

October 2004

GOVERNMENT POLICY STATEMENT ON ELECTRICITY GOVERNANCE

Foreword

The electricity sector has a critical role to play in underpinning the Government's growth and sustainability objectives. Sustainable economic growth will best be supported by an electricity system that:

- Is reliable and resilient
- Is environmentally responsible
- Delivers energy prices that are efficient, fair, and as competitive as possible consistent with these requirements.

The Electricity Commission has a key role in contributing to these objectives. The Commission's principal objectives are to ensure that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable and environmentally sustainable manner and to promote and facilitate the efficient use of electricity.

Electricity security of supply is essential to all aspects of our personal and working lives. The Commission will work with all stakeholder groups to ensure that, as a country, we achieve an appropriate level of security for a modern society.

The Electricity Commission will have responsibility for governance and regulation of the industry. Key roles for the Commission include:

- Maintaining a regulatory environment that is conducive to investment in all types of generation and that minimises any undue barriers to competition in generation and retail
- Using reasonable endeavours to ensure the Government's security target (supply in a 1 in 60 dry year) is achieved
- Overseeing key decision-making processes to ensure that transmission makes a cost-effective contribution to security
- Working with the Commerce Commission to help ensure target security levels for distribution networks are met at least cost
- Developing arrangements to ensure fairness for consumers
- Working with EECA to promote the efficient provision and use of electricity, particularly at the consumer end, and

- Ensuring proper coordination across the supply chain, so that accountabilities and interfaces are clear and delivery of cost-effective solutions is facilitated.

A range of other factors, for which the Commission does not have accountability, will impact on the electricity sector through time. These include:

- Climate change policy
- The Resource Management Act 1991 and related processes
- Policy and regulatory settings for the gas sector, including measures to encourage petroleum exploration, and
- The National Energy Efficiency and Conservation Strategy.

The Government expects the Commission to take into account and contribute as appropriate to the Government's wider policy objectives.

The Government also expects the Commission to provide early warning if it believes there is any material risk that current settings for electricity and for other policy areas are unlikely to produce sufficient investment, particularly in generation and the national grid.

This Government Policy Statement sets out the objectives and outcomes the Government wants the Commission to give effect to. It is made pursuant to s 172ZK of the Electricity Act 1992 as amended by the Electricity Amendment Act 2004¹.

Other related documents are the Sustainable Development Programme of Action², the National Energy Efficiency and Conservation Strategy³, the Climate Change Work Programme⁴ and the Government Policy Statement on Gas⁵.

Hon Pete Hodgson
Minister of Energy

¹ For the avoidance of doubt, the Government Policy Statement does not include the Foreword.

² <http://www.mfe.govt.nz/publications/sus-dev/sus-dev-programme-of-action-jan03.html>

³ <http://www.eeca.govt.nz/default2.asp>

⁴ <http://www.climatechange.govt.nz/sp/consultation/confirmed-policy.htm>

⁵ <http://www.med.govt.nz/ers/gas>

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Policy objectives for the Electricity Commission

- 1 The Government has amended the Electricity Act 1992 to set the following principal objectives for the Electricity Commission:
 - ensure that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable, and environmentally sustainable manner and
 - promote and facilitate the efficient use of electricity.
- 2 Consistent with those principal objectives, the Commission is required by the Act to seek to achieve the following specific outcomes:
 - a energy and other resources are used efficiently
 - b risks (including price risks) relating to security of supply are properly and efficiently managed
 - c barriers to competition in electricity are minimised for the long-term benefit of end-users
 - d incentives for investment in generation, transmission, lines, energy efficiency, and demand-side management are maintained or enhanced and do not discriminate between public and private investment
 - e the full costs of producing and transporting each additional unit of electricity are signalled
 - f delivered electricity costs and prices are subject to sustained downward pressure
 - g the electricity sector contributes to achieving the Government's climate change objectives by minimising unnecessary hydro spill, efficiently managing transmission and distribution losses and constraints, promoting demand-side management and energy efficiency, and removing barriers to investment in new generation technologies, renewables and distributed generation.

Commission's powers and approach

- 3 The Commission should work with stakeholders including consumers, market participants and Government agencies to achieve its objectives.
- 4 In particular, whenever possible, the Commission should use its powers of persuasion and promotion, and provision of information and model arrangements to achieve its objectives rather than recommending regulations and rules.
- 5 However, the Government recognises that clear and effective regulations and rules are required in many key parts of the market. Accordingly, the Commission has powers under the Electricity Act 1992 to make recommendations to the Minister of Energy concerning new or amended regulations and rules. The Commission should be prepared to use these powers fully where required to achieve the Government's policy objectives.

Consultation

- 6 Where the Commission proposes new regulation or rules, or substantial changes to existing regulations or rules, the Act requires it to follow good processes. These include identification of the main options, assessment of costs and benefits, and consultation with and exposure of its analyses to affected parties. It is also required to satisfy itself that other options (such as information, education and voluntary arrangements) are unlikely to satisfactorily achieve the Government's objectives.
- 7 The Government expects the Commission to publish a protocol on its consultation processes.

Advisory groups

- 8 The Commission should make extensive use of advisory groups wherever possible to develop industry arrangements and make recommendations concerning regulations and rules. These advisory groups should have the necessary expertise and be appropriately representative of affected parties including consumers. The Commission should consider providing limited funding assistance for consumer representatives where it considers that this may improve the quality of decision-making.

Innovation

- 9 The Commission should keep in mind the importance of encouraging innovation. It should therefore consider, when deciding how best to deliver on its objectives, any trade-offs between certainty and clarity on the one hand and encouraging and allowing scope for innovation on the other.

Information

- 10 High quality information is essential to efficient markets. The Commission should give high priority to ensuring relevant information is made available to market participants and to the public at large on matters relating to the electricity sector.

Administration of regulations and rules

- 11 The Government expects the Electricity Commission to take responsibility for monitoring compliance, investigating alleged breaches and if necessary taking enforcement action in relation to regulations and rules.⁶ It should establish an impartial Rulings Panel to adjudicate on alleged breaches of the rules.

⁶ The Ministry of Economic Development is the administering Department for regulations and rules made pursuant to Subpart 2 of Part 14 or pursuant to Part 15 of the Electricity Act 1992.

Consumer protection

Domestic consumer contracts

- 12 The Electricity Commission should ensure that the terms and conditions of contracts between domestic consumers and electricity retailers (and where applicable, contracts between domestic consumers and electricity distributors) reflect the reasonable expectations of consumers. The Commission should develop, in consultation with the Ministry of Consumer Affairs and other relevant interests, model terms and conditions or guidelines for these contracts. It should recommend regulations if model arrangements or guidelines are not comprehensively implemented.
- 13 The Commission should include the following matters in the contracts:
- transparency of charge components
 - frequency of billing
 - company-specific arrangements for dispute resolution
 - arrangements for informing consumers about planned outages
 - arrangements for the benefit of low income domestic consumers as described below.
- 14 When developing arrangements for domestic consumer contracts, the Commission should have regard to any provision by the Commerce Commission for distribution businesses to engage with local communities on the trade-offs they wish to make concerning price and quality and reliability of supply.

Low fixed charges

- 15 The Government has introduced regulations⁷ to require retailers to offer low fixed charge tariff options of no more than 30c per day⁸ to domestic consumers. These tariff options should incorporate the following design features:
- domestic consumers consuming less than 8,000 kWh/year must pay less on a low fixed charge tariff option than on any corresponding tariff option
 - the low fixed charge tariff options are to be advertised in the same manner as existing tariffs
 - the retailer must inform domestic consumers at least annually whether it may be beneficial for them to switch to a low fixed charge tariff option
 - the low fixed charge tariff options need only be available for homes where consumers usually reside
 - all retailers should make the tariffs genuinely available (subject to usual credit-worthiness tests), irrespective of the usage of the consumer, and

⁷ Electricity (Low Fixed Charge Tariff Option for Domestic Consumers) Regulations 2004, effective 1 October 2004.

⁸ Excluding GST, but after any prompt payment discount is subtracted.

- tariffs with tiers below 8,000 kWh per annum (e.g. high c/kWh for the first 2,000 kWh per annum) are proscribed to ensure that the lower fixed charge offers genuine advantages to small consumers.
- 16 The regulations also require distribution companies to offer low fixed charge distributor tariff options (to retailers or direct to consumers) at a maximum of 15c per connection per day. Compliance with the low fixed charge policy will be measured both before and after any rebates or discounts. Any rebates or discounts must apply consistently to consumers regardless of whether they are on a low fixed charge or standard tariff option.
- 17 The Commission will be charged with monitoring and enforcing these regulations.

Arrangements for the benefit of low income domestic consumers

- 18 The Commission should develop arrangements and recommend regulations if necessary to ensure that:
- consumers who may have difficulty paying their bills on time have access to electricity (although in a way that does not require retailers to accept unreasonable credit risk)
 - consumers have access to a mechanism to assist with budgeting if required
 - consumers who have difficulty paying can avoid the costs of frequent disconnections and reconnections, and
 - clear guidelines or standards exist for disconnections following non-payment.
- 19 The Commission should consider options such as pre-payment meters, alternative payment options (such as advance payments, more frequent payments or smoothed payments) and bonds. In principle, the Government considers that bonds in excess of the value of one month's consumption by an average household are inconsistent with fairness.

Arrangements in the event of retailer insolvency

- 20 The Commission should establish arrangements to ensure an orderly transition for consumers in the event that a retail company becomes insolvent.

Consumer complaints resolution system

- 21 The Government expects everyone (including potential consumers and owners and occupiers of land) to have access to a free, independent system for resolving complaints about electricity distributors (including Transpower) and electricity retailers, whether or not they have a consumer contract with the retailer or distribution company.
- 22 The Government expects the Electricity Commission, in consultation with the Ministry of Consumer Affairs, to ensure a system is in place that meets the Government's expectations and includes the following features:

- a code of practice for electricity distributors and electricity retailers setting minimum standards of conduct
 - membership by all distributors (including Transpower) and retailers
 - robust internal complaints-handling processes within all member companies
 - an independent, external, complaints resolution scheme that meets standard benchmarks, such as accessibility, independence, fairness, accountability, efficiency and effectiveness
 - self-funding by the industry, and
 - compensation where appropriate.
- 23 The Government supports the existing Electricity Complaints Commission Scheme and the associated Electricity Consumer Code of Practice. However, not all retailers and distribution companies have joined the scheme and the scheme's coverage falls short of the expectations set out above.
- 24 The Government therefore expects that the Electricity Commission will encourage the industry to develop this scheme further in a way that ensures it is consistent with the Government's expectations. If the industry is unable to provide an acceptable scheme, the Commission should recommend regulations to introduce a statutory scheme.

Electricity efficiency

- 25 The Electricity Commission has as a key goal the efficient provision and use of electricity. Electricity efficiency and demand side management help reduce demand for electricity, thereby reducing pressure on prices, scarce resources and the environment. The Commission should ensure it gives full consideration to the contribution of the demand side as well as the supply side in meeting the Government's electricity objectives.
- 26 As part of its research and information activities, the Commission, in conjunction with the Energy Efficiency and Conservation Authority (EECA), should undertake a comprehensive review of the potential of electricity efficiency to contribute cost effectively to achievement of the Government's electricity objectives, including estimating the level of investment required to realise this potential.
- 27 The Commission should also put in place arrangements and programmes to promote efficiency in the following components of the electricity sector:

Generation

- 28 Hydro, thermal and other fuels resources should be used efficiently in the generation of electricity. Disclosure of information, such as on hydro spill, is expected to help avoid unnecessary waste of resources.

Wholesale market

- 29 The Commission should facilitate and promote stronger demand-side participation in the wholesale market in support of the Government's overall objectives.

Conveyance

- 30 Electricity should be conveyed efficiently on the national grid and distribution lines. Transmission and distribution companies should have better incentives to manage transmission and distribution losses and constraints. The Commission should promote pricing structures that provide appropriate signals to manage those losses and constraints.

End-use

- 31 The Commission should promote the efficient use of electricity. It should seek this objective in multiple and mutually-reinforcing ways:
- by promoting and facilitating the efficient use of electricity by end-users, including providing financial incentives for investment in electricity efficiency where it is cost-effective to do so and in response to market failures and barriers
 - by promoting cost-reflective pricing
 - by seeking innovative ways to enable residential and other consumers without time-of-use meters to respond to pricing incentives to use

electricity more efficiently

- by keeping under review, and making recommendations to the Government as appropriate, on whether there is a strong case for requiring the progressive introduction of smarter meters for consumers
- by encouraging and facilitating demand-side participation in the wholesale and retail markets, and
- by promoting the efficient use of ripple control.

32 The Electricity Act 1992 enables the electricity levy to cover the Commission's costs of promoting efficient use of electricity. The Government expects the Commission to put in place cost-effective programmes and arrangements to promote efficient use of electricity and to make recommendations on its funding requirements for this purpose.

33 In undertaking such activities, the Commission should work closely with EECA, which is accountable to the Minister of Energy and has primary operational responsibility for delivering the Government's National Energy Efficiency and Conservation Strategy. In addition to wide-ranging promotional, information and assistance programmes, EECA is responsible for administering regulations relating to energy efficiency under the Energy Efficiency and Conservation Act. It is important that the Electricity Commission's activities complement the work of EECA and that duplication of effort is avoided.

34 The Government expects the Commission and EECA to publish a Memorandum of Understanding on how they will work together co-operatively to minimise any duplication of activity. Any purchase by the Commission of services from EECA should be formalised in contracts which should be made available on the Commission's website.

Security of supply

Background

- 35 A key priority of the Government is to improve security of electricity supply. Shortage risks occurred in 2001 and 2003, resulting in sustained high spot prices and the need for emergency conservation campaigns. This has caused inconvenience and disruption, and may have affected the attractiveness of New Zealand for business investment, especially for sectors using relatively large quantities of electricity. In the Government's view, security of supply is vital to achieving its objective of sustainable economic development.
- 36 Key components of security of supply are that:
- Sufficient generation capacity is built or energy efficiency improvements made to meet ongoing demand growth
 - Hydro and thermal generating capacity and fuels are appropriately managed, to deal with the risks of extended dry hydro periods better than we have in the past
 - The system has sufficient reserve energy (plant and fuel, or contracted demand response) to cope with extreme dry sequences or other unexpected supply disruptions
 - The national grid and distribution lines meet specified reliability objectives. (Transmission and distribution issues are covered in separate sections).

Security of supply objective for the Electricity Commission

- 37 A function of the Electricity Commission under the Electricity Act 1992 is to use reasonable endeavours to ensure security of supply, without assuming any demand reduction from emergency conservation campaigns, while minimising distortions to the normal operation of the electricity market. In particular, the Government wants the Commission to use reasonable endeavours to ensure security of supply in a 1 in 60 dry year. The Commission should also work with stakeholders to identify industry contingencies and develop strategies consistent with the operation of the electricity market to achieve its security of supply objectives.

Information, modelling and forecasting

- 38 The Commission should undertake and publish detailed supply and demand modelling and forecasting at least annually. The objective is to provide well-researched information on short and long term security of supply, including likely availabilities of fuels, new generation options, and likely price trends under various scenarios.
- 39 The Commission should ensure that public information is provided on:
- thermal fuel availability
 - hydro lake levels

- hydro spill
- generation capacity.

40 To establish the need for additional reserve energy (see below), the Electricity Commission should look out 3 to 5 years in more detail (given consent and construction timelines for new capacity), collect information, develop a baseline that makes assumptions about what known projects are likely to proceed, and identify any 'shortfalls' year by year. The need for additional reserve energy should be based on dry year risk taking into account prudent assumptions about availability of other plant.

Security of supply policy

- 41 The Electricity Commission should develop, consult on and publish a security of supply policy. The security of supply policy should specify the steps that the Commission will take at various stages during a contingent event such as an extended dry sequence. It should also include its procurement policies for reserve energy. The overriding objective is to give as much certainty as possible to the market.
- 42 The Commission should develop and publish an operational security of supply standard, possibly expressed as a loss of load expectation.

Minimum Hydro Zone

- 43 To help ensure security of supply, the Electricity Commission should develop and publish a minimum hydro zone giving its estimate of minimum hydro storage levels required at different times of the year to avoid the risk of shortages in a 1 in 60 dry year. This minimum zone should take into account the expected availability and use of thermal generation. The minimum hydro zone should not be catchment-specific but should be national or based on regions defined by likely transmission constraints during a dry hydro period.
- 44 The Commission should consult with interested parties in developing the minimum hydro zone.
- 45 Within this minimum zone, the Electricity Commission should have a second zone that would trigger a conservation campaign, on the basis that there is a significant probability that we are in a worse than 1 in 60 dry year event.

Good processes

- 46 In developing and operating its security of supply policies, the Commission should:
- put in place good consultation processes
 - ensure a high level of transparency and stability of policy settings
 - avoid ad hoc and discriminatory interventions

- put in place and publish protocols to manage potential conflicts between its roles as a participant in the market as a contractor for reserve energy and as a regulator.

Reserve energy

47 The Government wants the Electricity Commission to contract for reserve energy (generation and contracted demand response) to provide additional security of supply beyond the level achieved by the ordinary market. This will be a primary mechanism for the Commission in endeavouring to ensure security of supply in a 1 in 60 dry year. Any reserve energy procured to ensure security of supply in a 1 in 60 dry year should also be available to help cope with other unexpected supply contingencies, such as serious grid, plant or fuel supply disruptions.

48 The Government intends that the mechanism should operate as outlined below.

Quantity and type

49 The Commission's portfolio of reserve energy should be limited so that it is capable of producing no more than 1200 GWh of reserve energy over any given four month period. Transmission constraints and other relevant factors need to be taken into account in assessing the effective contribution of reserve energy to ensuring security of supply.

50 The reason for a firm maximum quantity is to ensure market participants have certainty as to the maximum role of the Electricity Commission in providing for reserve energy, and to minimise the risk of reserve energy affecting incentives for market participants to construct new capacity, enter into hedge and other contracts, and invest in demand-side management.

51 In contracting for reserve energy, the Electricity Commission should, as best it can, maximise static and dynamic efficiency. It should also take into account the additional flexibility provided by short term contracts.

52 Generation plant that is contracted as reserve energy should primarily comprise plant with low fixed costs and high operating costs, including plant that would otherwise have been mothballed or retired, rather than baseload plant.

53 In deciding whether to contract with existing plant, the Commission should take into account:

- the benefits of lower cost to the reserve energy scheme; and
- the potential detriments to security of supply and competition in the 'ordinary' market before replacement generation is commissioned.

54 Contracted demand response should form part of the Commission's portfolio of reserve energy, provided this is practicable, and the Commission is confident that the reduction in demand is additional to normal demand-side responses to higher prices.

- 55 The Commission should develop and publish its processes for procuring reserve energy including its processes for assessing competing offers of reserve energy.
- 56 The Commission should seek to minimise the impacts of the reserve energy scheme on the 'ordinary' market. The Commission should adopt a tight ring-fence whereby reserve energy may be used only for security of supply objectives, with the exception of distributed generation used for distribution network load management⁹. This will minimise the extent to which incentives to invest in ordinary generation and demand-side management are affected.
- 57 Contracts with reserve energy providers should provide for fixed payments for availability and variable payments when the reserve energy is called upon. Any spot price revenue received during operations should go to the Commission and be used for reducing reserve energy and other levies.
- 58 The Government has built a 155MW power station at Whirinaki for reserve energy use. Pursuant to the Electricity Act 1992, this power station will be available to the Electricity Commission by contract for the purpose of reserve energy.
- 59 For the avoidance of doubt, the Government does not want the Electricity Commission to own reserve generation plant.

Trigger mechanism

- 60 Reserve energy should be offered for dispatch to the system operator at 20c/kWh or the variable payments which have been contracted for, whichever is the higher.
- 61 However, if the minimum hydro zone is breached reserve energy may be offered for dispatch at a lower price to preserve hydro storage. If the minimum zone is breached and all available thermal generation is not being used to minimise hydro usage, the Commission should investigate the reasons and consider what action, if any, would be desirable.

Levy

- 62 The Commission is expected to recover some of the costs of contracting for reserve energy from spot market revenues when reserve generation operates. However, net costs should be recovered initially by way of a levy which is administratively simple and applies to all consumers based on wholesale purchases on an equal basis. (The levy should be reviewed as part of the overall review noted below).
- 63 Over time, the levy will aim to recover the net costs the Commission incurs for reserve energy (that is, operating and capital payments less any revenue received from the sale of reserve energy).

⁹ To ensure this exemption does not undermine the objective of a tight ring-fence, the Commission should define operating parameters carefully, including considering a cap on the MW capacity of the plant and on the number of hours a year the plant may operate for network management purposes.

Regulations

- 64 As noted, the Government considers it particularly important that the way the reserve energy mechanism operates should minimise any adverse impacts on incentives for investment in ordinary generation, demand side management, and management of price risks. Accordingly, it proposes to help provide regulatory certainty by specifying the key operational parameters of the reserve energy mechanism in regulations so that changes to those parameters can be made only by regulation. Furthermore, changes will be able to be made only on the recommendation of the Commission.

Review

- 65 The Electricity Commission should contract an independent third party to review the efficiency and effectiveness of the reserve energy policy in meeting security of supply objectives while minimising distortions to investment incentives in the ordinary market. Efficiency should include both static and dynamic efficiency. The review should take into account developments in other areas of security of supply policy such as security of supply co-ordination policy (see below).
- 66 The review should consider whether it is appropriate to relax the tight ring-fencing policy after considering any reduction in dynamic efficiency that this might create. The review should also recommend whether alternative levy arrangements would produce a fairer and more efficient outcome. In particular, it should investigate whether to allow for some element of self-provision of security of supply with an associated exemption from the levy, and if so whether the extent of any self-provision should be audited by a body independent of the Commission.
- 67 The review should provide an opportunity for public consultation, and should make recommendations to the Commission by 31 December 2006. The Commission should consider the report and make recommendations to the Minister of Energy by 31 March 2007.

Security of supply co-ordination

- 68 A key requirement for the secure operation of the New Zealand system is that hydro lakes are managed optimally to use as much water as possible while avoiding the risk of running out of storage, and that thermal plants have adequate fuel and operate in a timely manner to complement hydro generation and preserve lake levels when required. Risks of inadequate security of supply co-ordination will need to be monitored by the Electricity Commission.
- 69 Introduction of the reserve energy scheme may also impact on security of supply co-ordination. A risk is that (for example) hydro generators may observe the reserve energy and decide to run their lakes lower than they otherwise would have, or thermal generators might decide to procure less fuel.
- 70 The Commission should seek to minimise these risks by compiling and publishing high quality information, including on hydro lake levels, thermal fuel availability, scheduled plant and transmission outages and minimum hydro zones.

- 71 The Commission is also expected to be active in monitoring developments, using the powers available to it, and, if necessary, making recommendations to the Minister on any further powers it believes to be necessary to ensure the market operates efficiently. This may involve:
- undertaking 'co-ordination tenders' to incentivise (via payments) a combination of hydro storage and thermal fuel that is sufficient to achieve the security of supply standard over a short term timeframe (e.g. one year)
 - using the proposed additional powers in the Electricity Act 1992 to recommend regulations or rules, which should be applied in a non-discriminatory manner, to:
 - set minimum requirements on generators to hold or provide for reserve fuels (including water)
 - set requirements on generators to offer by tender a minimum volume of contracts that enable the price risks associated with the spot market to be managed, including requirements relating to the terms and conditions of those contracts (excluding prices and reserve prices). This would incentivise generators, if those contracts were taken up, to hold sufficient capacity and fuel to meet those contracts or to cross-insure with other generators for that purpose
 - set requirements on retailers and other direct buyers of electricity from the wholesale market to maintain minimum levels of hedge and contract cover with generators and/or minimum levels of demand-side management programmes and contracted demand response.

Conservation campaigns during security of supply situations

- 72 Although the Government wants the Commission to manage the electricity sector to minimise the risk of supply shortages, it recognises that there will be infrequent circumstances where there is a material risk of shortages (for example in a worse than 1 in 60 dry year). In this event, the Government expects the Commission to activate a conservation campaign in a timely manner, since conservation is significantly less damaging to the economy and less disruptive to consumers and public welfare than actual blackouts.

Use of ripple control of hot water heating during security of supply situations

- 73 The Commission is expected to ensure contingency arrangements are put in place for the use of ripple control of hot water heating for use as appropriate if conservation campaigns are required, and as a measure to temporarily reduce demand in events such as major and unexpected plant or transmission line outages. The Commission should recommend regulations and rules if required. (The use of ripple control for these purposes should not preclude its use for other purposes outside of security of supply situations).

Co-ordination of outages during security of supply situations

- 74 The Commission is also expected to put in place contingency arrangements to provide for the scheduling of rolling outages in the extreme event that blackouts are required to ensure a balance between supply and demand. The Commission should recommend regulations and rules if required.

System operation and wholesale and related markets

75 The Electricity Commission should take primary responsibility for achieving the Government's policy objectives for electricity in relation to:

- common quality and real time security
- dispatch and pool rules
- reconciliation and settlement
- information disclosure to improve market efficiency, including:
 - aggregate hedge and contract prices and volumes
 - offers by generators
- minimum prudential standards.

Hedge market transparency and liquidity

76 A transparent and liquid hedge market is a critical component of an efficient wholesale market. It enables market participants to manage their risks and facilitates retail competition. Concerns are regularly expressed that the current hedge market does not operate particularly well.

77 The Government has amended the Electricity Act 1992 to provide regulation-making powers to establish and promote hedge markets. As with other regulation-making powers, the Commission may only recommend regulations if it has first established that there are significant problems that are not resolvable through voluntary arrangements and co-operation. The regulation-making powers cover:

- disclosure of information on hedge and contract volumes and prices
- requiring generators to offer by tender a minimum volume of contracts that enable the price risks associated with the spot market to be managed, including the terms and conditions of those contracts (excluding prices and reserve prices)
- requiring generators to post buy and sell prices for hedge (including futures) contracts; and
- requiring buyers of electricity from the wholesale market to maintain minimum levels of hedge and contract cover with electricity generators.

Financial transmission rights

78 Under marginal cost nodal energy pricing, different locations experience different prices caused by transmission losses and constraints. The Electricity Commission should oversee the development of financial transmission rights (FTR) to enable market participants to manage risk in respect of transmission losses and constraints. A statement of policy concerning financial transmission rights is attached as Appendix One.

Transmission

Background

79 The way in which transmission services are provided and priced impacts directly and indirectly on all parts of the electricity industry, the economy and the environment. Transmission has strong natural monopoly characteristics, which makes it important that the Government sets out its policy expectations as to how transmission services should be provided and priced and how Transpower should operate. Poorly designed policies may, for example, encourage inefficient investment in generation, which would waste scarce capital resources and cause unnecessary environmental effects.

Objectives for the provision of transmission services

- 80 The Government's objectives for the provision of transmission services are that:
- the services are provided in a manner consistent with the Government's policy objectives for electricity
 - the services should be provided at the standards of power quality and grid reliability required by grid users and consumers as determined by the Electricity Commission
 - the efficiency of transmission services should be continuously improved so as to produce the services grid users and consumers want at least cost, and
 - the services are priced in a manner that:
 - is transparent
 - fully reflects their costs including risk
 - facilitates nationally efficient supply, delivery and use of electricity
 - promotes efficient investment in transmission or transmission alternatives
 - promotes nationally efficient use of transmission services by grid users and consumers.

Connection to and use of the national grid

- 81 The national grid is essential to all connected parties, and should be maintained and operated to a common set of grid reliability standards. These common standards should be embodied in grid rules that recognise the interconnected nature of the network.
- 82 Grid reliability standards should apply to agreements between Transpower and its customers dealing with connection to and use of the grid, investment planning (including replacement), transmission system design and construction, and transmission system maintenance.

- 83 The common standards for the grid should be determined by the Electricity Commission, following consultation with Transpower and affected parties. The Electricity Commission should ensure that the interests of end-customers are properly taken into account.
- 84 Transpower's customers should have some flexibility over standards (which could be higher or lower than the norm), so long as the integrity of the core grid is not compromised. The Commission should ensure that arrangements are in place to protect the interests of third parties when Transpower and one of its customers agree to a local variation from common standards.
- 85 All transmission customers should be required to have a transmission agreement with Transpower, and the Commission should develop a benchmark agreement as a default if the parties are unable to agree.

Investment in and maintenance of the transmission network

- 86 As part of its modeling and forecasting work, the Electricity Commission should provide for the development of statements of opportunities relating to transmission. These should:
- i incorporate electricity demand and supply forecasts
 - ii enable identification of potential opportunities for:
 - efficient management of Transpower's transmission network including investment in system expansions, replacements and upgrades
 - transmission alternatives (notably investment in local generation, demand-side management, and distribution network augmentation)
 - iii facilitate long term planning for timely securing of easements and resource consents
 - iv be prepared at least biennially.
- 87 Transpower should submit grid upgrade plans to the Electricity Commission for approval. The grid upgrade plans should be consistent with statement of opportunity forecasts and demonstrate the rationale for all expenditure (operation, maintenance and capital), taking into account the prescribed reliability standards. The plans should demonstrate that the proposed expenditure is required to meet reliability standards and/or deliver the greatest net benefit after taking into account transmission alternatives. The Electricity Commission should ensure that affected parties are fully consulted.
- 88 Where the Electricity Commission approves investment by Transpower, the cost of that investment should be recoverable by Transpower in accordance with the pricing methodology determined by the Electricity Commission.

Transmission alternatives

- 89 As part of its consideration of transmission investments, the Commission should ensure that transmission alternatives are properly considered to the extent practicable.

- 90 As part of its consideration of transmission pricing, the Commission should consider whether there would be net benefits in providing for a mechanism whereby investments in transmission alternatives receive payments reflecting some or all of the value of avoided transmission investment. This is a complex subject, and the Commission will need to take into account, among other things, practicalities, effects on incentives to invest in alternatives, and the extent of assurance that grid reliability standards will be met.

Pricing for connection to and use of the national grid

- 91 Transpower should determine its total revenue requirement (covering both sunk and new investments) subject to the constraints of Part 4A of the Commerce Act 1986. A transmission pricing methodology should determine how this total revenue is recovered from parties under the agreements for connection to and use of the grid. The transmission pricing methodology should include the allocation of any net FTR auction income, rentals and FTR-related payments.
- 92 The Electricity Commission should prepare and consult on a paper on pricing issues. The Commission should determine the pricing methodology after consideration of proposals from Transpower and consultation with affected parties.
- 93 Prior to the determination of a new pricing methodology by the Commission, the Act requires connected parties to continue to pay Transpower for connection and access to the national grid on the basis of Transpower's current pricing methodology.

Cost recovery and pricing principles

- 94 The Government expects transmission services to be priced as efficiently as possible and, subject to Part 4A of the Commerce Act 1986, Transpower's charges to recover the full economic costs of its services.
- 95 The principles to be applied by Transpower in developing the transmission pricing methodology, and the Electricity Commission in approving it are:
- the costs of connection should as far as possible be allocated on a user pays basis
 - the pricing of new and replacement investments in the grid should provide beneficiaries with strong incentives to identify least cost investment options, including energy efficiency and demand management options
 - pricing for new generation and load should provide clear locational signals
 - sunk costs should be allocated in a way that minimises distortions to production/consumption and investment decisions by grid users and consumers
 - the overall pricing structure should include a variable element that reflects the marginal costs of supply in order to provide an incentive to minimise grid constraints, and

- transmission pricing for investments in the grid should recognise the linkages with other elements of market pricing (including the design of FTRs).

Timetable

- 96 The Government recognises that implementation of new transmission arrangements will be very demanding on the Electricity Commission, Transpower and affected parties. Nonetheless, it is clear that important decisions on transmission are becoming urgent. Accordingly, the Government wants the Commission to meet the following timetable:

Development of draft benchmark agreements	June 2005
Publication of transmission pricing guidelines	December 2004
Approval of initial grid upgrade plan	September 2005 ¹⁰
Progress report on development of FTRs	June 2005

- 97 The Government requests the Commission to publish a detailed workplan for achieving these timetables, including intermediate steps.

¹⁰ Assuming that a public conference is not required.

Distribution

Distribution pricing methodologies

- 98 The Electricity Commission should develop in consultation with interested parties principles or model approaches to distribution pricing and monitor their uptake. The Commission should recommend regulations if required to ensure compliance.
- 99 The Government expects distribution companies to keep any changes to rural line charges in line with urban line charges. The Commission should monitor developments in rural charges.

Distribution use of system agreements

- 100 The Electricity Commission should develop in consultation with interested parties model use of system agreements for use by distribution lines. If the Commission thinks it necessary and beneficial, it may also recommend regulations. Arrangements should take into account the interests of consumers, retailers and distributors and should be consistent with:
- arrangements for connecting distributed generation to distribution networks (described later)
 - obligations imposed on retailers as a result of arrangements relating to contracts between retailers and consumers
 - arrangements covering distribution pricing methodologies
 - arrangements for the use of ripple control for load management, and
 - any other regulations promulgated under the Electricity Act 1992.

Interrelationship with the Commerce Commission

- 101 This section sets out the Government's expectations and intentions regarding the interrelationship between the Commerce Commission and the Electricity Commission with regard to the regulation of Transpower and electricity lines businesses by the Commerce Commission under the Commerce Act 1986 and the Electricity Commission under the Electricity Act 1992.
- 102 The Government expects the Commerce Commission and the Electricity Commission to work together closely to ensure that their respective roles are well co-ordinated, and to minimise any scope for uncertainties regarding jurisdictional issues.
- 103 Under the Commerce Act 1986 the Commerce Commission is charged with operating targeted control of electricity lines businesses including Transpower for the long term benefit of consumers. Under this regime, the Commission is required to set thresholds for electricity lines businesses, determine whether any businesses have breached those thresholds, and if so, consider whether to impose control on the prices, revenues and quality standards of those businesses¹¹. Where the Commerce Commission has declared all or any goods or services supplied by an electricity lines business to be under control, that business is unable to supply those goods or services unless an authorisation or undertaking relating to the price, revenue or quality of the services has come into effect.
- 104 Under the Electricity Act 1992, the Electricity Commission is empowered to make recommendations to the Minister of Energy on regulations and rules on a number of issues relating to:
- i power quality standards; reliability standards for the national grid; upgrades, expansions and replacements of Transpower's grid assets; terms and conditions for connection to the grid; and pricing methodologies for the recovery of Transpower's revenue requirements;
 - ii terms and conditions for the connection of generation to distribution lines;
 - iii pricing methodologies for the recovery of the revenue requirements of electricity distributors, and
 - iv terms and conditions for the use of lines (and related services) by competing retailers.
- 105 It is evident that the exercise of the Electricity Commission's functions, responsibilities and powers affects the work of the Commerce Commission, and vice versa.

¹¹ The Commerce Act, as amended in 2004, precludes the Commerce Commission from setting quality standards for Transpower.

- 106 The Commerce Act 1986 and the Electricity Act 1992 have been amended to:
- i require the Commerce Commission to take into account, when exercising its duties and powers under Part 4A of the Commerce Act 1986, any regulations and rules made under the Electricity Act 1992 (including any decisions made by the Electricity Commission under those regulations and rules), and
 - ii require the Electricity Commission to advise the Commerce Commission of any regulation, rule or decision made under the Electricity Act 1992 which is likely to affect the powers and duties of the Commerce Commission under Part 4A of the Commerce Act 1986.
- 107 The Government requests the two Commissions to develop and publish a Memorandum of Understanding on how they propose to operationalise the coordination of their respective roles.
- 108 The Commerce Act 1986 has been amended to allow responsibility for Part 4A to be transferred from the Commerce Commission to the Electricity Commission by Order in Council should there appear to be benefits in doing so. This transfer (after due process and consultation) may take place at any time with regard to Transpower, but may not take place before 1 April 2009 for other lines businesses.

Distributed generation

- 109 Distributed generation is generation which is connected to local distribution lines rather than the transmission grid. It is expected to play an increasingly important role in meeting electricity demand as the cost of smaller-scale and new renewable technologies continues to decline. Distributed generation can improve security of supply by creating diversity of fuel types, locations and technologies, and, where appropriately sited, helps reduce the need for transmission and distribution upgrades. Accordingly, it is important that there are no unnecessary barriers to its development.

Access to lines

- 110 The Government proposes to introduce regulations prescribing reasonable terms and conditions on which line owners and electricity distributors must enable generators to be connected to distribution lines. The objective is to facilitate the use of distributed generation by ensuring that it does not face undue barriers in connecting to lines. The Electricity Commission will have responsibility for administering the regulations and for proposing amendments as required.

Purchase of surplus generation by retailers

- 111 The Electricity Act 1992 provides powers to regulate terms and conditions for the purchase by retailers of small surpluses of electricity from generating units owned or operated by consumers.
- 112 It can be difficult for owners of distributed generation units to negotiate terms and conditions with local retailers to purchase small surpluses of electricity generation. High transaction costs are involved. The Government would like to see this barrier to the development and uptake of distributed generation reduced by setting appropriate terms and conditions for purchase of small electricity surpluses by local retailers. The Government envisages that this policy should apply to consumers with generation units capable of generating up to 40,000kWh over a year. A key principle however is that retailers should not incur ongoing financial losses by the requirement to purchase such electricity.
- 113 The Commission should seek to develop non-regulatory arrangements to achieve these objectives, but should recommend regulations or rules if voluntary arrangements are unsuccessful in achieving the policy outcomes the Government seeks.

Retail competition

- 114 The Government considers that competition between electricity retailers should, over time, help ensure that retailing costs are minimised, service quality is improved and downward pressure is placed on generation costs. Most consumers, especially in larger centres, have a choice of retailers, and the processes for consumers to change suppliers have steadily improved. However, the Government considers that retail competition is not as vigorous as it could be, and looks to the Electricity Commission to promote and facilitate retail competition, and to make recommendations to the Minister of Energy on any steps the Government should take, including regulating, to facilitate retail competition.
- 115 The Electricity Act 1992 provides a number of regulation-making powers relating to retail competition.

Terms and conditions for the use of lines and related services by competing retailers

- 116 The diversity and complexity of the terms and conditions offered by different lines companies for use of their lines is often cited as a significant barrier to expansion of retail competition. The Government considers that greater standardisation and simplification of tariff schedules and contractual arrangements will facilitate market entry by retailers.

The reconciliation of, and payment for, distribution line losses

- 117 Current methods for calculating, reconciling and arranging payment for distribution line losses by competing retailers are also often raised as a concern by retailers. The Commission should recommend regulations if it considers this is a material issue such that rules and regulations would facilitate more efficient outcomes and remove impediments to the effective functioning of the retail market.

Terms and conditions for access to electricity meters by retailers

- 118 Retailers must have ready and efficiently-priced access to end-use electricity meters in order to provide retail services. This is especially the case when retailers enter new market areas and/or customers wish to change retailers. By and large, access to meters does not appear to constitute a pervasive barrier to retail competition. However, there are regions where access has proven difficult and contentious, and the Commission is invited to consider whether regulations should be made to facilitate retail competition.

Arrangements to enable consumers to switch retail suppliers

- 119 The Electricity Governance Rules 2003 include detailed processes and procedures to ensure consumers are able to switch retailers with a minimum of inconvenience and cost. These rules are currently in operation, but the Commission should keep them under review, and make recommendations for improvement if required.

Availability of hedges

- 120 Independent retailers cite difficulties in obtaining hedges at reasonable prices from vertically integrated generator/retailers, which are their competitors, as a barrier to retail competition. The Electricity Act 1992 provides the Commission with a range of powers relating to hedge markets as described above. The Commission should exercise these powers if necessary to facilitate retail competition.

Accountability requirements

- 121 The accountability and reporting requirements for the Electricity Commission are set out in Part 15 subpart 2 of the Electricity Act 1992 and Part V of the Public Finance Act 1989.
- 122 The Government expects the Commission to prioritise work on the objectives and outcomes set out in this Government Policy Statement. The Government recognises that the Commission has a substantial task in front of it, and that it will take time to develop its capabilities and expertise. In terms of the Government's high level expectations, priority should be given to:
- Managing security of supply and implementing the reserve energy mechanism
 - Working with Transpower and grid users to facilitate priority investment in the grid
 - Promoting efficient use of electricity
 - Improving hedge market transparency and liquidity and demand-side participation.
- 123 In addition to the reporting requirements set out in legislation, the Commission should report at least quarterly to the Minister of Energy on progress against the Government's expectations in this Government Policy Statement.

Levy payments

- 124 The Government will seek an appropriation each year from Parliament to make payments to the Commission to enable it to perform its functions, powers and duties. These costs are to be recovered by way of levy from every industry participant (or class of industry participants) prescribed by regulations under section 172ZC of the Electricity Act 1992.
- 125 The Act requires the Commission, in preparing and recommending to the Minister its proposed appropriation, to consult with affected parties, and to advise the Government of the outcome of those consultations.

Status of existing Government Policy and Section 26 Statements

- 126 For the avoidance of doubt, all other previous Government Policy Statements on electricity market issues are supplanted by this Policy Statement.
- 127 The existing statement to the Commerce Commission under section 26 of the Commerce Act 1986 "Further Development of New Zealand's Electricity Industry" of February 2002 will be withdrawn.
- 128 A new section 26 Statement will be issued advising the Commerce Commission that this Government Policy Statement is a statement of the Government's economic policies within the meaning of that section.

Hon Pete Hodgson
Minister of Energy

Date: _____

Attachments:

One: Financial Transmission Rights

Appendix One

Financial Transmission Rights

Introduction

- 1 Under marginal cost nodal pricing, different locations experience different prices caused by transmission losses and constraints.
- 2 Financial transmission rights (FTRs) should be introduced to assist in the management of locational price risk resulting from transmission losses and constraints and to improve economic signalling (including the signals for new transmission investment). The loss and constraint rentals arising out of the spot market provide the appropriate underpinning for FTRs.
- 3 The Government's expectations in relation to FTRs are specified below.

Guiding principles for an FTR market

- 4 Realistic long term risk management mechanisms must be made available to end users and to competing retailers.
- 5 Economic efficiency is a critical goal that should be pursued in a robust but realistic fashion. The concept of economic efficiency includes the integrity of nodal price signals for price-sensitive generation, consumption and investment decisions.
- 6 FTR design and allocation should give priority to ensuring consumers have access to competitive markets, particularly in regions subject to transmission constraints, but otherwise have due regard to preserving continuity with established price relativities and commercial arrangements.
- 7 Pragmatic solutions must be developed which are implementable and enduring.
- 8 Transpower should not be required to take on commercial risk as a result of FTR arrangements without the agreement of Transpower's Board.
- 9 The design of FTR arrangements should mitigate and manage risk to distribution companies.

FTR policy framework

- 10 Transpower should continue to receive loss and constraint rentals, and should use the rentals to fund an FTR product.
- 11 A market for short to medium term FTRs should be introduced covering the interconnected grid (with or without spur lines).
- 12 Some or all of Transpower's off-take customers (including distribution companies and direct connect customers) should be offered a long term allocation of

FTRs.¹² If a distribution company prefers that its allocation be given to an agent appointed by the distribution company and approved by the Electricity Commission, Transpower should allocate the relevant FTRs to the agent.¹³ FTR recipients should be able to refuse an allocation.

- 13 Recipients of allocated FTRs should be able to put their FTRs into an auction and assign reserve prices in accordance with the process developed by the Electricity Commission. In this case, they should receive the value assigned to those FTRs by the auction (subject to the price exceeding the reserve). If the value assigned by the auction does not exceed the reserve price, the original recipient should retain the FTR.
- 14 Transpower should pass any excess FTR auction income (auction income not paid to those who put allocated FTRs back into the auction), residual rentals (rentals not utilised in the FTR market) and any income received as payment for an FTR allocation, less appropriate expenses, to those that pay Transpower's charges for sunk and new investments.
- 15 A distribution company should pass through rental-related or FTR-related cash flows to the distribution company's customers, retailers, and/or end users. The pass through should be transparent, should not discriminate between parties in a like position, and should as far as possible be non-distortionary. It should be consistent with the guiding principles for an FTR market, and in particular have due regard to promoting competition between retailers.
- 16 Distribution companies should be able to recover reasonable costs relating to their role under this policy statement.

Design issues

- 17 Design options considered by the Commission should specify (inter alia):
 - i The nodes to which FTRs should be allocated;
 - ii The methodology for offering an allocation of FTRs to distribution companies and Transpower's direct connect off-take customers;
 - iii Whether particular customers who pay for the sunk costs of specific assets should also be offered an allocation of FTRs relating to that asset;
 - iv The price, if any, to be paid for an FTR allocation;
 - v The hub or hubs (or a methodology for determining the hub or hubs) from which allocated FTRs will be defined;
 - vi A mechanism for approving the appointment of an agent by a distribution company;

¹² This focus on off-take customers does not preclude other customers from receiving a similar long term allocation.

¹³ Subsequent references in this policy statement to distribution companies should be read as applying also to an agent appointed by a distribution company to manage the distribution company's role under this policy statement.

- vii Methodologies for passing through rental-related and FTR-related cash flows from distribution companies to the distribution companies' customers, retailers, and/or end users;
- viii A process for deciding which FTRs allocated to distribution companies may or should be offered into the FTR auction, and a process for setting reserve prices. These processes should be consistent with the guiding principles for an FTR market, and in particular they should have due regard to promoting competition between retailers, and to ensuring an efficient FTR auction;
- ix The role, if any, of FTRs defined from generation nodes to a hub;
- x A mechanism by which allocations may be adjusted in response to changing circumstances, such as new network investment;
- xi The timing of the initial FTR allocation and auction; and
- xii The way in which FTRs are used to facilitate new transmission investment.