Submission

by

Business|NZ

to the

Honourable Pete Hodgson, Minister of Energy

on the

Post–winter review of the electricity system

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

POST-WINTER REVIEW OF THE ELECTRICITY SYSTEM

SUBMISSION BY BUSINESS NEW ZEALAND

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Introduction

This submission is made on behalf of Business New Zealand, incorporating regional employers' and manufacturers' organisations. The regional organisations consist of the Employers and Manufacturers Association (Northern), Employers and Manufacturers' Federation (Central), Canterbury Manufacturers' Association, Canterbury Employers' Chambers of Commerce, and the Otago-Southland Employers' Association. Business New Zealand represents business and employer interests in all matters affecting those sectors.

One of Business New Zealand's key goals is to see the implementation of policies that would see New Zealand retain a first world national income and to regain a place in the top ten of the OECD in per capita GDP terms. This is a goal that is shared by the Government. It is widely acknowledged that consistent, sustainable growth in real GDP per capita of well in excess of 4% per annum (and probably closer to 7-8%) would be required to achieve this goal. Continued growth of around 2% (our long-run average) would only continue New Zealand's relative decline.

The health of the economy also influences the ability of a nation to deliver on the desirable social and environmental outcomes that we all want. First class social services and a clean and healthy environment are possible only in prosperous, first world economies.

One of the comparative advantages that the New Zealand economy has enjoyed has been the availability of a secure and globally competitive supply of electricity. Events this winter saw that advantage significantly eroded. It is also important to note that in numerous cases this advantage remains eroded. Declaration of the end of the crisis has not meant a return to a stable and secure market (note examples below).

This submission will offer several recommendations intended to improve the market, its response to supply conditions and the way those conditions are advised to consumers.

Contributing factors to events over winter 2001

It is now well known that historically low inflows to the national hydro system early in 2001 led to diminished generation capacity, and thus as winter advanced the possibility emerged that supply could be curtailed. In addition, and partly as a

consequence of the reduced capacity, electricity spot prices reached very high levels.

While the low inflows and reduced generation should be signalled to the market by price increases other factors may have been at play that resulted in pricing levels that bordered on the unsustainable. We believe that three key major elements require prompt action: transmission constraints, the effectiveness of price triggers for marginal thermal generation capacity, and structural market deficiencies. These are discussed below.

It should, nevertheless, be noted that Business New Zealand remains totally supportive of a market structure to manage risk. There is no evidence that would support a return to central [government] management of supply or demand.

(1) Transmission:

A variety of transmission constraints have emerged. Anecdotal evidence suggests many of these constraints result from lack of investment in the national grid system. The lack of investment may result from ongoing disputes between Transpower and grid users over “who pays”. Clearly a healthy and robust national grid system is essential to optimising supply, particularly in “dry year” scenarios.

For example, in May of this year it emerged that there were a set of constraints in the lower North Island which both restricted generation from Taranaki and limited flow from north to south to help conserve southern lake hydro storage. Whilst the solution to this problem involved a relatively simple reconfiguration of the system it was not, in fact, fully implemented until late July.

This delay, and other constraints, contributed to falling southern lake levels and increasing prices.

(2) Marginal Thermal Generation:

Reserve, marginal thermal generation is, in theory, introduced to the market when the spot price of hydro generation is such that electricity from the thermal sources may begin to take market share.

As noted above, it was clear early in the winter that southern hydro storage was at historically low levels. This led to high spot prices that would have been expected to “trigger” the entry to the market of the thermal generation. For reasons that remain unclear reserve thermal generation did not run at capacity until June or July.

This clearly contributed to the extraordinary price levels. The question must, therefore, be asked as to whether the backup thermal units were withheld from

the market in order to leverage up the prices on the spot market The wider lack of transparency in the current electricity market and the apparent lack of demonstrably objective information may make this a difficult question to answer.

(3) Effectiveness of current structural market arrangements

The existing market arrangements were inadequate to deal with the winter 2001 scenario. The most obvious symptom of that inadequacy relates to the role of pricing and the ability to signal shortages to consumers (including the fact that household consumers were not impacted by price incentives).

Major consumers were exposed to unprecedented price levels in the spot area of their portfolios relatively early in the crisis period. There is ample evidence, however, that prior to the Minister's announcement of a shortage and a need to conserve, there was no effective message on the situation being transmitted to the bulk of consumers.

Many medium and small commercial consumers then found themselves in the unfortunate position of being confronted with substantial, and sudden, increases in their electricity accounts. As the situation deteriorated many others, coming off fixed termed contracts, found there was an unwillingness to supply them with electricity or, where there was, it was on terms that saw their projected monthly accounts increase by very large percentage points.

This situation continues, indicating increasingly ineffective market arrangements. There is little evidence that the market participants are moving to develop products to assist demand side management and the recently launched secondary trading market appears to be languishing mainly because its development is dependent on retailers offering flexible contracts, and these are not in evidence.

Lack of retail competition is a major contributor to questions about the effectiveness of the current market. Vertical integration and the concentration of retail customer bases in geographic areas are particularly problematic. A very recent case from Christchurch is illustrative. That market is dominated by one retailer who recently declined to renew a customer's contract. The customer tried three other major retailers that all declined to offer a contract. He is, therefore, without choice, exposed to the spot-market.

In summary, the factors that have created the less than effective market scenario include –

- thermal generators having excessive market power allowing them to charge their cost of supply above what would be expected in a competitive market;
- similar market power apparently used to foreclose on a competing retailer resulting in reduced retail competition;

- vertical integration and geographic consolidation creates an effective barrier to the entry of new retail competition;
- the ineffectiveness, or lack of, price signals to the majority of consumers means there is limited dry year financial incentives for conservation;
- the lack of market transparency in a number of areas, including pricing, offers a bias to generators and does not assist in facilitating demand side management;
- the inability by suppliers to manage transmission constraints leads to a reduction in nationwide retail competition, and
- some customers receive a share of transmission rental rebates, while others do not.

Recommended changes to the market arrangements

(a) Market information

Lack of data and information at a number of levels is clearly obstructing the development of effective demand side management strategies and preventing early detection of possible abuses of market power.

- It is recommended that the Minister requests historic and day-to-day inflow and hydrology data and information, spot prices, generator offers, primary hedge information and anonymous retail contract pricing be made public through a readily accessible medium such as the Internet. This should be at low or nil cost.

(b) Transmission

There is evidence of inadequate investment in the capacity and quality of the national grid and in the management of transmission constraints.

- It is recommended the Minister directs that Transpower consults with stakeholders and the Grid Security Committee and reports back to the Minister by 28 February 2002 on how the existing grid capacity may be enhanced prior to winter 2002.
- It is recommended the Minister directs that Transpower consults with stakeholders and reports back to the Minister before 31 March 2002 on attainable, forward new grid investment prior to winter 2002 for a five year period ending 2007.

(c) Retail competition

There is a lack of competition in the retail market. The Commerce Commission is currently investigating the acquisition of On Energy's retail base by Genesis and Meridian.

- It is recommended that should the Commerce Commission decide to not direct the divestment of On Energy's retail base from Genesis and Meridian, an independent cost/benefit analysis of alternative ways to

separate generation from retailing be undertaken and reported back to the Minister no later than 31 March 2002.

(d) Demand side management

There are limited demand side management products available and little in the way of financial incentives for the bulk of consumers to conserve electricity.

- It is recommended the Minister requests all retailers to demonstrate by 31 March 2002 that they have available a range of market products, targeting different groups of customers, that will provide continuing incentives for conservation, particularly in dry years.

(e) Supply side structure

Market power in a small market such as the New Zealand one is a problematic issue. There are few, if any, market models appropriate to such a small market where core generation is hydro generation. Given the issues highlighted above it is probably an appropriate risk management approach for the Minister to consider a comparative and in depth expert review of the electricity market following this exercise. Recent reports from the UK, for example, suggest significant price reductions and greatly improved liquidity already observed from the new structure commenced there in March 2001. While this is a new market, with less than a year's experience, there may be merit in the new Electricity Governance Board carrying out such a review once it is firmly established.

- It is recommended the Minister requests Cabinet approval for an amendment to the Government Policy Statement requiring the Electricity Governance Board to carry out a comparative and in depth review of the New Zealand electricity market within 18 months of its (the Board's) establishment.

Energy Efficiency and Conservation

The 10% for 10 weeks programme instituted during the winter crisis did not achieve its target. In defence of EECA, the absence of price signals and demand side management mechanisms did nothing to assist achieving the target.

It could be argued that if a number of the recommendations noted above were adopted future EECA action in dry years may not be required.

Whether or not that is the case, the release of the Energy Efficiency and Conservation Strategy would suggest it is the Minister's intent that energy conservation is not just something that is enacted in a "crisis" period but rather is something that is incorporated into all areas of the economy, including the electricity generation and supply industry.

Conclusion

Business New Zealand is of the view that much of what occurred over the winter 2001 period was avoidable. Deficiencies, inefficiencies and inappropriate market behaviour created as many problems as low hydro storage levels.

Our continuing reliance on core hydro generation and a likelihood of an imminent replay of the same problems make it imperative that they not be permitted to continue. We urge the adoption of the recommendations above, including a full market review, and the implementation of appropriate action to preclude any further form of market manipulation in a strategic and critical part of the economy that, given its underlying pricing, is a critical component of New Zealand's global infrastructural competitiveness

In all the circumstances of winter 2001, particularly in the context of the deficiencies on which we have commented above, Business New Zealand commends the Minister for his leadership and direction. We certainly consider that without that direction the outcomes could have been significantly worse. Nevertheless, the events have clearly signalled that various aspects of the electricity market require urgent attention.