CHH pulp & paper

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ELECTRICITY COMMISSION
LEVEL7, ASB TOWER
PO BOX 10041
WELLINGTON

By email to submissions@electricitycommission.govt.nz

ATTENTION: KATE HUDSON

7 December 2009

Dear Kate,

CARTER HOLT HARVEY PULP & PAPER SUBMISSION ON SCARCITY PRICING

Carter Holt Harvey Pulp & Paper Ltd (CHH) appreciates the opportunity to provide a submission on the Electricity Commission's consultation paper concerning scarcity pricing in the NZ wholesale market.

Introduction

CHH owns and operates a number of pulp and paper mills at Kinleith, Kawerau, Whakatane and Penrose (Auckland) . These mills produce bleached and unbleached softwood kraft pulp and a range of linerboards and paperboards used in packaging. CHH uses over 1000GWh per annum of electricity, of which some 360GWh per annum is internally generated.

Electricity is a key input into the processing of wood and the price paid for electricity impacts significantly on the company's operating costs.

CHH is an export earning business for the New Zealand economy and it is essential to the viability of our operations that electricity supply is obtained at a fair and reasonable price. It is important that the provision of electricity transmission reflects the service levels required by CHH and is priced at a rate that reflects the actual service obtained.

CHH is a member of the Major Electricity Users Group (MEUG) and supports the points made in the MEUG submission.

CHH wishes to make the following additional points for the Commission's consideration.

Summary of CHH's Key Points

CHH has considered the interrelated issues of transmission pricing, locational pricing signals and scarcity pricing, that fall within the Commission's Market Development Programme. CHH shares the widespread view that the current market arrangements, which result in a number of undesirable outcomes in dry year conditions, are not sustainable.

As a major user of electricity, CHH is significantly impacted by spot prices and the availability of energy hedge contracts. In general, CHH has adopted a conservative approach to its energy purchases, preferring to retain a high level of hedge cover for its energy needs to provide price stability and manage spot market volatility risk.

CHH has observed in previous low hydrology periods, supply risk ultimately lies with the consumer through conservation and rationing mechanisms. Increases in both retail and hedge contract prices following dry years suggest that suppliers have been building dry year premiums into prices. This may indicate some double dipping has occurred where suppliers have seen reduced risks to their businesses without a corresponding decrease in returns. Initiating some form of compensation to consumers through compulsory buy-back schemes may to a certain extent restore some price/risk balance but, in the absence of a fully competitive market these costs are still likely to be passed through to consumers. Combining compulsory buy-back and the scarcity pricing approach may provide a workable solution that provides incentives to both the supply and demand side to manage scarcity of supply risks.

CHH considers that electricity suppliers should be properly incentivised to invest in additional peaking plant and maintaining suitable existing plant as peaking plant so as to increase supply security overall and reduce the political intervention seen in the electricity market during previous dry-year events. Stability of energy supplies is a key driver of future investment in export revenue earning industries.

CHH has provided answers to the Commission's specific consultation questions and these are attached as Appendix 1.

Conclusions

In conclusion, CHH:

1. supports the Commission's Market Development Programme to review and improve on a range of market design issues

2. supports the Commission's broad direction in preferring a scarcity pricing option over compulsory contracting options and moving to develop a more detailed proposal for further consultation

3. agrees that there may be potential benefit in developing a compulsory buy-back arrangement for mass-market customers.

We thank you for the opportunity to submit on this important issue.

Yours sincerely

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Appendix 1: Responses to the Consultation Questions

CHH's responses to the pre-set questions are provided as follows:

<table>
<tr><th>QUESTION</th><th>RESPONSE</th></tr>
<tr><td>1. What concerns do you have with regard to security of supply under existing arrangements?</td><td>Primary exporting industries like CHH seek stable and robust market conditions governing energy supply; we are effectively exporting NZ energy resources bundled into value-added products. CHH shares widespread industry and public concern over the management of electricity supplies under prolonged and severe drought conditions. Events like those experienced in several of the winters through the current decade, including a very near miss in 2008, illustrate the severity of the problem.

In general, the Commission's summary of concerns in section 2.1 is a good summary of the issues. CHH believes that public perception of the issue is heightened to such an extent that tolerance of the status quo has effectively ended.

CHH would add to the concerns listed in the Commission's paper in para 2.1.2(g) the issue of the Commission's role in managing the Whirinaki plant under the Reserve Energy scheme, summarised later in the paper at section 3.6.</td></tr>
<tr><td>2. What, if any, other underlying issues lead to the potential for cost shifting among market participants?</td><td>In general, the Commission's summary of underlying issues in section 2.2 is a good summary of the issues.

The ability for some electricity suppliers to offload their supply risk through political processes is at the root of the problem; this underlying cause is skirted around in the paper. A robust solution to this situation is overdue.</td></tr>
<tr><td>3. What is your assessment of pros and cons of scarcity pricing approaches versus compulsory contracting?</td><td>CHH support scarcity pricing over compulsory contracting because:
• The additional complexity, administrative costs and time needed to put a compulsory contracting scheme in place do not appear to be justified by any supporting benefits
• Concerns over potential market power issues arise in both options but appear to be resolvable
• Scarcity pricing is a more light-handed approach that leaves more discretion to the market to determine optimal outcomes. On the other hand, compulsory contracting has the effect of placing the Government in the hedge market as setter of hedge price and quantity.

Moving into subsequent development stages, there is a need to ensure that market power issues are carefully considered. While peak prices will rise</td></tr>
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	during scarcity periods, CHH would be very concerned to see average overall prices driven upwards through exercise of market power. There is a significant amount of careful development work needed to produce an effective and robust scarcity pricing mechanism. CHH would like to see critical comparisons of international experiences undertaken in this work, specifically critically testing the extent of valid applicability of other models to New Zealand's weeks long energy scarcity phenomenon. Construction of a comprehensive cost-benefit analysis will also be a key component of the workstream.
4. What other broad options should be considered to improve security performance?	While beyond the powers of the Commission to create, the structural reallocation of generating assets considered in the Ministerial Review discussion paper would have significant benefits in improved supply security outcomes for New Zealand.
5. What approach to scarcity pricing should be preferred?	Scarcity pricing appears to be more suited to managing the dry year energy adequacy risk than it does for managing real-time capacity adequacy. While the desired market behaviour, incentivised by sharpened spot prices, is clear in the case of managing dry-year energy adequacy (i.e driving investment in peaking plant), however, it is not clear what behaviour ought to be signalled through prices in pursuit of short term capacity adequacy. CHH would strongly prefer that the short term capacity adequacy issue is treated quite separately from the primary energy security need.
6. Do you agree with the outlined approach whereby the Commission will progress with a detailed proposal for a scarcity pricing regime and for a default buy-back arrangement? If not, what would be the best approach for moving forward?	Yes. More work is needed on Option A.