"A BETTER DEAL FOR ELECTRICITY CONSUMERS"

AN OUTLINE OF THE NEW ZEALAND GOVERNMENT'S ELECTRICITY REFORM PACKAGE

7 April 1998

MINISTERIAL FOREWORD

"A Better Deal for Electricity Consumers"

An efficient electricity system is vital for a competitive, growing economy.

The Government's electricity reform package is comprehensive and far-reaching. It establishes a framework that will deliver benefits to consumers, the economy and the environment over the next 20 years.

The Government's overall energy policy objective is to ensure that:

- Electricity is available when required by consumers,
- Electricity is produced at the lowest possible cost to the economy as a whole; and
- Harm to the environment is minimised

The best way to achieve this is through vigorous competition wherever possible, combined with an effective regulatory regime where competition is not possible, most notably in the transmission and distribution (lines) businesses.

The current industry structure has significant limitations. In particular, the dominance of ECNZ (around 70% of the wholesale market) keeps prices too high and encourages over-investment in new generation. Vertical integration of distribution lines and retailing restricts consumer choice of suppliers.

The changes set out in this document are expected to result in:

- More competitive prices for consumers;
- Choice of electricity suppliers for smaller consumers;
- Reduced operating costs;
- Better timed investment in new generation; and
- Less harm to the environment.

Most importantly, the package will deliver a better deal for consumers over the medium term.

This document sets out the key details of the reform package. It is intended to be a point of reference for industry participants, interested parties and the media. However, it is not a legal document, nor does it address the wide range of technical questions which are likely to be raised. Further information on these issues will be provided ~~during~~ the implementation process.

Rt Hon Bill Birch
Minister of Finance
For and on behalf of shareholding Ministers

Hon Max Bradford
Minister of Energy

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PART A:
BACKGROUND AND SUMMARY

BACKGROUND

General objectives

A. A modern, competitive economy needs an efficient electricity system.

B. Consumers' electricity demands need to be satisfied in a manner which:

- Are least cost to the economy as a whole; and

  So that scarce resources are not wasted

- Are consistent with sustainable development.

  So that harm to the environment is minimised.

Specific goals

C. To achieve this goal:

- Wholesale and retail electricity prices should signal the full cost of producing each extra unit of electricity;

  So that investors and consumers can make decisions which seek to get the most value from each extra unit of electricity

- Electricity costs and prices should be subject to strong and sustained downward pressure;

  So that electricity producers are forced to innovate and find least-cost solutions over time.

D. In generation, these outcomes are best achieved by a process of effective competition among buyers and sellers, in particular:

- *Competition in generation:* multiple generators should compete vigorously against each other in producing electricity and investing in any necessary further capacity;

- *Demand-side alternatives:* energy efficiency options should compete actively as an alternative to buying additional more expensive power;

- *Competition in contracts:* buyers should be offered a diversity of prices and other terms and conditions for purchasing electricity contracts;

- *Competition in spot market:* prices for electricity in the spot market should be disciplined by effective competition among buyers and sellers.

E. In distribution, the desired outcomes are best achieved by:

- *Cost minimisation:* distribution companies seeking to minimise costs while providing the level of services demanded by customers. An effective price control threat, along with information disclosure, should encourage distribution companies to cost minimisation; and

- *Customer trade-offs:* customers making trade-offs between price and alternative levels of service, and distribution companies providing the level of services demanded by customers through a process of contractual negotiations.

F. In retail, the desired outcomes are best achieved by

- *Competition in retail:* multiple retailers competing vigorously to supply customers; and

- *Demand-side alternatives:* competing retailers and other market participants providing information to consumers on energy efficiency alternatives and consumers evaluating the costs and benefits of those options compared to buying more electricity.

Industry reforms to date

G. Over recent years, the industry has evolved through various stages:

- In 1987, ECNZ was established as an SOE;

- In 1991, Transpower was formed as a separate subsidiary within ECNZ;

- In 1993, the former electricity supply authorities were established as energy companies;

- In 1994, Transpower was established as a separate SOE.

H. In June 1995, the Government announced an initial package of reforms, mainly focused on the generation sector. Among other things, it provided for:

- The formation of Contact Energy Limited, with around 25% of ECNZ's assets;

- The sale of eight small hydro stations;

- Various restraints on ECNZ expanding and exercising its dominance;

- A framework for buying and selling electricity through a wholesale pool; and

- Policy statements on security of supply, electricity distribution and electricity pricing.

I. The 1995 reform package was a significant step in the direction of effective competition in generation.

Gains in wholesale market

J. The 1995 reforms have delivered a range of benefits, including:

- Lower wholesale prices than were expected without the split;
- Worthwhile reductions in controllable generation costs;
- A fully operational wholesale electricity market (the New Zealand Electricity Market); and
- Significantly improved information flows in the market, and the associated benefits of greater transparency and contestability of views.

Problems in wholesale market

K. However, the current generation structure also has a range of problems and limitations, in particular:

- ECNZ is still dominant in the spot and contracts markets, and is likely to remain so for many years unless there is further break up. The result is that:
    - *Prices are not competitive:* Spot and contract prices are significantly higher than they would be in a fully competitive market;
    - *Weak future price signals:* Market signals of medium to long term prices are not readily available due to limited trading of contracts. This is caused by several factors, in particular ECNZ's incentives to manage its business risks internally;
    - *Over-capacity:* New stations have been committed prematurely, resulting in over-capacity and harm to the environment which could have been deferred or avoided;
    - *Insufficient pressure on costs:* The level of pressure on generation costs is not as strong as it could or should be; and
    - *Waste of fuel:* Less efficient generation plant (New Plymouth) is running ahead of more efficient plant (Huntly), which wastes gas and increases CO_2 emissions. The risk of spilling scarce water is also higher.

- In addition, the 1995 restraints on ECNZ expanding or exercising its dominance are likely to be ineffective over time. There is significant scope for differences of interpretation and problems in monitoring and enforcement.

L. These problems are not unexpected. The 1995 reform package was a step in a direction, not an end-point. It expressly contemplated that further reforms may be necessary to more fully achieve effective competition in generation.

Problems in distribution and retail

M. There are three main outstanding policy problems in the distribution and retail sector which have yet to be effectively addressed:

- *Monopoly rents:* Pressure on costs and profits in distribution, which is a natural monopoly, are relatively weak. While competition in electricity retailing is limited, monopoly rents may also arise in retailing.

- *Barriers to retail competition:* Owners of local electricity companies have the incentives to deter competition in retailing by:

    - failing to provide low cost systems to enable customers to switch retailers;

    - unreasonably restricting access by competing retailers to their distribution network; and/or

    - using monopoly rents to cross-subsidise retail customers at risk to competitors, thereby decreasing the risk that these customers will be competed away.

- *Uneconomic generation:* Local electricity companies have incentives to cross-subsidise generation investments from distribution and retail customers not subject to competition.

No privatisation

N. The Coalition Agreement rules out the privatisation of Contact Energy, ECNZ and Transpower.

1998 reforms

O. The reforms as summarised in the following section below are designed to address the problems in paragraphs K and M above.

SUMMARY

GENERATION REFORMS

- **Split ECNZ into three SOEs**

  ECNZ is to be split into three SOEs comprising:

  - Huntly + Tongariro
  - Waikato hydros
  - Waitaki + Manapouri

- **Remove restraints on ECNZ's dominance**

  Existing restraints on ECNZ exercising its dominance imposed by shareholder directions under section 13 of the SOE Act are to be removed when the split is completed.

- **Develop a detailed implementation plan**

  A Transition Team is to prepare a detailed implementation plan over the next two months. SOE Development Groups will then be formed to negotiate detailed contracts for the split within the framework of the Transition Team's implementation plan.

- **Key factors to address before final decision**

  Government decisions so far are `in principle' and subject to:

  - Appropriate consultation with Maori on Treaty issues;

  - Certification by Transition Team and SOE Development Groups on financial viability;

  - Certifications by SOE Development Groups that each new SOE is structured to compete vigorously;

  - Obtaining positive affirmation from market participants, especially wholesale buyers, that they accept full responsibility for security of supply risks; and

  - Advice from the SOE Development Groups and officials where appropriate, that they have identified any likely changes to station usage and made suitable arrangements to address any environmental issues. Existing protections and penalties under the Resource Management Act are to remain in force.

DISTRIBUTION AND RETAIL REFORMS

- **Strengthened disclosure requirements**

  Information disclosure requirements, including ODV rules, are to be substantially strengthened. In addition, the disclosure regulations will be amended to provide for a greater level of information which is more readily understandable to ordinary consumers.

- **Improved public analysis**

  Government will fund better analysis of disclosed information, including publishing regular comparative performance tables and graphs.

- **Need for low cost system to enable consumers to switch supplier**

  The industry is required to deliver, within 12 months, a low cost option to enable small consumers to switch electricity supplier if they wish. If this is not delivered, the Government will regulate for a mandatory default switching system (likely to be a form of 'deemed profiling').

- **Ownership separation of lines and competitive businesses**

  Lines businesses are to be owned separately from retail, generation and any other competitive businesses in the electricity sector. In particular, power companies can either:

  - By 1 April 1999, set up a separate trust-owned company for their distribution or electricity retailing/generation activities; *or*

  - By 31 December 2003, sell their distribution or electricity retail/generation services and, between 1 April 1999 and the time of sale, operate these activities as separate companies on an arms-length basis.

- **Increased threat of price control**

  The threat of price control on the monopoly lines business is to be strengthened by:

  - Empowering the Commerce Commission to apply price control within Government set criteria or thresholds, subject to Ministerial override; and

  - Enabling the Government to seek advice from the Commerce Commission on the thresholds and criteria which, if breached, could trigger selective price control.

These mechanisms for strengthening the threat of price control are subject to further work on design and implementation.

PART B:
GENERATION REFORMS

RESTRUCTURING OF ECNZ

Objective

1. The objective is to promote effective competition in the New Zealand generation market by restructuring ECNZ into three competing State-owned enterprises (SOEs) which are -

   - commercially viable entities; and
   - effective competitors.

Implementation principles

2. The restructuring of ECNZ outlined below is to be implemented in a manner which best achieves the objective in paragraph 1 above.

3. Subject to paragraph 2, implementation is to be planned and executed in a manner which:

   - is consistent with the financial parameters set out in paragraphs 27-36 below;
   - minimises implementation costs;
   - enables the new SOEs to be fully independent as soon as possible; and
   - avoids any unnecessary adverse impacts on the financial statements of the Crown.

4. For the avoidance of doubt, implementation is to be consistent with:

   - the State-Owned Enterprises Act 1986 and any directions issued by the shareholding Ministers under section 13 of that Act; and
   - any other relevant law, including the Resource Management Act 1991.

5. A Transition Team, acting as an advisor to the Government and working in consultation with ECNZ, is to prepare an implementation plan for approval by ECNZ's shareholding Ministers. If possible, the implementation plan is to be agreed with ECNZ. SOE Development Groups for each new SOE are to establish detailed contracts for the transfer of assets and liabilities, within the framework of the Government-approved implementation plan. Further details on this process are set out in paragraphs 22-26.

Allocation of major assets

6. The three SOEs are to be based on the following key asset groups:

   - the Waikato hydro system *(SOE 1)*;

- the Huntly thermal station, the Te Awamutu station and the Tongariro system *(SOE 2)*; and

- Manapouri and the Waitaki hydro systems *(SOE 3)*.

7. The remaining small hydro stations are to continue to be sold pursuant to Memorandum of Understanding between the Government and ECNZ dated 8 June 1995, except that any which are not sold before the completion of the ECNZ split are to be allocated as follows:

- SOE 1: Managahao

- SOE 2: Waikaremoana

- SOE 3: Cobb, Coleridge, Highbank

Explanatory note:

Based on current forecasts, this should give rise to a generation market with the following market shares (MW in 2002)

- *SOE 1: 13%*
- *SOE 2: 17%*
- *SOE 3: 30%*
- *Contact: 25%*
- *Private: 15%*

Under this structure, interdependent hydro stations are held within the same SOE. The main hydro reserves - Lake Pukaki - would be held by SOE 3. To minimise transition costs, the current ECNZ is likely to become SOE 3. Even though ECNZ would not be a new SOE in legal terms, it is intended, nevertheless, that an SOE Development Group would prepare detailed business, financial and organisation-build plans for it as if it was a new SOE.

Related assets

8. The generation portfolios referred to above are to include all rights, interests and privileges (including intellectual property (subject to paragraph 9-11 below), resource consents, fuel contracts and development sites) required by, or most efficiently associated with, the relevant portfolios.

Intellectual property

9. During the period between the date of announcing these measures and completing the transfer of assets to the new SOEs, ECNZ will provide to the new SOEs access to all intellectual property required to achieve the objective set out in paragraph 1 above.

10. On transfer of the assets to the new SOEs, ECNZ will provide the new SOEs with duplicates of all intellectual property required to achieve the objective set out in paragraph 1 above, and the new SOEs will pay for any reasonable duplication costs.

11. For the avoidance of doubt, a duplicate copy of strategic models will be provided by ECNZ to the new SOEs.

Transfer of staff

12. It is intended that ECNZ staff associated with the power stations referred to in paragraph 6 above will be transferred to the relevant SOE.

13. If any redundancies or severances occur after the date of transfer of the power station staff, the employer in each case shall bear the costs.

14. ECNZ and the Transition Team will agree on an appropriate process to allow some or all of ECNZ's existing head office personnel staff to transfer to the new SOEs. ECNZ and the new SOEs will endeavour to avoid redundancies or severances arising from this process. If any such redundancies or severances do occur, the costs will be shared between ECNZ and the new SOEs in proportion to the book value of their assets on the date of transfer. The new SOEs will pay their shares of any such costs to the residual ECNZ entity after the separation is completed.

    Explanatory note:

    The approach outlined above is intended to avoid redundancies and severances in the separation process. The agreed cost-sharing agreement will create strong incentives for ECNZ and the new SOEs to put in place a process that ensures a smooth staff transition.

Existing ECNZ contracts

Principles

15. Legal rights and obligations in existing contracts between ECNZ and its customers, suppliers and lenders are to be protected as far as possible.

16. Consistent with paragraph 3 above, the costs to the Crown and ECNZ of assigning, amending or renegotiating any of ECNZ's existing contracts are to be minimised.

Process

17. In its implementation plan, the Transition Team is to outline a framework for addressing each of ECNZ's major existing contracts, including ECNZ's existing debt obligations, the Comalco contracts, the Fletcher Challenge Energy heads of agreement relating to gas, the Contact gas supply contract and ECNZ's existing hedge or bilateral contracts relating to electricity supply or pricing.

Debt contracts

18. ECNZ's existing debt contracts will remain in force. The Transition Team will advise the Government on options for continuing to satisfy any security and other prudential covenants within these contracts.

Explanatory note:

The mechanisms used for separating Contact and Transpower are examples of how this can be achieved. In time, the new SOEs will approach the debt markets on their own account.

Transmission contracts

19. ECNZ's existing contracts with Transpower will, at some stage in the restructuring process, have to be renegotiated. It is expected that Transpower will cooperate fully in this process.

Comalco contracts

20. The restructuring is to be implemented in a manner which does not require any material change to the existing Comalco contracts.

Explanatory note:

The Transition Team's implementation plan will need to work within this parameter. Initial indications are this would be achieved by leaving the Comalco contracts with ECNZ as SOE 3 (which is to control the Manapouri and Waitaki systems).

Fletcher Challenge Energy Heads of Agreement for Gas

21. Options for managing this arrangement are to be explored by the Transition Team and addressed in its implementation plan. This will take into account SOE 2's need to ensure fuel contracts for Huntly.

Implementation process

22. Implementation of this restructuring will be carried out in three stages:

- Stage one *(about two months)*: preparing an implementation plan to provide a more detailed framework for stage two negotiations between ECNZ and the proposed new SOEs;

- Stage two *(about six months)*: negotiation of detailed arrangements for the possible transfer of assets and liabilities; development of detailed business plans for each proposed SOE, including operating strategies, human resources, financial structures and organisation-build; and certification to Government as to financial viability and competitiveness based on the parameters set out in this document;

- Stage three *(up to three months)*: subject to final decisions by Government on whether to proceed with the restructuring, actual implementation of the ECNZ separation and establishing the new SOEs.

23. Stage one is to be carried out by a Transition Team, in consultation with ECNZ. The Transition Team will be appointed by, and make recommendations to, the Government. Detailed terms of reference on the Transition Team's role are set out as in Part D.

24. Stage two is to be carried out by SOE Development Groups, in consultation with ECNZ. The SOE Development Groups will also be appointed by the Government. Detailed terms of reference on their role will be provided closer to the appointment of the SOE Development Groups.

Explanatory note:

If ECNZ becomes SOE 3 (as is likely), it is intended, nevertheless, that ECNZ would still go through the SOE development process for strategic, financial and organisational planning purposes.

25. During stage two, the Transition Team will remain in place with the primary role of monitoring progress against the implementation plan, providing advice on the resolution of any disputes between ECNZ and the SOE Development Groups, and driving the process to achieve the target timetable.

26. At stage three, if the Government decides to proceed, the SOE Development Groups are likely to become SOE Establishment Boards and actual implementation and organisation-build would proceed.

Financial parameters

Valuation and financial structure

27. Issues relating to the valuation of assets, and any liabilities to be transferred from ECNZ to the new SOEs are to be agreed between the Transition Team and ECNZ, subject to the approval of ECNZ's shareholding Ministers.

28. The financial structures of the SOEs are to be agreed by the SOE Development Groups respectively with their shareholding Ministers, in consultation with the Transition Team.

29. To facilitate the separation process, the objective is to transfer assets to the new SOEs at book value. This approach will be followed provided that the shareholding Ministers are satisfied that it is consistent with the overall objective set out in paragraph 1 above.

30. The SOEs will undertake to review their asset valuations and capital structures within 12 months of the separation date (or other such date as agreed between each company and its shareholding Ministers).

31. The purpose of such reviews is to provide an opportunity to adjust the financial structure of the companies to reflect the establishment of long term contracts, and to ensure the companies have asset values suitable for their future operation.

Procedure for ECNZ to repay equity capital to the Crown

32. Following the transfer of assets to the new SOEs, ECNZ will have surplus equity capital.

33. ECNZ will pay the Crown, subject to the Companies Act 1993, the surplus shareholders funds arising from the transfer of assets to the new SOEs.

Expected financial flows

34. The timing and amounts of financial flows will be determined by shareholding Ministers on the advice of ECNZ and the Transition Team. Provided the Transition Team and the shareholding Ministers are satisfied that the proposed flows are consistent with the objectives set out in paragraph 1 above, the expected set of transactions to occur on settlement date is as follows:

- the Crown supplies appropriate capital to the new SOEs on the basis of a proposal from the Transition Team that is approved by the Government;

- the new SOEs use these funds for working capital and to purchase a portfolio of assets and liabilities, or shares in a subsidiary company, from ECNZ for cash;

- ECNZ transfers a portfolio of assets and liabilities, or shares in a subsidiary company, for cash to the new SOEs, and uses all of the proceeds to reduce its capital and, if appropriate, make a loan to the Crown. The amount and terms of any loan or any debt finance the Crown supplies to the new SOEs (under the sub-paragraph above) is expected to be identical to the amount and terms of the loan from ECNZ to the Crown.

35. It may be appropriate for ECNZ to use a portion of any loan to the Crown as security for an in-substance debt defeasance transaction. Such a defeasance could assist in protecting the position of ECNZ's creditors, as was the case in the separation of Contract Energy. This is an issue for the Transition Team to address in its implementation plan.

36. The question of whether the separation is implemented by a transfer of assets or shares in a subsidiary is an issue for the Transition Team to address in its implementation plan.

Target dates

37. The target date for the completion of stage two is 15 December 1998.

38. The target date for completion of implementation is 1 April 1999.

Dispute resolution

39. If agreement cannot be reached for the purposes of valuation and financial structure (paragraphs 27 and 28 above refer) by a date set by ECNZ's shareholding Ministers, the matters not agreed will be determined by shareholding Ministers.

40. Subject to paragraph 39 above, if a difference arises between during stage two among ECNZ and any of the SOE Development Groups, which prevents agreement being reached between them on a matter referred to in this document by a date determined by the Transition Team or the shareholding Ministers, then, unless the shareholding Ministers determine otherwise, ECNZ and the SOE Development Groups will be bound by the decision of the Transition Team to be given within 14 days of the date referred to above.

Shareholder directions

41. Shareholding Ministers may issue directions under section 13 of the State-Owned Enterprises Act 1986 in relation to the separation of key asset groups.

42. The Government will consider the option of inviting Parliament to make a minor amendment to the State-Owned Enterprises Act 1986 to clarify that ECNZ's shareholding Ministers may issue directions under section 13 of that Act on key implementation issues. If necessary, the Government will also consider the option of inviting Parliament to empower shareholding Ministers to decide the terms and conditions on which the transfer of assets and liabilities are to take place.

RELATED ISSUES

Existing restraints on SOE generators

43. In early 1996, shareholding Ministers issued directions under section 13 of the State-Owned Enterprises Act 1986 which:

- prohibit ECNZ and Contact from purchasing any energy company or any significant share in an energy company;
- requires ECNZ to sell eight small hydro stations;
- prohibit ECNZ from building more than 50% of all new capacity (with exclusions for co-generation and renewable technologies such as wind power);
- require ECNZ to 'ringfence' any investment additional capacity;
- require ECNZ to offer specified volumes of longer term financial contracts.

44. These requirements are to be addressed as follows:

- When the transfer of assets from ECNZ to the new SOEs has been completed, the shareholders' restriction on Contact and ECNZ buying energy companies are to be lifted and the SOE generators are to be subject to the same regulatory rules as may apply from time to time on any other market participant;
- The sale of small hydros is to continue in accordance with the provisions of the Memorandum of Understand dated 8 June 1998 between ECNZ and the Government ('the MOU'), except that the MOU will be amended to confirm that the selection of eligible energy companies as potential bidders will also be subject to the restrictions set out in Part C below on lines businesses owning generation businesses.

  Explanatory note:

  Under the distribution reforms set out below, lines businesses will not be eligible to buy the small hydros. The MOU preference to sell small hydros to "energy companies within the general region of the hydro station" will apply to the former retail part of those companies. It is possible, therefore, that the size of the "general region" for eligible bidders will need to be enlarged to ensure reasonable contestability. This will continue to be considered by Ministers on a case-by-case basis.

- The remaining three shareholder restraints referred to above are to be removed when the transfer of assets from ECNZ to the new SOEs has been completed.

Security of energy supply

45. The Government has issued a policy statement on managing the risk of dry years (insufficient rainfall or snow melt into the hydro catchments) and other supply risks, which is set out in the Part D of this document.

46. Final decisions by Cabinet on whether to proceed with the restructuring is subject to obtaining positive affirmation from market participants, especially wholesale buyers, that they accept full responsibility for security of supply risks.

Explanatory note:

In a well-functioning wholesale market with effective competition:

- *Responsibility for effectively managing the risks of non-supply should rest with buyers and sellers;*
- *The Government should not step in to protect players which fail to arrange adequate protection. (To step in would increase the likelihood of future supply shortages by undermining the incentives on buyers and sellers to put in place proper risk management strategies);*
- *The risk of non-supply can be managed using a variety of mechanisms, including back up generation, load reduction (buying power back), self-generation and hedge contracts;*
- *Each buyer and seller needs to assess their exposure and determine the most cost-effective risk-management strategy for them. There is no single best strategy for all; and*
- *The key point is that security of supply risks will not increase as a result of this restructuring so long as each wholesale buyer and seller accepts full responsibility for protecting themselves against the risks. In fact, the Government's advice is that security of supply risks should, over time, be managed more efficiently, with a lower risk of wasting valuable water;*

This is why the Government is inviting EMCO to facilitate the process set out above in which wholesale buyers and sellers confirm their acceptance of this responsibility.

The risk of shortage will be reduced during the transition period by the significant surplus of new capacity which is due to come on-stream over the next five years or so.

Environmental issues

47. The existing processes, protections and penalties under the Resource Management Act apply to the new SOE's.

48. Final decisions by Cabinet on whether to proceed with the restructuring are subject to advice from the SOE Development Groups and officials where appropriate that they have identified any likely changes to station usage and made suitable arrangements to address any environmental issues.

Explanatory note:

In developing this generation reform package, government officials analysed the likely environmental impacts and obtained independent expert review of that analysis by Eden Resources Limited. A copy is available from the Ministry for the Environment.

In summary, breaking ECNZ into three competing SOEs is expected to have little adverse environmental impact and may confer benefits in the short to medium term. Longer term impacts are expected to be positive for the environment compared with maintaining the status quo.

Amongst other things, the reforms encourage retail competition and require that generators and retailers accept responsibility for managing security of supply risks. This should provide incentives for retailers to offer energy services with the least cost combinations of energy efficiency measures and supply to suit customers' individual price, service and security of supply preferences.

The recent experience with supply to the Auckland CBD is one example where the energy retailer and consumers put in place a range of demand side techniques that were cheaper than supply side options.

Demand-side measures help reduce peak power demands and hence the need for new generation capacity. This is significantly less harmful to the environment in the longer term.

Treaty issues

49. Final decisions by Cabinet on whether to proceed with the restructuring are subject to appropriate consultation with Maori on Treaty issues.

Explanatory note:

The process of consultation is likely to be similar to that followed for the separation of Contact Energy.

Crown representatives will inform each of the relevant Maori groups of the proposals and invite Maori to inform the Crown of any Treaty implications. The Crown will then consider those views with an open mind, in particular the extent to which existing mechanisms protect Treaty claims, before making a final decision on whether to proceed with the proposed split of ECNZ.

For the avoidance of doubt, the Government notes that existing Treaty protection mechanisms, including the system of memorials and powers of resumption in relation to SOE land, will remain in place and apply to the new electricity SOEs.

Next steps in Cabinet decision process

50. Final decisions by Cabinet on whether to proceed with the generation restructuring are subject to:

- Appropriate consultation with Maori on Treaty issues;
- Certification by Transition Team and SOE Development Groups on financial viability;
- Certifications by SOE Development Groups that each new SOE is structured to compete vigorously;
- Obtaining positive affirmation from market participants, especially wholesale buyers, that they accept full responsibility for security of supply risks; and
- Advice from the SOE Development Groups and officials where appropriate, that they have identified any likely changes to station usage and made suitable arrangements to address any environmental issues. Existing protections and penalties under the Resource Management Act are to remain in force.

PART C:
DISTRIBUTION REFORMS

IMPROVED INFORMATION DISCLOSURE

Objective

51. The measures described in this section are intended to increase the transparency of:

- excessive costs, profits and prices in distribution and the currently non-contestable component of electricity retailing;

- anti-competitive behaviour, in particular cross-subsidisation of electricity retailing (from distribution or non-contestable retail customers), thereby promoting retail competition; and

- cross-subsidies from distribution and non-contestable retail customers to generation.

Current information disclosure regime

52. The current Electricity (Information Disclosure) Regulations 1994 and Handbook for Optimised Deprival Valuation of Electricity Lines Businesses:

- require disclosure of information on electricity companies' financial and non-financial performance. These include disclosure of line charges, access agreements and separate financial statements for distribution, retail and generation businesses; but

- are subject to various shortcomings, for example the financial separation and ODV rules are too open to interpretation These shortcomings undermine the transparency of electricity companies' performance.

Strengthened disclosure requirements

53. The Government has decided to amend the Electricity (Information Disclosure) Regulations 1994 and Handbook for Optimised Deprival Valuation of Electricity Line Businesses. The key changes are as follows:

- companies will be required to use a detailed methodology for allocating items among business activities for disclosure purposes, which will require:

    - companies' line business financial statements to include only natural monopoly line activities; and

- costs, revenues, assets and liabilities to be allocated amongst companies' line and contestable activities on an "avoidable cost" basis (that is, the line business financial statements will include only those items or components of items which it would require if it were a stand-alone line business);

- electricity retailers will be required to disclose details of their wholesale electricity costs and the revenue obtained from specified electricity retailing customer groups; and

- companies will be precluded from exceeding the standard asset lives and values in the ODV Handbook (the standard lives of some assets are being increased in the new version of the Handbook).

54. Exposure drafts of these amendments were issued for public consultation in 1997. The new regulations are expected to be promulgated shortly and will take effect in 1998/99.

Government-funded analysis of disclosed information

55. The Government will fund increased analysis of disclosed information by (for example):

- preparing and publishing additional comparisons of companies' performance;

- analysing companies' application of the new allocation methodology;

- monitoring companies' application of the ODV methodology; and

- analysing companies' line charge methodologies.

56. It is expected that this increased analysis will enable ready public comparison of companies' performance.

User-friendly disclosures

57. The current information disclosure regime will be further enhanced by:

- requiring companies to disclose line charges on customers' bills; and

- requiring electricity supply companies to publish "user-friendly" summaries of their disclosures (in addition to their full disclosures).

Explanatory note:

Pressure on lines companies to minimise their costs and prices will be increased if their customers can more readily:

- *identify and comment on a separate line charge which is comparable across line providers; and*
- *understand other key elements of the wider information disclosure regime by reviewing simplified summaries.*

Impact of ownership separation on the information disclosure regulations

58. The changes to the Electricity (Information Disclosure) Regulations 1994 referred to in paragraph 53 above will require further minor amendment in the light of ownership separation requirements described in paragraphs 66 and 67 below, including a requirement for distribution companies to disclose financial statements ring-fenced to lines and separated from any `other' activities they undertake using an avoidable cost allocation methodology.

Explanatory note:

Ownership separation is not a substitute for information disclosure. The risk of excessive costs and margins in distribution will remain so long as lines are a natural monopoly function. Improved information disclosure regulations are therefore required.

Following ownership separation, electricity distribution companies will be permitted to operate both natural monopoly (distribution) activities and any other competitive services other than electricity retailing and generation. Financial separation will therefore still be required to assist in identifying whether the natural monopoly component of electricity distribution companies have excessive costs or profits (monopoly rents).

LOW COST MECHANISMS FOR CHANGING RETAILER

Objective

59. The measures described in this section are intended to address:

- the failure by the industry to provide low cost systems to enable customers to switch retailer, and
- the risk of anti-competitive restrictions to distribution lines for competing retailers.

Explanatory note:

Customers supplied by competing retailers are required to have half-hourly meters of certain minimum standards of accuracy installed, unless the incumbent company agrees to an alternative form of measurement. (Half-hourly metering is required because electricity is bought and sold on a half-hourly basis.) The costs of installing meters that meet these accuracy standards, and of handling the half-hourly data provided, tend to deter new entry. The current industry rules impose unnecessarily expensive compliance costs on competitive supply.

Lower cost alternatives could be developed to enable customers to switch supplier if they wish. This requires incumbent companies to agree on lower cost rules for assessing half-hourly consumption and data reconciliation. The problem is that incumbent electricity companies have limited incentives to agree on these cheaper alternatives as more of their customers could be competed away.

Measures

60. The Government expects industry participants to establish, by April 1999, a low cost system (or systems) which will enable consumers, if they wish, to switch retail suppliers.

61. The industry is expected to focus, in particular, on developing cheaper systems for assessing and reconciling electricity consumption by domestic and other small customers.

62. The Electricity Market Company Limited (EMCO) and the Electricity Supply Association of New Zealand (ESANZ) are expected to play key leadership roles in facilitating this industry initiative.

63. If the industry fails to make sufficient progress, or to achieve a workable outcome within twelve months, the Government will put in place by regulation a mandatory default system to enable consumers to switch between competing retailers.

64. To support the above, the Government will:

- set out the key policy objectives and principles it expects the industry to meet in developing a low cost switching system. (These are set out in a policy statement in the Part D);
- seek regular (monthly) reports from the industry on progress in developing this mechanism; and
- invite Parliament this year to amend the Electricity Act 1992 to empower the Executive to require the industry by regulation to use a 'default' switching system.

SEPARATION OF DISTRIBUTION FROM CONTESTABLE ELECTRICITY ACTIVITIES

Objective

65. The measures described in this section are intended to address the risks of:

- anti-competitive restrictions on access to distribution lines for competing retailers;
- cross-subsidisation of retail activities from distribution lines; and
- cross-subsidisation of generation activities from distribution lines.

Separation concept

66. Legislation is to be introduced prohibiting common ownership of:

- electricity distribution; and
- electricity retailing and/or electricity generation.

Explanatory note:

The benefits of preventing vertical integration between competitive and monopoly services are as follows:

- *it will eliminate the ability and incentives of a monopoly lines business to:*
  - *restrict access to its network by competing retailers; and/or*
  - *use monopoly rents from lines to cross-subsidise retail customers; and/or*
  - *use monopoly rents from lines to cross-subsidise investments in generation;*
- *it will eliminate the risks of vertically integrated electricity companies failing to distinguish adequately between the business risks and requirements of:*
  - *the monopoly lines business (on the one hand), where the focus should be on efficient asset management (including security of supply) and cost minimisation; and*
  - *the competitive retail or generation businesses (on the other hand), where the focus should be on managing entrepreneurial risk;*

- *it will help to better expose the monopoly lines business to closer scrutiny by users and other market participants. The lines businesses will become stand-alone entities which will be more easily targeted for consumer comment, in the same way that Transpower has become more transparent since it was separated from ECNZ in 1994;*

- *it will encourage the amalgamation of retail businesses to achieve greater efficiencies and stronger competitive choice for consumers; and*

- *it will encourage the amalgamation of lines businesses to achieve lower costs and better service to users.*

Unless integration of monopoly lines with retail and generation is prevented:

- *it is likely that, over the next five to ten years, a small number of large regional vertically integrated monopolies will form, each operating within a de facto franchise area with the potential for limited competition and choice for consumers; and*

- *the Government's overall energy policy objectives of -*

    - *ensuring strong competitive disciplines on costs and prices in retail and generation, and*

    - *efficiency drivers in distribution which proxy those competitive pressures -*

are not likely to be achieved.

Specific ownership rules

67. Legislation will be introduced to implement the following rules (referred to in this section as 'the cross-ownership rules'):

- no person with an electricity distribution business may own more than 10 percent of a business that is involved in electricity retailing or generation in any part of the market, or vice versa;

- two or more persons with an electricity distribution business may not own more than 20 percent in aggregate of a business that is involved in electricity retailing or generation in any part of the market or vice versa; and

- similar rules will prohibit the exercise of material influence by a person involved in electricity distribution over a person involved in electricity retailing or generation and vice versa, whether by contract, arrangement or understanding.

68. The detail of the cross-ownership rules, including definitions of key terms, will be set out in the legislation.

Explanatory note:

In the Government's view clear and strict rules are required for separation between lines and contestable electricity activities to be effective. The formulation of the above rules has taken into account the following key factors:

- *the 10 and 20 per cent thresholds recognise that companies with disparate ownership can be disproportionately influenced by concentrated small holdings, which could be used to frustrate the objectives;*
- *the rules need to minimise incentives to create artificial avoidance arrangements and/or use litigation for tactical purposes;*
- *the rules need to provide for straightforward enforcement and strong penalties, supplementing Commerce Act remedies; and*
- *the rules need to minimise opportunities and incentives to maintain indirect control.*

Overview of options

69. All electricity supply companies, however currently owned, must elect either to:

- *Option 1*: by 1 April 1999, set up a separate trust-owned company for their distribution or electricity retailing/generation activities; *or*
- *Option 2*: by 31 December 2003, sell their distribution or electricity retailing/ generation activities and, between 1 April 1999 and the time of sale, operate these activities as separate companies on an arms-length basis.

Option 1: Trust separation

70. Under this option, electricity supply companies must, by 1 April 1999, sell all or part of their distribution or electricity retailing/generation undertaking to a separate ratepayer, community, customer or charitable trust, or customer co-operative.

71. Where an undertaking is transferred to a new trust pursuant to paragraph 70 above, the cross-ownership rules set out in paragraph 67 above will not apply to the extent that:

- the beneficiaries of the new trust are the same as the beneficiaries of an existing trust; and
- the beneficial interest in the trust is widely held in the community.

72. Where an undertaking is transferred to a new co-operative pursuant to paragraph 70 above, the cross-ownership rules set out in paragraph 67 above will not apply to the extent that:

- the beneficiaries of the new co-operative are the same as an existing co-operative or existing trust; and
- the co-operative is widely held in the community.

73. The exemptions in paragraphs 71 and 72 above from the cross-ownership rules only apply to cases of common trust beneficiaries and common co-operative membership. For the avoidance of doubt, the exemption does *not* cover:

- the trust-owned companies or co-operative companies themselves (eg trust-owned distribution company A cannot purchase more than ten percent of the retail or generation company B);
- other shareholders in the trust-owned company or members of the co-operative company (eg non-trust owners *are* subject to the cross-ownership rules); or
- the trust or co-operative itself (eg trusts *are* subject to the cross-ownership rules where they purchase other businesses).

74. Separated trust-owned or co-operative companies will be required to comply with arms-length principles and rules, which will be set out in detailed legislation.

Explanatory note:

The arms-length principles and rules will require companies to operate as if they had no common ownership. Examples of the arms length principles and rules include:

- *no person can be a director of both companies or a trustee of both shareholding trusts;*
- *the directors or board of one company must act in the best interests of that company (this rule is intended to overcome the provisions in the Companies Act that enable, in particular circumstances, directors of a subsidiary company to act in the best interests of the holding company); and*
- *in allocating dividends or rebates, the distribution (lines) company must not discriminate among beneficiaries on the basis of whether or not the beneficiary is a customer of the retail or generation company.*

The rules will also restrict the information which can be provided by either company (or its directors) to the other company (or its directors), and the uses which can be made of such information.

75. By 1 April 1999, companies will need to have:

- reached a complete and unconditional agreement to transfer their distribution assets and liabilities, or the assets and liabilities of the electricity retailing/generation businesses, to a company in which the new trust or co-operative is a shareholder; and

- ensured that any other shareholdings comply with the ownership separation rules.

76. The conclusive agreement referred to in paragraph 75 above should include:

- an agreed description of the assets and liabilities to be transferred to the trust-owned company;

- details of the way in which the existing contracts of the electricity supply company are to be assigned between the distribution and electricity retail/generation companies;

- details of the procedures to be followed in resolving any outstanding issues; and

- the price or consideration which the trust will make for the assets and liabilities to be transferred.

77. By 1 April 1999, companies will also need to have put in place separate accounting procedures for the two companies.

78. By 1 April 2000, companies choosing Option 1 must have completed the transfer of assets and liabilities to the new trust-owned company, including resolving all outstanding issues.

Option 2: Non-trust separation

79. Under this option, an electricity supply company must:

- by 31 December 2003, divest either its distribution or electricity retail/generation activities to any person or entity, except a trust or co-operative under paragraph 70 above, to a level that satisfies the cross-ownership rules set out in paragraph 67 above; and

- from 1 April 1999 until the completion of the divestment required above, operate their distribution and electricity retail/generation activities as separate companies on an arms-length basis. Legislation will set out arms-length principles and rules. These are likely to be similar to those rules set out in paragraph 67 above.

80. By 31 December 2003, companies must have reached a complete and unconditional agreement to transfer their distribution assets and liabilities, or the assets and liabilities of the electricity retailing/generation businesses, to a person (other than a trust or co-operative) consistent with the cross-ownership rules in paragraph 74 above.

Allocation of customer meters

81. Under either Option 1 or 2 outlined above, customer meters could be owned by either the distribution or electricity retailing/generation companies. However, financial disclosure rules will require that any customer meters which are owned by distribution companies are to be excluded from the financial statements of the lines business.

Explanatory note:

Meters are a contestable service, likely to be subject to further innovation in the relatively short term. However the Government would be concerned if metering was used anti-competitively. If problems emerge, the Government will review the financial separation requirements mentioned above with a view to imposing stronger regulatory or structural safeguards.

Enforcement, penalties and remedies

82. Penalties and remedies will be court-based and set at levels which should effectively deter contraventions. Enforcement will be available to any person.

Explanatory note:

A law has limited effect unless it is effectively enforced. Penalties and remedies under the ownership separation legislation will support the goals of the legislation. This requires that the penalties and remedies are set at a level which means that companies expect in advance that it will be costly to breach the legislation. Enforcement by any person will also sharpen incentives to comply.

The legislation will specify offences, which will include breach of the cross-ownership threshold rules, failure to divest by 1 December 2003, and failure to implement corporate separation or set up a trust by 1 April 1999.

Penalties and remedies could include divestiture of assets, fines, civil damages, injunctions and other orders (for example, corporate probation/supervision, and behavioural undertakings).

Application of Commerce Act

83. Changes are being considered to the Commerce Act such that the distribution and retail/generation companies will not be treated as interconnected bodies corporate.

84. Arms-length arrangements between the companies will therefore become subject to the Commerce Act.

PART D:
POLICY STATEMENTS AND TERMS OF REFERENCE FOR THE TRANSITION TEAM

- *Competition in contracts:* buyers are to be offered a diversity of prices and other terms and conditions for purchasing electricity contracts; and

- *Competition in spot market:* prices for electricity in the spot market are to be disciplined by effective competition among buyers and sellers.

Transmission prices

Consistent with its statement of corporate intent (SCI), Transpower is to provide the quality and quantity of transmission services demanded by its customers through a process of contractual agreement. Transpower is to price demanded services in a manner which is consistent with the Government's statement of economic policy issued under section 26 of the Commerce Act 1986. Customers are to make the trade-off between the level and quality of services and their price.

Distribution prices

As for transmission services, the Government expects distribution companies to provide the quality and quantity of distribution services demanded by its customers through a process of contractual agreement. The Government also encourages distribution companies to enable customers to make trade-offs between the level and quality of services and their price. Before entering into contracts, customers should be invited by distribution companies to take into account the cost-benefit tradeoffs of alternative levels of service. An accompanying policy statement sets out the Government's policy principles in relation to a security on distribution lines.

The Government expects distribution companies to minimise costs while providing the level of service demanded by customers.

The price control provisions in Part IV of the Commerce Act have particular relevance to distribution companies given that they provide a natural monopoly service.

Retail prices

The measures set out in the Government's reform package are intended to reduce substantially barriers to retail competition. Under the new industry structure, retail prices are expected, in due course, to be established by competition between competing retail suppliers.

Overview of regulatory regime

The regulatory regime for the electricity industry will now comprise four key components:

- The Commerce Act which is designed to prohibit and protect against anti-competitive behaviour and the acquisition or strengthening of market dominance;

- Ownership separation of natural monopoly (distribution and transmission) from competitive (retail and generation) electricity businesses;

- The Electricity (Information Disclosure) Regulations 1994 (to be enhanced by further amendments) which are intended to make transparent the operation of businesses in the electricity industry which have market dominance; and

- The threat of further regulation, including price control under Part IV of the Commerce Act, if market dominance is abused.

The Government has decided in principle to empower the Commerce Commission to impose price control within certain thresholds or criteria to be set by the Government. The Commission's decisions to impose price control may be subject to a Ministerial override. Further work on design and implementation for this empowering mechanism is to be completed before the Government makes final decisions on whether to proceed.

Parliament Buildings
WELLINGTON
7 April 1998

GOVERNMENT POLICY STATEMENT: MANAGEMENT OF ELECTRICITY SUPPLY RISK

Background

A key risk to the security of electricity supply in New Zealand is climatic uncertainty. We rely heavily on hydro generation and New Zealand has limited water storage capacity. Unusually low rainfall, or "dry years", can create electricity shortages. The economy will continue to face this risk for the foreseeable future. Its significance will reduce gradually if the proportion of non-hydro generation increases.

On 8 June 1995, when announcing the creation of Contact Energy Limited as an SOE, the Government issued a policy statement concerning the management of "dry year risk". The Government wishes to re-emphasise the principles underlying that statement and to see the electricity industry explicitly take responsibility for managing "dry year" and other supply risks.

Objectives

The Government's objective is to provide a framework which will ensure that "dry year" and other supply risks are managed prudently at least cost to the economy as a whole.

In New Zealand's predominantly hydro system, a key outcome should also be to minimise any wasting (or spilling) of water.

Before 1995

- "Dry year" risk was managed on a central basis;
- ECNZ operated the system to cope with a "1 in 60 dry year" event;
- Wholesale buyers of electricity paid ECNZ a fixed charge of about 1.5c/kWh; and
- The spot price was managed by ECNZ and could not rise above a certain cap.

1995 reforms

Since October 1996, with the implementation of the reforms announced in June 1995:

- ECNZ's implicit obligation to manage the system to cope with a "1 in 60 dry year" event ceased;

- Responsibility for "dry year" risk shifted to all buyers and sellers in the wholesale electricity market;

- The Government advised that it would *not* step in to protect buyers or sellers with inadequate risk management strategies;

- Spot prices are determined by supply and demand. Spot prices are no longer capped;

- Better information has become available from the wholesale market process on changing hydrology conditions;

- Buyers are expected to manage their exposure to the risks of shortage, in particular the extremely high spot prices that can be expected in a shortage;

- Sellers (mainly generators) are expected to sell contracts to protect their revenue stream, and to ensure that they have adequate generation available, even in a dry year, to back their contractual commitments.

1998 reforms

Under the restructuring package announced today:

- Responsibility for managing "dry year" and other supply risks will continue to rest with *all* buyers and sellers in the wholesale electricity market;

- The Government confirms that it will *not* step in to protect buyers or sellers with inadequate protection;

- Buyers and sellers are likely to employ a range of risk management strategies, including:

  - establishing electricity hedge contracts;

  - contracting between generators for back up generation;

  - contracting with customers for interruptible load (reduced consumption) in the event of a shortage;

  - self-generation; and

  - self-insurance.

- Other low costs risk management strategies are likely to develop as a fully competitive market becomes established;

- Generators will continue to be expected to provide "dry year" protection only at a quality and quantity that is demanded through a process of agreement with buyers of those services;

- Each wholesale buyer will continue to be expected to make the trade-off between risk and price through the contractual arrangements they agree with generators;

- Spot prices for electricity will continue to be set by competing buyers and sellers responding to changing supply and demand;

- Increased competition in the generation market is expected to cause spot prices to better reflect, among other things, the projected risk of electricity shortage and the value of electricity to buyers in a shortage;

- The market for hedge contracts, and secondary trading of hedge contracts, is expected to become more active and provide more efficient price signals of possible shortages; and

- These developments are expected to improve the quality of information and signals available to buyers and sellers on the risk of a future electricity shortage.

Acceptance of responsibility

Wholesale buyers and sellers should take a prudent approach to management of their exposure to "dry year" and other supply risks. As noted above, the Government will *not* step in to protect wholesale buyers who fail to provide adequate protection. Such action by a government would in fact increase the likelihood of future supply shortages by undermining the incentives on buyers and sellers of electricity to arrange put in place appropriate risk management strategies.

One of the guiding principles in the constitution of the New Zealand Electricity Market (NZEM) is:

"To foster markets for electricity which ... allow market participants to identify and take responsibility for managing risk."

Before making final decisions on generation restructuring the Government wishes to see the wholesale buyers and sellers of electricity explicitly accept responsibility for managing their exposure in relation to "dry year" and other supply risks.

To this end, the Government has asked the administrator of the NZEM and MARIA Rules to facilitate a process to enable the principles set out in Part D of this policy statement to be adopted in substance by the parties to those rules. This process is to be completed no later than 1 December 1998.

The Chairperson of the Electricity Market Company (EMCO) has been asked to report to the Minister of Energy every two months on progress in this regard.

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7 April 1998

APPENDIX

PRINCIPLES FOR MANAGING ELECTRICITY SUPPLY RISKS

1. Dry year and other supply risks should be managed in such a way as to minimise overall costs to the economy.

2. Responsibility for managing risks relating to supply rests with wholesale buyers of electricity and their consumers.

3. Generators are responsible for providing protection against supply risk at a quality and quantity that is demanded by their customers and established in contracts .

4. Spot and contract prices in the wholesale market should signal the changing risks of a dry year event.

5. A range of mechanisms are available to market participants to manage dry year and other supply risks, within and outside the wholesale market.

6. The trade-off between the costs of supply and protection measures should be made by those at risk.

7. The wholesale market rules should not be biased against any particular protection mechanism.

8. The Government is not expected to step in to protect wholesale buyers who fail to put in place adequate protection arrangements.

GOVERNMENT POLICY STATEMENT: SECURITY OF ELECTRICITY LINES

Background

Lines businesses own and operate the equipment (lines, cables and transformers) which connect the transmission grid and/or local generation to individual customer premises. The quality and security of electricity supply depends in part on the age and condition of equipment, the availability of backup and the way in which the lines business manages its network.

Customers generally want a high level of supply security. However there is a trade-off between the level of supply security and cost. Absolute security would normally be prohibitively expensive (except for some industrial processes where uninterrupted supply is critical). Cheaper alternatives may be available, such as insurance, backup generation and self-insurance.

Security standards for the distribution network have traditionally been set by lines businesses often with engineering considerations taking primacy. Consultations with customers have been limited.

Objectives

The risks of failure of the distribution network need to be managed in a way which minimises overall costs to the economy.

Mechanisms

This is best ensured through contractual negotiations between the lines business and the party or parties, such as individual customers, customer groups or retailers, paying for the lines service.

This provides the right incentives for users, informed by the lines business and other interested parties, to make trade-offs between security standards, risks, costs, and alternatives.

Smaller customers

It may appear that smaller customers, which have few if any alternatives to full reliance on the lines business, are vulnerable to unilateral decisions on security standards and costs by the lines business. These unilateral decisions can be reflected in contracts which have been imposed in circumstances where consumers (either individually or through representative groups) have had little or no input into the terms of the contract. Where that occurs, the courts are likely to review critically the terms of such contacts, particularly exclusion clauses that purport to eliminate, or greatly reduce, the liability of lines businesses for failure to provide reasonable security of supply.

The development of competition in retailing, which will be accelerated by the separation of lines and retail/generation businesses and the other measures being taken by the Government, is likely to improve the negotiating position of consumers. Retailers are likely to become the intermediaries between lines businesses and end customers. Retailers will want to contract with lines businesses for the provision of lines services to their customers, and retailers which are able to offer the best trade-off between price and supply security will have a competitive advantage. This will help ensure customers are well informed on price and security trade-offs.

Lines businesses and retailers are expected to provide information so that all consumers can evaluate the cost-price trade-offs of alternative security arrangements before entering into contracts for line services.

Retailers

Retailers, after they have been separated from lines, are also expected to ensure on behalf of their customers, that contracts with lines businesses include appropriate liability provisions for failure to provide reasonable security of supply.

Principles

The following principles should be taken into account in establishing contractual arrangements for line services:

- The risk of failure of lines should be managed in such a way as to minimise overall costs to the economy;
- Minimising costs requires a trade-off to be made between security standards and costs in comparison with alternatives such as insurance, self-insurance and back-up generation;
- The trade-off between security standards and costs is best made by users after full consideration of alternatives;
- Lines businesses should ensure that users are adequately informed and consulted about options when developing contracts and considering major investments or changes in network management practices; and
- Decisions on security standards along with penalties for non-performance should be incorporated in contracts between lines businesses and users.

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7 April 1998

GOVERNMENT POLICY STATEMENT: CHOICE OF RETAIL SUPPLIER FOR ALL CONSUMERS

Objectives

The Government considers that all consumers should have choice of electricity retail suppliers. Electricity retailing is not a natural monopoly. Competition should be able to develop for all consumers (including domestic and small consumers) in all parts of the retail market.

Background

Competition in electricity retailing requires that competing retailers each use the same distribution network for transport of electricity. This requirement is analogous to Clear and BellSouth requiring use of Telecom's communications network in order to provide national calling and cellular services, respectively.

Competition requires that the incumbent and new entrant retailers agree on a way to reconcile the amount of electricity (transmitted through the distribution network) that each purchased from the wholesale electricity market. As electricity is sold on the wholesale market on a half-hourly basis, this reconciliation needs to take place for each half-hour.

The Metering and Reconciliation Information Agreement ("MARIA") sets out the current basis on which this is done:

- The consumption of consumers supplied by entrant retailers is measured using half-hourly time-of-use meters (unless the incumbent retailer agrees to an alternative form of metering) and this data is supplied to the National Reconciliation Manager ("NRM");

- The network losses are allocated amongst the incumbent and entrant retailers by the distribution network and this information is supplied to the NRM; and

- The difference between the total electricity sold to entrant retailers (including the losses allocated to each entrant retailer) and the bulk supply meter reading (which measures electricity transmitted into the distribution network) is calculated in order to determine the incumbent retailer's wholesale electricity cost.

Problem

These metering and reconciliation requirements impose substantial costs on entrant retailers which incumbent retailers do not incur. These costs are higher than the gross margins for most retail consumers at present, particularly domestic and other small consumers (current technology means that the cost of half-hourly meters, including meter reading, is expensive).

Incumbent retailers have little incentive to develop cheaper alternatives that would overcome this barrier to retail competition.

Measures

The Government intends to facilitate the development by the electricity industry of a cheaper system for measuring and reconciling electricity consumption. To this end:

- The Government expects the industry to develop by 1 April 1999 a low cost metering and reconciliation system, which will enable all consumers (including domestic and other small consumers) to switch retailers if they wish;

- The industry's low cost metering and reconciliation system should:

  - be kept simple to minimise costs. (For example, serious consideration should be given to arrangements in which a 'profile' for half-hourly consumption by consumers without half hourly meters is derived by deducting the amount of electricity used by consumers who have half hourly meters from the total amount supplied through a grid exit point. Alternatively, given the large numbers of smaller consumers without half hourly meters, profiles could be established using statistical sampling techniques);

  - not preclude or discourage the development of time of use meters. (Half-hourly meters have the advantage of accurately conveying price signals to consumers. Their cost is falling rapidly. Progress is required however in lowering the cost of data management and reconciliation to facilitate the use of half-hourly meters); and

  - comply with the Commerce Act. (The industry's process should provide for the possibility of having to obtain an authorisation from the Commerce Commission);

- The Government will seek monthly reports from the industry on its progress in developing this low cost metering and reconciliation system;

- If the industry fails to establish a low cost metering and reconciliation system by 1 April 1999 the Government will introduce a mandatory 'default' system by regulation; and

- To this end, the Government will invite Parliament this year to amend the Electricity Act 1992 to empower the Government to make the regulations referred to above.

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TERMS OF REFERENCE FOR THE TRANSITION TEAM

Purpose

The document outlines the key tasks of the Transition Team which is to oversee the implementation of the proposed restructuring of ECNZ. It is addressed to the chairman and members of the board of the Transition Team.

Objectives

The Government's objective is to promote effective competition in the New Zealand generation market by restructuring ECNZ into three competing State-owned enterprises (SOEs) which are -

- commercially viable entities; and
- effective competitors.

Outline

Major assets are to be allocated among the three SOEs as follows:

- SOE 1: Waikato system
- SOE 2: Huntly station, Te Awamutu station + Tongariro system
- SOE 3: Manapouri + Waitaki systems

Final decisions by Cabinet on whether to proceed are subject to:

- appropriate consultation with Maori on Treaty issues;
- certifications on the financial viability of each new SOE;
- certifications that each new SOE will compete vigorously against all other market participants;
- obtaining positive affirmation from market participants, especially wholesale buyers, that they accept full responsibility for security of supply risks; and
- advice from the SOE Development Groups and officials where appropriate, that they have identified any likely changes to station usage and made suitable arrangements to address any environmental issues. Existing protections and penalties under the Resource Management Act are to remain in force.

General tasks

The Transition Team's tasks are to carry out the tasks referred to in Part B of this document, in particular -

- to develop, within around two months, in consultation and (if possible) agreement with ECNZ, an implementation plan with the key steps and strategies for achieving the split of ECNZ, and

- to drive the preparation and implementation processes -

in both cases, within the principles and parameters set out in Part B above. The implementation plan is to be approved by ECNZ's shareholding Ministers.

Treaty of Waitangi

The Government will consult Maori on Treaty issues relating to the proposed split of ECNZ. The Government's final decision on whether to proceed is subject to this consultation.

Security of supply

The administrator (EMCO) of the New Zealand Electricity Market Company (NZEM) has agreed to facilitate a process to clarify how electricity supply risks are to be managed in the proposed market structure. Key elements of this process are as follows:

- As part of the reform package, the Government has issued a policy statement on managing the risks of energy shortages. A set of principles are attached to that statement.

- EMCO will facilitate a process by which market participants can vote to adopt these principles as part of the New Zealand Electricity Market (NZEM) and Metering and Reconciliation Industry Agreement (MARIA) constitutions. This would provide positive affirmation that market participants, in particular buyers, accept the responsibility for insuring against dry year risks, and that neither the Government nor its SOEs will step in to insulate any parties which failed to protect themselves adequately against supply risk.

- The NZEM and MARIA rule change processes need to be completed before the Government makes final decisions on whether to proceed with the split of ECNZ.

- The Chairman of EMCO has been asked to report to the Minister of Energy every two months on progress in this matter.

Implementation principles

The Transition Team's role is to assist in preparing and (subject to final decisions by Cabinet) establishing the new SOEs in a way that meets the Government's objectives as set out above, in accordance with the implementation principles set out in Part B. In addition:

- preparation and implementation should meet the timetable set out below;
- the Transition Team's expenses are not to exceed the amounts appropriated for that purpose.

Specific tasks

The Transition Team will develop a detailed framework for implementing the restructuring, including any contracts:

- for the transfer of stations to the SOEs as follows:
  - SOE 1: Waikato stations
  - SOE 2: Huntly + Tongariro stations
  - SOE 3: Manapouri + Waitaki stations
- for the transfer to the SOEs of all related assets rights as described in Part B;
- for the transfer to each new entity of:
  - staff associated with the relevant power stations; and
  - ECNZ's current head office staff, as agreed with the Interim Development Group for each entity.
- to provide the new entities with duplicates of all intellectual property required to achieve the Government's objective set out above. (The new entities will pay for any reasonable duplication costs);
- to address, in accordance with Part B, ECNZ's existing major contracts, including its debt obligations, the Comalco contracts, the Fletcher Challenge Energy heads of agreement relating to gas, the gas supply contract with Contact Energy, and ECNZ's existing hedge and bilateral contracts relating to electricity supply or pricing;
- to address such other agreements as are necessary for the SOEs to commence operations as fully separate companies on 1 April 1999; and
- for capitalising each SOE in accordance with the financial parameters set out in Part B and below.

The Transition Team is also to carry out such other actions as are necessary to achieve the Transition Team's objectives and tasks, as may be agreed between the Transition Team and ECNZ's shareholding Ministers.

Design of financial transactions

Implementation of a three-way split will involve a relatively complex set of commercial transactions involving ECNZ, the Crown and the SOEs. In summary, the Crown's objectives for the Transition Team in designing the financial transactions will be to:

- split the Crown's existing shareholding in ECNZ into equivalent holdings in the three SOEs;

- achieve the split without a net capital injection. (New capital would only be injected if it is absolutely and if it is approved by Cabinet on the recommendation of Shareholding Ministers, in consultation with the Transition Team. The Crown seeks to minimise new equity while providing for commercial viability);

- issue debt to the SOEs at such time as they can arrange their own debt raised from financial markets. (This is likely to match an equivalent loan to the Crown from ECNZ);

- protect the position of ECNZ's existing debt-holders. (This could involve a Government guarantee of some or all of ECNZ's existing debt. There would be no Government guarantee of debt raised by the new entities); and

- minimise the Crown's residual risks and obligations to third parties during the transition phase.

ECNZ's legal form

The Transition Team's implementation plan is to address the questions relating to how ECNZ's existing legal form should be treated in the restructuring, having regard to the implementation principles referred to above. If ECNZ becomes SOE 3, it is intended, nevertheless, that ECNZ should still go through the SOE development process referred to below for strategic, financial and organisational planning purposes.

Executive support for Transition Team

The Transition Team is expected to engage executive staff to assist in carrying out its tasks. The executive staff will be accountable to the Transition Team board.

Certification by Transition Team

Before the Government makes final decisions on whether to proceed with the separation, the Transition Team will be invited to provide written certification to the Government that the overall arrangements which have been established ensure that, in the opinion of the Transition Team members, the Government's objectives and principles referred to in these terms of reference are likely to be achieved. The Government will have regard to the certification report in making decisions on whether to proceed with the split.

Interim Development Groups (IDGs) for each SOE

Subject to satisfactory progress by the Transition Team, ECNZ's Shareholding Ministers will appoint an IDG for each SOE. Each IDG would have its own terms of reference and will be responsible to shareholding Ministers.

Each IDG will represent the interests of a proposed SOE until that SOE is formally established with its own board and management.

The IDGs will be required to:

- establish detailed arrangements for the proposed transfer of assets and liabilities within the Government - approved implementation plan; and

- develop detailed business plans covering human resource, financial structuring and organisation-build.

Before making final decisions, the Government will consider certification reports from each IDG on viability and competitiveness issues. The certification reports also should address factors relevant to those issues, including:

- projections of expected financial performance;

- gas supply arrangements;

- arrangements for dispatch and scheduling;

- arrangements for sharing any non-duplicable strategic resources (eg modelling staff or hardware);

- the division or sharing of intellectual property;

- environmental issues; and

- any other critical success factors.

Role of the Transition Team once the IDGs are established

Once the IDGs are established, the Transition Team will remain in place with the primary role of monitoring progress against the implementation plan, providing advice on the resolution of any disputes between ECNZ and the SOE Development Groups, and driving the process to achieve the target timetable.

In relation to dispute resolution, the Transition Team is to identify areas of dispute, whether between IDGs, or between an IDG and ECNZ. Where possible, the Transition Team should seek to resolve each issue. Where this is not possible, the Transition Team is to refer the issue to shareholding Ministers for resolution, along with its recommendations for how Ministers should proceed.

Timeline

The target dates for the Transition Team's work are:

- 15 April 1998: Transition Team commences work

- 31 May 1998: Transition Team makes progress report

- 30 June 1998: Transition Team makes progress report
- 30 June 1998: Interim Development Groups appointed
- 15 December 1998: Government considers advice from the Transition Team and the outcome of Treaty consultations and security of supply issues and decides whether to confirm its decision-in-principle.

If the Government decides to proceed

- By 1 April 1999: Settlement of financial arrangements and separation of staff. Three SOEs commence operations as stand-alone companies

Any changes to this timetable are to be agreed by shareholding Ministers and the Transition Team.

Accountability

The Transition Team will be accountable to the Minister of Finance and the Minister for State-Owned Enterprises for the delivery of its outputs within the specific times and budgets agreed with the Ministers. In this context, the Transition Team will be required to provide a detailed work programme, budget and business plan prior to 15 May 1998.

In respect of matters relating to energy policy issues, Shareholding Ministers will consult with the Minister of Energy.