

21 May 2002

Mr Bill Naik  
Chief Adviser  
Business and Competition Branch  
Commerce Commission  
PO Box 2351  
WELLINGTON

by email to [Bill.Naik@comcom.govt.nz](mailto:Bill.Naik@comcom.govt.nz)

Dear Mr Naik

**Submission: Authorisation Application by Electricity Governance Board Limited**

This submission will firstly outline Comalco's position relating to the existing long-term contractual arrangements it has in place with Meridian Energy Limited ("Meridian") and indirectly with Transpower New Zealand Limited ("Transpower").

Secondly, Comalco will respond to the Commission's draft determination, focusing on the areas Comalco believes they can assist the Commission with in reaching their final determination.

Comalco supports the submissions made today by the Major Electricity Users' Group (MEUG) and the Consumer Coalition on Energy (CC93).

**1. Comalco Power Agreements and related arrangements**

Comalco has in place long-term contracts with the principal supplier, Meridian, who in turn subcontracts part of their obligations to Transpower. This principal supplier has changed through assignment, novation and agreement since the initial arrangements were entered into

in 1959. Counter-parties have been the Crown, Ministry of Energy, Electricorp / ECNZ and Meridian Energy.

Comalco is the largest consumer of electricity in New Zealand, purchasing in excess of 5,000 GWh per annum, around 15% of total national demand, therefore Comalco has a major interest in the New Zealand electricity industry. The smelter has typically been New Zealand's largest export earning production facility, with total export sales for 2001 of about \$1.1 billion.

A majority of Comalco's electricity has been contracted since 1963. The current term of the entire agreements ensure Comalco has continued access to in excess of 550 megawatts until 2022.

Aluminium production requires a very substantial long-term capital investment. Comalco New Zealand and Sumitomo Chemical Company of Japan have made those substantial investments, including a recent \$464 million upgrade. A major factor in locating aluminium production facilities relates to secure, long-term access to economically priced electricity. Contracting for long-term supply of electricity, on clearly defined terms, is critical in order to manage investment risk. In order to avoid unacceptable and unreasonable risk, Comalco has ensured long-term, physical access to electricity. Comalco has both obligations and property rights attached to those long-term arrangements. This is standard practice across the world's 140 aluminium smelters, with some of our competitors managing this risk by partial or full equity stakes in electricity generation.

Comalco is strongly opposed to the proposed arrangements, and believes they are far from an acceptable outcome for New Zealand and for all electricity consumers. The basis for this view is outlined in the second section of this submission, and was addressed in our initial submission on this application<sup>1</sup>. These views were also expressed as a participant in the Electricity Governance Establishment Committee processes, without effect.

Therefore, Comalco has no intention of joining the rulebook.

Comalco is also of the view that the arrangements before the Commerce Commission, if authorised and implemented, must not in any way interfere with or alter Comalco's pre-existing property rights, for the term of the agreements. Therefore, while Comalco does not intend to enter the arrangements (assuming they are authorised and implemented), Comalco also believes that neither Meridian or Transpower should enter the arrangements unless they are satisfied their existing, long-term obligations to Comalco are not, and will not, be affected to Comalco's detriment. Comalco will expressly require these undertakings from those parties prior to them joining them rulebook.

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<sup>1</sup> dated 22 February 2002

Attached to this submission is a copy of a joint letter from Comalco, Transpower and Meridian Energy, to the Chairman of EGEC, outlining this fundamental problem with the proposed arrangements. Significantly, all three parties believe that unless these issues are addressed, to the satisfaction of all three parties, they will not join the proposed new arrangements.

As a broader comment, Comalco considers that the proposed arrangements are poorly designed, unduly complex and costly, commercially naïve and not in the national interest.

Unlike the existing MACQS arrangements, the governance arrangements are unsound, as are the decision processes. The numerous weaknesses in the rules mean unacceptable risk for any party to them.

Given the significance of electricity for the economy, the rules would be a serious impediment to any significant user investing in electricity - dependent production facility in New Zealand. The sheer uncertainty and unpredictability of the arrangements and the lack of reasonable checks and balances are commercially unacceptable.

We would consider it surprising, if an experienced commercial director of an organisation which had a significant interest in the electricity sector or reliance upon it, after being well briefed on the implications of the proposed arrangements, would agree to adopt the rules. They are simply too unpredictable, risky and complex.

In summary, Comalco has no intention of joining the proposed arrangements, and will ensure that their pre-existing property rights are fully protected.

## **2. Response to draft determination**

Comalco supports the 26 April 2002 draft determination by the Commerce Commission. We agree that the public benefits of the proposed arrangements do not outweigh the competitive detriments.

We believe the application should be withdrawn, substantially modified, and resubmitted. Prior to the implementation of a Crown EGB, there is the ability for industry, including consumers, to submit an application for an arrangement that has comprehensive support. We believe that arrangement would have to provide the following:

- Existing contractual rights fully protected;
- An EGB with executive powers, preferably Crown owned with acceptable Guiding Principles;
- Facilitation of decision-making where rule changes only proceed where there is a defined net benefit, with those parties adversely impacted being duly compensated<sup>2</sup>;
- Broad industry wide representation guaranteed for rulebook chapters;
- Guiding Principles aligned to the GPS;
- Future bi-lateral contracting freely available.

It is our assessment that the current application falls well short of the above requirements.

We believe the Commission has appropriately defined the application and the market definition.

### **Commerce Act 1986 issues<sup>3</sup>**

We believe the Commission needs to more closely examine the impacts of the wholesale pricing mechanism, relating to section 30. While the Commission has made comparisons to the 1996 NZEM application, significant industry structural changes have ensued since 1996.

As vertical integration between generation (wholesale market sellers) and retail (wholesale market purchasers) has only developed since late 1998, this factor needs to be fully assessed.

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<sup>2</sup> This was a key criteria of the MACQS arrangement

<sup>3</sup> addresses Q3-6.

It appears that four main entities represent the significant majority of both the wholesale market sellers and buyers. The sell-to-buy portions are also relatively matched. In some cases, the location of the generation assets and retail bases are mainly confined to geographic regions (e.g. Upper North Island)

In our view, there is a serious lack of wholesale competition, driven mainly to these structural features. We therefore believe the Commission should further assess the competitiveness of this wholesale arrangement, especially as this is where prices are being discovered.

There must be open access to the transmission grid, and parties should have the ability to contract for transmission services whether or not members of the proposed arrangement. Non-members, such as Comalco, will continue to engage in transmission pricing determinations with the transmission provider. We do not believe there is justification for charging non-members more than members for transmission services. Those non-members will not be ‘free-riding’ off any rulebook arrangement, as they will be also engaging with the transmission provider. Any arrangement that inflicts an additional levy on non-members risks being discriminatory, and potentially in breach of the Commerce Act.

The wholesale market pricing arrangements should not be given the protection of an authorisation.

#### **Counterfactual<sup>4</sup>**

While Comalco does not agree the applicant’s counterfactual was the most likely, we do believe it is viable. We believe there is still the ability for the proposed arrangements to be modified to address the significant issues consumer interest have. We also believe that there is a likelihood that a Crown EGB will be considerably more attuned to the national interests and to the interests of consumers, therefore reducing the need, and considerable cost, of lobbying. We believe this reduced cost of the counterfactual must be factored into the net benefit assessment.

For the purposes of this submission, we shall assume the Commission’s counterfactual.

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<sup>4</sup> addresses Q7-8.

## **Ability for blocking of Pro-competitive rule changes<sup>5</sup>**

It is our view that the proposed governance arrangements entrench the NZEM supply side dominance of the critical elements of the industry. We believe there are clear examples of pro-competitive rule changes being blocked in the NZEM forum, and other forums where supply side interests carry majority decision-making powers<sup>6</sup>.

The exercising of this power has, in our view, been seriously detrimental to electricity consumers. We believe that some pro-competitive rule changes have only been implemented due to extreme political pressure, with only the risk of imminent regulation acting as the impetus.

### ***Example 1: Removal of Demand Bids***

Demand side participants have lobbied the NZEM for the review of and possible abolition of demand side bids into the NZEM process. Until the **Ministerial Inquiry into the Electricity Industry** released its findings, this was not given any significant focus. After the Inquiry, the NZEM set up a sub-group to the Market Price Working Group (“MPWG”) to investigate. The decision of the NZEM was to delay any recommendations, due to the possible merger of NZEM and MARIA (“NZEX”).

The issue was again raised within the Rationalisation Working Group during 2001<sup>7</sup>, but again deemed to be not critical, with the justification being that the three rulebooks are “frozen”, and should be merged with as little change as possible. However, significant changes were made during this rationalisation process to rules that moved rules from Common Quality (Part C) to Trading (Part G), which better suit generator-retailer voting entitlements.

After the Winter 2001 events, it was clear that the government policy was calling for consumers to be able to better respond to market signals. Demand bids can restrict this ability to respond. The NZEM then agreed to refocus on the issue. Two consumers were asked to join the MPWG. In April 2002 The NZEM Rules Committee agreed to an investigation project.

### ***Example 2: Release of Generator Offers***

This has been a very contentious issue between NZEM and non-NZEM parties. The NZEM forum has twice considered the option of release, and decided not to proceed.

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<sup>5</sup> addresses Q9-15.

<sup>6</sup> for example, the EGEC Rationalisation Working Group.

<sup>7</sup> for further background, refer to attached RWG Minority View Paper to EGEC.

As with the Demand Bids process above, it appears that the catalyst has been the Winter 2001 events, and the threat of impending regulation that has brought the change of stance regarding transparency. Even in the final stages, where the Minister's Winter Review findings called for release after two weeks, the four week release proposal by the NZEM represented further resistance. It appears the NZEM is now, reluctantly, seeking Commerce Commission authorisation for the two week release.

These two examples illustrate that in order to achieve movement on pro-competitive rule changes by a supply side dominated arrangement, there is the need for extensive consumer lobbying to the NZEM, Officials, and to whatever Inquiry or Review that has to develop to get progress. Only with the real threat of regulation does it seem likely that future pro-competitive rule changes be made, particularly in Part G – Trading area.

While progress has finally been made on these two areas, one must ask what has been the direct and indirect cost of this delay to NZ electricity consumers. If there had been transparency around offer prices from the outset of the NZEM, it is arguable that offer behaviour may have been, at least partly, different from 1996-2002. This may have resulted in lower prices being discovered. Also, due to the lack of movement relating to demand bids, there has been significant administrative cost and potentially the lack of ability to respond to market prices.

If the arrangements were to be authorised, we believe there would be a reduction in the risk of political intervention. This could significantly reduce the likelihood of, or at least delay timing of, pro-competitive rule changes being adopted.

It is our view that there is a fundamental mismatch between the financial incentives of the supply side members who make up the NZEM membership (and the proposed Part G), and what is in the best interests of New Zealand electricity consumers. The former has clear profit maximisation motivations, which at times are counter to the need to provide NZ electricity consumers, large and small, with least cost supply of electricity, on a sustainable basis.<sup>8</sup>

In summary, we believe the governance arrangements are flawed.

### **Transitional Issues<sup>9</sup>**

Comalco believes there are issues relating to the granting of transitional dispensations, which the draft determination does not fully appreciate. There is a risk that transitional dispensations may be granted that requires the need for additional ancillary services to be procured. As the

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<sup>8</sup> addresses Q25.

<sup>9</sup> addresses Q27.

transitional dispensations provide that the industry (ultimately consumers) will pay for the cost of dispensations, we believe they should be agreed in a transparent manner, as opposed to the lack of disclosure that is being given until the rulebook is operational. Parties will not know the quantum of ancillary service costs they are liable for, due to the granting of these dispensations, until they have joined the rulebook and are bound.

It is arguable as to whether or not a Crown EGB would have conducted the process in this manner. Assuming that the Crown EGB would be more consumer focused, it is plausible that there would be greater transparency and also that the party with the non-conforming plant would be required to meet any incremental ancillary service costs, as opposed to being spread across the industry and consumers. We believe the Commission should make a more detailed assessment of this transitional element.

### **Government Policy Statement Influence<sup>10</sup>**

Comalco believes it is more likely that a Crown EGB would adopt the provisions of the GPS more readily than the proposed industry model. As the governance of the industry model is very similar to some existing arrangements (e.g. NZEM verses Part G), and previous experience has demonstrated, at times protracted, or no progress to implement Government Policy by the industry, we believe that the Crown EGB would more readily adopt future GPS's.

As one of the desired outcomes of a GPS is to ensure the enhancement of consumer welfare, we believe consumers would benefit more readily under the counterfactual.

### **Costs and Benefits**

Broadly, we believe:

- There would be lower lobbying costs under the counterfactual, especially from a consumer perspective.<sup>11</sup>
- There is no evidence to suggest that a Crown EGB outcome would result in over-investment in the grid, as opposed to the proposed industry arrangement. Transpower has held this role in the past, and assuming there is no fundamental change in Transpower's approach to grid investment, it is unlikely to change in the future. We believe this remains the case even with closer Government involvement, as would be the case with the Crown EGB.<sup>12</sup>

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<sup>10</sup> addresses Q29-30.

<sup>11</sup> addresses Q38

<sup>12</sup> addresses Q39



- We believe there would not be a material increase in the cost of capital or the regulatory risk under the counterfactual<sup>13</sup>

### **Conclusion**

- the proposed arrangement will not result in a net benefit, over and above those that may be realised under the Commission's counterfactual argument, and
- the Commerce Commission has jurisdiction, and
- the application should be declined.

We are available to discuss any aspects of this submission. Also, Comalco wishes to have the opportunity to be represented at the Commission's conference.

Yours sincerely

Kerry McDonald  
**Executive Director**

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<sup>13</sup> addresses Q33-34.