

REGULATION

How Backward Can We Get?



(With a concentration on the electricity sector)

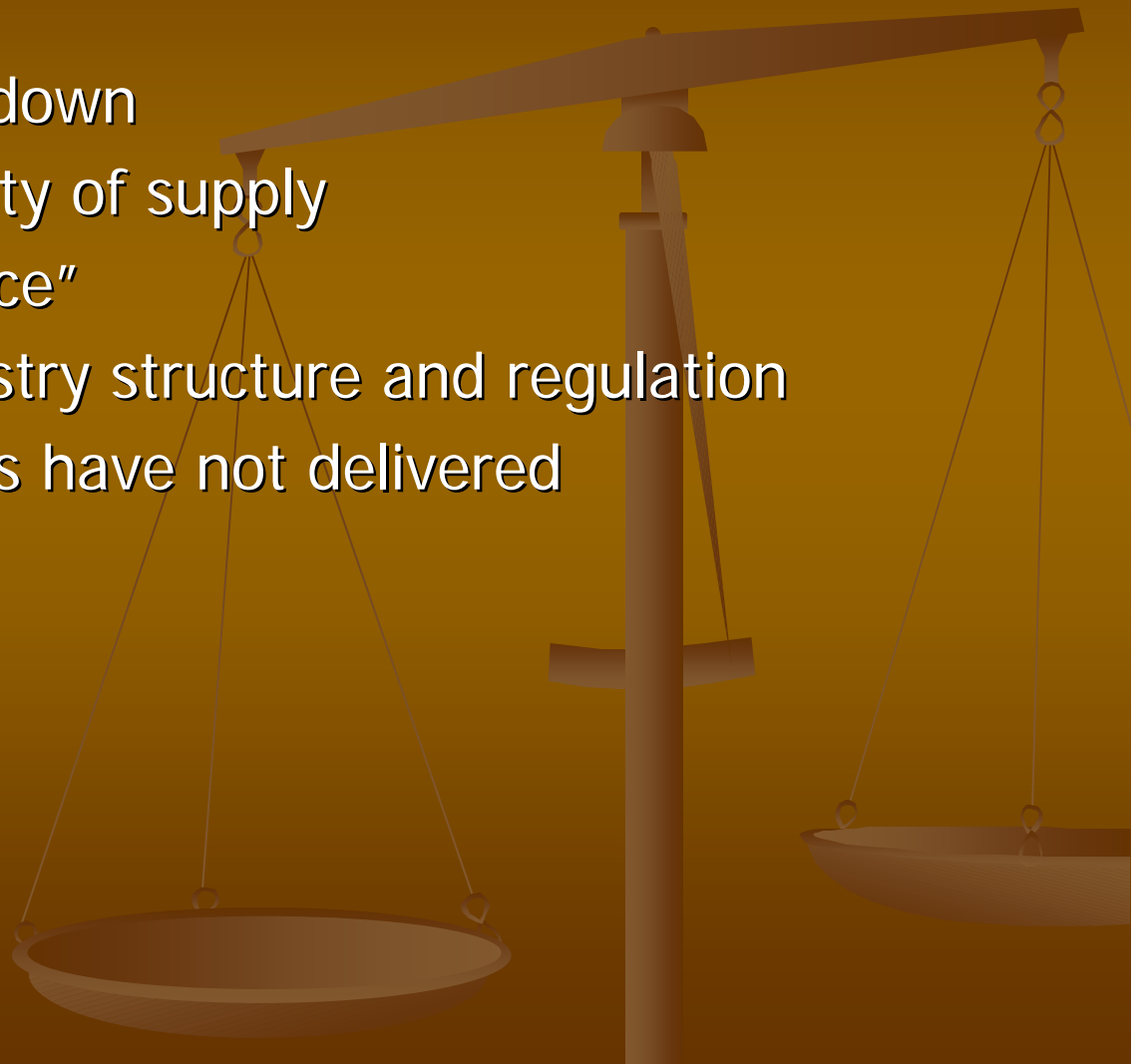
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28 September 2005

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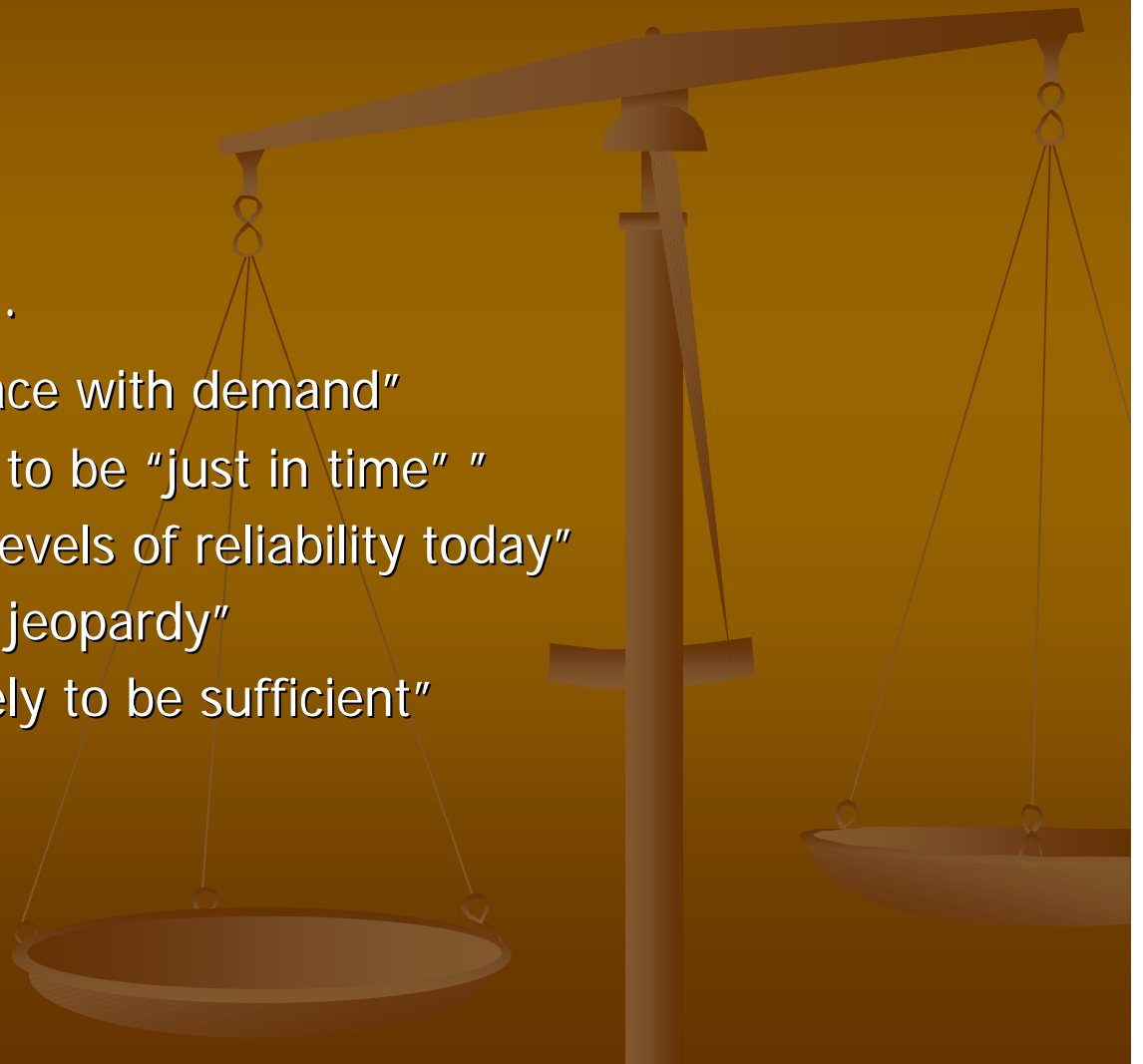
The Electricity Industry Customer Perspectives

- Prices going up, not down
- Nervous about security of supply
- Sceptical about “choice”
- Confused about industry structure and regulation
- In summary: reforms have not delivered



What Works?

- Wholesale market
- Spot price discovery
- No recent disasters
- EC says confidently ...
 - ... "Generation keeping pace with demand"
 - ... "New generation likely to be "just in time" "
 - ... "System delivers high levels of reliability today"
 - ... "Winter security not in jeopardy"
 - ... "Future investment likely to be sufficient"



Problems and Worries

- Forward price discovery (in some years prices must exceed LPMC)
- Security of supply
- Transmission capacity for Auckland and Christchurch
- Absence of longer term contracts for business sector
- Transpower regulatory conflicts:
 - EC oversees investment
 - CC revenue threshold
- Trade-offs between transmission capacity and generation
- Government ownership of much of the sector
- Conflicting interests of government (and regulators)
- Unknown costs of market distortions from extensive regulation
- Lack of cost/benefit analysis of ownership and regulatory structures
- In summary: many worry zones – huge uncertainties

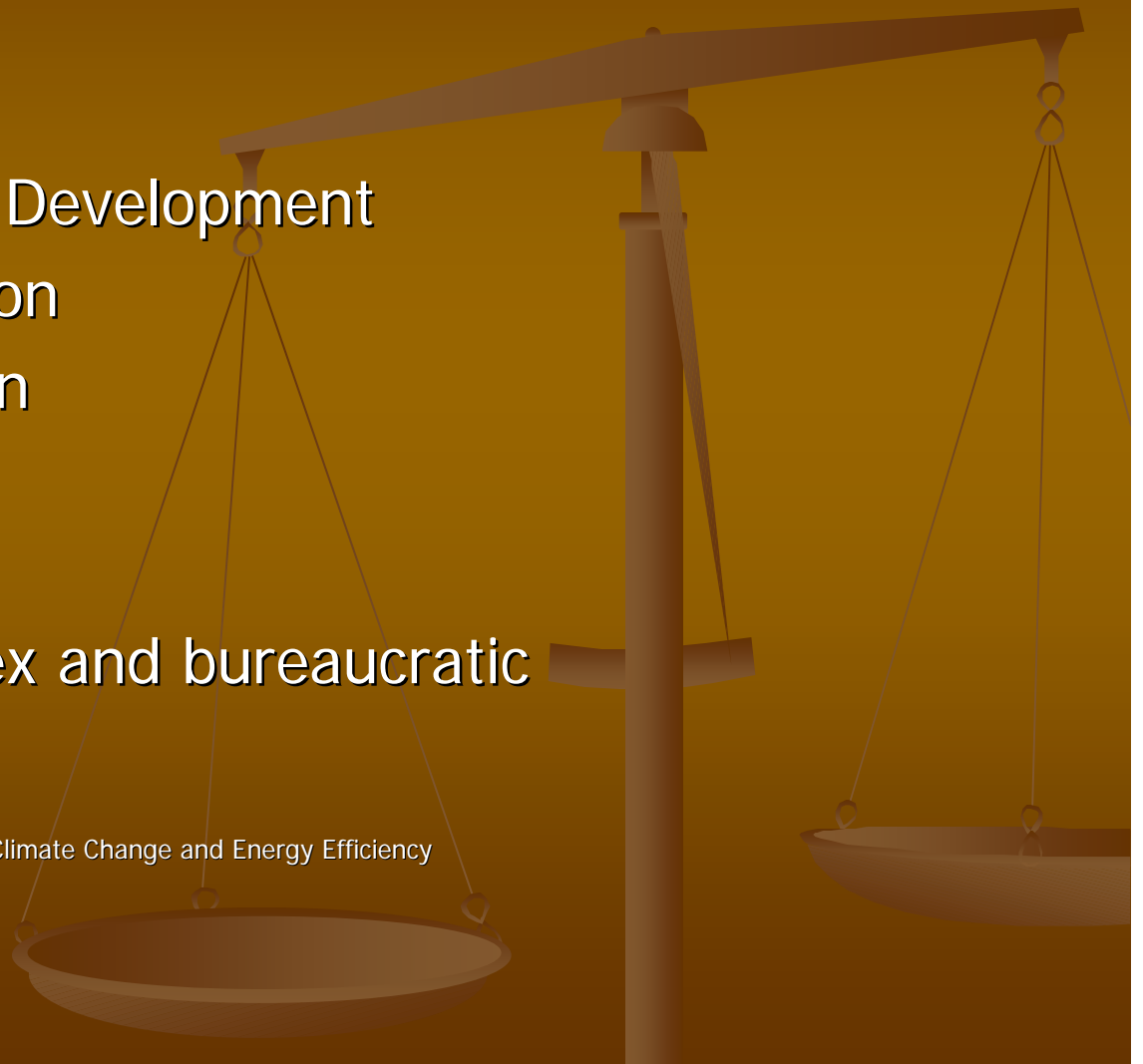


Regulatory Hierarchy

- Government
- Minister
- Ministry of Economic Development
- Commerce Commission
- Electricity Commission
- Transpower
- Power companies
- In summary: complex and bureaucratic

NB:

For 2006, total of \$166 million in Vote Energy and Vote Climate Change and Energy Efficiency
Cost of EC \$86 million Levy amount \$79 million



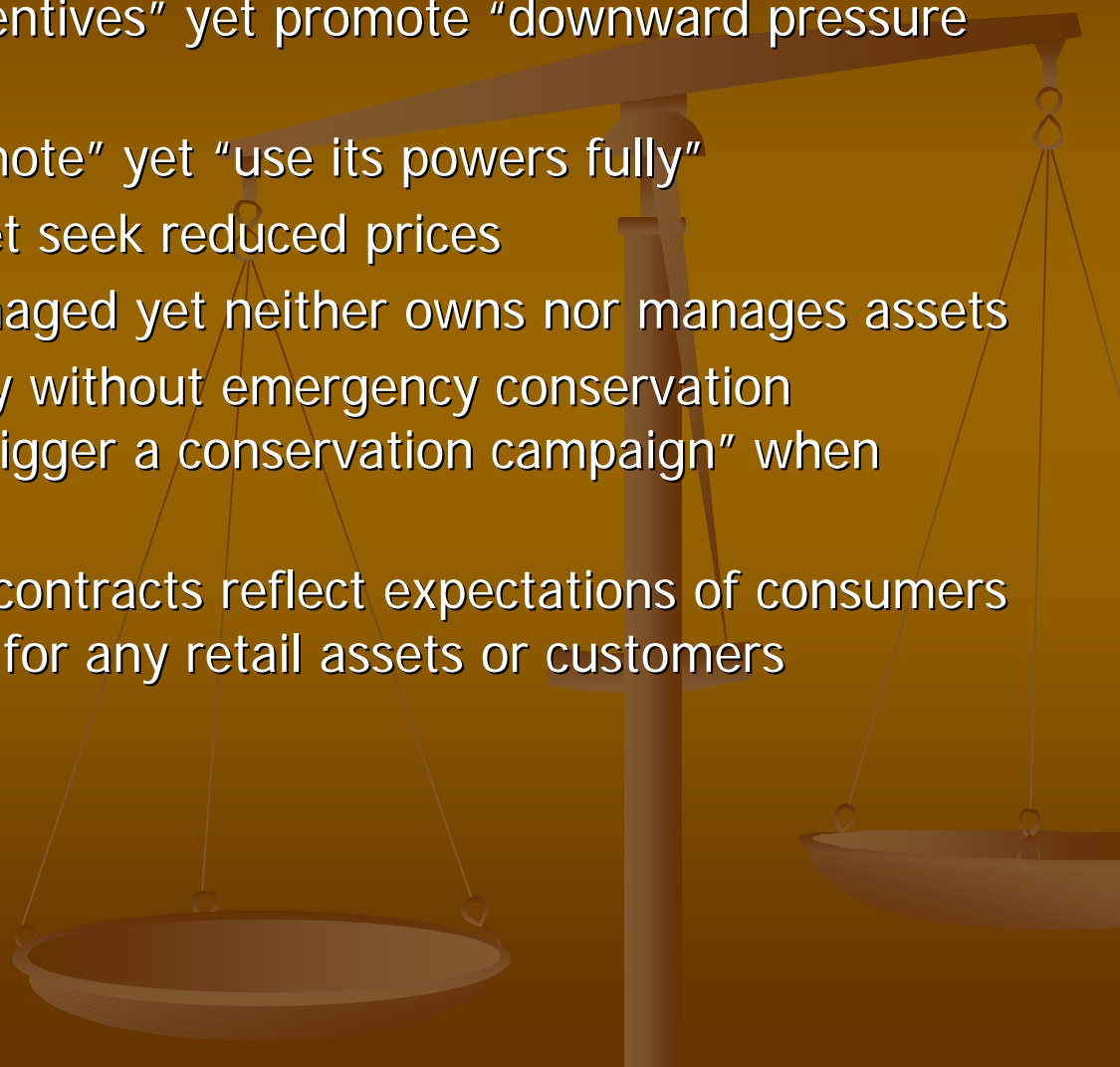
Role of Government

- Policy formation
- Legislator
- Regulator and rules maker
- Appointment of members EC and CC
- Owner of competing generation
- Owner of competing retailers
- Owner of transmission
- Social arbiter
- Political overseer
- In summary: massive conflicts of interest



Electricity Commission Competing Objectives

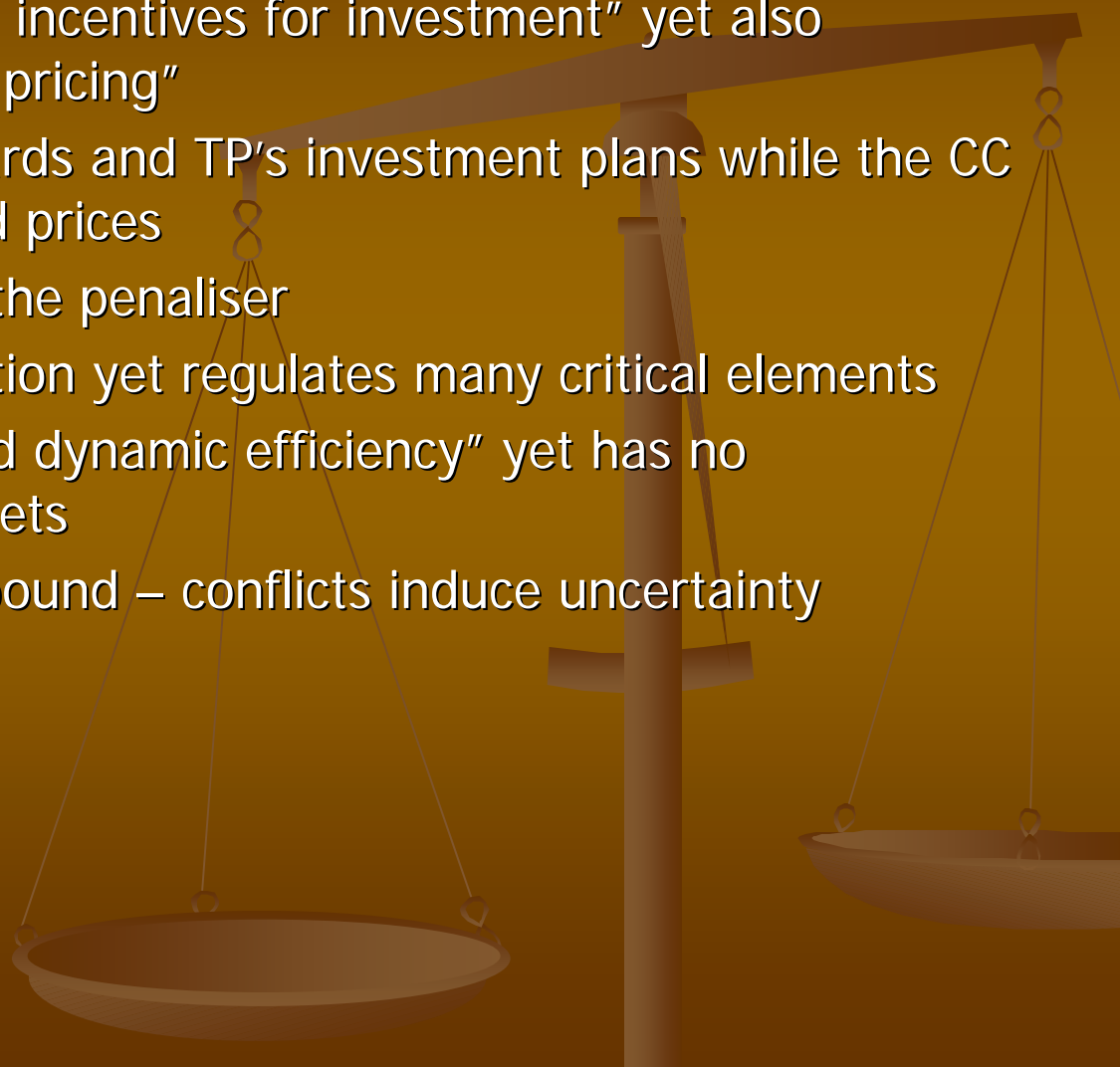
- Enhance “investment incentives” yet promote “downward pressure on prices”
- Must “persuade and promote” yet “use its powers fully”
- Must “signal full costs” yet seek reduced prices
- Ensure risks are well managed yet neither owns nor manages assets
- Ensure “security of supply without emergency conservation campaigns” yet has to “trigger a conservation campaign” when necessary
- Has to ensure consumer contracts reflect expectations of consumers yet has no accountability for any retail assets or customers



Electricity Commission contd

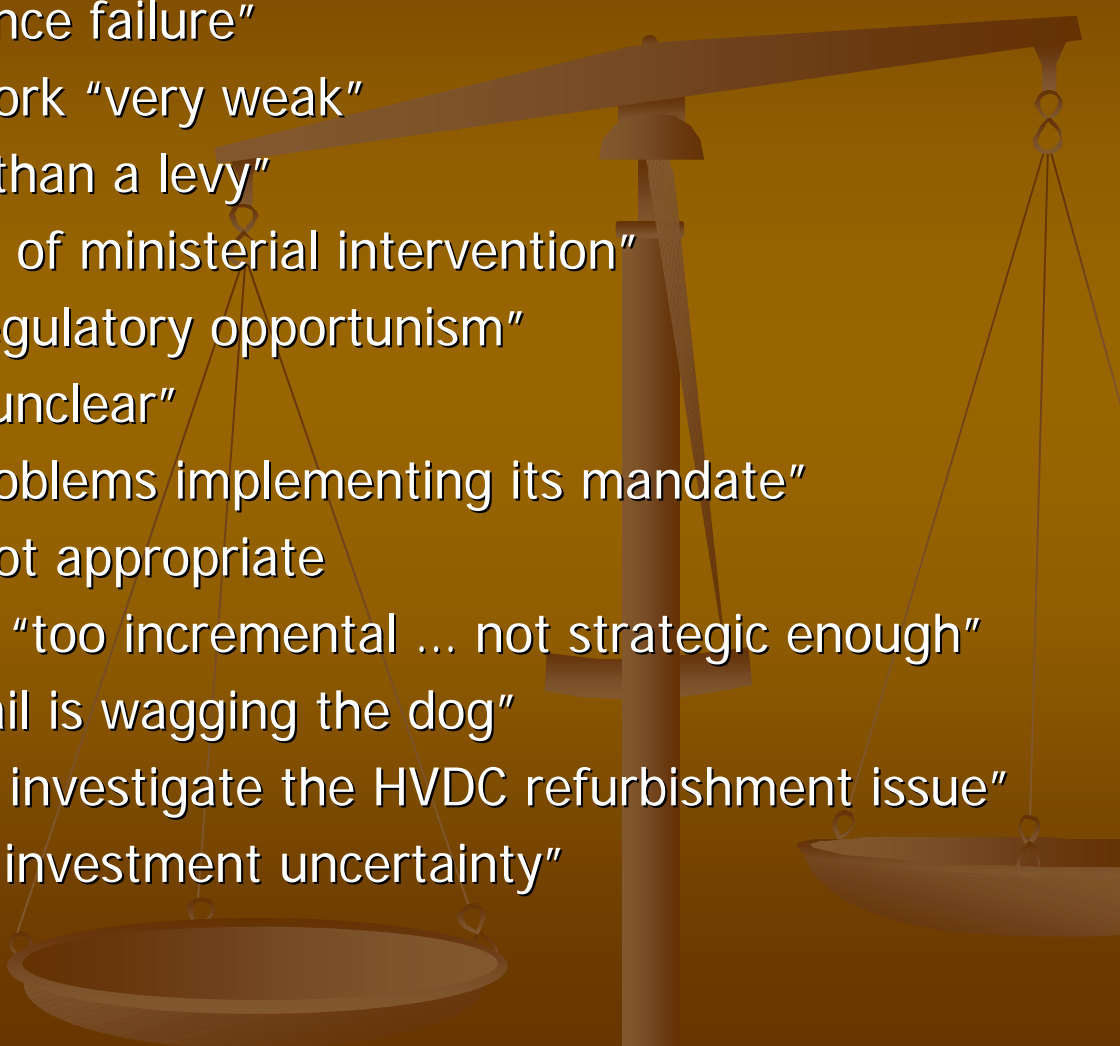
Competing Objectives

- Has to promote “financial incentives for investment” yet also promotes “cost reflective pricing”
- Has to decide grid standards and TP’s investment plans while the CC controls TP’s revenue and prices
- Is the regulator but also the penaliser
- Has to encourage innovation yet regulates many critical elements
- Must “maximise static and dynamic efficiency” yet has no accountability for any assets
- In summary: conflicts abound – conflicts induce uncertainty

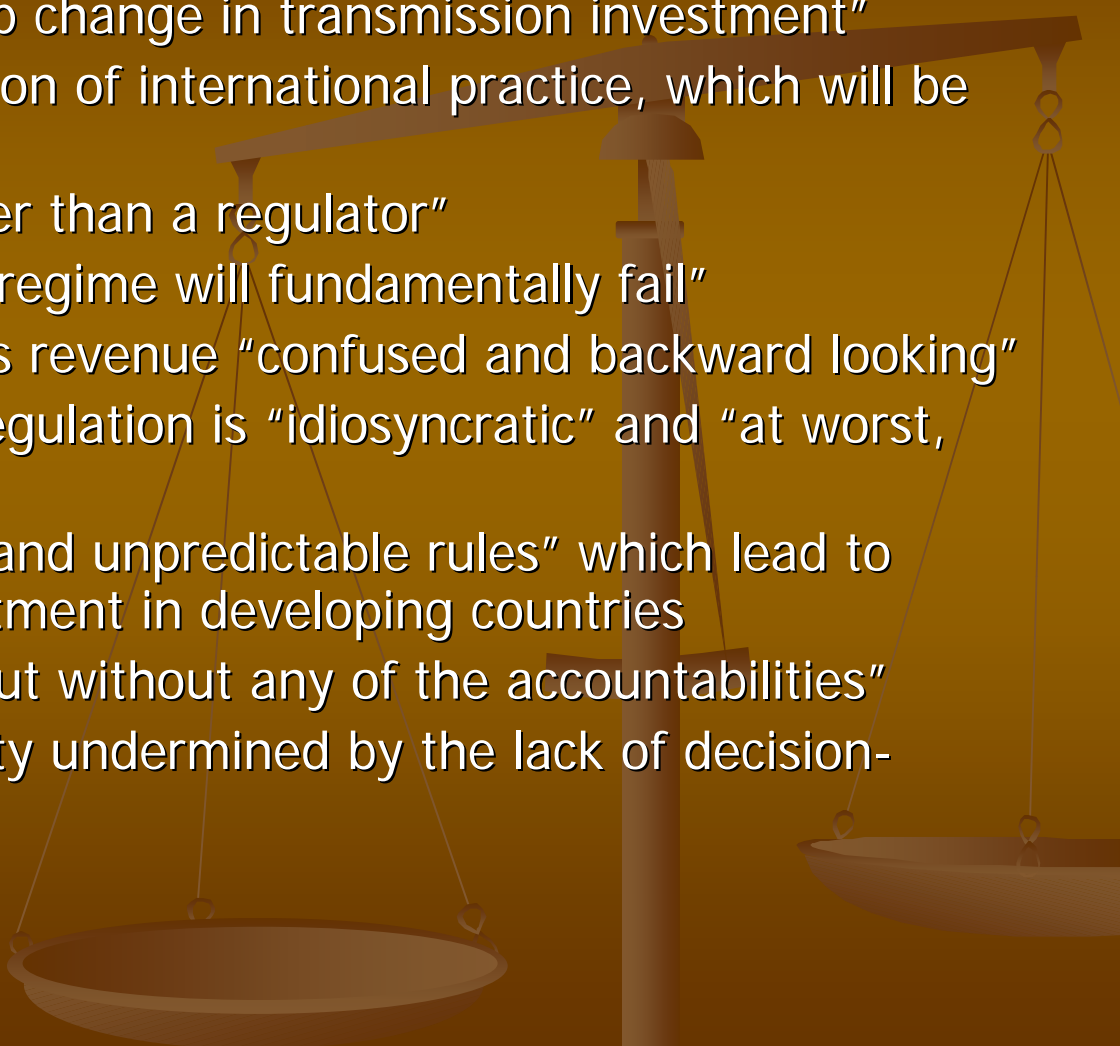


Criticisms of the Regulatory Regime

Some excerpts (1)

- "Risk of serious performance failure"
 - EC accountability framework "very weak"
 - Levy "far more like a tax than a levy"
 - "Extraordinarily high level of ministerial intervention"
 - "Limited constraints on regulatory opportunism"
 - "Boundary of EC's scope unclear"
 - "Likely to have serious problems implementing its mandate"
 - "Just in time" approach not appropriate
 - Approach to transmission "too incremental ... not strategic enough"
 - "Initial SOO implies the tail is wagging the dog"
 - EC "has not attempted to investigate the HVDC refurbishment issue"
 - SOO is "creating industry investment uncertainty"
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Criticisms (2)

- "Time has come for a step change in transmission investment"
 - New Zealand "is a distortion of international practice, which will be costly to users"
 - EC "more a central planner than a regulator"
 - New Zealand "regulatory regime will fundamentally fail"
 - Oversight of Transpower's revenue "confused and backward looking"
 - New Zealand electricity regulation is "idiosyncratic" and "at worst, incoherent"
 - Analogy to the "complex and unpredictable rules" which lead to infrastructure underinvestment in developing countries
 - EC the "system planner but without any of the accountabilities"
 - Transpower "accountability undermined by the lack of decision-making ability"
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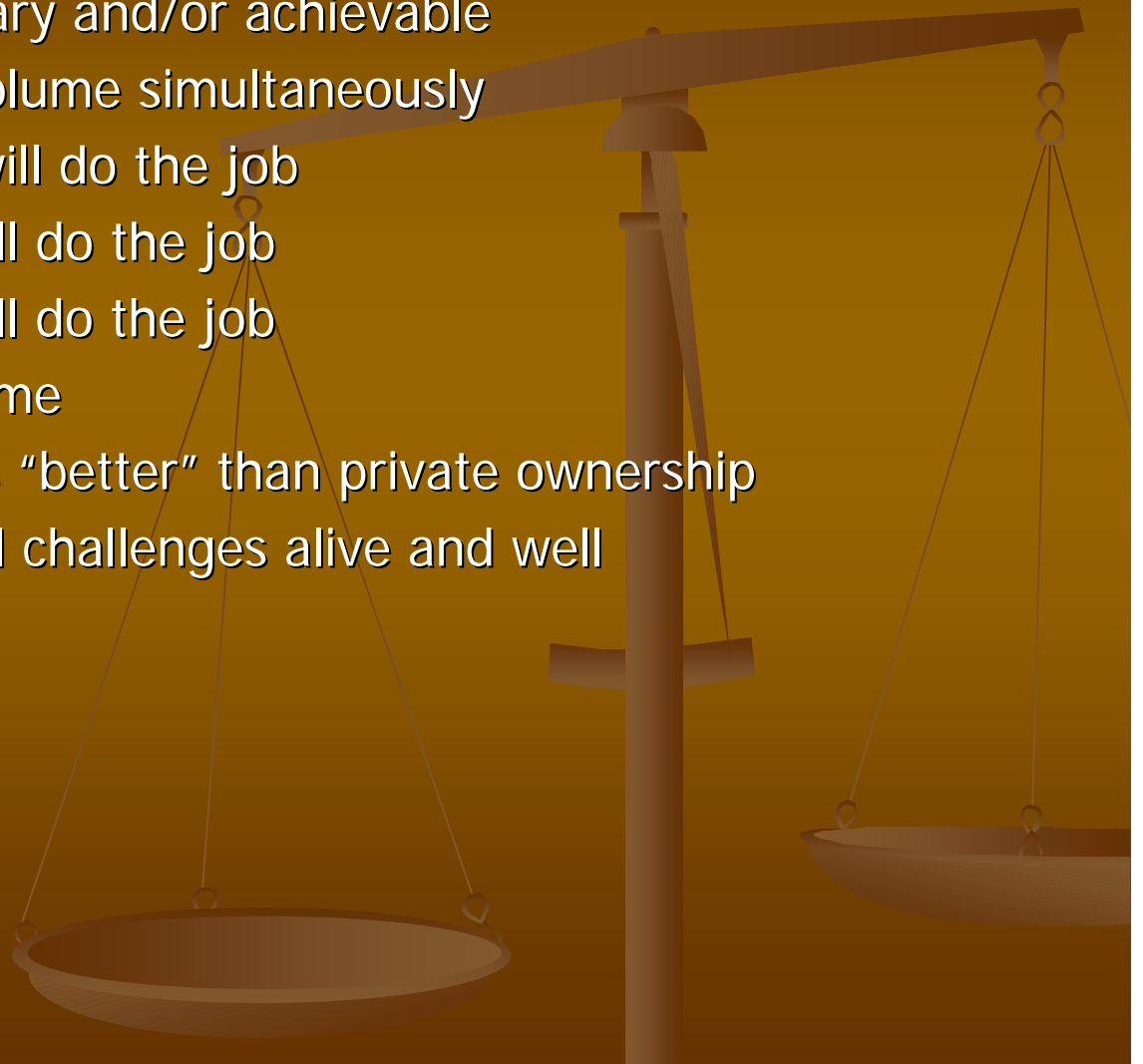
Criticisms (3)

- This will “create risks for transmission investment ... and inefficient duplication of resources
- Allocation of responsibilities between “EC and CC remains unclear”
- On CC’s price path threshold for TP, “revenues will, by definition, be insufficient to meet TP’s forward-looking needs”
- Summary: No one is happy (except the EC ?)

NB:
EC is the Electricity Commission
CC is the Commerce Commission
TP is Transpower

Myths?

- “Price stability” is necessary and/or achievable
- Can regulate price and volume simultaneously
- Demand side measures will do the job
- Distributed generation will do the job
- Renewable generation will do the job
- “Just in time” will be in time
- Government ownership is “better” than private ownership
- In summary: educational challenges alive and well

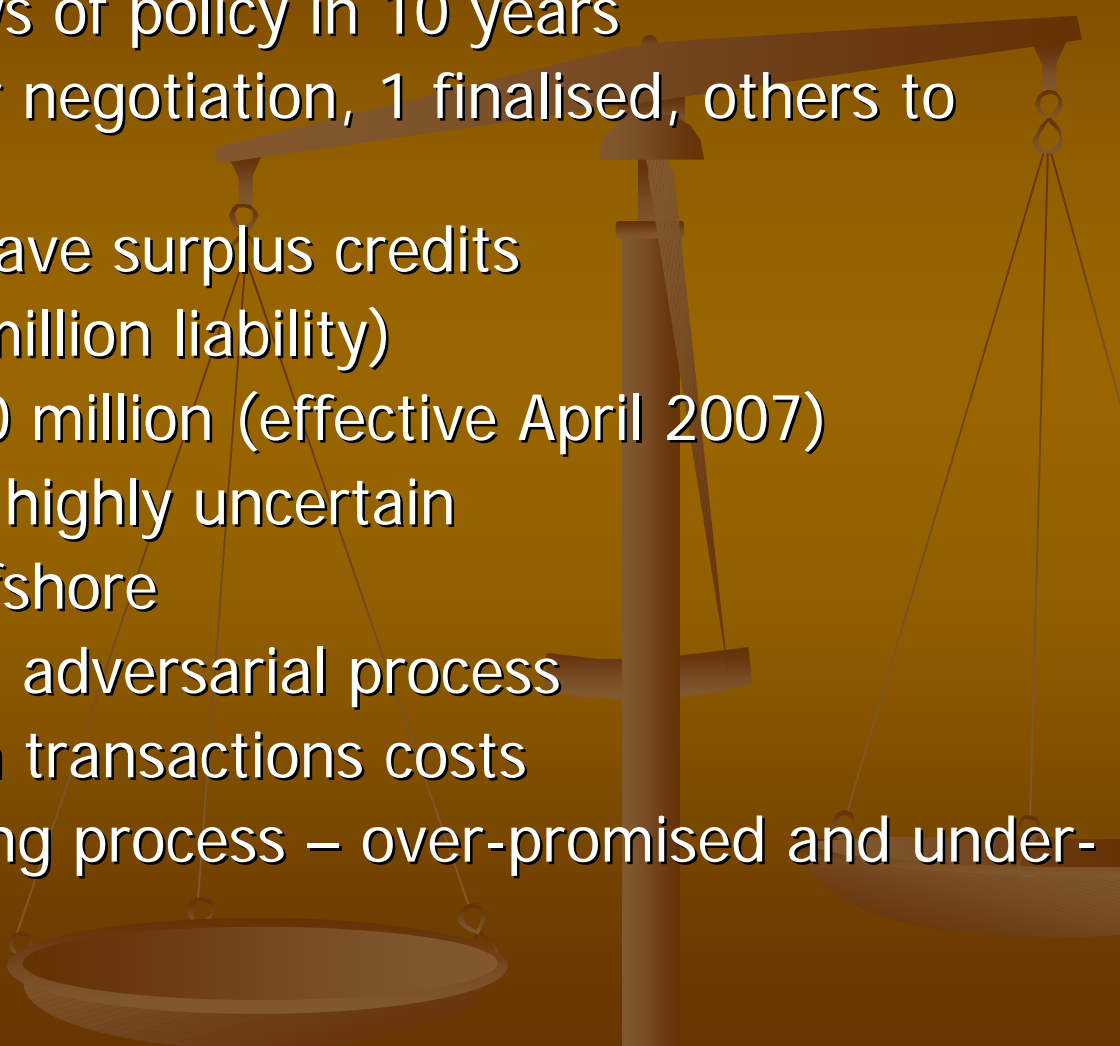


Resource Management Act (RMA)

- Existed 14 years
- 14 Amendments
- 1 Policy statement
- Slows and discourages investment
- In summary: bureaucratic nightmare



Kyoto NGA's (Negotiated Greenhouse Agreement)


- Four complete reviews of policy in 10 years
 - 15 agreements under negotiation, 1 finalised, others to come
 - Initially we were to have surplus credits
 - Now a deficit (\$300 million liability)
 - Tax on business \$360 million (effective April 2007)
 - Exemption levels still highly uncertain
 - Incentive to move offshore
 - Protracted, changing, adversarial process
 - Excruciating and high transactions costs
 - In summary: appalling process – over-promised and under-delivered
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Re-regulation or extended regulation

- Commerce Act
- Local Authorities legislation
- Resource Management Act
- Employment Relations Act
- Kyoto Protocol
- Takeovers, accounting standards, governance
- Banking
- Telecommunications
- Electricity
- Not just the regulations ... but manner of administration



Conclusion

- Electricity subject to extensive regulation
 - And so are many other industries
 - This creates delays, non-commercial decisions, high costs and uncertainties
 - Moreover, conflicts abound in the industry due to regulatory issues and government's multiple roles
 - Do the benefits outweigh these huge costs?
 - My conclusion – they cannot possibly do so
 - So where should we go?
 - More reliance on private sector ownership, more self-governance, less intrusive regulation
 - Past decade has been high economic growth for New Zealand
 - But, the next decade will be regulatorily constrained
 - A return to the past
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Appendix

Electricity Commission - 1

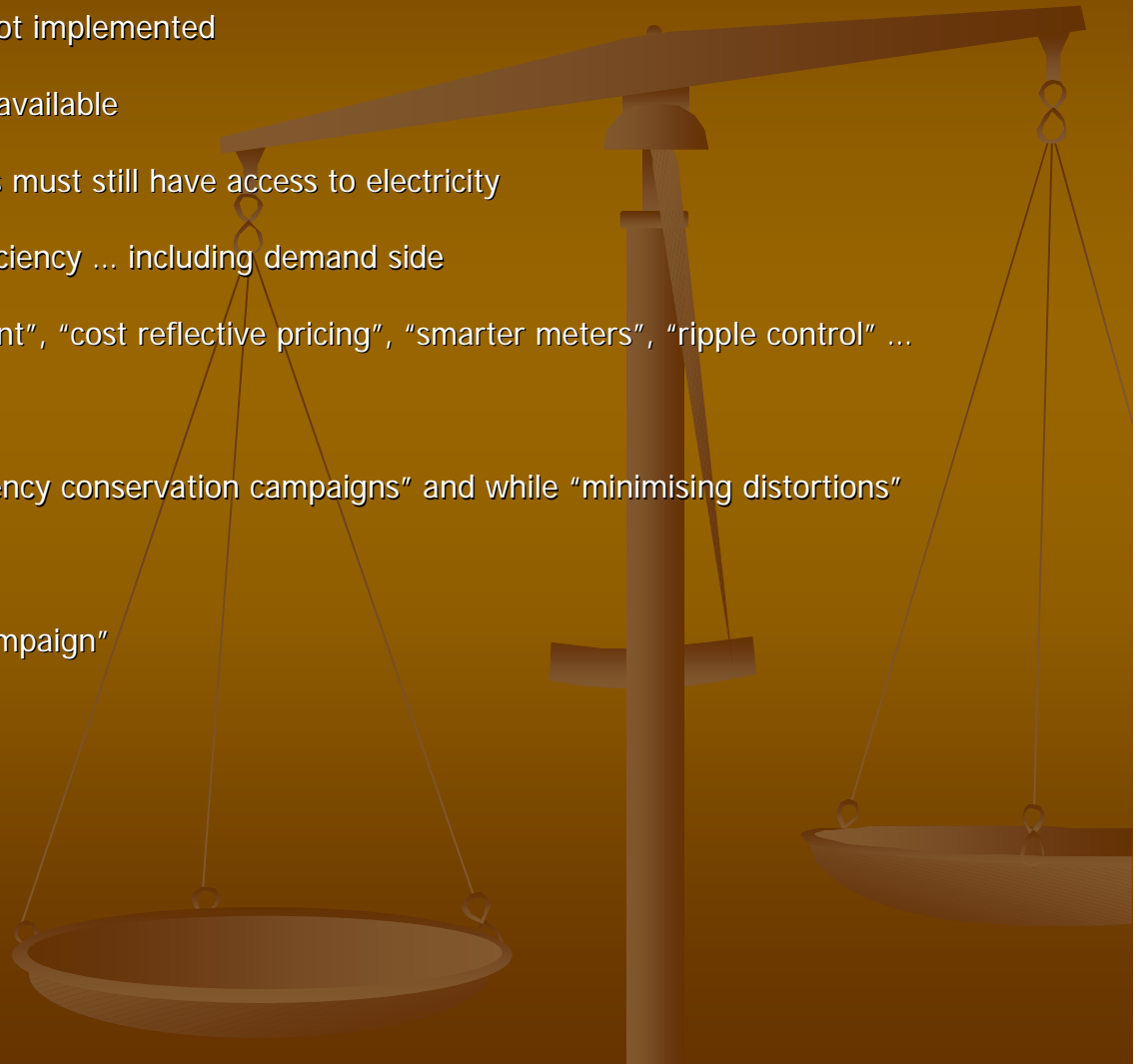
Roles and Functions

- Electricity is to be produced and delivered to all consumers in an efficient, fair, reliable and environmentally sustainable manner
- Inter alia ...
 - Risks (including price risks) relating to security of supply are properly and efficiently managed
 - Incentives for investment ... are maintained and enhanced
 - Full costs ... are signalled
 - Prices are subject to sustained downward pressure
 - Electricity sector contributes to ... climate change objectives
 - Assess all options
 - "Persuade and promote" yet "use its powers fully"
 - It should consult, use advisory groups "extensively", encourage innovation, provide information, enforce compliance ...



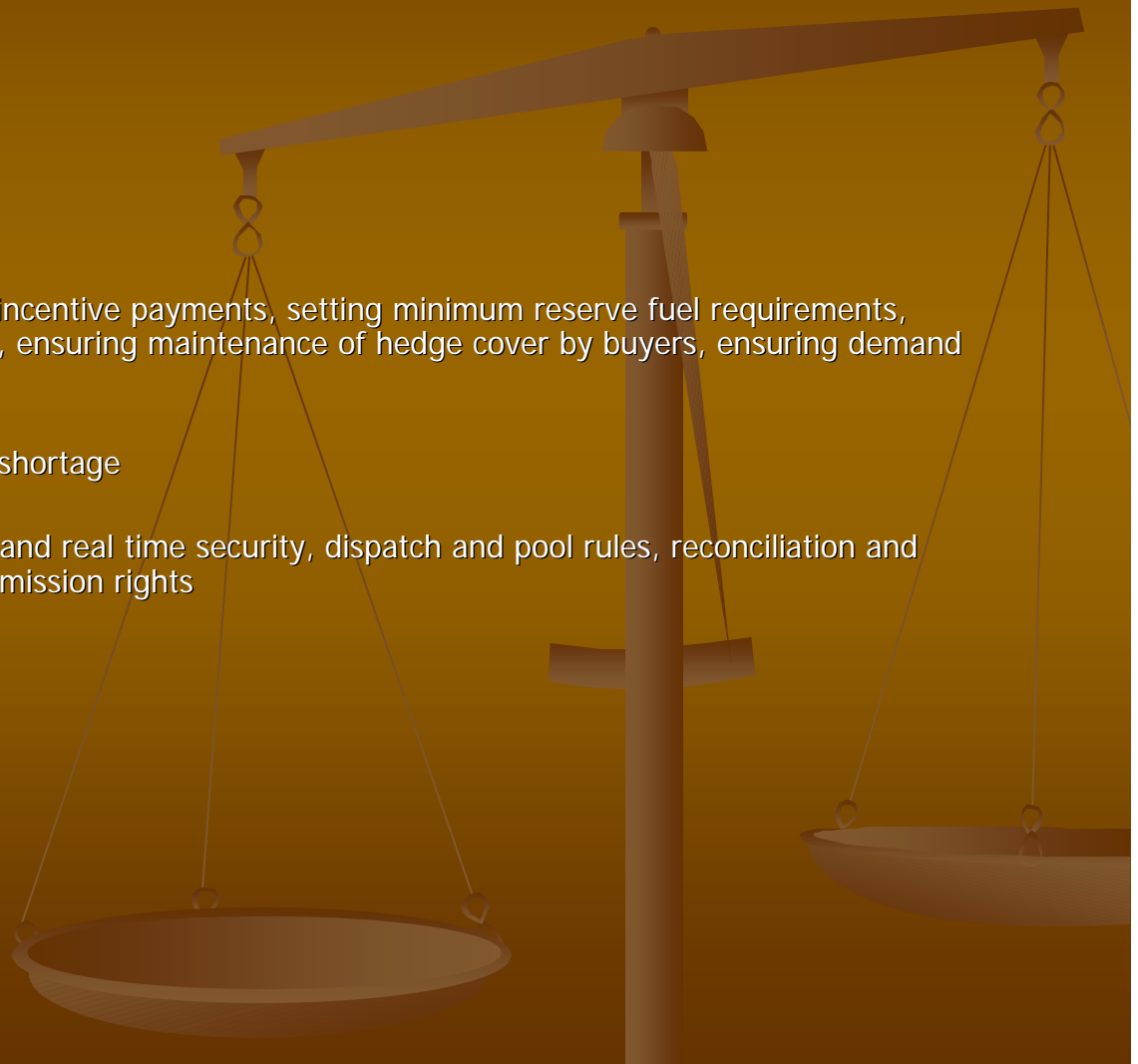
Electricity Commission contd - 2

- Ensure consumer contracts reflect reasonable expectations of consumers
- Develop model contracts and regulate if not implemented
- Ensure low fixed charge tariff options are available
- Consumers who have difficulty paying bills must still have access to electricity
- Put in place arrangements to promote efficiency ... including demand side
- Promote "financial incentives for investment", "cost reflective pricing", "smarter meters", "ripple control" ...
- Work with the EECA
- Ensure security of supply without "emergency conservation campaigns" and while "minimising distortions"
- 1 in 60 dry year, "minimum hydro zone"
- Second zone to "trigger a conservation campaign"



Electricity Commission contd - 3

- Contract for reserve energy
- Limit this to 1200 Gwh over four months
- "Maximise static and dynamic efficiency"
- Apply a levy to recover costs
- Security of supply co-ordination including incentive payments, setting minimum reserve fuel requirements, ensuring offers of contracts by generators, ensuring maintenance of hedge cover by buyers, ensuring demand side programmes for wholesale buyers ...
- Activate conservation campaigns if risk of shortage
- Responsible for policy on common quality and real time security, dispatch and pool rules, reconciliation and settlement, hedge markets, financial transmission rights



Electricity Commission contd - 4

- Grid reliability standards
- Establish benchmark transmission contracts
- Statements of opportunities
- Approve Transpower's grid upgrade plans
- Determine Transpower's pricing methodology
- Consider all alternatives
- Distribution pricing – model and recommend regulations
- Rural line charges to be kept in line with urban charges
- Work with the Commerce Commission which operates the threshold required for line companies
- Facilitate consumers switching retailers
- Regulate to facilitate retail competition
- All this is done by 40 staff

