

## **Regulatory Impact Statement**

### **DESIGN OF LEVY REGULATIONS TO FUND THE NEW ELECTRICITY GOVERNANCE REGIME**

#### **AGENCY DISCLOSURE STATEMENT**

This Regulatory Impact Statement (RIS) has been prepared by the Ministry of Economic Development (MED). It provides analysis of options for the design of levy regulations to fund the new electricity governance regime as provided for in the Electricity Industry Act 2010.

This RIS investigates the various options for allocating the levy to electricity industry participants. The levy is required to fund the functions of the new Electricity Authority (EA), the electricity efficiency function that transfers to the Energy Efficiency and Conservation Authority (EECA); the development of supply and demand scenario function that transfers to MED; and some security of supply functions that transfer to the System Operator. This RIS also investigates various options for allocating the levy to fund some new functions and costs.

The proposed levy design broadly aligns with the existing levy arrangements.

The option of the Crown funding the new governance arrangements (including the new customer switching fund and establishment costs) was not considered because Cabinet has already agreed that these costs are to be recovered by a levy on industry participants.

Gareth Wilson  
Manager, Electricity

## STATUS QUO AND PROBLEM DEFINITION

The Electricity Commission (EC) is currently responsible for overseeing New Zealand's electricity industry and markets. The EC regulates the operation of the electricity industry and markets (wholesale and retail) in accordance with the Electricity Act 1992 and government energy policy. The EC is also responsible for promoting and facilitating the efficient use and conservation of electricity.

The costs incurred by the EC<sup>1</sup> are recovered from electricity industry participants through the Electricity (Levy of Industry Participants) Regulations 2005. Under the levy regulations, particular classes of industry participant are levied for particular functions as set out in Table One below.

*Table One: Allocation of costs under the Electricity Commission levy regulations*

Function/Activity	Class of industry participant that pays
Security of Supply Operations	Purchasers = all
Market operations	Generators = 1/2 Purchasers = 1/2
Transmission operations	Transpower = all
Electricity efficiency operations	Purchasers = all
Registry and consumer operations	Retailers = 1/2 EDBs (not Transpower) = 1/2
Common quality operation	Generators = 1/3 Purchasers = 1/3 EDBs and Transpower = 1/3
Other activities (including Rulings Panel)	Generators = 1/3 Purchasers = 1/3 EDBs and Transpower = 1/3
Industry participant classes are defined as: <ul style="list-style-type: none"> <li>- <b>Purchaser:</b> purchases electricity from the clearing manager or from an embedded generator</li> <li>- <b>Generator:</b> sells electricity to the clearing manager or to a retailer</li> <li>- <b>Distributor (includes Transpower)</b><sup>2</sup>: a person who supplies line function services to any other person or persons</li> <li>- <b>Retailer:</b> a purchaser who supplies electricity to a consumer or to another retailer</li> </ul>	

<sup>1</sup> Including the costs of service provider contracts

<sup>2</sup> Electricity Distribution Businesses (EDBs) and Transpower are referred to separately in this paper where appropriate.

In December 2009, Cabinet decided on a number of changes to New Zealand's electricity system to improve competition, increase security of supply, and ensure effective and stream-lined governance [CAB Min (09) 43/4 refers]. The Electricity Industry Act 2010 (the Act) implements these changes and comes into force on 1 November 2010. The Act replaces the parts of the Electricity Act 1992 that relate to the Electricity Commission. It also repeals the Electricity Industry Reform Act 1998, but replaces some of its provisions (namely, the ownership, corporate separation and arm's length rules), albeit slightly modified.

The existing levy arrangements need to be revised to take into account the changes that the Act makes, otherwise the electricity governance costs will not be recoverable from industry participants. These changes are:

- the establishment of an Electricity Authority (EA) to replace the Electricity Commission (EC)
- the transfer of the EC's electricity efficiency function to the Energy Efficiency and Conservation Authority (EECA)
- the transfer of the EC's role in developing electricity supply and demand scenarios<sup>3</sup> to the Ministry of Economic Development (MED)
- the transfer of emergency management<sup>4</sup> and provision of information and forecasting on security of supply from the EC to the System Operator (Transpower)
- approval of Transpower's grid upgrade plan proposals and setting the test for evaluating proposals<sup>5</sup> which transfer from the EC to the Commerce Commission (CC)<sup>6</sup>
- the discontinuation of the EC's reserve energy scheme<sup>7</sup> (although the Whirinaki generation station contracts will remain until the station is sold to Meridian)
- provisions in the Act to provide for the Minister of Energy and Resources to request to the EA to undertake a review of a particular issue, and report back
- the role of assessing exemption applications from the ownership, corporate separation and arm's length rules set out in the Act becomes the responsibility of the EA.

Cabinet also agreed to the establishment of a \$15m levy-recovered fund to promote customer switching [CAB Min (09) 43/4 refers].

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<sup>3</sup> This work is currently in the form of the Statement of Opportunities (SOO) that the EC is required to prepare pursuant to part F of the Electricity Governance Rules 2003.

<sup>4</sup> E.g. convening working groups to coordinate industry actions, and running conservation campaigns when there are electricity shortages.

<sup>5</sup> Transpower is currently required to submit grid upgrade plans to the EC for approval under part F of the Electricity Governance Rules 2003.

<sup>6</sup> The levy regulation changes required to enable the costs of this function to be recovered by levy following this transfer are dealt with in a separate Cabinet paper on amendments to the Commerce (Levy on Suppliers of Regulated Goods and Services) Regulations 2009.

<sup>7</sup> Under the scheme, the EC can procure different sources of reserve generation and reserve demand to meet security of supply objectives. The scheme only includes the Whirinaki generating station.

The Act provides for new levy regulations to be developed to recover the costs of these new governance arrangements, the new customer switching fund, and establishment costs<sup>8</sup> through an industry levy. The Act also provides for the levy to recover any costs resulting from the temporary continuation of the reserve energy scheme<sup>9</sup>.

New levy regulations need to be made so that the costs of electricity industry governance can be recovered from industry participants. The regulations should be in place as soon as possible after the Act comes into force to ensure a smooth transition to the new arrangements.

## **OBJECTIVES**

The objective is to recover the costs of the new electricity governance arrangements (including the cost of new functions and establishment costs) from industry participants.

The new levy regulations should not significantly alter the existing levy arrangements, and should also be straightforward to administer.

Two guiding principles were developed to assess the options for allocating costs in this situation:

- A Where the function remains the same, but is performed by a different agency, existing allocations should remain.
- B For all other functions, levy costs should be allocated, as best possible, to the beneficiaries of the function.

The levy arrangements should accord with the Treasury's Guidelines for Setting Charges in the Public Sector (2002).

## **REGULATORY IMPACT ANALYSIS**

### ***Continuing and transferred functions***

The current levy design<sup>10</sup> was based on six principles<sup>11</sup>, which are still considered an appropriate basis on which to set the levies in respect of the functions that have not significantly changed: They are:

- Economic efficiency – the levy should promote efficient market behaviour
- User/causer pays – where the costs are identifiable, levies should be based on who causes the costs

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<sup>8</sup> Includes the costs incurred on or after 1 January 2010 relating to establishing the EA, disestablishing the EC, transferring functions to other agencies, and preparing the initial Electricity Industry Participation Code (that essentially replaces the current Electricity Governance Rules 2003).

<sup>9</sup> The Whirinaki generating station will continue until its sale is completed (for security of supply purposes).

<sup>10</sup> Which has been consulted on twice – originally in 2003, and then in 2005 when changes were proposed to take into account amendments to the Electricity Act that extended and clarified the EC's functions.

<sup>11</sup> These principles were developed taking into account the Treasury's Guidelines for Setting Charges in the Public Sector (2002)

- Rationality – there should be a logical nexus between participants and the costs imposed on them
- Simplicity – the levy structure should not create undue transaction costs, and should be transparent
- Equity – users in similar situations should be treated similarly, and
- Revenue sufficiency – the levies need to be sufficient to recover the costs.

As the continuing functions do not alter significantly (despite the transfer of some functions to other agencies), alternative allocation options between industry participant classes were not considered in detail. For example, while the electricity efficiency function transfers to EECA, the benefits of improved energy efficiency in the supply and consumption of electricity remain the same – that is, they are likely to flow to consumers through price effects. This approach accords with the first of the guiding principles: that existing allocations should remain the same where the function remains the same but performed by a different agency.

Submitters largely agreed with this proposed design – that is, for the existing functions that are either continued by the EA, or that transfer to other agencies, the existing allocations remain the same. Two submitters raised specific concerns about this proposal:

- The Major Electricity Users Group (MEUG) disagreed with the continued levying for the electricity efficiency function, but Cabinet has already decided the function should continue to be levied.
- Transpower disagreed with the proposal that it continue to pay for the supply and demand scenario development function that transfers to MED, arguing that it would no longer be the main beneficiary of the function. However, preparatory work by MED indicates that Transpower will continue to be the main beneficiary of this function.

The preferred option is that the existing allocations be retained.

### ***New costs and new functions***

Alternative options were considered for the new customer switching fund, recovery of establishment costs and new functions that will be undertaken by the EA.

#### ***Customer Switching Fund***

The customer switching fund will provide benefits to consumers of electricity that are able to switch retailers (which are the majority of customers). One option would be to levy these consumers directly for the fund. This would be too costly as it would require setting up a system for billing each customer a small amount of money (a few dollars per year). Further, there is no provision in the legislation to enable individuals to be levied.

The preferred option is to allocate the cost to retailers (based on the number of connections) as retailers have the most direct relationship with consumers, so can pass on the cost of the fund in the most direct way within their existing billing systems. This will better ensure that costs are more accurately passed on to those who benefit from the regulatory function.

### *Establishment costs*

Establishment costs include the costs of establishing the EA, disestablishing the EC, and of transferring functions from the EC to the CC and EECA. The option exists to separate out the costs by activity and allocate them to the beneficiary of that activity. However, this is only practical for some of the costs – the remaining establishment costs cover a range of activities that benefit all industry participants and consumers.

The preferred option is to allocate the cost of transferring the grid upgrade approval function to the CC to Transpower (as the beneficiary of that function), and the cost of transferring the electricity efficiency function to EECA to purchasers (as is the case with electricity efficiency costs). The remaining establishment costs should be allocated across all industry participants as they will all benefit from the activity.

### *Reviews on request of the Minister*

Under the Act, the Minister has the ability to request a review and report on “any matter relating to the electricity industry”. One option is to allocate the costs of any review requested to “other activities” so that they are paid for by all industry participants. This option assumes that the whole industry will benefit from any review undertaken, which may not be the case because the review could relate to a specific aspect of the industry, such as switching between electricity retailers.

Alternatively, the costs could be allocated solely to retailers (who will pass them on to consumers), but this option assumes that consumers will always be the beneficiaries of any review. While it is likely that consumers will be the ultimate beneficiary of any review, this will depend on the matter under review and will therefore not be certain until the request is made.

The preferred option is to provide that the costs be allocated to the particular function/activity that the review relates to, and are therefore paid by the relevant participants. Otherwise, if the review is of a more general nature, it should be allocated to “other activities” and therefore paid for by all participants.

### *Exemption applications*

There are two options for recovering the EA’s costs of assessing exemption applications from the ownership, corporate separation and arm’s length rules set out in the Act.

The options are to:

- Develop fee regulations<sup>12</sup> to recover the costs from the applicant. This requires a reasonable estimate of the likely costs involved in assessing applications. As

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<sup>12</sup> The Act includes a fee regulation making power.

the number and nature of applications is uncertain under the revised provisions, it is currently difficult to make a robust estimate of the costs.

- Allocate the costs to “other activities” and therefore recover them from all industry participants<sup>13</sup>. This option was proposed in the discussion paper.

Submitters disagreed with the proposal to not introduce fee regulations at this time arguing that the costs should be met by the applicant.

However, the preferred option is that development of any fee regulations is deferred until a robust estimate of the costs involved is available. An assessment can then also be made on whether the cost of making and administering fee regulations outweighs the benefits of a strictly “user pays” approach<sup>14</sup>. In the meantime, it is proposed that any costs incurred in assessing any applications be allocated to “other activities”.

This is also consistent with how the EA will treat the costs of other exemption applications, and the costs monitoring and compliance work (e.g. reviewing existing exemptions).

### ***Other amendments to the current arrangements***

Consideration was given to the option of formalising an exemption to the levy regulations for three non-grid connected networks: Stewart Island, Chatham Islands and the Haast network. These networks are not currently levied because the cost of invoicing these networks outweighs the amount that would be recovered<sup>15</sup>.

There was no opposition to this proposal from submitters, so the preferred option is to provide an explicit exemption for these three non-grid connected networks.

Options were also considered to more appropriately levy “grid direct” customers<sup>16</sup> who are effectively levied twice under the current regulations. The options were that these customers are either:

- Exempt from paying the levy as either a purchaser or generator, or
- Only required to pay a levy on either their net generation (as a purchaser or generator), or on their total consumption and any portion of their generation that is above this (for example, on a monthly basis).

Submitters had mixed views on the options, but the preferred option is to exempt these “grid-direct” customers from paying as generators, and levy them only as purchasers. This provides a balance between ensuring they continue to contribute to the costs of electricity governance, but are not being unfairly levied.

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<sup>13</sup> Applicants will either be, or work for, electricity industry participants.

<sup>14</sup> Based on current application rates, the EA would collect around \$20,000 per year from fees (compared to its electricity governance and market operations budget of about \$60m).

<sup>15</sup> Because they are relatively small and data (to calculate the levy) are not as readily available.

<sup>16</sup> Commercial customers that generate large amounts of electricity, mostly for their own use

## **CONSULTATION**

A discussion paper was posted on the Ministry of Economic Development website for public consultation and directly sent to electricity industry participants and interest groups.

Submitters largely agreed with the proposed design, but raised some specific concerns about particular aspects of the design, which are discussed in the above analysis. These concerns were taken into account in the final design of the levy where appropriate.

In developing the proposed design, the Ministry of Economic Development consulted with the following government departments: the Commerce Commission, Electricity Commission, Energy Efficiency and Conservation Authority, and The Treasury. The Department of Prime Minister and Cabinet was informed.

## **CONCLUSION AND RECOMMENDATIONS**

The preferred option is for the existing design to be retained, with necessary modifications to allow for the transfer of some functions to other agencies, and the additional of new functions/costs.

The Ministry's view is that the existing design is fit for purpose. However, an explicit exemption for three large non-grid connected networks should be added, and large commercial "grid direct" customers, that generate large amounts of electricity mostly for their own use, should be exempted from paying as generators (and just levied as purchasers).

For the new costs and functions, the following options are preferred:

- The costs of the customer switching fund should be allocated to retailers
- For the establishment costs, the cost of transferring the grid upgrade approval function to the CC should be levied to Transpower, the cost of transferring the electricity efficiency function to EECA should be allocated to purchasers, and the remaining establishment costs should be levied to all classes of industry participant (excluding retailers, which are a subset of purchasers).
- The costs of any reviews requested by the Minister should be allocated to the particular function/activity that the review relates to, and are therefore paid by the relevant participants. If the review is of a more general nature, it will be allocated to "other activities" and therefore paid for by all participants.
- The costs of assessing applications for exemption from the ownership, corporate separation and arm's length rules set out in the Act should be allocated to the "other activities" category and paid for by all industry participants until such time as the EA has a robust estimate of the costs involved. Fee regulations can then be proposed, if necessary.

The above preferred options are summarised in Table Two below.



*Table Two: Allocation of new costs and functions*

Function/Activity		Class of industry participant that pays
Customer Switching Fund		Retailers (based on no. of connections)
Establishment costs	Transitional costs for grid upgrade function	Transpower = all
	Transitional costs for electricity efficiency function	Purchasers = all
	All other	Generators = 1/3 Purchasers = 1/3 EDBs and Transpower = 1/3
Reviews on request of the Minister		Depends on subject of review
Other activities: Applications for exemption from cross ownership and involvement rules		Generators = 1/3 Purchasers = 1/3 EDBs and Transpower = 1/3

## IMPLEMENTATION

Once a levy design is decided, new regulations will be drafted and recommended to Cabinet. The regulations will be promulgated after 1 November 2010 (when the Act takes effect), so it will be necessary to communicate with industry participants about timing and the transition process.

Industry participants will be informed of the final design (once it is agreed to by Cabinet) and of the arrangements for the transition to the new regulations.

## MONITORING, EVALUATION AND REVIEW

The Ministry of Economic Development will continue to monitor electricity governance arrangements. The Electricity Authority will administer the levy regulations and will notify the Ministry of any issues arising with them.

The development of any fee regulations for the recovery of the costs of assessing applications for exemption from the ownership, corporate separation and arm's length rules set out in the Act will be considered when a robust estimate of the costs involved is available. An assessment will also be made on whether the cost of making and administering fee regulations outweighs the benefits of a strictly "user pays" approach.