least until a workable hedge market is in place. While the level of the trigger value is an obvious area for further analysis, Business New Zealand wonders whether a two-tiered threshold is appropriate given the possibility of participant gaming and lobbying around their declaration. In addition, greater consideration is needed of the following issues: a) Business New Zealand appreciates that on the commencement of rolling outages, the market has essentially failed and an administered price is required. However, Business New Zealand did not believe that this was the purpose of scarcity pricing. Business New Zealand thought that scarcity pricing was intended to *signal* the likelihood of *future* scarcity and therefore incentivise appropriate behaviour well before conservation campaigns (let alone rolling outages). While an administered price is likely to be required under rolling outages, what happens under rolling outages should not be confused with the objective and implementation of scarcity pricing; b) scarcity pricing should signal a cap (i.e. a maximum price) and not a floor (a minimum price). Prices should be able to react dynamically to changing market conditions. These conditions could change from half hour to half hour (for example, with a downpour). Maintaining a price floor for the duration of a public conservation campaign

5 Report entitled 'Review of 2008 Winter and the Period Leading into Winter', undated, Chapter 5, Recommendations, page 47.

Review Recommendation	Business New Zealand Position
	(which could run for a number of weeks) on the face of it seems a particularly inflexible mechanism; c) the introduction of scarcity pricing should not be tied to the introduction of a public conservation campaign. While the introduction of such a campaign is a tangible signal of impending supply/demand imbalance, Business New Zealand considers that leaving its introduction to the commencement of a public conservation campaign is too late. The potential introduction of a scarcity price (i.e. a single tier) should be based on New Zealand-specific conditions (e.g. lake levels, inflows and margins) and be able to be introduced <u>at any time</u> during the year should those conditions be met. This approach is more likely to better incentivise a more liquid hedge market and the build of new peaking plant; and d) given its predominantly punitive characteristics, the introduction of the consumer rebate appears better matched to the introduction of a public conservation campaign than a scarcity pricing signal. In essence, Business New Zealand is painting a picture of three elements: 1. an enduring incentive of scarcity pricing whose introduction is subject to easily understood criterion; 2. the introduction of a consumer rebate on the commencement of a conservation campaign; and 3. the market being placed into 'administration' on the commencement of rolling outages. In Business New Zealand's view, this approach will better manage the risk of 'trigger gaming' and mitigate any effects of the changed incentives that generators may face under the introduction of scarcity pricing. Business New Zealand agrees that declaration of this mechanism is best left to the Minister, on advice from the System Operator. Finally, Business New Zealand notes that there is a sequencing issue regarding the implementation of this proposal, the Whirinaki proposal and the possibility of a dry-year in 2010. In the event that scarcity pricing cannot be implemented before next winter (which would seem a strong probability), Whirinaki should continue to be operated by the Crown as reserve cover, but under new pricing rules (see response on recommendation 5 below).

Review Recommendation	Business New Zealand Position
3. Clarify roles and responsibilities for security of supply.	Agree. But Business New Zealand is not convinced that the boundaries have been drawn in the right places. For example, Table 2 on page 21 of the consultation paper states that the System Operator will be accountable to the new regulator for the fulfilment of its roles with respect to security of supply. Business New Zealand expects that the intention is that this line of accountability is only for the performance of the System Operator against the rules and contract. Business New Zealand is also unclear as to the precise role of the Security and Reliability Council in terms of the accountability of the System Operator. Business New Zealand supports the concept of such a Council but issues such as this need to be clarified before it can give its full support. See recommendations 16 and 27, and paragraphs 6.4 – 6.31 below for further comments on where the rules associated with the Grid Investment Test should rest.
4. Phase out the reserve energy mechanism, and reassign the Whirinaki power station to an SOE or sell it.	Agree. The present reserve energy scheme must be discontinued as it both blunts price signals to investors and discourages participants from hedging risk. It is Business New Zealand's strong preference that Whirinaki be sold on the open market and operated commercially at the earliest possible opportunity. Trade sale, as opposed to an allocation to an SOE, is most likely to reveal its full market value. Trade-sale would also reveal the market's preference for location and fuel type. In order to maximise its value, consideration should be given to first hedging its output, in order to sell it with a 'book'.
5. Alternatively, if the Government wants to retain the reserve energy mechanism as a backstop, then it should: 5.1 Reassign Whirinaki to an SOE or sell it. 5.2 Ensure that a mechanism is developed (such as a surcharge on spot prices) through which parties that benefit from any reserve energy when it is called on (that is, parties that are exposed to spot prices) contribute to the standing costs of that reserve energy.	See response to recommendation 4 above. The distortions evident from the actions of the Electricity Commission during the last winter are, in Business New Zealand's view, sufficient evidence for removing the Crown from operating a reserve energy mechanism, even by way of contract. If the scarcity pricing mechanism is implemented appropriately, this should deal with the 'missing money' problem, incentivise the construction of the appropriate type of dry-year response plant and/or hedging behaviour. This should remove the need for the Crown to participate directly in the electricity market, and enable the removal of a substantial distraction. As noted in response to recommendation 2 above, should scarcity pricing not be implemented before next winter, Whirinaki

Review Recommendation	Business New Zealand Position
	should continue to be operated, but on a commercial, arms-length basis, whereby the cost of its fuel and a portion of its fixed costs are recovered from the spot market. This would provide market participants with the right incentives to manage their dry-year risk until such time as scarcity pricing is implemented. A corollary to this would be the removal of the ability of the Electricity Commission to socialise the recovery of any of Whirinaki's operating costs from all market participants via its levy.
6. Require SOEs to disclose their risk positions and other relevant information in the same way as private sector companies listed on the Stock Exchange, to improve the quality of information available on risk and sharpen risk management incentives.	Agree. Standardised disclosure (including the requirement of instantaneous disclosure of significant information) across all generator-retailer companies is appropriate, subject to some de-minimus threshold.
7. Investigate developing terms and conditions for accessing 'reserve water' in lakes in dry year emergencies which cap benefits to generators and provide for compensation to affected communities and mitigate or avoid environmental effects.	Agree. Further investigation is warranted but Business New Zealand caveats its agreement. Fundamentally, such water is effectively another source of reserve energy and needs to be addressed in a consistent way. Business New Zealand cautions that the Crown potentially stepping into the realm of setting hydro generator resource conditions for such a use is likely to result in implications for the value of others property rights (e.g. alternative water users such as farmers). The basis of resource consent conditions are influenced by a wide range of often competing factors and while inclusion of factor relating to reserve water may be appropriate it should simply be placed in the mix, alongside the other factors. Some guidance in the setting of new resource consents may be warranted. However, once a consent is granted, further interference in the operation of the generation plant based on those consent conditions may well be undesirable. Business New Zealand would expect to see a clear net public benefit that shows it would be cheaper to access reserve water than other forms of fuel. Business New Zealand also suggests that if guidance is warranted in this area, that it be applied consistently across the country and not exclusively to the southern hydro-schemes.

5. RESTRAINING THE COSTS OF GENERATION

5.1 This section outlines Business New Zealand's views on the review's recommendations on restraining the costs of generation.

5.2 Stakeholders and market participants need to be confident that new capacity is being built in a timely manner, at an efficient cost (including the most appropriate technology), and in the right location. In Business New Zealand's view, there are two key components to this, these being:

a) the removal of barriers to the development of new generation and the reconsenting of existing generation capacity; and

b) signalling the New Zealand electricity sector as a stable investment destination.

5.3 Business New Zealand considers that the changes proposed by the review will contribute to the attainment of these two components. Its comments on the specific recommendations are set out below.

Review Recommendation	Business New Zealand Position
8. Ensure, when making decisions on climate change policy, that full weight is given to the importance of providing certainty for investors including, to the extent possible, providing for stability and predictability on the future cost of carbon and other emissions.	Agree. It has become increasingly clear that over recent years, energy policy has been seen as a tool by which to deliver climate change goals. This was most clearly demonstrated in the last Government's introduction of a ban on new thermal generation. In Business New Zealand's view, the Government's focus must first and foremost be on securing reliable energy at least cost. Once this is settled (to the extent that it ever will be) there is a legitimate discussion to be had regarding those areas where the electricity market is able to contribute to other policy areas such as climate change. However, each potential area of contribution must be assessed on its relative merits and stand on a clear demonstration of its net public benefits. A failure to consider such potential areas of overlap in this way risks blurring the objectives being sought from the sector, and diminishing the attainment of reliable energy at least cost.
9. Ensure that the current reviews of the Resource Management Act and water allocation consider: 9.1 Whether and how the 'call-in' process could be used to better effect for generation projects (new and existing). 9.2 Other fast-track mechanisms for	Agree. These are all positive initiatives. However, Business New Zealand has one specific comment relating to the drive to make improvements to the RMA for the benefit of the electricity sector. This relates to the need to be even-handed in the application of such changes across all sectors of the economy. For example, the consenting of operational changes that can deliver significant energy efficiency gains (such as the installation of high pressure boilers) is often fraught with consenting difficulties. These changes are made as they are more cost effective than the alternative electricity use while achieving the same outcome – a more efficient and reliable electricity system.

Review Recommendation	Business New Zealand Position
consenting (or re-consenting) nationally significant generation projects. 9.3 Providing for water and geothermal rights to match the life of the assets. 9.4 Whether certain types/sizes of generation could be deemed to be a permitted activity in predefined circumstances and areas. 9.5 The terms for consents, particularly the lapse provisions, to better recognise the nature of large-scale generation investment projects. 9.6 Whether powers such as compulsory acquisition of land, with appropriate compensation provisions, should be available for nationally significant generation projects.	
10. Ensure that the current petroleum resources review takes full account of the importance of gas to electricity generation using existing or new assets.	Agree. Access to new significant gas finds is, in the short-to-medium term, likely to be the key factor in holding down the cost of new generation in any substantive way.
11. Improve the quality of published information on gas reserves.	Agree.

Review Recommendation	Business New Zealand Position
12. Identify barriers to the development of geothermal energy which can and should be addressed by the Government.	Agree. However, Business New Zealand notes that the focus should be on regulatory barriers (e.g. consenting-related) rather than on providing preferential access by developers to privately owned geothermal resources. The Government may also wish to play a role in facilitating access to geothermal energy on Maori land interests. This role could vary from providing business advice and assistance to Maori land interests, increasing governance and management capabilities, and reviewing the regulatory framework over Maori land entities to enable Maori geothermal resource owners to pursue geothermal ventures.
13. Consolidate responsibility for the promotion of energy efficiency in EECA, and remove it as a responsibility of the electricity regulator, while: 13.1 Carrying out a strategic review of EECA to ensure it is well-focused and performing effectively. 13.2 Transferring best practice approaches developed by the Electricity Commission where possible. 13.3 Reviewing funding for EECA, with a general principle that funding should be through levies where the beneficiaries can be clearly identified and administrative (collection) costs are low.	Agree. In a country the size of New Zealand it seems unusual, to say the least, to have two regulatory agencies responsible for promoting energy efficiency. Business New Zealand strongly supports the role of energy efficiency plays in meeting New Zealand's overall energy demand needs and its the potential role and in lowering the cost of business and creating a healthier, more productive community. Business New Zealand also strongly endorses the three conditions associated with the transfer of responsibility of energy efficiency to EECA. With the addition of the Budget 2009 four year funding of $323.3 million to fit homes with insulation and clean heating devices such as heat pumps and approved wood burners, EECA becomes a $100 million per annum plus entity and it is appropriate to undertake a strategic reassessment of it. Given the range of initiatives occurring across the public sector regarding electricity and the encouragement of renewable energy (such as the building code and the development of the Emissions Trading Scheme), it is important that EECA understand the specific relationships between the variety of tools being chosen across the public sector, and carefully target its interventions to maximum effect when combined with them. It is important, when intervening on the expectation that society will be better-off, that this presumption is tested. In order to achieve the best result for New Zealand-inc, it is important to ensure that options considered for implementation both address a well-defined market failure and provide a clear net benefit to society. A failure to carefully target interventions risks distorting economic decisions. Careful targeting is also critical to ensuring that public funding does not indefinitely crowd-out the private sector (in other words that those be developing energy efficiency initiatives are not because of public sector spending in the area). The policy rationale for most energy efficiency interventions is that they are painless for consumers (that is, unambiguously cost effective for all but the most capital-constrained) and compensate for the limitations

Review Recommendation	Business New Zealand Position
	in individual's ability to optimise many small cost-benefit decisions (in other words, power consumption is too small an item for individuals and small businesses to bother to make efficient decisions. A collective solution is therefore an efficient means of dealing with transaction costs). However, this case needs to be made explicitly for any proposals chosen for adoption. This framework is particularly pertinent to the consideration of electricity efficiency. Electricity is not priced below long-run marginal cost ('LRMC') so there is no allocative inefficiency to fix and there are serious questions associated with basing a rebate on the cost of carbon, as this is only credible if the marginal new generation capacity is thermal (which we know from the review not to be the case).[6] Business New Zealand welcomes both the review of funding and the conditions under which levy funding will be adopted. In general, Business New Zealand sees no good public policy reason to tax one group of consumers to provide entirely private benefits to another group. Business New Zealand notes that electricity efficiency in the residential market is increasingly being justified on the basis of health outcomes.[7] This would, at a minimum, tend to suggest that such initiatives be funded directly out of taxes or public health funding rather than from a levy. And most medium to large sized businesses are already well incentivised to adopt energy efficient practices. In this case, the levy acts as a tool to subsidise other segments of the market. Finally, while a levy mechanism may provide easy recourse to a source of funds, its use, even in the presence of an obligation to consult, has proven not to be a good accountability tool (especially if experience with the responsiveness of the Electricity Commission to concerns raised with both its process and proposals in its consultation process are anything to go by). As a general principle, Business New Zealand would prefer that the Government not use a tax on electricity users to fund its electricity market objectives.

6 For example, the Ministry of Economic Development's forecasts indicate that most new generation will come from renewable sources. If, for example, additional supports are provided for renewable generation as part of climate change policy initiatives, this 'renewables era' may last a lot longer. As a result, increases or decreases in the rate of growth of electricity demand will accelerate or slow this development path of renewable supplies. The amount of thermal generation from existing gas and coal fired power stations will be largely unchanged as these plants will not be displaced until the end of their economic lives.

7 "It's designed to reduce health risks from living in cold, damp homes and provide energy efficiency gains," Minister of Energy and Resources, Hon Gerry Brownlee, pres release dated 28 May 2009.

Review Recommendation	Business New Zealand Position
14. Review whether there are likely to be net benefits, compared to alternatives, in developing a National Environmental Standard for small-scale distributed generation, such as solar photovoltaics, micro-wind turbines and solar water heating panels.	Agree.

6. IMPROVING PROCEDURES FOR UPGRADING TRANSMISSION SERVICES

6.1 This section outlines Business New Zealand's views on the review's recommendations on improving procedures for upgrading transmission services.

6.2 Business New Zealand considers that an effective and efficient transmission system is a fundamental underpinning to a fully-functioning competitive electricity market. Without such base infrastructure, the energy market can neither operate effectively, nor provide the required level of security. Business New Zealand, therefore, welcomes the review team's continuation of the recent trend of proactive reassessment of how to improve the regulatory framework for transmission.

6.3 Business New Zealand considers that the two changes proposed by the review will contribute to the attainment of improved outcomes. Its high-level comments on the specific recommendations are set out in the table below, followed by more substantive comments.

Review Recommendation	Business New Zealand Position
15. Amend the Grid Investment Test to make it clearer, simpler and less prescriptive, and to take into account wider competition benefits.	Agree. But Business New Zealand has concerns about the extent to which this proposal will reduce, or loosen accountability for securing least cost outcomes for consumers. Ultimately, any change must be aimed at providing the highest net public benefit. To this end, Business New Zealand would need to be convinced that changes to the Grid Investment Test (the 'GIT') to "make it clearer, simpler and less prescriptive" appropriately balances the goals of consistency, predictability and the facilitation of investment while providing the best signals to all electricity sector participants and reducing total costs. While there is certainly abundant anecdotal evidence that the GIT needs refining, Business New Zealand needs to see an analysis of the specific changes proposed and their benefit to consumers before being able to agree to it.

Review Recommendation	Business New Zealand Position
16. Transfer approval of major grid upgrades to the Commerce Commission to ensure integrated consideration of transmission expenditure, performance and prices, subject to rules on service and reliability standards, pricing methodologies and the grid investment test set by the electricity regulator.	Agree. On the face of it, this solution looks highly persuasive – simple to implement and addressing an obvious regulatory fault-line. However, the review team needs to think more carefully about how to ensure the objectives sought from a transmission regulatory framework should be achieved and whether the particular formulation proposed is the most appropriate means of delivering it. On this basis, Business New Zealand supports the complete transfer of grid approval related roles to the Commerce Commission. However, key to the delivery of least cost outcomes for consumers is accountability for performance by both the regulator and the regulated entity. See recommendations 3 and 27, and paragraphs 6.11 – 6.31 below for a more detailed discussion of this point.

6.4 Transmission has a vital role in ensuring that consumers are provided with reliable, reasonably priced electricity, which will ultimately enable sustained economic growth for the country. In contrast, grid congestion and constraints inhibit the ability of electricity markets to deliver efficient outcomes.

6.5 The question is how to design a coherent transmission regulatory framework that delivers this. This, in turn, falls to what a coherent transmission regulatory framework should achieve. But this discussion is nowhere to be seen in the two and a half pages devoted to this issue. The presumption may be that this discussion has long been had, but Business New Zealand considers that it is useful to canvass these issues, albeit briefly, in an effort to inform the choice of solution. It is important that stakeholders can see that the preferred solution is driven less by frustration and more by principles.

6.6 In its analysis of this issue, Business New Zealand considers the following 'prior' question to be the most appropriate one:

> "How should the transmission regulatory framework be structured to provide consistency and predictability and facilitate investment while providing the best signals to all electricity sector participants and reducing total costs?"

6.7 In responding to this question, when analysed in conjunction with an appropriate set of transmission-specific objectives[8], it quickly becomes apparent that the problems go beyond the administrative overlap between the Electricity Commission and Commerce Commission. However, it is also imperative that the problem(s) identified are just that - problems and not simply the transparent manifestation of more fundamental, underlying problems with the regulatory regime.

6.8 Business New Zealand acknowledges that both the Electricity Commission and Transpower have worked extremely hard over the past year or so to improve how the transmission framework works but clearly further improvements can be made. The key question is what changes will address the question posed in paragraph 6.6 above and deliver on the objectives set out in footnote 8?

6.9 Simplifying the GIT may be appropriate, but Business New Zealand needs to be assured that the changes deliver appropriate benefits to consumers. Business New Zealand supports a reassessment of the GIT, but would not support changes to either the current rules or the regulatory framework that are driven by administrative convenience for Transpower.

6.10 With respect to the transfer of roles, the elimination of over-lapping responsibilities is an obviously beneficial change. This should avoid companies from being caught in a regulatory tug-of-war. 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.

6.11 However, it is unclear that the proposal set out in recommendation 16 - the transfer of the approval of major grid upgrades while leaving

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8 In looking to address any question regarding the optimal nature of a transmission regulatory framework, it is important to first understand what set of objectives are sought. The following are considered relevant:

1. A secure and reliable electricity system;
2. Economically efficient and timely investment in transmission that incentivises, over time, the provision of the quantity and quality of transmission services that maximise net public benefits, including providing a grid that is robust against a range of possible futures, and facilitates:
    a. Competitive wholesale and retail markets;
    b. Diversity in energy supply, including renewables; and
    c. Minimisation of regulatory uncertainty through:
        i. high quality, respected and, over time, predictable, decisions;
        ii. decisions consistent with commercial best practice; and
        iii. open, inclusive and transparent processes by the regulator and regulated parties;
3. Clarity of responsibilities and roles between regulatory authorities (including between themselves where more than one) and market participants; and
4. Transmission provider is able to effectively provide quality services to participants in a way that minimises costs.

the development of the rules relevant to those upgrades with the electricity market regulator (such as pricing methodologies and the GIT) - does not simply alter, as opposed to eliminate, the boundary issues. The risk is that the proposal simply entrenches the current three-way fault-lines, albeit at a different point in the regulatory framework. It also allows for the risk of 'scope-creep' by the new regulator.

6.12 Business New Zealand fundamentally believes that there should be only one economic regulator for the electricity sector and that that regulator should cover the economic regulation of both transmission and distribution systems.

6.13 Therefore, Business New Zealand considers that further work is warranted on where the responsibility for certain roles should lie in order to achieve this objective. It believes that a clearer outcome for all participants can be achieved by allocating all grid approval roles to the Commerce Commission, operating under clear legislative authority. Fundamentally, little difference exists in practice between the GIT rule setting and input methodology setting under Part 4 of the Commerce Act.

6.14 It is also important to keep regulatory culture and behaviour in mind when considering how roles such as application of the GIT and its relationship to the grid reliability standards are allocated.

6.15 Business New Zealand assumes that the specific nature of proposal is driven by the desire to keep separate the functions of rule making from their enforcement (the point being to develop an arrangement that that eliminates the regulator's temptation to unilaterally change the rules when outcomes are not as expected). This is a legitimate concern in the allocation of regulatory functions.

6.16 However, even with the partial transfer of roles as proposed, broader issues are at play. These relate to the Commerce Commission and its culture, regulatory practices and understanding of the electricity industry more broadly. In order for a reallocation of *any* roles to be successful, these issues need to be carefully considered.

6.17 The question is whether these issues are of a sufficient magnitude to prevent the transfer of *any* functions relevant to grid approvals over to the Commerce Commission. In other words, whether the net benefits of shifting the rules to the Commerce Commission are greater than the net benefits of continuing to split the roles across two regulators. This is an empirical question that needs to be tested.

6.18 Business New Zealand's initial view is that the proposal is a step in the right direction thought needs to be more complete. This is reinforced by its understanding of the work being undertaken by the Commerce Commission on the development of Part 4 of the Commerce Act, and the expectation that the framework for investment approvals will align New Zealand with internationally recognised practices for the regulation of transmission services.

6.19 Improvements to the understanding of who has what role and how that role is delivered have been made (indeed as recently as the last set of amendments to the Government Policy Statement), and Business New Zealand assumes that these clarifications will carry over to the functions picked up by the Commerce Commission.

6.20 Issues such as the separation of the regulation of energy market natural monopolies and competition law enforcement and the Commerce Commission's day-to-day regulatory practices are not sufficient to prevent an initial transfer of roles (albeit a broader one than proposed in recommendation 16). However, Business New Zealand would recommend that they should be pursued, but on a slower timetable.

6.21 Some have suggested that rather than the split roles being a problem, consumers have benefited from the Electricity Commission's rigorous testing of grid upgrade proposals by driving down the costs of Transpower's initial proposals. This may be true in specific instances but Business New Zealand remains unconvinced that the aggregate costs associated with the regulatory duplication and associated 'wheel spinning' (including the transaction costs of participating in the regulatory processes as well as legal and any other costs) have not overwhelmed any consumer benefits.

6.22 In Business New Zealand's view, the changes proposed are necessary, but not sufficient. Key to this is being assured that robust regulatory outcomes for consumers will be achieved. The key element of this leg of the equation concerns how to ensure accountability for performance.

6.23 Business New Zealand takes a relatively simple approach to this matter. There should only be one grid planner – economic efficiency demands that this be so. The primary issue for Business New Zealand is how to ensure that Transpower is appropriately held accountable for its planning.

6.24 Business New Zealand can unequivocally state that if doubts regarding Transpower's grid planning competency did, in any way drive the process taken by the Electricity Commission and contributed towards the outcome, then it is wholly inappropriate to address that by the development of a contestable grid planning capability. If the key issue is Transpower's management of its capital projects – for whatever reason – is the management of cost over-runs or the ability to factor in new and unanticipated information regarding demand or technology, then developing a contestable grid planning function would not appear to be the answer to this.

6.25 Business New Zealand contends that a well thought-through and implemented transmission regulatory regime would, as its core objective, aim at ensuring that those parties best able to manage the risks associated with project implementation be accountable for their management. On the face of it, this suggests to Business New Zealand that the agency accountable for the design, build and operation of the grid should have such accountability sheeted home to it and not have that accountability undermined by tensions over who should be doing what function.

6.26 This view is underpinned by the understanding that it is standard corporate governance procedure to review capital projects as they progress and that such reviews are generally driven by two factors – changes in costs and changes in the environment. If the problem is that Transpower is unlikely to do this, or to do it sufficiently well, then this would be a failure of Transpower's corporate governance processes and should be addressed directly by government, and not indirectly by a regulator.

6.27 While this is appropriate, Business New Zealand also considers that Transpower can still improve the level and quality of interaction it has with market participants and key stakeholders regarding its grid upgrade proposals. This needs to be done in such a way so as not to reduce Transpower's accountability, but to empower it to continue to improve.

6.28 Business New Zealand understands that Transpower has made improvements already and is showing a strong commitment to continue to do so.

6.29 However, further improvements are possible. Business New Zealand suggests that similar to the proposed Security and Reliability Council, Transpower should be required to submit its grid upgrade proposals to such a senior industry and stakeholder body for scrutiny (not approval). Such a high-level peer review should serve to provide stakeholders with greater confidence that its views are being taken into account at the very commencement of the planning process and that the grid is being right-sized, at the right cost, for the right reasons.

6.30 In Business New Zealand's view, such a process - while non-binding - should serve to take what has to date been considerable heat out of the other end of the equation, that of the formal regulatory approval process.

6.31 Business New Zealand recognises that the success of such a process has as much to do with organisational culture as what needs to be done. Business New Zealand understands that significant effort is being put into the issue of organisational culture and we welcome such moves.

7. IMPROVING WHOLESALE AND RETAIL COMPETITION

7.1 This section outlines Business New Zealand's views on the review's recommendations on improving wholesale and retail competition.

Review Recommendation	**Business New Zealand Position**
17. Subject to further analysis following submissions, restructure SOE assets, by either: 17.1 Option One: Create a new SOE generator-retailer comprising the Huntly and Manapouri power stations, and, additionally, transfer Tekapo A and B to Genesis and Whirinaki to Meridian. 17.2 Option Two: Transfer the Huntly power station to Solid Energy, the Manapouri station to Genesis and the Whirinaki station to Meridian. 17.3 Option Three: Transfer the e3p and P40 power stations from Genesis to Meridian and the Manapouri power station from Meridian to Genesis.	Agree that the issue of restructuring of SOE assets be analysed further. While a legitimate tool worthy of more substantive analysis and debate, it is Business New Zealand's preference that it only proceeds as a part of this round of changes if a much more compelling case can be made. In general, Business New Zealand considers that there is 'option value' in waiting to see if the range of other recommendations set out in the report deliver the improvements expected of them. See paragraphs 7.2 – 7.11 below for more detail on Business New Zealand's position.
18. Introduce, as a priority, a transmission hedging mechanism to assist retailers manage risks created by transmission congestion.	Agree. This must be a top priority for the new regulator. A transmission risk hedge product would allow participants to better manage locational price risk and whose purpose would be to increase retail competition and improve hedge market liquidity.
19. Facilitate greater demand-side participation in the wholesale market, including providing for: 19.1 More accurate forecasting of prices. 19.2 Real-time (not ex post) spot prices. 19.3 Demand response to be dispatched in the same way as generation.	Agree. These changes have been languishing on the Electricity Commission's work programme since its inception and must be a priority for the new regulator. However, any such arrangements need to be implemented in order to minimise set-up and on-going administrative costs and to be sufficiently flexible in order to accommodate a range of operational circumstances. As pricing moves closer to real-time, Business New Zealand believes that further consideration should be given to the establishment of a day-ahead market.

Review Recommendation	Business New Zealand Position
20. Allow lines companies to provide electricity retailing services in their local areas subject to: 20.1 Retaining the existing provisions in the Electricity Industry Reform Act that: • Require corporate separation and compliance with arms-length rules between lines and energy (generation and retailing) businesses. • Require lines companies to put in place transparent and non-discriminatory use-of-system agreements with their retail business. • Have the effect of prohibiting common ownership between lines businesses and generators owning more than 100MW of generation connected to the national grid. 20.2 Prohibiting a retail business owned by a lines business from buying the customer base of an existing retailer (to ensure there is a net increase in retail competition).	While the proposed removal of the current constraints “may help provide more retail competition” Business New Zealand notes that the expectation is that “in some smaller or more remote areas where there is currently only weak retail competition there may be interest in providing an alternative retail offering….” The entry of small (predominantly trust-owned) lines companies (who are subject only to information disclosure requirements under the Commerce Act) into retailing on their own networks is likely to result in the creation of small regional monopolies rather than more vigorous competition, as other retailers find they cannot compete with the fully vertically integrated companies. The proposal may, at best, deliver limited efficiency benefits, or at worst the destruction in the value of the owner-consumer’s wealth. Business New Zealand considers that as a first best option, transmission hedges are more likely to deliver the outcomes sought by the review. However, should the review not consider this to be the case, Business New Zealand believes that a viable alternative arrangement warrants further investigation. While the primary aim of this proposal is the attempt to enliven the retail market, Business New Zealand sees greater advantages to freeing up the entry of lines companies in the generation market. 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 a transparent and non-discriminatory connection agreement, an unconstrained ability to retail off-net, and an appropriate set of constraints on separation is likely to be a more efficient outcome while giving major users and more contestable source of hedge cover. If this is accepted, the prohibition to limit the purchase of existing retail bases off-net should not be pursued (and in any case, on-net it would be extremely difficult to write law around such a condition that could be easily monitored and enforced). Finally, irrespective of what position is finally settled on in terms of the increased involvement of lines companies, it is now clear that the Electricity Industry Reform Act has become virtually incomprehensible. It is no longer clear what its defining purpose is (for example, is it pro-competition, or climate change and pro-renewable energy, or security of supply). As the review is likely to result in substantial changes to the Electricity Act, this provides a good opportunity to review the overall architecture of the electricity sector legislation, and the possibility of combining the Electricity Act and Electricity Industry Reform Act.

Review Recommendation	**Business New Zealand Position**
21. Develop more standardised tariff structures and business rules for use-of-system agreements for lines businesses to facilitate access by retailers.	Agree. This provides the opportunity to reduce costs and contribute to a more vigorous retail market. Consistent with its view set out in a recent CC93 submission to the Electricity Commission, Business New Zealand supports the implementation of a flexible 'principled' approach to address distribution pricing structures with a mandatory 'safe-harbour' option as a fall-back if required. The principled approach would involve standardising nomenclature, definitions and pricing templates and would lower retailer transaction costs without impacting on distribution pricing flexibility and efficiency.
22. Ensure that guidelines and standards on smart meters provide for (or allow upgrades for) energy efficiency capability, open access communications, customer switching, and the development of smart networks.	Agree. It is important that a clear set of minimum standards exist in order to both facilitate competition (it is important that the use of such meters do not become a barrier to customer switching) and to enable the transmission of 'industry-good' information. Business New Zealand considers that unless clear evidence of a market failure exists the introduction of smart meters should be left to market participants to determine. Mandatory provision risks outcomes that stifle innovation and entrench particular technologies. However, if a more aggressive wider roll-out of smart meters was thought to be desirable, one mechanism by which to achieve this could be via their mandatory installation in all new houses. Finally, while prevalent in a number of areas – though particularly in the retail market – Business New Zealand observes the use of guidelines that are, to all intents and purposes, de facto regulatory rules (for example, the Guidelines for Advanced Metering Infrastructure which, while advisory, the Electricity Commission "recommends that they are followed"). As a matter of good regulatory practice, the onus must be on the regulator to do the analysis to show that regulations are either warranted or not. Unless strictly guidelines, regulations (and the discipline that they require in their establishment) should be used.

Review Recommendation	Business New Zealand Position
23. Encourage retailers to make tariffs available, as an option for consumers, that provide incentives to better manage electricity consumption including through shifting load to off-peak times and conservation during dry years.	Agree. The regulator should undertake an analysis of the range of tariffs available to incentivise consumers to better manage their consumption with a view to determining whether all retailers should be required to offer a peak/off-peak tariff. As referred to in the response to recommendation 22 above, the form of this 'encouragement' needs to be carefully targeted. However, Business New Zealand notes the recent announcement by one of the major retailers to voluntarily introduce such a tariff. Links to the work undertaken in response to recommendation 25 below may also be appropriate. Business New Zealand also considers that a reconsideration of the low fixed user charges regime would be appropriate in this context. The low fixed user charges act as a subsidy from high to low users. Business New Zealand does not support this, and the efficacy of the low fixed user charge needs to be reassessed.
24. Ensure that all wholesale market data is publicly released the following day to improve scrutiny of and by market participants.	Agree. However, Business New Zealand does not consider this proposal sufficiently addresses the key role of the market regulator as a disseminator of market information. The absence of the collection and use of market-based information by the Electricity Commission to shine the light on its performance, and the performance of its participants, was a key (albeit implicit) criticism from the Wolak Report. The lack of a strong and visible compliance and enforcement mechanism has contributed to this. In Business New Zealand's view, it is a fundamental role of a regulator to disseminate information that enables a more informed discussion to be had by market participants and stakeholders. Business New Zealand considers that the central position of any market regulator to the market it regulates uniquely places it to facilitate more informed choices by participants by acting as an information broker. While the Electricity Commission has to date achieved this, it has predominantly been in response to specific issues rather than of a more generic, 'sunshine' basis where the actions of market participants can be revealed and if necessary subjected to further scrutiny. Business New Zealand also considers that benefits can accrue by the market regulator commissioning and releasing well targeted research on 'industry good' issues fundamental to the market design and its operation. The purpose of this research would be to better inform market participants and to facilitate better market outcomes.

Review Recommendation	Business New Zealand Position
25. Encourage and facilitate customer switching through: 25.1 Providing $5 million a year, from electricity levy funding, to promote the benefits of customer switching. The fund should be contestable, and should continue for as long as demonstrated benefits, in terms of savings to consumers, exceed $10 million a year. 25.2 Shortening the timeframe for switching between retailers from 23 days to three days for customers with smart meters. 25.3 Improving the Powerswitch website by requiring retailers to provide updated information to improve its accuracy and coverage.	Agree. However, Business New Zealand wonders whether this will address the problem. Business New Zealand assumes that the implied problem is that existing retailers are failing to be sufficiently active in demonstrating the benefits available from switching. If this is the case, Business New Zealand wonders about the extent that this fund – ultimately paid for by consumers – will simply lift responsibility for the problem away from the retailers. Business New Zealand agrees with recommendations 25.2 and 25.3.

Business New Zealand's Approach to Asset Swaps

7.2 Restructuring the electricity SOEs (or, more precisely, two of them) features as the first of the review team's options to improve wholesale and retail market competition.

7.3 As noted above, Business New Zealand considers that the options put forward are legitimate in the context of seeking downward pressure on prices by the introduction of greater wholesale and retail market competition.

7.4 However, Business New Zealand has some reservations about the need for the swap now (that is, whether a swap is a well targeted intervention) and the whether the competitive benefits expected from it will be achieved. In this section, Business New Zealand outlines the nature of these reservations. Given the reservations, and the presence of a comprehensive range of other proposals in the discussion paper, it is Business New Zealand's belief that, in the first instance, there is likely to be value in waiting to see whether the benefits from the other proposals are delivered before moving to swap assets.[9]

7.5 As a generic approach, Business New Zealand has a strong preference that market participants are provided with the right commercial incentives to change their commercial behaviour and deliver appropriate outcomes for end-consumers. As a matter of principle, Business New Zealand considers that market-based tools should be used to improve these incentives. In a market-setting, this generally means (unless there are extremely strong advantages in regulating through ownership) setting the over-arching policy framework within which the market participants operate.

7.6 The review team has taken the view that the competitive outcomes sought from the electricity market cannot be achieved by market incentives alone and that change to the ownership structure is desirable.

7.7 Business New Zealand recognises that a new asset owner in the South Island will provide the new owner with energy to retail. This will be a positive development. However, before proceeding, the following issues need to be considered further:

a) it is a static solution to a dynamic problem. As the proposal will alter all participants' incentives and behaviour, it will be difficult to know with any certainty that an asset swap will prevent the problem from manifesting itself in some other form. This raises the ever-present spectre of further, more dramatic changes in ownership structures which may increase basis risk in the market;

b) other solutions are available (indeed proposed) by the review team that are both market-orientated and likely to address the problems (or at least contribute significantly towards addressing them). In our view, addressing the root cause of the problems of:

   i. the inability of generators to adequately protect themselves against volatility in transmission prices (for constraints and losses); and/or
   ii. inadequate incentives for generators to hedge dry-year risk

   may well be addressed *in the first instance* by:

   i. providing some form of transmission risk hedge tool; and
   ii. making improvements to the contracting market to encourage hedging, particular inter-generator; and

[9] This is generally known as "the option value of waiting". In addressing complex policy issues it is often the case that multiple solutions are proposed. However, where possible, single policy measures should be used (at least initially) so that their effectiveness can be assessed. If the responses are inadequate (in other words, the expected benefits do not materialise), then the original intervention can be intensified or additional measures deployed. The effect of waiting is to practically set a higher cost-benefit threshold for those interventions that cause market changes that are uncertain but irreversible.

iii. development of the transmission network (for example, the scope for competitive rivalry will be enhanced once the HVDC link is upgraded);

c) it is unclear regarding the extent to which the option three swap (e3p and P40 for Manapouri) will in light of the Rio Tinto commitments, provide sufficient unencumbered energy to allow for a meaningful degree of retail market competition in the South Island;

d) the benefits have not been quantified except to the extent of the benefits required to offset the costs. In Business New Zealand's view, given the potential for significant market disruption and uncertain outcomes, the benefits of structural change need to be demonstrably large. In the context of a multi-billion dollar per annum business,[10] and the availability of other options, the national benefits need to be compelling;

e) a clear pathway needs to exist to assure end-consumers that the benefits are going to be captured by them. For example, it is unclear the extent to which option three is more focused on balancing dry-year/wet year risk positions, rather than significant retail market benefits;

f) the extent to which retail market competition will be real, active *and* enduring is unclear. This is what matters to end-consumers. Option three promises the prospect of greater regional competition amongst existing players, but the withering transitional hedge contract could lead to customer shedding. There are a number of examples over recent years of retailer load shedding to maintain optimal portfolio and geographic balance; and

g) subject to the nature of the asset being swapped, the transition could be both complex and disruptive. At a time when the Government is seeking to bolster security of supply and enhance SOE performance, this could preoccupy both Boards and act as a significant operational distraction at a time when one is least wanted.

7.8 Given these issues, Business New Zealand would welcome further market analysis of the competitive benefits that could emerge from a swap of assets, and its timing, particularly in light of the other proposals being considered.

7.9 However, should the review team remain convinced that move to implement an asset swap should proceed as an integral part of the overall package of changes, then Business New Zealand considers

[10] For the year ended July 2009 (excluding the high value months of May and June 2008) the value of electricity sold through the clearing manager was $2.6 billion. Over the last 5 years, the monthly average value is $290 million per month.

that a fuller range of options should be considered. These options could range from simply allocating Genesis Energy a South Island power station (i.e. with no reciprocal swap) through to the consideration of the broader set of electricity SOE assets and the allocation of development sites and retail portfolios.

Summary: Asset Swaps

7.10 Business New Zealand looks for clear evidence that the competitive benefits in the wholesale and retail markets outweigh the costs associated with the swap of assets. Business New Zealand remains to be convinced that an asset swap option should be implemented, at least as a first-best option. Other solutions exist that are incentive-based, likely to be better targeted at the underlying problems and as, if not more, likely to deliver the expected benefits.

7.11 Ultimately, the proof of the pudding is in the eating. Clear evidence of different commercial behaviour in response to the new incentives faced from the balance of the proposals is needed (see paragraphs 9.4 – 9.6 below on the need for a review to be scheduled). Without clear evidence, the option of assets swaps (and other options for that matter) should clearly come back into play.

The Discarded Options

7.12 A large number of options to improve wholesale and retail market competition were considered, and discarded. These options are set out in Appendix Twenty. Consistent with Business New Zealand's emphasis on market tools, we consider that, in this instance at least, their discarding is appropriate.

7.13 However, with the exception on mandatory hedging, there is no clear sense from the discussion paper of how the options discarded ranked, in terms of relative net public benefit. This analysis would have been informative.

7.14 In addition, Business New Zealand considers that further consideration of the role a simplified set of nodes could play in assisting in the development of the hedge market is warranted. One suggestion for retail contracts is to revert to a two or three node system with an ex ante average loss factor to other nodes set one year ahead (similar to the approach used by ECNZ for their contracts).

7.15 Even if the review team decides not to proceed with the option to swap assets or any of the options that have been discarded, Business New Zealand considers that this is not where things should lie. Consistent with its desire for a review no later than 2012 (see paragraphs 9.4 - 9.6), Business New Zealand considers that two steps can be taken, these being:

a) the legislative ability for them to be introduced at some later stage by the Minister of Energy should be provided for. This will allow for action to be taken quickly should it be necessary; and

b) the net public benefit of the introduction of these discarded options (particularly vertical separation, price caps, and mandatory hedges) is reconsidered as a part of the review.

Recovering the Costs of Restructuring - An Electricity Tax on Low Use Consumers?

7.16 Finally, Business New Zealand notes the proposal (set out in paragraph 139 of the discussion paper) that the cost of asset restructuring is to be recovered from customers (defined in this case as residential consumers or small business) via a levy. This is a direct tax on low volume electricity users.

7.17 The presence of the levy mechanism is not a good public policy basis for its use. The administrative costs of collection via the levy must be shown to be lower than the alternative of tax funding. Business New Zealand considers this to be unlikely and suggests that as for previous electricity market reforms, these costs be met from general taxation.

8. IMPROVING GOVERNANCE OF THE ELECTRICITY SECTOR

8.1 This section outlines Business New Zealand's views on the review's recommendations on improving governance of the electricity sector.

8.2 Business New Zealand's framework for this section is the Business New Zealand/LECG report. Fundamentally this report said that when considering the objectives sought, and the regulatory problems being addressed, other entities appeared to be better suited than the Electricity Commission to delivering what is required. Business New Zealand still believes this to be true.

8.3 Business New Zealand approaches the issue of governance by separately considering issues of institutional form, from that of the behavioural and operational features of the preferred entity.

8.4 In terms of form, a number of potential alternative models have been considered by the review team or put up for discussion over the past few months. All of these have their advantages and disadvantages.

8.5 In general, Business New Zealand considers there to be a broadly linear relationship from the regulatory problems being addressed (general competition, network-based competition and natural monopoly), the regulatory functions or tools applied to them, through to the nature of the institution best suited to deliver them. In other words, "form follows function". In Business New Zealand's view, while the context in which this occurs is strongly influenced by the cultural and legal framework present, as well as the resources and expertise available, none of this immediately implies that the sector being regulated is automatically relevant in the decision on ‘how’ to regulate. This in turn suggests that an approach that provides consistency across sectors has some value.

8.6 How do we ensure that the chosen entity performs? This is as important as the type of institution. Fundamentally, this comes down to what is wanted from it. This falls to the following factors - credibility and accountability – and in turn, the behavioural and operational features necessary to deliver them. Independence, broad representation, policy coherence, non-conflicting objectives, culture and transparency are vital in this regard.

8.7 Combined in the right way, the elements of form and accountability are fundamental to reducing uncertainty, lowering basis risk and keeping downward pressure on prices.

8.8 Business New Zealand considers that the changes proposed by the review will contribute to the attainment of these goals but that further consideration of some aspects is likely to deliver even greater improvements. Its comments on the specific recommendations are set out below.

Review Recommendation	**Business New Zealand Position**
26. Replace the Electricity Commission with an Electricity Market Authority as follows: 26.1 It would be an Independent Crown Entity under the Crown Entities Act 2004. 26.2 Its objective would be to ensure the efficiency of the electricity market, including reliability, for the long-term benefit of consumers. 26.3 Board members would be appointed by the Governor-General on the recommendation of the Minister of Energy and Resources, and nominated as follows: • Two members nominated by Consumer New Zealand and Business New Zealand respectively. • One member nominated by	Agree that a new regulatory entity is required. However, Business New Zealand is not convinced that the creation of the Crown entity as proposed is either warranted or necessary. Business New Zealand believes that further consideration as to the entity’s form is required. This is based on the: a) commonality of the regulatory problems faced in the electricity market, as with other markets; b) the limited remaining roles for the entity; and c) need to deliver strong accountability to industry participants and broader stakeholders. In light of these reasons, Business New Zealand wonders whether the establishment of a Crown entity is either fit-for-purpose or likely to be the least-cost solution. See paragraphs 8.9 and 8.33 below for further comments.

Review Recommendation	Business New Zealand Position
generators and retailers. • One member nominated by lines businesses including Transpower. • One member and an independent chair nominated by the Minister. 26.4 The Minister would only be able to recommend appointments of persons nominated by market participants (as applicable), but would not be required to accept any particular nomination. Criteria for members would be set down in legislation (such as independence, expertise, and ability to work as a Board member). 26.5 Its functions would be: • Developing and approving market rules (including guidelines and model contracts). • Monitoring compliance with rules and, through a Rulings Panel, penalising breaches. 26.6 It would be required to set up working groups to prepare proposed rules, and the board would be required to hear representations on proposed rules from the chair of working groups before making decisions.	

<table>
<tr><th><u>Review Recommendation</u></th><th><u>Business New Zealand Position</u></th></tr>
<tr><td>27. Transfer approval of major grid upgrades to the Commerce Commission as part of its overall regulation of Transpower under Part 4 of the Commerce Act, but with reliability and service standards, transmission pricing methodologies, and the Grid Investment Test set by the regulator.</td><td>Agree, subject to the responses set out in recommendations 3 and 16, and the comments set out in paragraphs 6.11 – 6.31 above.</td></tr>
<tr><td>28. Transfer the following functions to the System Operator:
28.1 Information and forecasting on security of supply. Long term forecasting, and preparation of the ‘Statement of Opportunities’ would be undertaken by MED alongside its preparation of the Energy Outlook.
28.2 Emergency management.
28.3 Operation of reserve energy (if retained).
28.4 Contracting for market operations (for example, market clearance and reconciliation) pursuant to rules set by the regulator.</td><td>Agree. Business New Zealand considers that functions relating to the day-to-day maintenance of security are best left to the System Operator.

Business New Zealand also considers it appropriate for the Ministry for Economic Development to develop the Statement of Opportunities but with the caveat that its use not be compulsory, but an input in the mix of available information on plausible scenarios.

However, Business New Zealand has some concerns regarding the allocation of the market operations contracts to Transpower. Business New Zealand agrees with these changes subject to the following:
a) the removal of regulation 30(2) that entrenches Transpower as the System Operator. The purpose of such a change (while of no immediate consequence) is to ensure that the System Operator faces the right incentives given the potential threat of an alternative provider; and
b) a requirement that Transpower must make the market operations contracts contestable, and not be able to be taken in-house.

Finally, the discussion paper briefly canvasses, but dismisses the option of establishing an Independent System Operator (‘ISO’) as a part of this round of changes. On balance, Business New Zealand considers that this is appropriate (if for no other reason that the high level of market disruption). However, this also provides an opportunity to allow the benefits from greater System Operator transparency and change in culture to be delivered.

Therefore, while not a priority in this round, Business New Zealand considers that a workstream should be established by the Ministry of Economic Development to fully investigate the costs and benefits of an ISO model for New Zealand. This workstream should be cognisant of the gains expected from changes already underway, and be completed to coincide with the review suggested by Business New Zealand for no later than 2012.</td></tr>
</table>

Review Recommendation	Business New Zealand Position
29. Require the regulator to set up and service a Security and Reliability Council, comprising senior level persons from the electricity market, to meet periodically to help monitor and provide advice on the System Operator's performance of its functions and on security of supply issues generally.	Agree. A Security and Reliability Council is a worthwhile addition to the overall regulatory architecture. Care, however, needs to be taken to ensure that lines of accountability are both clear and transparent. In particular, Business New Zealand can see advantages (both relating to keeping the role of the regulator tightly focused, and in providing an independent voice on security of supply) of keeping the Council independent of both the regulator and Transpower.

Choosing the Right Form of Regulator

8.9 In choosing the unique form of the regulator, significant emphasis appears to have been given to the unique issues facing the electricity market. Business New Zealand continues to puzzle over why policy makers continue to insist that each sector is 'special' and in need of a bespoke regulator. With some (albeit important) exceptions at the margin, three regulatory problems exist – that of encouraging competition, how to mimic competition in the presence of natural monopolies and market access (i.e. network-based competition regulation) and the range of tools to address them are similarly well-known.

8.10 In light of this, Business New Zealand considers that greater weight should be given to consistency of entity form than is currently being given. Doing so would preserve the possibility of a future merging of regulatory entities (possibly into an energy market regulator) should that be appropriate.

Focusing on the Regulator's Roles

8.11 Business New Zealand agrees with the removal from the ambit of the regulator of functions such as energy efficiency and affordability. The remaining roles are:

a) developing and approving market rules (including guidelines and model contracts); and

b) monitoring compliance.

8.12 These are (appropriately) extremely circumscribed roles. Given this, Business New Zealand, considers that greater focus needs to be given by the review team to the model most likely to deliver the significantly reduced scope of roles sought of it. Business New Zealand remains to be convinced that a Crown entity and the incentives and costs associated with it, is necessary.

8.13 Consistent with the views set out in the Business New Zealand/LECG report, a better approach would be to have the rules independently designed by an industry and wider stakeholder process with the rules subject to scrutiny from the Commerce Commission for any anti-competitive behaviour.

8.14 Business New Zealand appreciates that the choice of regulatory entity will be influenced by the constitutional concerns relating to the delegation of Parliamentary powers. But this appears to have been the review team's key concern in wishing to establish a Crown entity. However, Business New Zealand considers that this could be addressed by such factor as the:

a) appropriate form of Commerce Commission scrutiny;

b) careful prescription of the entity's powers set out in legislation; and

c) provision of a clear understanding of the boundary between the policy framework and its implementation. The regulator must not be responsible for setting the policy framework. This must fall to the Ministry of Economic Development as the Crown's primary advisor on energy matters (for a variety of reasons, this boundary has become blurred in recent years and clarity on this aspect would help in the choice of entity).

8.15 However, consideration of stakeholder-driven entities have been relegated to the Appendix and dismissed. Specifically, the commentary set out in Appendix 21 of the discussion paper approaches the Telecommunications Carrier Forum and the Gas Industry Company as if each model must be rigidly adhered to. Clearly this need not be the case in their translation to the electricity sector. Business New Zealand can see no good reason, if one is adopted, why its best features cannot be adopted, but with variants as appropriate.

8.16 In addition, the concern is expressed that their translation into the electricity sector will result in less stakeholder involvement that the preferred alternative. However, the key expectation of Business New Zealand would be that any new entity would be industry *and* wider stakeholder-led entity. To be otherwise would defeat the very purpose of the exercise and not deliver the outcomes sought from the new regulator.

8.17 Finally, it is also important that any conclusion about the involvement of electricity industry, business and consumers in driving regulation should not be confused with the regulation of natural monopoly and market access (i.e. network-based competition regulation). These latter two regulatory functions are clearly the preserve of the Commerce Commission (and, as noted above, it is Business New Zealand's presumption that these roles will transfer to the Commerce Commission). And to be even clearer, Business New Zealand sees no place for a return to the fully self-regulatory structures of the NZEM or MARIA arrangements, but considers that these arrangements had benefits that the new regulatory entity should seek to mimic, while avoiding its detriments.

Delivering Improved Performance

8.18 Fundamental to improved performance by an independent regulator is clarity of focus. The Electricity Commission faces too many conflicting objectives. Business New Zealand considers that the goal of the regulator must be to protect the long term interests of electricity consumers. It should do this by promoting, where appropriate, effective competition and the delivery of reliable electricity at efficient prices.

8.19 Meaningful participation is critical to ownership and therefore accountability and performance. The absence of significant stakeholder input was a key failure of the NZEM and MARIA models, and this was (albeit in a different form) carried over into the Electricity Commission. There is now an absence of stakeholder ownership of its work and no stakeholder accountability for the quality of outputs. The incentives it creates are therefore unhelpful for the consistent delivery of high quality consensus advice of benefit to New Zealand as a whole.

8.20 This situation is compounded by the absence of a clearly enunciated strategic direction for the market and a consensus programme of work aimed at delivering that strategic direction.

8.21 Three lessons fall out of these issues:

a) while operating within the overall policy framework set by the Government, creating an accountability 'distance' between the regulator and the participants and broader stakeholders in a highly complex and interconnected market is as likely to be more detrimental than not;

b) the need for greater strategic-buy in by participants and stakeholders of the regulator's work programme. The establishment of a CEO panel from across the range of stakeholders to assist in the development of strategic priorities would be helpful; and

c) the need to get the culture of the regulator 'right'. This is likely to require a significant shift in behaviours as opposed to a rebranding exercise. The regulator's 'home' culture of seeking a vibrant, competitive market needs to be reflected in the skills required to implement competitive market policies.

8.22 A well designed governance structure should also result in a continuous search for improved market rule design while minimising costs and a rigorous compliance and enforcement regime.

8.23 With respect to rule making, Business New Zealand hopes that the return to the terminology of “working groups” (as opposed to advisory groups) is deliberate. Combined with the issues outlined above, the advisory group process has effectively disenfranchised those involved and effectively neutered what had been a relatively vibrant rule change process operated under the NZEM and MARIA arrangements.

8.24 The new regulator needs to recreate the positive elements achieved under the previous governance arrangements and institute a rule making process that enlivens the technical and innovative development of the market.

8.25 Clearly, the membership of the working groups is critical to achieving a higher level of participation and ownership of the outputs. As currently operated, some major stakeholders are, in some instances, excluded from the advisory group process. Business New Zealand proposes that greater weight be given to those who by their choice:

a) express an interest in participating; *and*

b) can demonstrate a clear interest in the topic area.

8.26 While more participation can have its down-sides, Business New Zealand believes that these are out-weighed by the benefits of the direct application of a broader-based expertise and buy-in to the issues.

8.27 The issues associated with consumer representation relate to skills and resources relative to other participants in the working groups. Funding by the regulator should enable these, if in deficit, to be bought in, in order to level the playing-field. Such funding must be provided, irrespective of the form of the regulator.

8.28 The real issue then becomes representation *per se* and, Business New Zealand concedes that it may simply not be possible to have all classes of consumers represented on all of the working groups. In this regard, Business New Zealand will look to the regulator for an even-handed approach.

8.29 If this is the case, the degree to which the regulator is effectively communicating its priorities and the work of its working groups becomes important. The sector has suffered from the absence of a clear communication strategy. Better communication provides consumers with the ability to better marshal their resources in order to respond more effectively and the concept of open consumer fora/workshops similar to the model used by the Gas Industry Company should be actively pursued.

8.30 With regard to compliance and enforcement, at its most basic level, the need for a compliance regime is driven by a desire to ensure that the integrity of the overall regime (in this particular case, the regime that encompasses that portion of the electricity market that is under the auspices of the regulator). At a more specific level, the needs can be specified as a desire (or 'need') to:

a) support, promote and enhance the principle objective of the regulator;

b) maintain the effective operation of the regime in terms of overall confidence;

c) encourage transparency;

d) incentivise compliance with the rules; and

e) ensure appropriate accountability for performance.

8.31 This was largely the basis on which the Market Surveillance Committee ('MSC') operated under the NZEM. The MSC was modelled after traditional commodity market enforcement bodies and comprised of independent members (usually senior legal practitioners and economists). It played an important (and visible) role of ensuring that the market's guiding principles were upheld and the market's integrity was maintained. Business New Zealand looks to a return to such a model under the new regulator.

8.32 Finally, whatever the final form adopted, a Ministerial appointed board would be a retrograde step. The politics of appointment 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 Commissioners. This would taint the work of the new regulator even before it commenced operations. Business New Zealand also considers that a stakeholder-led arrangement with strong accountabilities back to the stakeholders is more likely to ensure downward pressure on the costs of delivery.

8.33 Business New Zealand considers that the entities named are appropriate given their respective constituencies.

9. GETTING FROM HERE TO THERE

9.1 This section outlines Business New Zealand's thoughts on a transition path.

9.2 The discussion paper outlines at a fairly high level of detail, a set of proposals across the spectrum of market design and governance. While the Electricity Commission is already undertaking work on a number of the proposals, much more work is needed. It is important not to lose momentum in the coming months and Business New Zealand looks to relatively quick decisions on the key design elements.

9.3 This leads Business New Zealand to make the following recommendations:

a) a second consultation round is required. This round needs to canvas the changes settled upon and their detail in light of the feedback received on this discussion paper. However, its primary focus needs to be on implementation, that is, it needs to set out the details of the transition path, including:

   i. the issues on which further stakeholder input is expected and the form of that input;
   ii. details of the legislative amendment programme; and
   iii. the timeframe changes will be implemented over;

b) the establishment a transitional unit to manage the transfer of the Electricity Commission's functions to their appropriate 'home'. Business New Zealand considers that once the final shape of the regulator is determined, this unit should be established with haste and a strong line of communication established with industry and stakeholders regarding its role and functions;

c) clear direction is given to the Electricity Commission. Direction should be given to the Electricity Commission to assist in any way it can to ensure the smooth hand-over. The development of a 'hand-over' package is likely to form a key part of this; and

d) a set of clear priorities need to be given to the new regulator. While direction as to what the answer should be (a trap fallen into with the use of the Government Policy Statement) should be avoided, a number of clear strategic priorities fall out of this review, these being the implementation of:

   i. scarcity pricing;
   ii. a revised transmission pricing methodology;
   iii. a transmission hedge tool; and
   iv. the demand-side initiatives.

These all need to be in place by the end of 2010.

9.4 While generally supportive of the changes proposed, consistent with the views expressed in various sections of this submission, Business New Zealand seeks to be assured that positive changes are actually delivered. Therefore, Business New Zealand seeks a review to be completed no later than 2012 with this in mind. Too frequently, reviews have been triggered by crises, or the perception of crises, but once past, policy efforts move elsewhere and until the next crisis, no real follow up to assess the outcomes of the reviews is done.

9.5 Business New Zealand sees this review as a real opportunity to break this ‘boom or bust’ cycle of reviews. Specifically, Business New Zealand considers a review is vital for the following reasons:

a) to give confidence to consumers that the outcomes (once clear what these are) of the review either have been, or are in the process of being delivered (such as the emergence of a more vibrant retail and hedge market); and

b) to ensure that the new regulator has made quick progress on a number of key design elements.

9.6 In Business New Zealand’s view, the fact that an ex post review has been scheduled with the threat of further, more stringent regulatory action, is useful in ensuring that the outcomes are in fact delivered.

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.