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Dear Carl

Scarcity Pricing Arrangements – Proposed Design

BusinessNZ is pleased to have the opportunity to provide a submission to the Electricity Authority on its consultation paper entitled 'Scarcity Pricing Arrangements – Proposed Design' dated 29 March, 2011.[1]

Introduction

Consistent with the view set out in its submission to the Ministerial Review of Electricity Market Performance, BusinessNZ supports the introduction of scarcity pricing.[2] However, it is increasingly apparent that as progress on this issue has been made, BusinessNZ's ability to support its introduction has diminished to the point that it cannot support the proposed design, preferring instead the status quo until a less complex and intrusive alternative to addressing the problem is conceived.

BusinessNZ has set out a number of comments to expand on this view, below.

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[1] Background information on BusinessNZ is attached in Appendix One.

[2] BusinessNZ submission to the Ministry of Economic Development entitled 'Improving Electricity Market Performance', dated 16 September, 2009, page 7.

Specific Comments

BusinessNZ's comments (in no particular order of preference) are as follows:

1. the Electricity Authority seems unable to definitively settle on the problem that the 'missing money' predicament is intended to address. While it is undoubtedly true that:

   > "supply emergencies can take different forms, depending on whether they reflect a shortage of generation capacity in the immediate period or insufficient energy and/or fuel supply to meet projected demand over coming weeks or months"[3]

   this does not mean that scarcity pricing should be designed as multiple responses to both issues. While BusinessNZ appreciates that both capacity and energy/fuel issues are inextricably interwoven, in the case of scarcity pricing, an energy or fuel shortage must be seen as symptomatic of a shortage of capacity, rather than as equal causes.[4] This characterisation sheds some light on the nature of the primary problem scarcity pricing seeks to address, that is, a capacity adequacy problem or more specifically a peak capacity adequacy problem. In this regard, BusinessNZ also takes its cue from the Electricity Authority's consideration of the other reasonably practical alternative – that of *capacity payments*.

   In simple terms, BusinessNZ understands scarcity pricing to be a tool that provides the incentives that will deliver sufficient capacity (this could be either thermal or hydro capacity or demand reduction) to deliver sufficient energy to avoid the need to suppress prices. The mechanism is therefore primarily intended to provide hydro-generators[5] with the incentives to better manage their fuel stocks via contracts with thermal capacity;

2. the dissection of the problem and the solutions into multiple parts makes the solution set overly complex and extremely difficult to assess in terms of the effectiveness of the component parts. Not only is the proposed solution set expected to directly address both capacity *and* energy problems, but sub-sets of issues within these broader categories. In addition, decisions with regard to the customer compensation campaign have only just been made yet are to be

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[3] Electricity Authority consultation paper entitled 'Scarcity Pricing Arrangements – Proposed Design', dated 29 March 2011, page 17, paragraph 45.

[4] In a dry year, it is generally acknowledged that New Zealand is energy rather than capacity constrained. However, in the context of scarcity pricing, BusinessNZ considers the distinction between capacity and energy to be an artificial one – hydro-generation capacity with no water makes the presence of that capacity irrelevant. In this case, only thermal capacity, or well-fuelled hydro-capacity will matter.

[5] Except for the mythology that has emerged around 2001 there has never been, to BusinessNZ's knowledge, a shortage of thermal fuel stocks that would warrant the (mis)use of a scarcity pricing-type mechanism.

addressed (again) by the proposed scarcity pricing mechanism. The arguments for doing so are extremely weak in BusinessNZ's view.

It is BusinessNZ's strong preference that scarcity pricing solutions are aimed at a clearly identified and material market failure and that, consistent with its view that waiting has an option value, while the costs and benefits are uncertain, adding additional aggressive policy interventions to force greater action risks creating unwarranted market distortions and imposing otherwise avoidable price shocks on to both businesses and consumers. BusinessNZ's advice is that small steps be used initially so that their effectiveness can be assessed. If responses are inadequate, the original intervention can be intensified or additional measures can be deployed. If instead aggressive interventions are applied now to the same problem, then it will not be possible to assess which intervention to intensify if responses are inadequate because the effects of the different measures will not be separable.

While the Electricity Authority has assessed the next reasonably practicable alternative (capacity payments) against the Code amendment principle 4 (a preference for small scale 'trial and error' options), BusinessNZ sees no such analysis for its preferred option against the status quo. BusinessNZ considers that the multi-faceted scarcity pricing mechanism as proposed by the Electricity Authority would require significant changes to a number of aspects of the wholesale market and could not be regarded as incremental in nature. Despite this, the Electricity Authority's preference is, based on largely speculative analysis, to continue to tinker with the instantaneous reserves settings and implement three price floors;

3. BusinessNZ does not understand why the Electricity Authority has so readily dismissed the option of a price cap, with consideration of it relegated to Appendix G, pages 150 – 152 of the 152 page consultation paper, when as recently as November 2010 the Scarcity Pricing and Default Pricing Technical Group considered a paper entitled 'Scarcity Pricing – Price Capping Mechanisms'.[6] Importantly, BusinessNZ notes the strictly factual description of the summary of scarcity pricing mechanisms in other energy-only markets – the three of which *all* employ price caps.

   BusinessNZ agrees that that trying to avoid price suppression induced by demand restraint is appropriate, but is unclear given the analysis set out in the technical group paper how this has lead to a preference for price floors rather than a price cap, or greater involvement of the demand-side. BusinessNZ appreciates that section 42(1)(a) of the Electricity Industry Act states that the Electricity Authority must:

   > "have amended the Code so that it includes all the matters described in subsection (2) (the **new matters**);"

[6] Paper dated 11 November 2010, for 18 November 2010 technical group meeting.

where one of the new matters listed (section 42(2)(b)) is:

> "imposing a floor or floors on spot prices for electricity in the wholesale market during supply emergencies (including public conservation campaigns):"

However, section 42(1)(b) provides an important exclusion in stating that to the extent that the Code does not include all the new matters, then the Electricity Authority must have delivered to the Minister a report that must:

> "(a) identify which new matters are not included in the Code; and
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> (b) explain why the Authority has not amended the Code to include those matters; and
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> (c) suggest alternative methods by which the matters are or may be provided for; and
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> (d) set out if, when, and how the Authority proposes to provide for the matters."

Strict adherence to the implementation of price floors, even for public conservation campaigns) is not required if better alternatives exist. BusinessNZ considers that a price cap warrants additional serious investigation. As noted in the technical group's paper, in the absence of a fully functioning demand-side market, a price cap can be seen as a default demand side bid – in the sense that buyers would rather be curtailed than consume energy at prices above the cap and it would provide protection against very high prices arising from an extreme event, and from the exercise of market power (as any bids over the scarcity price would be higher than the price at which consumers would curtail demand and would be the extraction of a monopoly rent). While a market-based mechanism (such as a day or week-ahead market) via which consumers choose to curtail demand in response to price would be most preferable, a price cap in turn, is likely to be preferable to a series of price floors;

4. the cost-benefit analysis is likely to be substantially over-stated for at least two reasons:

    (a) the extent to which the proposed solutions signify a positive move from a sub-optimal state of security to an optimal state. Public information from Transpower regarding the state of system security seems to imply that there is no security problem at least until about 2020; and

    (b) recent market pricing events suggests that the more conservative alternate case used by the Electricity Authority (of $5,000, based on the Whirinaki pricing strategy) is insufficiently conservative.

Both of these factors suggest that the range of net-benefits is likely to be somewhat less than the worst-case $19 to $24million outlined in the consultation paper. BusinessNZ also understands that there is little, if any, incremental benefit between a scarcity price for the public conservation campaign and a scarcity price for rolling outages. In light of this, BusinessNZ would also be extremely interested in understanding how the costs and benefits of each individual intervention measures up.

In addition, consistent with BusinessNZ's view that waiting has an option value, where interventions cause market changes that are uncertain but irreversible, policy design should set a higher cost/benefit threshold. An incorrect decision by the Electricity Authority may potentially impose very large costs on businesses and the economy. Such costs occur through distorted resource use and reduced investment and innovation (that is, they impair allocative and dynamic efficiency). Reduced investment results in a compounding loss of value that may become quite substantial over a long period;

5. the information disclosure-related proposals are at best ill-conceived, and at worst naive. It is highly likely that the costs of such a proposal will outweigh its benefits, and in any case, it is likely to be impossible to measure the success of policy interventions targeted at eliminating lobbying. In addition, such proposals seem unduly prescriptive. It is BusinessNZ's strong preference that in light of the implementation of a scarcity pricing mechanism, market participants face the accountability of their risk management actions through the incentives signalled via the market. Alternative proposals should be abandoned;

6. BusinessNZ was surprised to see analysis of a capacity mechanism as the other reasonably practicable option. Responses to an Electricity Commission consultation paper as long ago as December 2009 showed that this alternative had no support amongst stakeholders. BusinessNZ is therefore mystified as to its inclusion in this most recent consultation paper particularly when the analysis is clearly at a point of determining implementation detail. In light of this, it would have been more appropriate to have given the option of a price cap that status; and

7. the over-riding sense from the consultation paper is that further analysis of this mechanism and how it would be implemented is required. In particular, the extent to which scarcity prices will fall on electricity users who have for legitimate risk management reasons, decided not to be fully hedged, specifically those who have limited operational flexibility to shift production in a way that reduces energy off-take from the grid. Without careful consideration of this and other factors, the use of scarcity pricing as a mechanism aimed primarily at

generators could simply destroy economic value in the productive sector.

Summary

BusinessNZ considers that a scarcity pricing mechanism has a role to play as a measure to assist with avoiding periods where price formation has failed to adequately reflect appropriate incentives for efficient investment in demand and supply side capacity. Scarcity pricing is, in BusinessNZ's view, likely to drive more efficient behaviours with respect to the management of risk and as such, is likely to be in the long-run interests of businesses and consumers.

However, it is important that the Electricity Authority assure itself (and market participants and stakeholders) that such a scheme is the right response, and not over engineered. Policy making in an uncertain environment is not new but neither is the prescription – minimise economic harm and preserve future options by waiting until more, improved information comes to hand before taking definitive action. The Electricity Authority would be well-advised to take heed of such advice.

Yours sincerely

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BusinessNZ

APPENDIX ONE: ABOUT BUSINESSNZ

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' Chamber of Commerce Central, Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), BusinessNZ is New Zealand's largest business advocacy body. Together with its 70 strong Major Companies Group, and the 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, BusinessNZ is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business NZ contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

BusinessNZ's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.