Business NZ
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Lumley House
3-11 Hunter Street
PO Box 1925
Wellington 6001
New Zealand

Tel: 04 496-6555
Fax: 04 496-6550
www.businessnz.org.nz

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Kate Hudson
Electricity Commission
Level 7, ASB Tower
PO Box 10041
WELLINGTON

via e-mail: submissions@electricitycommission.govt.nz

Dear Kate

Scarcity Pricing and Compulsory Contracting: Options

Business New Zealand is pleased to have the opportunity to provide a submission to the Electricity Commission on its consultation document entitled 'Scarcity Pricing and Compulsory Contracting: Options', dated October 2009.[1]

Introductory Comments

Business New Zealand agrees the market design should be corrected for the distortion caused by demand restraint not being priced in the spot market or retail market. Therefore, Business New Zealand supports exploring ways to place improved incentives on all market participants to deliver better market-based outcomes.

In Business New Zealand's view scarcity pricing is likely to drive more efficient behaviours with respect to the management of dry-year risk and as such, is likely to be in the long-term interests of businesses and consumers. The industry should work through the detail as soon as possible in both the energy and reserves markets to ensure a more efficient level of security of supply.

Moving Towards the Right Solution

Based on the information presented, Business New Zealand supports the use of a scarcity pricing mechanism. However, it is important that the use of scarcity pricing is well matched to a clearly identified problem and the practical relationships between its use and the use of other, similarly targeted, mechanisms are well understood.

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[1] Background information on Business New Zealand is attached in Appendix One.

In particular, Business New Zealand wonders whether what is described in the consultation paper as the "underlying problem" (cost shifting) is itself a symptom of the more fundamental economic problem of misaligned incentives resulting in sub-optimal investment levels.

This has colloquially become known as 'the missing money' problem. 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.

With respect to similarly targeted mechanisms, the inter-relationships between scarcity pricing and such mechanisms as AUFLS, rolling outages, and the recently established Capacity Adequacy Industry Working Group (recently convened to consider how to incentivise sufficient existing capacity to be offered into the market during real time events) need to be clarified. The Electricity Commission should consider how the implementation of scarcity pricing will interact with the use of these other measures in a co-ordinated manner.

Business New Zealand has a range of other comments with regard to scarcity pricing:

1. the relationship of scarcity pricing to the compensation scheme: Business New Zealand is unconvinced of the relationship between the two. While Figure 2 on page 18 of the consultation document shows that both scarcity pricing and a compensation scheme are needed to avoid generator-retailers benefiting from a conservation campaign, this analysis appears to be as much a construct of the assumptions as of real market conditions. Business New Zealand agrees that such a mechanism is likely to play a useful role in the overall market design, but its use or purpose should not be made more sophisticated than it is – that of a punitive tool signaling a cost to retailers of a conservation campaign. Business New Zealand also considers its use as a tool should stand on its own merits as any of the complementary measures outlined in paragraph 3.3.3 of the consultation paper will be required to;

2. the trigger to scarcity pricing, a conservation campaign and compensation regime: the introduction of scarcity pricing should not be tied to the introduction of a public conservation campaign. While the introduction of such a campaign is a tangible signal of an *impending* supply/demand imbalance, Business New Zealand considers that leaving its introduction to the commencement of a public conservation campaign is too late. The potential introduction of a scarcity price should be based on New Zealand-specific conditions (e.g. lake levels, inflows and margins) and be able to be introduced at any time during the year should those conditions be met. This approach is more likely to better incentivise a more liquid hedge market and the build of new peaking plant and use of existing but under-utilised thermal plant. Given its predominantly punitive characteristics, the introduction of the

consumer rebate appears better matched to the introduction of a public conservation campaign and the maintenance of energy adequacy than a scarcity pricing signal. The calling of a conservation campaign is also likely to be highly politicised. The introduction of scarcity pricing should not be linked to this as it will only undermine the integrity of the scarcity pricing tool;

3. the issue of targeting the compensation scheme: the analysis outlined in section 3.5 of the consultation paper appears to indicate that a fully hedged supplier would not benefit from the introduction of a compensation scheme. Business New Zealand considers that the analysis should be extended to determine whether there is any case for targeting the use of this punitive mechanism to those who would most benefit from conservation campaigns (presumably 'short' generator/retailers);

4. the risk of the adoption of scarcity pricing exacerbating market power problems: Business New Zealand encourages the Electricity Commission to actively assess the potential for the exercise of market power leading to contrived rather than genuine scarcity. While the primary responsibility for the pursuit and action of cases of abuse of market power rests with the Commerce Commission, Business New Zealand considers it to be the legitimate jurisdiction of the Electricity Commission (and its successor organisation) to undertake market supervision to deter and detect practices that are not consistent with the operation of an efficient, competitive electricity market;

5. sequencing scarcity pricing and other market design features:

    a. the introduction of scarcity pricing should be accompanied with the development of a liquid hedge market. The failure to see the development of a more mature energy hedge market risks the more volatile prices falling on major electricity users 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; and

    b. the resolution of the use of Whirinaki: Business New Zealand does not support the continued use of Whirinaki but notes that there is a sequencing issue regarding the implementation of scarcity pricing and the future possible use of Whirinaki in the short term before its sale is completed. In the event that scarcity pricing cannot be implemented before next winter (which would seem a strong probability), Whirinaki should continue to be available as reserve cover, but under new pricing rules that do not suppress market prices and have those who need it pay for it in the market;

6. setting the scarcity price: the Electricity Commission should undertake and socialise the analysis on how it intends to set the scarcity price. While there are pros and cons associated with either a demand or supply side methodology, Business New Zealand considers that the choice of methodology should be influenced by the problem being a capacity issue; and

7. coverage of compensation payments: there would appear to be no good reason why these payments, if implemented, would not be extended to include small to medium sized businesses on fixed price, variable volume contracts;

Finally, Business New Zealand does not support the use of capacity or compulsory contracts. Practice in overseas jurisdictions have shown they are extremely difficult to implement in a way that does not distort investment decisions. They have also proven prone to substantial market power problems.

Summary

Business New Zealand welcomes the work undertaken by the Electricity Commission. Business New Zealand believes that the absence of a scarcity pricing mechanism has been a key gap in the overall architecture of the market.

While further work is warranted on *both* of the scarcity pricing options before a clear preferred option is identified, Business New Zealand considers that the choice of preferred options should be strongly influenced by the nature of the capacity inadequacy, or ‘missing money’ problem. This, in turn, will provide guidance as to whether the scarcity price should be implemented at the time of demand-supply imbalance or pre-shortage. These factors, coupled with a desire to depoliticise the market, tends Business New Zealand toward Option B – modified scarcity pricing – but with its implementation disconnected from public conservation campaigns.

Yours sincerely

John A Carnegie
Manager, Energy, Environment and Infrastructure
Business New Zealand

APPENDIX ONE: ABOUT BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 70-member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand 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 New Zealand 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.

Business New Zealand'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.