DOMESTIC ENERGY USERS' NETWORK

Members

Age Concern NZ
Child Poverty Action Group
Grey Power Federation
Public Health Association
Rural Women NZ

Convenor:
Molly Melhuish, 04-568-4873, 027-230-5911, melhuish@xtra.co.nz
Secretary:
Peter Rutledge, 04-233-6062, 027-326-8503, p.rutledge@clear.net.nz

50+ GREY POWER
NEW ZEALAND FEDERATION (INC)

ENERGY PORTFOLIO

Chair: Judy Lamont. 07 323 6316, judy.lamont@clear.net.nz
Energy Analyst: Molly Melhuish. 04 568 4873, melhuish@xtra.co.nz
Committee: Duncan McDonald. 04 938 5945, dunval@paradise.net.nz
Off Board Committee: Keith Allum, Peter Rutledge

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Submission: Consultation Paper, Scarcity Pricing - proposed design

29 April 2011. Contact, Molly Melhuish, 04 568 4873, melhuish@xtra.co.nz

Summary

Domestic consumers are concerned that the proposed scarcity pricing regime would increase their power prices and give little benefit in improving reliability. The regime is designed to improve profitability of new power stations to be used during shortage events. But the power stations are to be funded largely from wealth transfers (excess profits) from domestic power bills. The new electricity regulation requires any "fairness" issues to be taken to the Minister of Energy, instead of being dealt with by the Electricity Authority. This is described in a recent international review of New Zealand's energy policies as "cumbersome", creating regulatory uncertainty, which is bad for business investment. DEUN and Grey Power call on the Authority to implement the scarcity pricing safeguards suggested by the Scarcity Pricing Advisory Group.

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Scarcity pricing aims to ensure wholesale electricity prices rise as shortages are approached. This, the Electricity Authority says, will promote investment and innovation for a reliable electricity supply, "for the long-term benefit of consumers".

The Authority's CEO Carl Hansen told a public briefing on scarcity pricing on April 19 that the electricity market must be seen as both credible and durable. Investors, he said, must have confidence that prices will rise as electricity shortages approach. If that confidence is undermined, electricity generators may not build the new power stations needed to meet demand growth.

Domestic consumers have little confidence in this electricity market. We believe prices are rising not to increase reliability of New Zealand supply, but to create almost risk-free investment in new power stations. This raises asset values, a direct benefit to shareholders. Generators seek to maximise short-term returns, and even invest in overseas projects where renewable energy subsidies make them more profitable than in New Zealand. New power stations support Government's energy strategy, to maximise the contribution of the energy sector to New Zealand's economic growth. They are paid for largely by wealth transfers from domestic consumers to Industry Participants. [1]

Scarcity pricing will raise average prices to domestic consumers. The economic costs of domestic price increases include impacts of cold houses – these impacts cascade through the health system and also affect school attendance. Budget-stressed families impose even wider costs through society. Only large consumers have options to protect themselves by hedging their prices.

The table below summarises the positions taken at the briefing. Industry Participants include generators, retailers, lines companies, Transpower, and major electricity users. Large consumers expressed concern about impacts of scarcity pricing, but they can negotiate for their interests from within the Authority's advisory groups. Concerns of domestic consumers are still being ignored.

	Most Industry Participants	Domestic consumers
Aim	The electricity market must be credible, and durable. To be of long-term benefit to consumers, the market must encourage new investment and innovation	The electricity market is designed to reduce risks and increase profits of suppliers. Small consumers are paying ever-higher prices as profit-maximising behaviour is locked in
Framing the problem	Too many public conservation campaigns in dry years, too much lobbying for reliable supply	Retail prices are too high and are rising too fast
Proposed solution	Set a minimum spot price during supply emergencies, to assure revenues will rise not fall during shortages	Set caps on spot prices and "offers"[2]. This will reduce but not eliminate excess profits. Recycle remaining profits partly to vulnerable consumers
Rationale for solution	Power prices need to rise to make new power stations commercially viable, to meet demand growth	There seems little constraint on price rises, so safeguards are needed against abuse of market power – e.g. price caps

[1] The electricity market can transfer wealth from small consumers to suppliers (price gouging) or major electricity users (cross-subsidies to them at the expense of domestic consumers). Both types of wealth transfer hurt domestic consumers but are perfectly legal. Scarcity pricing provides new opportunities for these.

[2] Genesis offered Huntly generation at 20 dollars per kilowatt-hour on March 26, when a transmission line was out for maintenance. The offer was accepted because otherwise there would have been blackouts in Auckland. The price is now under dispute procedures.

Benefits of solution	New peaking stations (like Whirinaki) will be commercially viable with scarcity pricing	Investing in energy efficiency and non-electricity fuels could reduce demand peaks, typically at lower cost than new power stations
Impacts of solution	NPV benefit = ~$100 million in the base case, or $25 million in lowest-benefit case	Risk of up to $20 billion prudential requirement in event of rolling outage. Any benefits of scarcity pricing will be overwhelmed by costs of abuse of market power: March 26 provisional spot prices mean $75m for generators
Proposed safeguards against excessive prices	Preferably none, or temporary safeguards during a transition period only	Caps needed on spot prices and/ or offers. "cumulative price caps" in case of rolling outage, to forestall huge prudential requirements
Role of demand response during shortages	We're working hard to enable big industry to benefit when they cut demand during shortages	You should pay householders who reduce demand during shortages, but NOT penalise them for demand peaks [3]
Need for more security	Industry accepts the need for new investment in "security"	Security is ok now. Any regulated encouragement of new "security" investment will not be efficient

The consumer view was accommodated in a consensus view from the Scarcity Pricing Advisory Group. The positions summarised above were made clear at a meeting of the Scarcity Pricing Forum in February, where DEUN made its position particularly clear. But the Scarcity Pricing Consultation document, approved shortly afterwards, showed the Board's clear preference for the industry position. It made no mention of market power, which will exacerbate any scarcity pricing impacts, and which is a much bigger influence on power prices than the proposed scarcity pricing.

The Forum's chairman explained to consumer representatives that he saw our concerns as largely about market power, which was "tangential" to the purpose of scarcity pricing. He considered that the Forum had reached consensus around the industry position. The fact that two of the most articulate critics of scarcity pricing were absent due to the earthquake a couple of days earlier did not seem to affect his interpretation of "consensus".

The Advisory Group Charter requires groups to try to reconcile divergent opinions "in a manner that achieves wider stakeholder 'buy in'" but is still consistent with the Authority's interpretation of the new Electricity Industry Act and its new Code Amendment Principles.

[3] The Lines Company has changed the way it charges for its network, basing the next year's lines charge on the single highest peak demand. This puts huge risks onto its consumers. We need more carrots. not more sticks

The Act narrows the role of the Authority, compared to its predecessor the Electricity Commission, so that any issues relating to "fair" or "environmentally sustainable" must be taken up with Ministers. If changes to the electricity Code make power prices unaffordable, this is considered to be an issue for welfare, not electricity regulation.

This puts scarcity pricing, like the bigger issue of market power, directly into the political arena. And this in turn creates "regulatory uncertainty", which is bad for business investment.

An overseas perspective on New Zealand's energy regulation has been provided by the International Energy Agency's four-yearly Review of New Zealand's energy policies, released in March this year.

> "Concerning the regulatory responsibilities within the energy sector, the country has a number of overlapping regulatory bodies in the energy sector, which contribute to a sometimes cumbersome and unpredictable regulatory environment for market participants . . . Successful energy policies require a stable energy strategy and regulatory certainty."

The Review also noted that all consumers were paying prices higher than justified by the cost of new generation, with domestic customers bearing a large portion of the cost, and that retail profit margins are "relatively high".

The Authority's masses of detailed rules are designed by Industry Participants to protect the interests of investors rather than consumers. This is made explicit in the Authority's Consultation Charter:

> "As amendments to the Code can substantially affect industry participants, and **unpredictable and ill-founded amendments can undermine investor confidence**, the Authority considers there is value in stating principles that the Authority and its advisory groups must adhere to when considering Code development matters. The primary purpose of the principles is to provide industry participants with greater predictability about decision-making on likely amendments to the Code**, to maximise investor certainty**." [our emphasis]

The original industry self-regulation lasted only from 1996 to 2002, when consumers voted against it. The Electricity Market Company was then supplanted by the Electricity Commission, with wider objectives including "fair" and environmentally sustainable".

The Commission has now been replaced by the Electricity Authority, but this time there is no way within the regulatory structure for consumers to vote against it. The vote, this time, is purely political.

In fact a feature of the Authority's interpretation of the Act is its replacement of substantive pricing principles by empty legalistic principles the meaning of which can only be tested in court. It was just such a court decision that confirmed the principle that maximising profits is not an abuse of market power unless collusion can be proved. The Regulatory Standards Bill, if passed, might be able to permanently lock in decisions by the Authority.

The Authority could still redeem itself, by providing the safeguards called for by consumers, first in regard to scarcity pricing, and in due course, in regard to the bigger issue of market power. The Domestic Energy Users' Network and Grey Power call on the Authority to agree to the scarcity pricing safeguards suggested by the Scarcity Pricing Working Group.

Appendix A Specific matters: comments by DEUN and Grey Power

The Authority seeks feedback on the issues and proposals discussed in this Consultation Paper. Parties are also invited to provide their views on the following specific questions:

Question	Comment
Q1. To what extent is price suppression an issue with current pricing arrangements?	Price suppression has occurred, but it appears that last year's modification to arrangements for IR shortfalls may have greatly reduced price suppression. This could throw some doubt on the reliance of the analysis on pre- 2010 data in the supply/ demand/ price relationships.
Q2. To what extent do you agree that the spot price suppression will adversely affect security of supply?	The close linkage in section 4.2 between "missing money" and investment in last resort generation is not persuasive. Profit-maximising generators have the incentive to withhold generation to drive spot prices up, as described in section 4.3. This withholding could well have a greater impact on security of supply than any attempt to fill the "missing money" hole
Q3. What is your assessment of historic security of supply performance, and the likely future performance under current arrangements?	See above answer
Q4. What is your view of the proposed price floor to be applied in emergency load curtailment?	A price floor during capacity or energy shortages seems likely to systematically skew spot prices upwards. To prevent large wealth transfers from consumers to suppliers, any price floor should be accompanied by price caps. An initial level for a price cap could be calculated as in the appendices to the consultation document, however it should be monitored and revised more often than 3-yearly.
Q5. What is your view of the proposed treatment of load curtailment in AUFLS events?	Agree no AUFLS event should trigger scarcity pricing.
Q6. What is your view of the proposed approach to pricing during IR shortfalls?	Same as q 4
Q7. What is your view of the proposed price floor to be applied in rolling outage load curtailment?	Same as q 4
Q8. What is your view of the proposed disclosure mechanism?	These are complex mechanisms, no opinion
Q9. What is your view of these possible financial mechanisms?	Same as above

Q10. What is your view of the comparative merits of disclosure versus a spot price floor to address concerns about over-reliance on public conservation campaigns? Is there merit in pursuing both mechanisms?	Same as above
Q11. What is your view of the proposed approach to imposing a minimum geographic threshold before any scarcity price floor is applied?	Scarcity pricing adds so much risk to buyers that added complexity through nodal price matching seems inappropriate.
Q12. What is your view of the preferred approach to transition arrangements?	Safeguards including caps on prices and offers should be maintained, not just during a "transition" period, but until every consumer, Including domestic consumers, is able to to contest those high spot prices. Domestic consumers are likely to be able to reduce peak demands at less cost than for other sectors, so the prime focus of DSM should be in the residential sector. This requires not only smart (not dumb) meters, but smart tariffs that reward peak reduction commensurate with the value that reduction offers to the supply side.
Q13. What is your view of the proposed approach to review arrangements?	See above
Q14. What is your view of the proposed changes when assessed against the Electricity Authority's statutory objective?	The proposed changes appear not to meet the statutory objective criteria. In particular, s 199 acknowledges that any benefits of the proposed changes would depend on a reasonably competitive hedge market. This is not happening now – there is market power in the hedge market as well as in the spot market, As for the reliability limb, S 210 appears to define the "efficient reliability" in a circular mannar – that which is consistent with the intended outcome. Indeed the whole "analysis" against the statutory objective is based on rhetoric rather than evidence, and so is not persuasive.
Q15. What, if any, other reasonably practicable options should be considered?	Non-dispatchable demand-side management, encouraged through pricing that rewards demand responsiveness. This should be available to all three consumer sectors – domestic, commercial and industrial.
Q16. What is your view of a capacity mechanism, when assessed against the Electricity Authority's statutory objective?	Same as q. 8

Q17. What is your view of the costs and benefits of the proposed changes?	Domestic consumers dispute the assumption that a cost to them delivers equivalent benefit to some other party. Costs of domestic price increases include impacts of cold houses – these impacts cascade through the health system and also affect school attendance. Budget-stressed families impose even wider costs through society. The estimated net benefits are small ($3-12 million per year) compared with spot price swings happening today, and could even be negative (section F.27) if scarcity pricing is not durable.
Q18. What is your view of the likely impact on prices of the proposed scarcity pricing changes, both in the near term (static effects) and over time (when parties can adjust their plans and behaviour)?	Figure 6 is very helpful as it distinguishes domestic from industrial impacts. Why would price-responsive domestic consumers get less net benefit in 2 of the 3 cases than flat-load or peaky domestic consumers? The answer may be that the assumed benefits come from investment in the supply side not the demand-side. Critical peak tariffs ought to reward price-responsive consumers with lower bills, with "smart tariffs" developed in consultation with consumers. We are not persuaded that new baseload generation will cap spot prices, as older generators are more than likely to be retired..
Q19. What further pro-competitive initiatives should the Authority be considering at this time?	The market in hedge contracts is key; a decade and a half of code/ rule changes have not made it either large or liquid. See above on residential demand-side. Industry monitoring will be critical to allow adaptation any scarcity pricing regime to evolving industry practices.
Q20. Do you agree that the undesirable trading situation provisions could be invoked to address an exceptional event, and ensure that scarcity pricing is not applied in an inappropriate situation? If not, what changes should be considered in relation to the undesirable trading situation provisions?	Gaming exacerbates the effect of scarcity pricing, as shown in papers for the October meeting of the Scarcity Pricing Technical Group. This reinforces the case for safeguard mechanisms over and above the cases shown in the Consultation Document. The international examples shown all use price capping, offer capping or both.
Q21. What is your view of price capping mechanisms, when assessed against the Electricity Authority's statutory objective?	To date the most effective competition for domestic consumers has been from innovative retailers such as Powershop and Pulse. Any scarcity pricing risks that suppressed innovative retailers would be a major cost for domestic consumers.