The Treasury

Mixed Ownership Model for Crown Commercial Entities:
Treasury Advice Information Release

4 September 2012

Release Document

www.comu.govt.nz/publications/information-releases/mixed-ownership-model

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[2] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information, or who is the subject of the information

[3] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[4] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[5] 9(2)(h) - to maintain professional legal privilege

[6] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice, or

[7] Information is out of scope or not relevant.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [3] appearing where information has been withheld in a release document refers to section 9(2)(f)(iv).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.
Treasury Report: Regulation of the Electricity Market

Date: 8 March 2012

Action Sought

<table>
<thead>
<tr>
<th>Name</th>
<th>Action Sought</th>
<th>Deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minister of Finance (Hon Bill English)</td>
<td>Note contents</td>
<td>None</td>
</tr>
<tr>
<td>Associate Minister of Finance (Hon Steven Joyce)</td>
<td>Note contents</td>
<td>None</td>
</tr>
<tr>
<td>Minister for State Owned Enterprises (Hon Tony Ryall)</td>
<td>Note contents</td>
<td>None</td>
</tr>
<tr>
<td>Associate Minister of Finance (Hon Dr Jonathan Coleman)</td>
<td>Note contents</td>
<td>None</td>
</tr>
</tbody>
</table>

Contact for Telephone Discussion (if required)

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Telephone</th>
<th>1st Contact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Juston Anderson</td>
<td>Senior Analyst, Commercial Transactions</td>
<td>[1]</td>
<td>✓</td>
</tr>
<tr>
<td>Andrew Blazey</td>
<td>Manager, Commercial Transactions</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Minister of Finance’s Office Actions (if required)

None.

Enclosure: No
Treasury Report: Regulation of the Electricity Market

1. The Government has stated that it would only proceed with the Mixed Ownership Model if it met five tests, one of which was that the Government was “satisfied that industry-specific regulation adequately protected New Zealand consumers”. This report, as requested by the Minister of Finance’s office, formally sets out Treasury’s view on whether regulation of the electricity market in New Zealand meets that test.

Description of the Regulatory Environment

Generic Regulation

2. The electricity industry is subject to the Commerce Act 1986, the Fair Trading Act 1986, the Consumer Guarantees Act 1993 and the Resource Management Act 1991, among others. This report focuses on regulation that is specific to the electricity sector.

The Electricity Authority

3. The Electricity Authority (EA) is the primary regulatory body for the electricity market. The EA is an independent Crown entity responsible for the efficient operation of the New Zealand electricity market. The EA’s statutory objective is to “promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers”. The EA has an extensive work programme of initiatives to deliver on its objective.

4. In 2011 the EA published a detailed document explaining its interpretation of its statutory objective, and then consulted widely on this document before finalising it. The EA has publicly stated that “almost all submitters on the draft Interpretation, including consumer organisations, supported the EA’s approach”.

The Commerce Commission

5. The Commerce Commission is responsible for regulating suppliers of electricity lines services under the Commerce Act, on the grounds that these services are provided “in a market where there is little or no competition, and little prospect of future competition”. Commerce Commission regulation (from 1 April 2011) also applies to Transpower, the operator of the New Zealand national electricity transmission grid.

6. Electricity distribution businesses and Transpower are subject to price-quality regulation by the Commerce Commission. This means that the Commission sets:
   • the maximum prices/revenues that are allowed at the start of the regulatory period
   • the annual rate at which maximum allowed prices can increase, and
   • the minimum service quality standards that must be met.
7. In addition, Transpower must seek Commerce Commission approval for investment proposals for upgrades to the electricity transmission grid that are above a certain size.

2006 Review of Electricity Policy

8. In 2006 the previous Government conducted a review of electricity policy. The review concluded as follows:

- Prices – “while aggregate real electricity prices have been relatively constant for the past 25 years, domestic prices have risen for much of this period due largely to the removal of cross-subsidies from commercial consumers. More recently prices have risen as excess generation capacity has been exhausted and the long run cost of existing and new thermal generation has increased with the depletion of Maui gas. Overall, prices are tracking the long-run cost of new thermal generation and New Zealand’s prices remain low compared to most other OECD countries.”

- Generation Investment – “projections show that the system security margin is likely to increase over the 2006-2012 period as significant new planned generation comes on stream. An additional 1200MW of new generation is planned for the 2007-08 period, with an additional 955MW under investigation for potential construction between 2007 and 2012.”

- Investment Quality – “the current market model reduces the risk of poor projects going ahead. Currently, capacity increments are coming from a diverse range of investments regarding geographic location and type. This contrasts with investment before the split of ECNZ, which tended to focus on larger plant.”

- Security of Supply – “New Zealand’s dependence on variable hydroelectricity production means the system can be periodically stressed by water constraints. While it would not be cost-effective to invest in sufficient generation capacity to entirely alleviate any possibility of a dry year shortage, high spot prices (and exposure of some businesses to spot prices) have led to perceptions of a lack of security of supply. More recently a number of steps have been taken by the Electricity Commission to improve management of dry years.”

9. The review also considered potential alternative market structures, including a “single buyer” model, and an option of amalgamating the three electricity SOEs into a new entity. The review rejected these alternative options, concluding that current arrangements remained “the best model for producing and supplying the required level of electricity at least cost”.

Electricity Commission Market Design Review

10. In 2007 and 2008 the former Electricity Commission (EC) conducted a review “to identify what changes could be made to the electricity market to improve its performance” (the Market Design Review). The review included extensive consultation with interested parties.

11. The review confirmed the structure and regulation of the electricity market was appropriate, but it recommended a number of initiatives designed to address various second-order issues. These initiatives have subsequently been picked up by the EA, and include encouraging customer switching, development of a liquid hedge market, improving market information, increasing competition in the
frequency keeping market, and encouraging greater standardisation of network
pricing structures.

Commerce Commission Investigation into the Wholesale Electricity Market

12. In 2009 the Commerce Commission completed a four-year investigation of the
wholesale electricity market by concluding that there had been no breaches of the
Commerce Act and that there was no basis on which to continue investigating the
allegations of breaches.

13. At the same time the Commission released a report by a United States academic,
Professor Wolak, which concluded that the exercise of legal market power by
electricity generators generated $4.3b in supernormal profits for those companies
over the 2001-2007 period.

14. However, as we reported to you at the time, two independent peer reviews of
Professor Wolak’s report identified significant flaws with his methodology that
render the conclusions he reached worthless (T2009/1508 refers). Unfortunately,
these critiques have received little attention, and the headline figure of $4.3 billion
“excess profits” from the Wolak report continues to be cited by critics of the
electricity industry in New Zealand.

15. Setting aside any flaws in Professor Wolak’s methodology, the $4.3 billion figure
for “excess profits” is not credible, as it represents over 90% of the total after-tax
profits earned by the five major electricity companies\(^1\). If these profits had not been
made, these companies would have earned relatively small amounts on their
billions of dollars of assets – certainly far less than their cost of capital - and would
have had insufficient cashflows to fund any of the significant investment in new
generation that occurred over 2001 to 2007 and the years following that. Without
that investment, New Zealand would most likely be experiencing significant
shortages of electricity and (ironically) higher prices.

16. Given that we do not believe the Wolak report’s conclusions can be relied upon, in
our view the report provides no justification for any regulatory action by the
Government.

Electricity Industry Act regulatory changes

17. In 2009 the Government initiated a Ministerial review into the electricity market,
which was led by the independent Electricity Technical Advisory Group (ETAG).
The review proposed 29 measures to improve the performance of the electricity
market, its institutions and its governance, including:

- replacing the Electricity Commission with the EA. The objective of the EA is
to promote competition, reliable supply and efficient operation of the
electricity market for the long-term benefit of consumers
- simplifying the functions of the EA by transferring functions to other bodies
- setting up a Security and Reliability Council, comprising senior level people
from the electricity sector including electricity users, 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

\(^1\) MRP, Meridian, Genesis, Contact and Trustpower reported total after-tax profits of approximately $4.7 billion from
2001 to 2007.
• transferring the Tekapo A and B power stations from Meridian to Genesis Energy
• requiring Meridian Energy, Genesis Energy and Mighty River Power to undertake ‘virtual asset swaps’ involving long-term (15 year) hedge contracts
• putting in place a liquid hedge market for electricity
• permitting lines businesses to retail electricity and construct new thermal generation, subject to some conditions
• a fund to promote consumer switching
• introducing more standardised lines tariff structures and use-of-system business rules
• introducing a transmission hedging mechanism
• facilitating more demand-side participation in the wholesale market
• ensuring 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
• encouraging retailers to make smart tariffs available, as an option for consumers, that provide incentives to better manage electricity consumption
• shortening the maximum timeframes for switching between retailers
• developing terms and conditions (including pricing guidelines and principles) for purchase of power by retailers from small-scale distributed generation
• abolishing the reserve energy scheme and selling the government-owned Whirinaki power station
• requiring retailers to make payments to consumers in the event of a conservation campaign or dry year power cuts
• requiring all generators to disclose information relating to supply risks and management of risks, and
• reviewing options for providing clear government direction on the national significance of hydro generation in water allocation decisions.

18. These recommendations were implemented by the Electricity Industry Act 2010.

Comment

19. Treasury supported the conclusions of the 2006 review of the electricity market, and we believe those conclusions are still valid today. In fact, since the 2006 review the Government has further strengthened protections for consumers, as outlined above, including establishing the EA as a statutorily independent Crown Entity and specifying its legislative objective as being to regulate the industry “for the long-term benefit of consumers”.

20. The 2007/2008 Market Design Review by the EC also supported the current design of the electricity market and its regulation, although it resulted in a number of initiatives to improve various second or third-order aspects of the market’s operations. The EA has implemented, is in the process of implementing, or is consulting on these initiatives.
21. As the EA is a relatively new entity, its performance has yet to be fully
demonstrated. The High Court's decision regarding the legal challenge to the EA's
decision regarding the events of 26 March 2011 (the “Undesirable Trading
Situation”) was an important test for the EA – as you know, the Court dismissed
the challenges to the EA’s decision (although appeals against the Court's decision
are possible).

22. Another important test will be the EA’s decision on HVDC pricing, which has been
a contentious issue for many years. However, our views are that the early signs of
the EA’s performance are promising, for example:

- the EA’s interpretation of its objective is, in our view, appropriate, and the
  interpretation appears to be widely supported
- the EA’s work to raise awareness of the opportunities for consumers to
  switch electricity retailers, which has resulted in a significant increase in
  consumer switching and therefore an increase in the competitive pressure
  faced by retailers
- the EA’s work to encourage the development of a liquid hedge market for
  electricity, and
- the robust (albeit lengthy) process the EA has proposed on HVDC pricing.

What Difference Would Mixed Ownership Make?

23. The extension of the Mixed Ownership Model to the electricity SOEs should not
make any difference to regulation of the electricity market. The EA currently does
not take account of the Government’s 100% ownership of Meridian, MRP and
Genesis Energy in its regulatory decisions. It treats these companies in the same
way as privately-owned Contact and Trustpower, and it does not take account of
impacts on the Government as owner of the SOEs.

24. Nor do the EA or the Commerce Commission take account of the fact that the
three electricity SOEs have a common 100% owner, the Crown. The three SOEs
are prevented by a clause in the Commerce Act from using their common
ownership to act together to maximise their joint profits, to the detriment of
consumers.

25. The sell-down of up to 49% of the electricity companies will not change any of this.

26. We note that the regulatory environment for electricity has been subject to many
significant changes over time, with the establishment of the EA (and the other
changes that accompanied it, including the physical and virtual asset swaps
between the electricity SOEs) being the most recent. Therefore, based solely on
the historical evidence, there is a risk that a future government will decide that
current regulation is not satisfactory and requires change.

27. The extension of the Mixed Ownership Model to the electricity companies should
not prevent a future government from changing the regulatory environment, if it
wishes to do so. Past governments have been able to significantly change the
regulation of other sectors of the economy, regardless of whether the companies
involved in those sectors were privately owned, Government owned, or a mixture
of both.
28. Contact Energy and Trustpower are already privately owned, as are a number of other smaller companies, so any regulatory changes in electricity already have the potential to impact on private owners. This private ownership did not prevent the Government from taking action in 2010 and 2011 to encourage increased competition between electricity retailers. We do note that some of those actions – the virtual and physical asset swaps between the SOEs - would have been more difficult to do if the SOEs had some private ownership.

29. We acknowledge that the extensive changes in the electricity sector over the past decade would probably not have happened to the same extent, or at the same pace, if there had been greater private ownership of the companies in the sector. However, we think a more cautious approach to regulatory changes in the electricity sector would be a benefit of mixed ownership, not a cost.

Recommended Action

We recommend that you note the contents of this report.

Andrew Blazey
Manager, Commercial Transactions Group

Hon Bill English  
Minister of Finance

Hon Tony Ryall  
Minister for State Owned Enterprises