



**Submission to Electricity Commission on
Proposed Request for Appropriation for the
2006/07 Financial Year**

From

Contact Energy

31 January 2006

Overview

The Electricity Commission's annual appropriation consultation is one of the most important consultations the Commission undertakes each year. It is the main opportunity for the Commission's past performance and future intentions to be held to account, and as such plays a critical role in (hopefully) satisfying market participants that the Commission is undertaking its regulatory functions commensurate with best practice. Without this reassurance, the regulatory uncertainty faced by market participants will rise, resulting in very real cost impacts on consumers through potentially deferred investment and increased cost of capital.

Contact Energy believes that the Appropriation Consultation presents the Commission with an opportunity to present a clear message to industry about its overarching priorities and the objectives it will achieve over the coming year. The document therefore should reflect the relative importance the Commission accords to all the issues facing it.¹

In this context, Contact Energy is surprised and disappointed at the quality and presentation of the information contained in the Electricity Commission's discussion paper. We are surprised, because the level of information presented is essentially the same as that presented in the consultation document on the 2005/06 appropriation.² And we are disappointed, because the Commission seems to have completely disregarded the feedback that it received in response to that paper.

Further, we are concerned about some elements of the Commission's intended work priorities as they appear to go beyond the mandate given it through the Government Policy Statement (GPS). Even the perception of regulatory creep is damaging to investor confidence, even if it should subsequently be demonstrated that the Commission was acting within its mandate.

Previous stakeholder comments

Contact believes that an instructive starting point for considering this year's appropriation consultation is with the feedback given in response to last year's consultation.

Of the nine submissions that the Commission received in response to last year's appropriation consultation, six had serious concerns regarding the level of detail presented in the document. All of these six suggested ways that the appropriation consultation document could be made more relevant to facilitate a more meaningful consultation process. Unfortunately, the Commission has not taken up these suggestions, nor has it explained why it has chosen not to do so. The only reference that the discussion paper makes of last year's consultation process is in paragraph 10:

The level of detail presented in the consultation document has been raised with the Commission. Some parties have sought considerable detail, such as how much time the Board may spend on particular work, months in advance of that work actually

¹ For what it's worth, Contact's view of the key priorities for the Commission are work on transmission issues, particularly in the context of the Auckland security situation, transmission hedging, and coincident peak charging; and on the design and implementation of a capacity mechanism. These issues are detailed further in our response to the "Big Picture" issues, attached as an appendix.

² Electricity Commission, *Proposed Request for Appropriation for 2005/06 Financial Year*, 21 April 2005

starting. Other stakeholders have suggested that budget at the workstream level is quite suitable for them.

Contact suggests that this is a disingenuous description of last year's submissions. What was requested in the six submissions was more information, not necessarily minute detail. Contact is disappointed that the Commission seems to dismiss stakeholders' concerns with the consultation process in such an offhanded way. Further, it is not clear who the stakeholders are who indicated that the current consultation format is "quite suitable," as the three submissions who did not request further information did not mention the matter at all.

Relevance to current consultation

Contact believes that the recommendations presented in last year's submissions are equally relevant to the current appropriation consultation process as to the previous one. Further, the degree to which the submitted recommendations seemed to echo one another suggests that there is a high degree of consistency of opinion among stakeholders on these matters. Contact therefore hopes that the Commission will give serious thought to implementing these recommendations in subsequent appropriation consultations.

Elements that should be included

Following is a list of elements that Contact considers should be included in a meaningful appropriation consultation document and which are missing from the current and previous document. In many cases, there is a high degree of consistency between our recommendations and the comments provided in last year's appropriation consultation.

1. *Statement of the Commission's work priorities*

The Commission's view of its own work priorities is conspicuous by its absence in the consultation document. The document instead identifies "key proposed activities," of which there are 63 in total. It is not credible to suggest that all 63 of those items are equally important, yet nowhere in the document is there an indication of which of those work streams the Commission considers a priority.

The GPS specifically requires the Commission to "prioritise work on the objectives and outcomes set out in this Government Policy Statement."³ It is not clear that this has been done, and it should be the starting point for developing the Commission's budget. Contact submits that an articulation of the Commission's priorities, and an explanation of the basis for those priorities, including how they relate to the GPS priorities, should be an essential component of any future appropriation consultation. The appropriation consultation should also recognise the inter-related nature of the various work areas of the Commission, and it should give some indication as to how the Commission proposes to progress and manage interconnected work streams that are progressing in parallel.

Further, it is not clear what feedback the Commission has had regarding stakeholders' views of priority work issues. The discussion document notes that the Commission has used industry feedback on "Big Picture" issues. However, the

³ para. 122

Commission has not published those responses on its website, nor has it produced a summary of those submissions. As a result, there is also no indication of what stakeholders see as the Commission's priorities, either on the EC website or in the discussion paper. The discussion paper states that certain topics were a "major theme" or attracted "significant comment," but no attempt has been made to quantify these statements. For example, the paper states that there was "strong support" for resolving load management issues – but Contact does not consider this issue to be a priority in the current context, and we wonder how many stakeholders listed it as a priority issue.

In addition, it is not clear how much weight the Commission accords the stakeholder feedback on big picture items. The document notes that stakeholders did not identify forecasting and modelling work as priorities, yet the Commission "puts a high priority on developing quality"⁴ and has listed 8 key proposed activities under this heading.

Contact urges the Commission to publish the responses to the "Big Picture" issues request immediately, along with any summary that was presented to Commissioners. Not to do so would create the perception that such exchange-of-views exercises are simply going through the motions, further increasing the perceived regulatory risk to potential investors.

2. Objectives, Major Tasks and Sub-Tasks

Contact submits that the Commission's priorities should flow down to its objectives for the year, and then to the major tasks that fall under each objective, and, where appropriate, to the major sub-tasks under each major task. We believe that each of these levels should be explicitly outlined in the appropriation consultation document, so that each piece of work proposed by the Commission can be linked back to one of the Commission's priorities as well as to a specific GPS requirement.

Further, Contact suggests that the objectives, major tasks and sub-tasks should, to the extent possible, be expressed in terms of measurable outputs and should have estimated dates of completion for each.

This outline approach to presenting the proposed pieces of work – starting with priorities, moving to objectives, then major tasks and sub-tasks – would enable stakeholders to see more clearly the linkages between the proposed work and the Commission's requirements under the GPS. Expressing the work in terms of measurable outputs with deadlines would give a clearer picture of the work the Commission expects to bring to completion during the year. Both of these enhancements would facilitate a better understanding among stakeholders of what outputs their levy payments are "buying" and would lead to a better consultation process.

Such an approach should also facilitate better expression and understanding of the inter-linkages *between* different workstreams. Not to explicitly address these inter-linkages risks poor outcomes.

Objectives

Contact suggests that Objectives be defined in terms of relatively high-level goals that the Commission intends to achieve over the coming year. They should flow logically from the Commission's statement of its priorities. For each objective, we believe a specific measurable performance indicator or milestone should be identified, along with a date that it is expected the milestone will be reached.

⁴ Page 26

Major Tasks and Sub-Tasks

From the Commission's objectives should flow the specific pieces of work necessary to accomplish the high-level objectives. These proposed major tasks should also explicitly link back to GPS requirements. They should be outcome-focussed and have target dates for completion. Where possible, these major tasks should be broken down into key sub-tasks, also with target completion dates. For example, one of the Commission's proposed major tasks might be to develop and implement a certain piece of regulation (by a certain date); key sub-tasks under this heading might include the expected dates by when:

- the issue will be considered by the relevant Advisory Group;
- the issue will go out for consultation; and
- a decision on the matter is likely to be made.

In addition to enhancing the quality of the consultation process, providing this level of detail will enable stakeholders to anticipate when input and consultations on specific topics will occur, and thus allow them to prioritise their own workloads in response. This should improve the quality of information stakeholders are able to provide for the various consultations, leading to better informed decisions by the Commission.

3. Budget Estimates at the Major Task Level

Contact submits that budget estimate information should be broken down to the major task level. We do not understand the distinction that the discussion paper attempts to make between "appropriation" and "detailed budget."⁵ The appropriation request is an aggregation of the detailed budget items. In our view, without an understanding of the budget elements, it is not possible to understand the appropriation request.

Contact reminds the Commission that it is required to consult on the proposed appropriation, not merely solicit feedback on proposed work areas. Therefore, sufficient detail must be provided about the proposed appropriation to allow for considered and informed comment. Simply stating that the proposed budget allocation for transmission, for example, is \$3.433 million, without any other context, is just not meaningful.

In addition, we submit that, while the Commission is involved in a significant amount of ongoing work, very little of this work could be classified as routine. Therefore, thinking about the Commission's budget in terms of a baseline is incorrect. There are few baseline functions that the Commission is responsible for. Rather, the Commission is charged with developing and implementing new regulations or other arrangements. This suggests that, rather than starting with a baseline budget, the Commission's proposed budget should be built up through adding together the estimated costs of all of the Commission's proposed work tasks.

Providing proposed budget amounts broken down to the major task level would provide stakeholders with information that would allow them to weigh the merits of pursuing one major task over another. Resources are limited, and it is appropriate that stakeholders be given sufficient information to make a judgement about which proposed pieces of work are likely to provide the most value for money in the current context. A proposed piece of work might be worthy of doing, but its cost or its focus

⁵ Paragraph 11(a) of the discussion document states "The workstream level provides a sufficient breakdown to enable understanding of the appropriation, and the consultation is on the "appropriation", not a "detailed budget."

might mean that it is more appropriately deferred – or brought forward. Including budget estimates on proposed major tasks will therefore allow stakeholders to comment more meaningfully on the Commission’s proposed appropriation.

4. Meaningful Measures of Last Year’s Achievements and Expenditures

The Commission is now an established government agency, which means that budget proposals for the Commission no longer need to be developed in a vacuum. There is now a record of prior year budgets and performance against objectives, and this record should be used to inform the present budget proposal.

Contact submits that this step is where the development of the current year’s budget proposal should start – with an objective assessment of last year’s achievements and expenditures compared to last year’s objectives and budget. Thus, for each objective, major task, and sub-task proposed for the previous year, the appropriation consultation document should provide a brief indication of the outcome, in terms of extent to which the item was achieved, and thus which items will carry over into the following year. Providing a list of activities over the previous year, as the consultation document does, gives no indication of the degree to which last year’s objectives and key tasks were achieved.

Further, an indication of actual spending over the previous fiscal year should be given. The consultation document provides actuals for 2004/05, but only budgeted amounts for 2005/06. There is thus no indication of how accurate the forecast budget was for the immediately preceding year, which is the most relevant comparison. Contact realises that the 05/06 year is not yet over, so actual expenditures are not possible to list for the entire year, but year-to-date actuals would have been a useful indicator. Alternatively, as the consultation document states that “the Commission has had one year of being close to fully staffed,”⁶ perhaps the previous 12 months of actual budget data could have been provided.

5. Timing

The Electricity Act stipulates that the “Commission must, before submitting a request to the Minister seeking an appropriation of public money for the following year, or any change to an appropriation for the current year, consult with those industry participants who are liable to pay a levy under section 172ZC about that request.”⁷ Yet, according to Contact’s understanding of the budget process, budget bids have already been submitted to Ministers. The timing of this consultation process therefore suggests that the Commission has not fulfilled its statutory obligations in this regard. Contact submits that in future years, stakeholders should have the opportunity to participate in the formation of the budget bid *prior* to it being submitted to the Minister.

For the current year, Contact expects that the results of this consultation will be fully represented to Ministers in the bilateral budget process.

⁶ Para 37

⁷ Section 172ZCA

Specific Comments

Contact has specific comments about the Commission's proposed work areas. We reiterate our concerns that, as presented, the proposed activities do not indicate the priority the Commission accords them, do not include timeframes, and are not explicitly linked to GPS requirements. The addition of this contextual information would have facilitated meaningful feedback on the proposed activities. Nevertheless, we provide our comments on the Commission's proposed activities below:

Transmission

Contact continues to believe that Transmission should be the Commission's primary focus. Thus, on the face of it, we support the Commission allocating nearly 40% of its budgeted workstream funds to the transmission area, although we would have preferred the Commission to compare the proposed amount with actual expenditure levels for the previous year to date or 12 months, as stated above.

In general, we support the Commission's proposed activities under the Transmission workstream. Specific comments on the proposed activities follow:

- Draft Benchmark Transmission Agreements (ii): Contact would like clarification on whether this work will address the counterparty issue
- Locational Transmission Pricing (vi): This work is relevant to the way existing as well as new grid investment is priced. Contact considers that there is no reason to distinguish new and existing grid investments in the pricing framework. This reasoning is developed in our cross-submission on HVDC pricing.
- Incentive-based Regulations (ii under "other proposed activities"): It is not clear what is meant by this point. Contact requests clarification that this work would consider ways in which Transpower could be incentivised to manage outages. If this is the case, then we would support the work.

Security of Supply

Contact strongly supports the development of alternative measures to ensure security of supply, particularly market-based measures. We therefore believe that this work has close links with the wholesale and hedge market design work.

In terms of specific comments, there seems to be a degree of overlap between the proposed activities, so it is not clear whether they are separate activities or different aspects of the same one. The first point under "Key proposed activities" mentions a review of the reserve energy regime; point (vi) lists an investigation of alternative means of attaining security of supply; and point (i) under "other" lists design work to implement alternative means. Contact submits that more complete information about the security of supply work, and the steps that the Commission intends to undertake to advance this work, would be useful to stakeholders.

Wholesale Market

Contact submits that one of the biggest issues in terms of wholesale market design is the impact of wind on the system. It is very important that all the ramifications of an increasing amount of wind generation are considered and that the market design reflects these ramifications appropriately. The eventual ways that the market accommodates wind generation will have an effect on the value of wind generation investments, as well as other generation investments. This issue should therefore be

considered as a priority, as investment decisions that are being considered now will be affected by the eventual market design.

Wind generation is mentioned in the key proposed activities in terms of the refinements in trading rules that might be required, but the issue is more extensive than that. There are also the wider impacts of wind. Wind is an intermittent source, so thought must be given as to how wind generation should be backed up, and whether the current energy-only market design delivers the right signals to participants to invest appropriately.

Other points:

- Contact questions the inclusion of demand side bidding and forecasting (ii) as a priority. This is an issue that has gained little traction over the past several years, and we do not consider that it is a priority in relation to more pressing issues of market design
- Weekly wholesale market reports (iii under Other): Contact notes that the Commission already produces weekly reports that are published on the its website. Does the inclusion of this activity under “other” suggest that the Commission intends to devote more resources to this activity?

Retail Market and Distribution

There are some important issues that need resolving in the retail area. Contact agrees that work on the model approach to distribution pricing is a priority, as is work on improving the reconciliation process. Contact submits that the list of key proposed activities should also include developing measures to identify controlled load profiles and differential pricing to uncontrolled profiles.

Other specific points:

- Identify measures for improving competition (5th point under retail market development) and monitoring measures relating to retail competition (7th point under market operations): Promoting and facilitating competition is the purview of the Electricity Commission; however, Contact believes that any contemplated measures to improve competition in the retail sector will have to be very carefully considered in terms of their effects on the market. Contact is concerned to see the priority status accorded this point, as the work to measure competition in the industry has only recently begun, and thus there is no clear indication of the extent to which the quality of retail competition is lacking. The Commission appears to be pre-judging the outcome of this work. Contact submits that this proposed activity should be de-emphasised pending the outcome of the competition measures work.

In regard to the proposed activity to monitor measures relating to retail competition activity, Contact is unsure of which measures the Commission means. Retail market statistics are already collected and published by the Commission, and Contact supports this activity. But if the proposed activity contemplated the monitoring of measures to improve competition (discussed above), then we consider this point to be premature, as it not only pre-judges the competition measures work, but also the process involved in implementing any identified regulatory option.

- We question the need and the justification for some of the identified activities, including: identifying and developing market guidelines to assist existing and potential market participants; identifying and developing rules for enhancing the performance of the market (6th and 7th points under retail market development);

and developing pricing and competition information (2nd point under retail consumer protection)

The GPS does not address these activities, and nor does the consultation document address why the Commission believes these activities are priorities. While assisting market participants and enhancing the market sound like worthwhile activities, the Commission must be selective in those things that it considers priorities, given limited resources. Contact submits that the priorities of the Commission should be strictly limited to those activities that directly relate to its responsibilities under the GPS. Other activities might be useful or desirable, but the merits of activities outside the GPS should be explicitly debated by market participants and government before they are proposed in an appropriation document. Contact therefore does not support these activities in this context.

System Operations and Common Quality

Contact is supportive of the proposed activities, particularly those that relate to the intermittent/wind generation integration work.

Forecasting and Modelling

Contact strongly disagrees with the proposed activity to forecast retail electricity prices. Contact is firmly of the belief that price forecasting should not be the responsibility of a government regulator.

Price forecasts are, by their very nature, imperfect. And given the range of uncertainties in the electricity market, there are significant margins for error. However, such forecasts are undertaken by a range of market participants to help guide their decisions in such areas as hedge management and investment in new plant. The combined effect of these forecasts and other market sentiment contribute to the price discovery process.

The danger of the Commission undertaking and publishing such forecasts is due to the fact that the Commission is an entity which has the powers to regulate (or at least recommend regulations) if it feels that the market is not working as it "should". This very fact means that such forecasts will carry a lot more weight than those produced by market participants. As such there is a grave danger that they will interfere with the price discovery process.

It is highly conceivable that hedge negotiations will start to be undertaken with reference to the Commission's forecasts, potentially adversely interfering with participants' risk management. Even more worrying is the potential that it will start to affect participants' investment decisions. If the Commission's long-term forecasts were lower than those of a market participant considering an investment in new plant, even if the participant thought that their forecasts were 'right' and the Commission 'wrong', the very fact that the Commission has considerable powers to recommend regulations and alter prices to levels it believes are more acceptable means that the participant may be deterred from making such investments. In this way, the long-term dynamic efficiency of the market may be impaired and supply security affected.

Market Governance

Contact has no specific comments to make under this topic.

Electricity Efficiency

To the extent that the Commission can act as a catalyst and promote energy efficiency measures that otherwise would not happen, we believe the Commission has a useful role. However, the Commission must be very careful how it undertakes this role, as it may find itself distorting the electricity and/or energy efficiency retail markets, or crowding out or disincentivising private investment in energy efficiency measures.

As we set out in detail in our submission on the Funding Programme for CFLs, the heart of our concern relates to the Commission's intention to run competitive selection processes to pick "winners" who will receive the Commission's exclusive support in a particular area. Contact would urge that this approach be revised, as detailed in our CFL submission.

Appendix: Extract from Contact's response to "Big Picture" Issues

Resolve the Auckland transmission issue – Highest priority

We support the Commission's process for evaluating the best option for meeting Auckland's future transmission needs, although we are concerned about the apparent level of disagreement between Transpower and the Commission on some fundamental technical issues. To this end, we would encourage greater involvement of the industry in deliberating on such technical issues and the detailed design of the Grid Investment Test. Unless there is strong buy-in from key stakeholders to the process and its outcomes, there is a likelihood that the Auckland upgrade decision will get even more political with consequently poor outcomes.

More immediately, we are very concerned about the security situation for Auckland for the winters of 2006 and 2007. However, we note that a number of industry initiatives are starting to happen on this front, and are hopeful that the issue will be resolved by next year through the appropriate resources having been devoted to the issue in the meantime.

Market design improvements

Transmission hedging and nodal / zonal pricing – High priority

At the moment, there is no mechanism through which price differentials between nodes can be hedged. This situation frustrates the operation of the hedge market and competition in retail, as evidenced by the reduced numbers of retailers in areas exposed to particular locational risks. It also creates distorted short-term signals for generation and retail behind transmission constraints. The lack of a transmission hedging mechanism is a clear market design failure that needs to be addressed and should be accorded a high priority.

In this respect, we are aware of the direction that the Hedge Market Development Steering Group is heading with regards to measures to improve the liquidity and transparency of the hedge markets, and we are highly supportive of them including consideration of a regional rebate mechanism (RRR) to allocate constraint rentals on a proportional load basis. Such an approach is an important first step in providing a viable transmission hedging mechanism.

Nodal pricing is an economically pure mechanism for delivering efficient dispatch and long-term investment signals. However, with this purity comes substantial transaction costs through greatly increased complexity in trading, and participants having to cope with hard-to-manage transitory phenomena such as spring-washers caused by temporary transmission outages. As well as hindering more liquid energy hedge markets, full nodal pricing may also require a more highly complex transmission hedging mechanism.

Accordingly Contact submits that consideration be given to whether simpler zonal pricing and/or zonal transmission hedging mechanisms could deliver the same dispatch and investment efficiency, but with simpler transmission hedging arrangements and more liquid and efficient markets. Such arrangements will not make transitory phenomena such as spring-washers and within-zone constraints disappear, but Contact believes that it could be possible to adequately address such issues with explicit arrangements that do not create such a large overhead on the "normal" market trading arrangements.

Appendix: Extract from Contact's response to "Big Picture" Issues

Coincident peak charging – High priority

Contact believes that transmission charging on the basis of contribution to regional system peak would create incentives to lower demand at this time of great stress. Our analysis suggests that in the Upper North Island this could unlock 40MW from better use of hot water alone, and potentially much more through more dynamic industrial response. Not only would coincident peak charging be more economically efficient, but we suggest that it could be the most cost-effective risk mitigation measure for the Upper North and South Islands, and we urgently urge its introduction as an easy "quick win" that could also make a material impact on the most pressing security situation we face.

Capacity mechanisms – High priority

Historically New Zealand has primarily had a requirement for infrequently-used MWh energy capability to cope with dry-years. An increased proportion of thermal generation may gradually reduce the scale of impact, although a greatly increased proportion of wind generation may exacerbate this effect .

Increasingly, however, New Zealand is also starting to face MW capacity constraints in certain locations behind transmission constraints.

In the future, high wind penetration levels may further exacerbate MW capacity constraint issues. This is because the variability of wind gives rise for two MW capacity requirements: highly flexible firm plant to balance the variations; and some infrequently-used capacity for periods of high demand when the wind is hardly blowing at all. It is likely that New Zealand's hydro capability will be able to fill much of this balancing / reserve requirement. However, Contact suspects this is likely to be limited to a greater or lesser extent , requiring additional thermal and/or demand-side response to fulfil this role.

It is not clear that an energy-only market won't deliver sufficient investment to provide energy and capacity security. Certainly, there is a wave of new generation coming forward (including a lot of wind) with a total potential greater than required. However, Contact suspects that due to the free-riding problem , plus significant information problems (participants evaluating highly complex phenomena), a non-optimal outcome may emerge characterised by insufficient demand-side response and insufficient firm flexible generation.

We therefore believe that a key long term work programme should be in evaluating market design elements such as capacity mechanisms which will better encourage peaking generation and demand side response for both dry-year and MW capacity issues.

Although it appears that we may have a couple of years grace before any current potential inadequacies in the energy-only market design manifest themselves, we note that investment decisions in significant amounts of wind and thermal generating capacity are likely to be made in the next few years. We believe that a well-focused and resourced workstream in this area is required in order that certainty can be introduced to market participants making such investment decisions, even if the decision is to continue with the current energy-only market design.

Contact understand that there is work underway to establish the extent of potential problems (wind, alternative mechanisms for dry-year security, demand-side response), and we support such initiatives. However, we maintain that having a market design that is robust to a range of potential physical scenarios will result in more optimal outcomes whatever the future may hold.

Appendix: Extract from Contact's response to "Big Picture" Issues

Simplification of network charging structure – Medium priority

At the moment, there is great diversity and complexity of charging structures among all the different network companies. This creates high fixed costs of entry for retailers, and is having the result that retailers are concentrating on those network areas with the highest customers. Contact submits that simplification of these charging structures would remove a significant barrier to retail market competition.

Locational Transmission charges – Medium / low priority

"Postage Stamp" pricing means that all users of the grid pay for the cost of a transmission upgrade, rather than just the parties who benefit from it. This dislocation of costs and benefits can lead to inefficient outcomes. Locational charging would assign the costs to those who benefit, thus enhancing efficiency. However, there are drawbacks to locational charging which need to be addressed, namely the potential for significant price shocks, plus significant complexity in their implementation

Demand-side response – Medium / low priority

Allowing greater participation of the demand-side in the market will promote greater efficiency of electricity use. Contact supports the process already in place on this front.

As part of this effort Contact believes greater priority should be given to developing the profiling mechanism to enable recognition of controlled profiles. This would enable retailers to pass on the greater price benefits of controlled meters to consumers, encouraging their uptake. This in turn would provide a greater amount of controllable load to the market, thus enhancing real-time security of the electricity system.

One aspect of developing greater demand-side response that should be explored is the development of a day-ahead market. In addition to facilitating greater demand response, particularly from the industrial sector, it would more appropriately reward firm generating plant and deal with costs of unpredictability.