

# Hon Pete Hodgson

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Change**



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## Speech Notes

### **The Electricity Commission: securing supply**

*[Address to NZ Energy Federation conference on the Electricity Commission and market design options, Hotel Intercontinental, Wellington]*

Thank you for the invitation to speak today. I welcome your interest in the changes the Government is making to the electricity industry.

The publicity for this conference says it aims to explore the Government's decision to establish an Electricity Commission to deliver supply security.

I think it's important to be very clear, from the beginning, that the Commission has a broader role than that.

Its responsibility for addressing security of supply by contracting for the provision of dry year reserve generation capacity and fuel is important. But its primary role is to govern the industry as a whole.

It is worth bearing in mind today that the Government would be establishing the Commission even if there was no problem with the current market's response to dry year risk.

The industry's inability to agree on a new unified self-governance structure made the Commission necessary. The decision to introduce new measures for supply security have simply given it further responsibilities.

The Government's overall policy objective for electricity is to ensure that it is delivered in an efficient, fair, reliable and environmentally sustainable manner to all consumers.

The Electricity Commission will provide stability and direction for the market by giving it a unified governance structure. It will implement overdue improvements in transmission investment and demand side management, as well as taking new steps to ensure security of supply.

Even so, the Commission is not the Government's answer to every issue concerning electricity. The National Energy Efficiency and Conservation Strategy, climate change policy, Resource Management Act reforms and changes to gas industry regulation and governance are all part of the bigger picture.

That said, I'll get on with explaining the supply security policy.

The Government has moved on this because it has become clear that the market will not, by itself, provide sufficient supply security, particularly for very dry years. We need an electricity system that copes better with extremes.

The policy will also address the extreme volatility of spot prices in very dry years.

Some variability in price is essential, as price changes send important signals to market participants about investment priorities. But extreme volatility causes problems. Unfortunately, New Zealand has not developed adequate risk management markets — in hedges, on the demand side, or in cross-insurance between generator-retailers. Our businesses, including electricity businesses, are therefore unable to manage the risks of exposure to spot prices as effectively as they might.

The resulting volatility and exposure might suggest to potential investors, particularly in energy-intensive sectors, that New Zealand is a risky place to do business. Investors legitimately expect a secure electricity supply without the extreme price fluctuations we have experienced lately.

While we all recognise that electricity prices will need to rise to fund investment in generation, my concern is to provide industry with clearer messages about what prices to expect in the future, without the uncertainty of extreme price volatility.

Some argue that it is the fuel shortage brought on by a very dry period and constraints on the availability of gas rather than the market that is to blame for the current situation. While the immediate problem is indeed fuel – not generation capacity, as is so often asserted – the Government has concluded that future supply security does require adjustment to the market.

Security is being under-provided because it is a shared good. Some security-enhancing investments are not being made because, although they may be beneficial from a nation-wide economic perspective, the investor may not be able to capture enough of the benefits that accrue to all consumers from that investment. An example might be the absence of a sufficient coal stockpile at Huntly this year to cope with the demands of a very dry year.

Since the advent of the market, there has been no explicit security standard that the market is responsible for delivering, until now. The Commission will be directed to manage the sector such that electricity demand can be met in a 1 in 60 dry year without the need for national conservation campaigns.

In particular, the Electricity Commission will contract with generators for the provision of dry year reserve generation capacity and fuel. It will withhold these reserves from the market until dry year conditions look likely, at which point they will be released into the market at a high price.

At this stage the Government is not specifying what the 'trigger mechanism' for reserve generation will be. There appears to be a trade-off between maintaining

incentives for investment in ordinary generation and security of supply. For example, a trigger that involves running reserve generation very infrequently runs the risk that too little reserve will be offered into the market too late to avert a shortage. However, frequent use of reserve generation may affect the incentives to invest in the new ordinary generation capacity we need to keep up with economic and population growth.

I expect that consultation will reveal where the best balance lies - and that it will be possible to find a solution that provides security at a reasonable price without interfering significantly with commercial incentives to build new generation.

I also expect that the presence of reserve generation will significantly reduce spot market volatility in dry years. Prices above that of the reserve generation will be relatively rare, so the variability of prices will be much narrower than it is today.

The cost of ensuring we have adequate reserve generation will depend ultimately on the decisions the Commission makes about the range of plant required. Our estimate is that the effect on average prices over the long run should be well under half a cent per unit of electricity.

Note that it is "well under" half a cent a unit. This has been translated widely into the assumption that an extra half a cent a unit is going to be slapped onto the price of power just as soon as the Government gets around to it. Not so. The cost of securing reserve generation will be fed into the price of power as it is incurred by the Commission, which will build up a reserve generation portfolio over about the next three years. And when I say the cost will total well under half a cent a unit, I mean exactly that.

The cost is low because the reserve generation portfolio will comprise relatively low capital cost plant, plus heavily depreciated old plant. The fuel, though costly, will be rarely used.

The Commission will have the power to recover the cost of reserve generation in the manner it judges to be most efficient, for example through a levy on the industry.

The details of this solution matter and the key issues are set out in a discussion paper released on 20 May. This is the Government's preferred policy position. The Government is seeking comments on design details by the end of June and I hope that many here today will consider making submissions.

More specifically, feedback is sought on the most appropriate length of the contracts for reserve generation, the quantity and make up of reserve generation (in terms of new and existing generation), the optimal prices and conditions which would 'trigger' reserve generation and the form that the Commission's cost recovery should take.

Following consideration of the submissions, policy will be further refined.

The distinction between new generation needed to meet normal demand growth and reserve generation needed for dry years is an important one.

At current electricity demand growth rates, New Zealand needs to build new generating capacity at the rate of around 150 megawatts a year to meet demand and maintain an adequate dry year reserve. This is well within the industry's capability.

Between 1996 and 1999 more than 1250 megawatts of new capacity came on-stream, an average of around 300 megawatts a year. In early May I released information on electricity industry plans for new generation totalling more than 900 megawatts by Winter 2006.

I propose to introduce legislation in September to implement the new measures. The legislation will follow the normal pattern of being sent to select committee for consideration, so there will be plenty of opportunity for submissions from interested parties. I expect this legislation to be passed early in 2004.

To assist in achieving the 1 in 60 security standard, the Commission will have access to a toolbox of powers provided by the new legislation.

It will be empowered to require generators to offer long-term electricity hedge contracts into the market, for a nominated proportion of their reliable capacity, if it decides this is necessary to safeguard against under-investment in ordinary generation. Related powers to require electricity retailers and major electricity users to hedge a set proportion of their consumption will also be provided for.

It will also have to become involved in extensive electricity modelling and will have powers to require disclosure of information including coal stockpiles and more timely data on gas discoveries and reserves.

I intend to have an interim board in place by August, with a view to formally establishing the Commission in September and having a permanent board in place later in the year. These positions are being advertised nationally and internationally. I will be seeking individuals with a good understanding of the electricity sector and the experience and ability to make a real contribution to a critically important Crown Entity.

All Commissioners will be independent. This excludes any director, employee or significant shareholder of the supply side of the industry. This decision was made to avoid conflicts of interest and because it will be impossible for all sectors of the industry to be represented on the board. You may have seen the advertisements for the Chair and Commissioners currently running in the major newspapers. Applications close 23 June.

The Commission will be established under existing provisions for an Electricity Governance Board in the Electricity Amendment Act 2001. It will also have additional powers to be provided by new legislation.

Commencement rules for the Commission will be based on the rulebook developed by the recent industry processes, suitably amended to transform them from contractual provisions to statutory rules. I do not want to see all of the valuable work undertaken by the industry and consumer representatives lost. Draft rules will be put out for a brief period of consultation in July and come into force in October.

Note that I use the term “commencement” rules. I do this deliberately. The Commission, once established, will have the task of reviewing the rulebook and advising me of what changes, if any, it considers necessary to deliver on the outcomes sought in a revised Government Policy Statement. The current Government Policy Statement will be amended to incorporate the Government's 20 May announcements, and will be released in August.

Other important changes are on the way and I'll mention two in particular.

Firstly, the opportunities for lines companies to invest in both ordinary and reserve generation will be increased. They can already invest in new renewable generation without limit. The law will be amended so they can own reserve generation without limit and ordinary generation of up to 25 megawatts or 10 percent of their load.

Secondly, to encourage the development of distributed generation projects that are connected to local lines, rather than the national grid, lines charges will be regulated to ensure such generators pay no more than is reasonable for the additional costs that lines companies incur. Distributed generation often consists of small or very small projects but can include some quite big projects such as wind farms.

One of the outcomes the Government seeks is to facilitate the use of new electricity technologies, renewable energy, and distributed generation, and to ensure that there are no barriers to their use. If distributors' pricing methodologies are unduly harsh on distributed generation, then it won't be built.

It is important to note that renewable energy is expected to dominate ordinary generation investment over the next 20 years, simply because it is economic. There will be significant new wind, geothermal and hydro generation. Some combined cycle gas plant and co-generation will be part of the mix, but the dominance of renewable energy will ensure our electricity system makes continued progress towards environmental sustainability.

I am confident that the result of the changes announced last month will be an electricity system that business and domestic consumers will be able to count on, with much more confidence, for a reliable and fairly priced supply of power.

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