

# Proposal to amend Electricity Industry Act to enable collection of fees

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## Consultation Paper

Submissions close: 5pm 21 December 2012

23 November 2012



## Executive summary

The Electricity Authority (Authority) is proposing an amendment to the Electricity Industry Act 2010 (Act) to introduce a fee mechanism into the Authority's funding arrangements, thereby enabling the possibility of funding some Authority activities directly from fees, rather than relying entirely on levy funding as required under the existing Act.

In general terms, enabling the introduction of fees would involve amending the Act as follows:

- (a) removing the requirement in section 128 of the Act that the Authority's statutory functions are fully funded by the levy, and instead providing for the Authority's costs, other than those recovered via fees, to be met from the industry levy;
- (b) authorising the making of fee regulations covering such matters as the manner in which fees are set, which parties are obliged to pay the fees, and to whom fees should be paid; and
- (c) including suitable requirements around consultation and disclosure regarding the Authority's expected level of fee income and associated costs for the coming year.

Enabling the Authority to include fees in its funding arrangements would bring it into line with a number of other independent Crown entities and comparable energy sector regulators/market operators which recover their costs via a mixture of industry levy and fees.

The Authority is proposing this amendment because it considers that the introduction of fees to recover some costs would deliver efficiency gains in the following areas:

- (a) **Difficulties with introducing user-pays charging structures under levy arrangements** – The Authority would like the ability to replace levy funding with usage related fees for services where usage is a strong driver of the costs incurred. This would be more readily achieved with a fee regime than under the current appropriation and levy arrangements. If such user-pays charges were introduced, there may be further efficiency gains if service provider contracts were then structured in a manner that creates a stronger and more transparent link between the fees collected by the Authority and the payments that service providers receive.
- (b) **Inflexibility of the appropriations process** – The need to conform to the annual appropriations process (with its significant lead times) imposes some rigidity which can be problematic at times. For example, the introduction of a new service or function needs to be aligned with the appropriations cycle, as was the case with the Authority's development of the market for Financial Transmission Rights (FTRs).
- (c) **Engagement on service provision** – In many respects the Authority arranges market operations functions on behalf of the industry (for example, the provision of reconciliation and registry services). The current process, which is primarily geared

around Parliamentary scrutiny of annual appropriations, is not well suited to obtaining effective engagement between the Authority as purchasing agent, and its 'client' industry users on key issues. Furthermore, a fee mechanism could improve the Authority's ability to enter into longer term commitments where these are efficient, as it is not driven by the Crown's annual appropriations cycle.

The requirement under the Act that the Authority's statutory activities are fully funded by the Crown via the levy mechanism means that the Authority is not able to charge fees unless the Act is amended.

The proposal to amend the Act would only enable the possibility of fees. Fee regulations and amendments to the existing Levy Regulations would be required before any fees could be introduced. Consultation with affected parties is a key requirement of the regulation-making process. The intention is that the collection of any fees would result in a corresponding reduction in the amount collected through the levy.

The Authority invites stakeholder feedback on its proposal to seek an amendment to the Act to allow for some Authority activities to be funded by fees. Submissions close at **5pm on Friday 21 December 2012**.

If the Authority decides to proceed after considering submissions received, it will make a recommendation to the Minister of Energy and Resources.

## Glossary of abbreviations and terms

<b>Act</b>	Electricity Industry Act 2010
<b>AEMC</b>	Australian Energy Market Commission
<b>AEMO</b>	Australian Energy Market Operator
<b>Authority</b>	Electricity Authority
<b>BETTA</b>	The British Electricity Trading and Transmission Arrangements
<b>BSC</b>	Balancing and Settlement Code
<b>BSCCo</b>	Balancing and Settlement Code Company
<b>Code</b>	Electricity Industry Participation Code 2010
<b>EECA</b>	Energy Efficiency and Conservation Authority
<b>FMA</b>	Financial Markets Authority
<b>FTR</b>	Financial Transmission Rights
<b>Gas Industry Co</b>	Gas Industry Company Ltd (New Zealand)
<b>Levy Regulations</b>	Electricity Industry (Levy of Industry Participants) Regulations 2010
<b>MBIE</b>	Ministry of Business, Innovation and Employment
<b>MCA</b>	Ministry of Consumer Affairs
<b>Minister</b>	Minister of Energy and Resources
<b>NEM</b>	The Australian National Electricity Market (Australia)
<b>Ofgem</b>	Office of Gas and Electricity Markets (UK)
<b>Rules</b>	National Electricity Rules (in the NEM)
<b>SOI</b>	Authority's Statement of Intent



# Contents

<b>Executive summary</b>	<b>A</b>
<b>Glossary of abbreviations and terms</b>	<b>C</b>
<b>1. Introduction and purpose of this paper</b>	<b>1</b>
1.1 Introduction	1
1.2 Purpose of this paper	2
1.3 Submissions	2
<b>2. Current funding framework for the Authority</b>	<b>5</b>
2.1 Introduction	5
2.2 Overview	5
2.3 Appropriation of Crown funding	7
2.4 Industry levy	10
2.5 Key observations on current arrangements	11
2.6 Comparison with funding arrangements of other entities	12
<b>3. Delivering efficient funding arrangements</b>	<b>16</b>
3.1 Funding framework	16
3.2 Incentives and efficiency	16
3.3 Yardsticks for assessing funding framework	18
<b>4. Fees could improve efficiency of funding framework</b>	<b>20</b>
4.1 Key Authority conclusions	20
4.2 Difficulties with introducing user-pays charging structures under levy arrangements	20
4.3 Inflexibility of the appropriations process	21
4.4 Engagement on service provision	22
4.5 In conclusion	24
<b>5. Enabling a mixed fee and levy funding arrangement</b>	<b>26</b>
5.1 Amending the Act to allow for fees	26
5.2 The process from here	27
<b>References</b>	<b>29</b>

<b>Appendix A</b>	<b>Format for submissions</b>	<b>31</b>
<b>Appendix B</b>	<b>Current levy and fee provisions in the Act</b>	<b>32</b>
<b>Appendix C</b>	<b>Current funding arrangements</b>	<b>34</b>
<b>Appendix D</b>	<b>Funding arrangements for other entities</b>	<b>38</b>

## **Tables**

Table 1: Questions for submitters	31
Table 2: Authority's appropriations and output classes for 2012/13 financial year	35

## **Figures**

Figure 1: Overview of existing funding arrangements	6
Figure 2: A possible mixed levy and fee funding arrangement	7
Figure 3: Annual appropriations cycle	9
Figure 4: Components of Authority's forecast expenditure	10
Figure 5: Allocation of levy across classes of industry participant	11
Figure 6: Proportion of revenue derived from service fees or equivalent	13
Figure 7: Interaction between funding need, framework, and cost outcomes	16
Figure 8: Electricity Authority budget for 2011/12 (governance and market operations) \$ 000	23
Figure 9: Current annual levy rates to 30 June 2013	37

# 1. Introduction and purpose of this paper

## 1.1 Introduction

- 1.1.1 The Electricity Authority (Authority) has reviewed its funding arrangements to ensure they are efficient. In principle, if charges can't be set by the interplay of market forces, then it is necessary to adopt a market-like or an administrative approach to setting charges. Under both approaches costs should be recovered from the party or class of parties that cause costs to arise, and/or benefit from the provision of the good or service. In cases where this isn't possible the aim should be to recover costs in the way that causes the least harm to efficiency.
- 1.1.2 The Authority's development of a market for Financial Transmission Rights (FTRs) provided the catalyst for this review. In consultation with stakeholders during design and development of the FTR market, the Authority explored a range of funding options for the FTR market, however, some options were impeded or precluded by the current funding arrangements.
- 1.1.3 The Authority has also reviewed existing costs against a set of principles for efficient cost recovery. The Authority's analysis suggests that there is a case for a range of efficient user-pays charges to fund some areas, in particular where usage is a strong driver of the costs incurred. However, the Authority has concluded that user-pays charges would be complex to implement within the existing appropriations and levy arrangements.
- 1.1.4 The Authority has also considered the funding arrangements of other independent Crown entities and of the regulatory bodies in the New Zealand gas sector and the Australia and United Kingdom electricity markets.
- 1.1.5 Although there is a common perception that the Authority is funded by an industry levy, this is not strictly correct. Section 128 of the Electricity Industry Act 2010 (Act) requires all of the Authority's statutory functions to be fully funded by Crown revenue. This distinction is important because it means all of the Authority's core funding is subject to the Parliamentary appropriations process.
- 1.1.6 The Act empowers the Crown to recover the cost of funding the Authority's statutory functions via an industry levy. The level and structure of the levy is set out in the Electricity Industry (Levy of Industry Participants) Regulations 2010 (the Levy Regulations).
- 1.1.7 The Authority's review suggests that:
- a fee mechanism is typically more efficient for funding market services that are being provided to a clearly identifiable set of users or beneficiaries;

- the requirement under the Act that the Authority's statutory activities are fully funded by the Crown via the levy mechanism means that the Authority is not able to charge fees unless the Act is amended; and
- the Authority's funding arrangements are relatively unusual compared to other independent Crown entities and comparable energy sector regulators/market operators which recover their costs via a mixture of fees and industry levy.

1.1.8 In light of these findings, the Authority is proposing to seek an amendment to the Act to introduce a fee mechanism into the Authority's funding arrangements alongside the industry levy, to enable the possibility of funding some Authority activities from fees.

1.1.9 It is important to note that the proposal to amend the Act would only enable the possibility of fees. Further regulatory amendments, including making fee regulations and amending the existing Levy Regulations, would be required before any fees could be introduced. Regulations can only be made/amended by the Governor-General, by Order-in-Council on the recommendation of the Minister, and this process includes stringent requirements around Regulatory Impact Assessment and consultation. Furthermore, enabling some of the Authority's activities to be funded by fees would not, per se, affect the total level of the Authority's funding, only the mechanisms by which it is collected.

## 1.2 Purpose of this paper

1.2.1 The purpose of this paper is to consult with participants and persons that the Authority thinks are representative of the interests of persons likely to be substantially affected by the Authority's proposal to seek an amendment to the Act to allow for some Authority activities to be funded by fees.

## 1.3 Submissions

The Authority's preference is to receive submissions in electronic format (Microsoft Word). It is not necessary to send hard copies of submissions to the Authority, unless it is not possible to do so electronically. Submissions in electronic form should be emailed to **submissions@ea.govt.nz** with Consultation Paper—Proposal to amend Electricity Industry Act to enable collection of fees in the subject line.

If submitters do not wish to send their submission electronically, they should post one hard copy of their submission to the address below.

Submissions  
Electricity Authority  
PO Box 10041  
Wellington 6143

Submissions  
Electricity Authority  
Level 7, ASB Bank Tower  
2 Hunter Street  
Wellington

Tel: 0-4-460 8860

Fax: 0-4-460 8879

- 1.3.1 Submissions should be received by **5pm on Friday 21 December 2012**. Please note that late submissions are unlikely to be considered.
- 1.3.2 The Authority will acknowledge receipt of all submissions electronically. Please contact the Submissions Administrator if you do not receive electronic acknowledgement of your submission within two business days.
- 1.3.3 If possible, submissions should be provided in the format shown in Appendix A. Your submission is likely to be made available to the general public on the Authority's website. Submitters should indicate any documents attached, in support of the submission, in a covering letter and clearly indicate any information that is provided to the Authority on a confidential basis. However, all information provided to the Authority is subject to the Official Information Act 1982.



## 2. Current funding framework for the Authority

### 2.1 Introduction

2.1.1 Before describing the current funding arrangements and the Authority's proposed amendment to the Act, it is useful to set out some terminology adopted for the purposes of this consultation paper:

- **industry levy** – used to describe the current funding mechanism whereby the Authority's activities are paid for by the Crown, which then recovers these by imposing a levy on industry participants which they must pay to the Crown; and
- **fee** – used to describe a funding mechanism whereby the Authority receives funding directly from the users of certain market services.

2.1.2 The distinction between industry levy and fee mechanisms is discussed further in the following section, and the efficiency improvements that a fee mechanism can provide are discussed in Section 4.

### 2.2 Overview

2.2.1 The Act sets out the functions of the Authority. These fall into two broad categories:

- **Industry governance** – the Authority makes, administers and enforces the rules governing the New Zealand electricity market (the Electricity Industry Participation Code 2010 or "Code")
- **Market operation** – the Authority is responsible for running the central systems and processes to operate the New Zealand electricity system and market in accordance with the Code. In practice, the Authority contracts most of these functions to a range of external service providers.

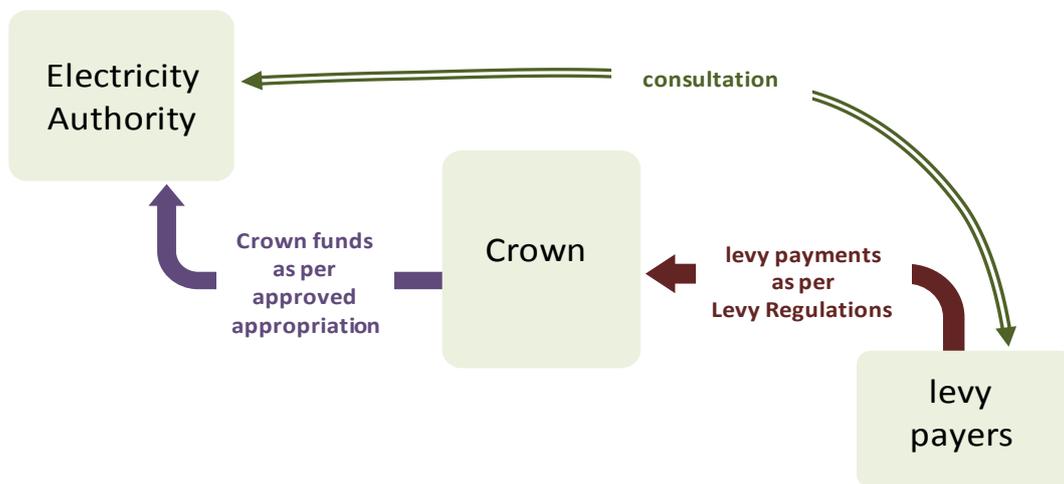
2.2.2 Section 128 of the Act provides for the Crown, via appropriations in Parliament, to be the sole funder of all the Authority's statutory functions. The Act requires the Crown to fully recover its actual costs via a levy on industry participants (refer Appendix B which sets out in full the Act provisions relating to the levy).

2.2.3 Section 115 of the Act is also relevant. It is a general regulation-making power for fees or charges relating to any matter under the Act (i.e. wider than just the Authority's statutory functions). Although section 115 authorises regulations to be made relating to fees, the requirement under section 128 that the Authority's costs are fully met from the levy renders this inoperable for recovering costs arising in relation to the Authority's statutory functions.

2.2.4 As provided under the Act, the levy also funds certain other electricity sector costs including in particular the electricity efficiency programmes delivered by the Energy Efficiency and Conservation Authority (EECA), and facilitating customer switching through the Powerswitch website overseen by the Ministry of Consumer Affairs (MCA).

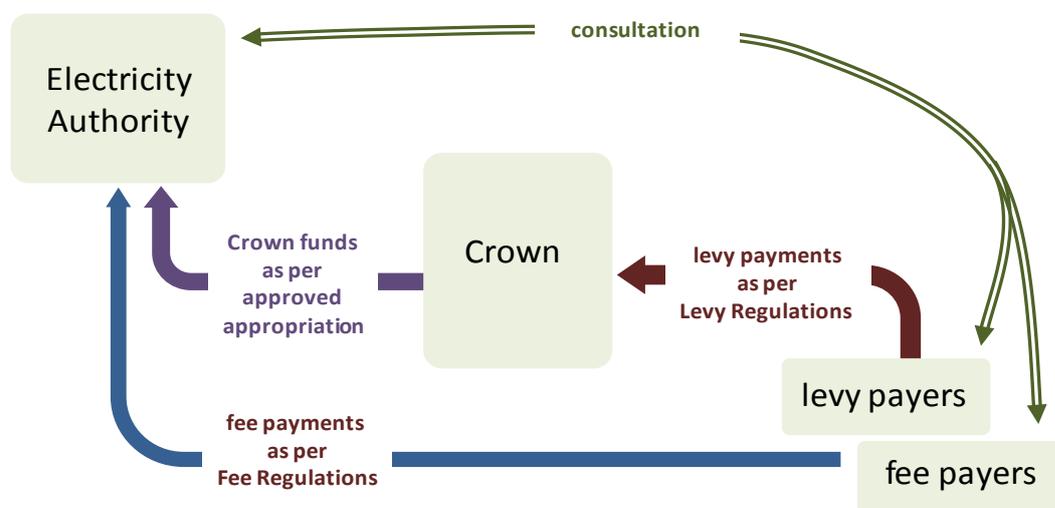
2.2.5 The funding flows are illustrated in Figure 1. The consultation includes the statutory requirement for the Authority to consult on those costs to be recovered by levies before it submits an appropriation request to Parliament. The Authority typically also sets out its intended work programme as part of the appropriation consultation. The key aspects of the current Authority funding arrangements are discussed in more detail in the following subsections and Appendix C.

Figure 1: Overview of existing funding arrangements



2.2.6 For comparison, Figure 2 illustrates an example of how the funding arrangements might operate if the Authority were also able to charge fees. Under comparable mixed funding arrangements (discussed further in Section 2.6) fees are typically set under fee regulations and are paid directly to the regulatory body. Some form of regular consultation on the level of fees and/or what the fees are to be used for is proposed to be required as part of the fee arrangements. For the Authority, this would be in addition to the statutory requirement to consult on its proposed appropriation for costs to be recovered via the levy.

Figure 2: A possible mixed levy and fee funding arrangement



## 2.3 Appropriation of Crown funding

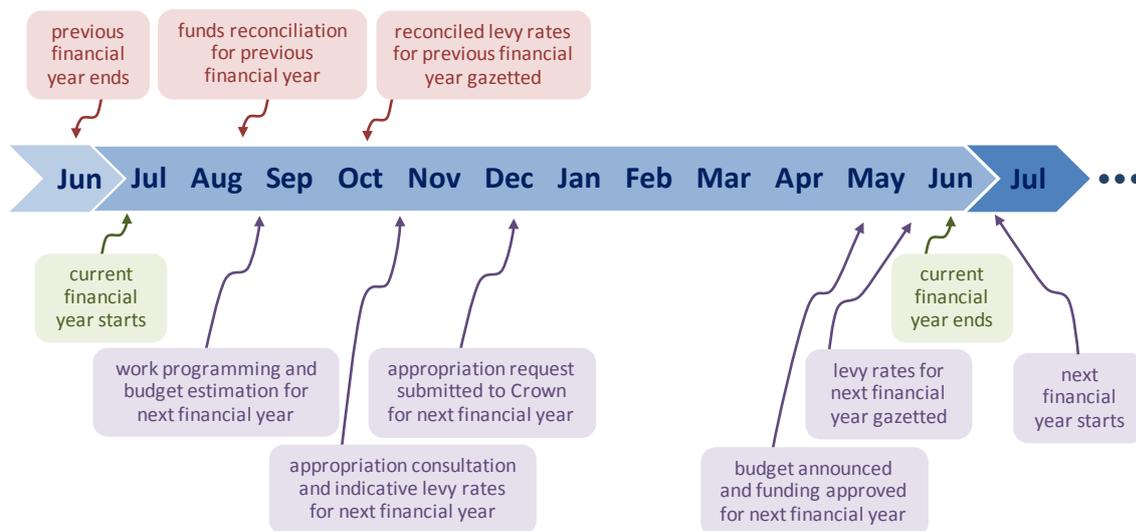
- 2.3.1 Section 128 of the Act requires all of the Authority’s statutory functions to be fully funded by Crown revenue. This means all of the Authority’s core funding is subject to the Parliamentary appropriations process. The industry levy (refer next section) is the mechanism by which the Crown is reimbursed for this funding.
- 2.3.2 An appropriation is the means by which Parliament gives legal authority to the Crown and Officers of Parliament to use resources. Appropriation Acts are the primary mechanism by which Parliament authorises Ministers to incur (on the Crown’s behalf) expenses and capital expenditure. No expenses or capital expenditure may be incurred other than in accordance with an appropriation or other statutory authority.
- 2.3.3 The Authority’s annual appropriations and levy setting process must meet the Government’s annual Budget timetable. It must also meet the specific requirements set out in the Electricity Industry Act and Levy Regulations.
- 2.3.4 The annual process is depicted in Figure 3 and the key features are summarised below<sup>1</sup>.
- not long after the start of the current financial year, the Authority begins preparation of its work programme priorities and estimated funding requirements for the next financial year commencing 1 July; it draws on the

<sup>1</sup> Some aspects of the timetable, particularly the timing of the appropriations consultation, can vary from year to year. The timetable described represents the Authority’s approach to the 2013/14 appropriations process.

Authority's statutory obligations, priorities and outcomes in the current SOI, new work programme activities, and Government expectations;

- in August and September the Authority prepares appropriations and work priority material for consultation with levy payers; this includes indicative levy rates based on the estimated funding requirements associated with the proposed appropriations; levy rates are calculated by applying the formulae set out in the Levy Regulations (discussed in section 2.4 and Appendix C); in the past the Authority and EECA have published a combined consultation paper;
- the Authority publishes its appropriations and work priority consultation paper in October; submissions close in November;
- the Authority (and EECA) consider submissions received; the Authority then reports on proposed appropriations (as does EECA) to the Minister;
- relevant information is subsequently included in the Budget and Appropriations Bill alongside all the other Government funding requests for the coming financial year;
- the Crown's expenditure for the coming financial year is set out in the Budget and presented to the House on Budget Day which is typically in mid to late May;
- the Authority's Statement of Intent (SOI) for the next three years is published within a few days of the Budget; the SOI includes information on the appropriations;
- once the Authority's appropriations (reflected in the Budget) have been announced, the Authority calculates the levy rates for the coming financial year, and implements these by way of a Gazette Notice (in June); monthly levy invoices issued during the financial year will be based on these gazetted levy rates;
- soon after the financial year ends on 30 June, the Authority begins the process of reconciling the previous year's actual costs and levy payments with the forecasts on which the levy rates were calculated and collected; this cannot be completed until the audited financial statements in the Annual Report are presented in the House of Representatives; reconciled levy rates are published at the completion of this reconciliation, and any under or over recovery identified is addressed with invoices or refunds as the case may be for each participant.

Figure 3: Annual appropriations cycle

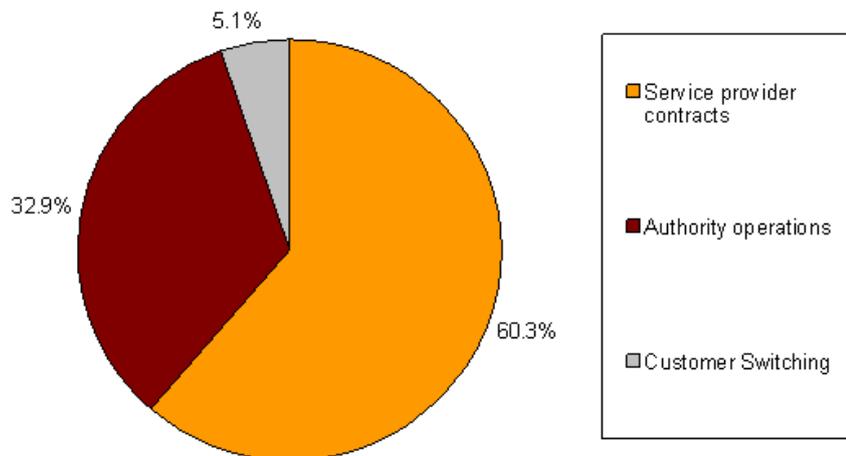


2.3.5 Further detail on the Authority’s appropriations is set out in Appendix C, focussing on the appropriations for the 2012/13 – 2014/15 years, as approved in May 2012 by the Crown through the 2012/13 appropriation process<sup>2</sup>.

2.3.6 Figure 4 shows the broad areas of the Authority’s planned expenditure for the 2012/2013 year. It is worth noting that the largest component is fees paid by the Authority to service providers that undertake day to day operation of the electricity market (e.g. system operator, pricing manager, reconciliation manager, clearing manager, registry manager - refer to Figure 8 for a breakdown of total service provider costs across the service provider contracts). These contracts typically extend for multiple years, and are structured primarily around fixed annual fees payable by the Authority for the service to be provided. While the appropriation includes a forecast for this expenditure in subsequent years, there is no approved appropriation beyond the first year.

<sup>2</sup> The Authority and the Crown are currently part-way through the 2013/14 appropriation process.

Figure 4: Components of Authority's forecast expenditure



**Notes:**

**Service provider contracts**—costs covering agreements between the Authority and companies that provide services to operate the electricity system and wholesale and retail markets.

**Authority operations**—all operational costs of the Authority (except service provider costs) including rent, overheads, staff costs, members' costs, and external legal and other professional advice.

**Consumer switching**—Authority costs for promoting to consumers the benefits of comparing and switching retailers.

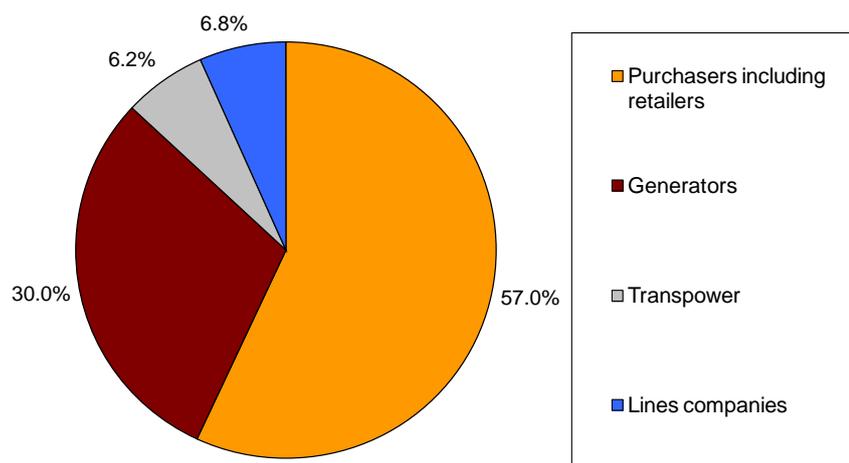
Source: Electricity Authority Statement of Intent 2012-15

## 2.4 Industry levy

- 2.4.1 The industry levy is made under the Levy Regulations pursuant to the Act. Every industry participant (or prescribed class of industry participant) must pay to the Authority on behalf of the Crown the levy prescribed by regulations.
- 2.4.2 The levy must be prescribed on the basis that it must meet all of the Authority's costs in full. The Act also requires that the levy also funds other electricity sector costs including EECA's electricity efficiency programmes, and the Powerswitch website to facilitate customer switching (see Appendix B).
- 2.4.3 The Authority sets the levy rates each year based on its expected costs, and then invoices the relevant participants in monthly instalments across the year. Levy payments are deposited in a Crown account, and any unpaid amount is a debt to the Crown. An annual reconciliation process adjusts for any under or over-recovery.
- 2.4.4 The Levy Regulations set out the formulae for allocating annual costs to levy payers and the process by which levy payers are invoiced for the amounts they are each liable to pay. The key steps and the levy rates that resulted for the 2012/13 year are set out in Appendix C.

2.4.5 The Authority is required to publish a notice in the Gazette setting out the annual levy rates as soon as practicable after they have been calculated. The levy allocation to each class of industry participant under the levy calculation for 2012/13 is shown in Figure 5 below, in which the Purchaser and Retailer levy components have been combined. Note that levy funding for EECA and MCA is included.

Figure 5: Allocation of levy across classes of industry participant



Source: Electricity Authority Statement of Intent 2012-15

2.4.6 Participants pay the annual levy to the Authority in monthly instalments in arrears. The formulae for calculating each participant's monthly instalment are prescribed in the Levy Regulations.

2.4.7 The Authority must deposit into a Crown bank account, and separately account for, each levy payment. Although the Authority administers the levy, no levy payments go through the Authority's accounts.

2.4.8 The levy is reconciled after the end of the financial year, using actual costs, actual quantities of electricity generated/purchased/conveyed, and actual numbers of consumer connections. The Authority undertakes this reconciliation as soon as practicable after the audited financial statements for the financial year are presented to the House of Representatives. The Authority is also required to have the reconciliation calculation independently audited and to gazette the reconciled annual levy rates.

## 2.5 Key observations on current arrangements

2.5.1 The Authority makes the following key observations on the current funding arrangements:

- (a) all of the Authority's funding is ultimately determined by the annual appropriation process in Parliament, and the Authority's access to funds must conform to the Crown's timetable and process; and
- (b) the Authority is not able to charge any fee for undertaking its functions set out in the Act, unlike some other Crown entities (refer section 2.6).

2.5.2 These matters, and others identified in a first principles assessment of the existing funding arrangements, are discussed further in Section 4 of this consultation paper.

## **2.6 Comparison with funding arrangements of other entities**

2.6.1 The Authority is an independent Crown entity, the organisational form in the Crown Entities Act 2004<sup>3</sup> with the highest degree of independence from government policy. This organisational form has typically been adopted for bodies fulfilling quasi-judicial or similar roles, where an arms-length relationship with government is regarded as important.

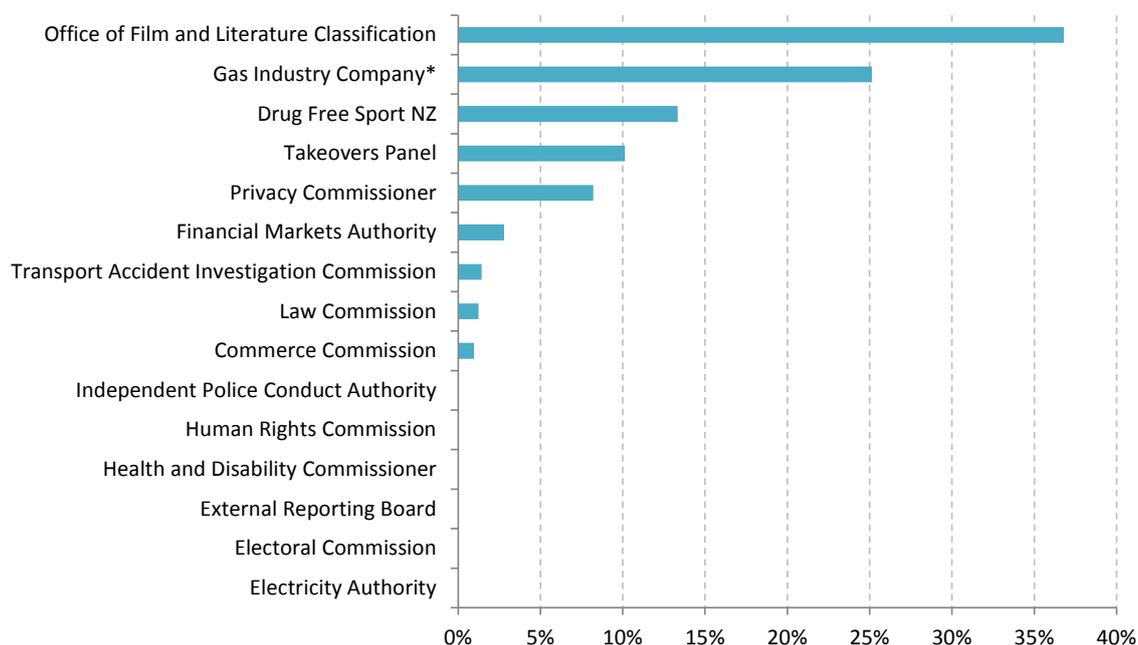
2.6.2 The Authority has considered the funding arrangements of all the independent Crown entities existing at 30 June 2011, with a particular focus on identifying the extent to which these bodies received revenue from fee-based arrangements. The results are summarised in Figure 6<sup>4</sup>.

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<sup>3</sup> There are three key organizational forms: Crown agents (which must give effect to government policy when directed by the responsible Minister), Autonomous Crown entities (which must have regard to government policy when directed by the responsible Minister), and Independent Crown entities (which are generally independent of government policy).

<sup>4</sup> Data for the Financial Markets Authority is based on budget for the year to June 2011. In some cases, organisations reported non-Crown revenue sources (e.g. interest), but this has not been classified fee-based.

Figure 6: Proportion of revenue derived from service fees or equivalent



Sources: Annual reports for year to 30 June 2011

\* Note: Although it is not an independent Crown entity, data for Gas Industry Company has been included here for comparative purposes.

2.6.3 The Authority has also considered the funding arrangements for key energy market operators/regulators. A brief description of these entities and their funding arrangements is set out in Appendix D of this consultation paper, and the Authority’s key observations are included in paragraph 2.6.4 below:

- the Gas Industry Company – this entity is the co-regulator for the gas industry and has regulatory and market operations functions comparable to those of the Authority, but operates as a company incorporated under the Companies Act 1993 with an industry-appointed Board;
- the Australian National Electricity Market (NEM) – the regulatory and market operation functions that in New Zealand are undertaken by the Authority, are split in the NEM and carried out by the Australian Energy Market Commission (AEMC) and Australian Energy Market Operator (AEMO) respectively; and
- electricity and gas markets in Great Britain – these are principally regulated by the Office of Gas and Electricity Markets (Ofgem), which operates under the governance of the Gas and Electricity Markets Authority.

2.6.4 The Authority's key observations from examination of the funding of independent Crown entities and of relevant energy market operators/regulators can be summarised as follows:

- There is significant variation in the proportion of funding derived from fees and Crown revenue.
- Broadly speaking, organisations providing services for which it is difficult to identify specific causers or beneficiaries rely heavily or exclusively on Crown revenue, for example the Electoral Commission and the Law Commission.
- By contrast, organisations undertaking a more 'transactional' activity where specific causers or beneficiaries can be identified, generally have more fee-based income. Importantly, this is the case even where the organisation has a statutory monopoly on providing the particular transactional service (for example, the Office of Film and Literature Classification is the only body with the right to approve certain materials for publication or release).
- Organisations which charge a fee can receive that money directly as income (rather than treating fees as a cost recovery mechanism for funds received via appropriation). For example, the Financial Markets Act 2011 allows the making of fee regulations which require "the payment to the FMA of fees and charges by financial markets participants in connection with the performance or exercise by the FMA of any function, power, or duty under this Act or any other enactment"<sup>5</sup>.
- Gas Industry Co has three principal sources of funding: annual levies, market fees, and annual fees. In practice, Gas Industry Co typically uses market fees to recover the costs of external providers engaged to undertake specific market services, such as running the registry and downstream reconciliation platforms that enable retail competition. Gas Industry Co has actively sought involvement by prospective fee payers (i.e. users) when awarding contracts to external service providers. Shorter term commitments and policy development work are generally funded from the levy.
- In the Australian market, the AEMC (regulatory functions) is directly funded by the participating jurisdictions in the NEM and does not derive any income from market fees. The AEMC is largely focussed on the provision of public goods, and its broad based funding arrangements reflect this. By contrast, the AEMO (market and systems operations) carries out functions for which specific causers or beneficiaries can be more readily identified. As a not-for-profit company, it must ultimately recover all of its costs from market participants via fees.

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<sup>5</sup> Section 67, Financial Markets Act 2011.

- In the UK, it appears that all of the policy development and enforcement costs of Ofgem (regulatory functions) are provided by Parliamentary appropriation, and a portion of these costs are recovered from industry. Elexon, the contracted provider of balancing and settlement market services, is completely funded by market fees which are defined in the Balancing and Settlement Code approved by Ofgem. The system operation function is carried out by National Grid in accordance with a licence issued by Ofgem. The function is regarded as a monopoly service and is subject to price control by Ofgem. Ultimately, the costs of system operator services are recovered as fees payable to National Grid, which must be paid by users as a condition of their own licences.

2.6.5 In summary, by contrast with the other NZ independent Crown entities reviewed here, the Authority is unusual in that it has no fee income but much of its role is focussed on the provision of transactional services with clearly identifiable causers/beneficiaries. When considered alongside other relevant energy market operators/regulators, the Authority appears relatively unusual because it is completely funded from Crown revenues (albeit with levy recovery), whereas other similar bodies generally use fee income to recover costs where specific causers/beneficiaries can be identified, and Crown or levy income to recover other costs.

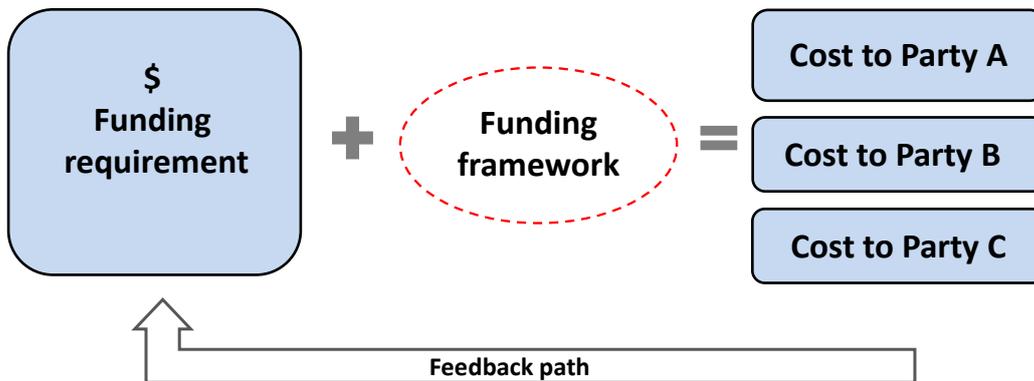
### 3. Delivering efficient funding arrangements

#### 3.1 Funding framework

3.1.1 The Authority has assessed its current funding framework to determine whether it facilitates, or constrains, the attainment of efficient outcomes.

3.1.2 It is important to emphasise that it is the funding framework that has been assessed, and that is the subject of this proposal. The funding requirement itself (i.e. total annual costs of the Authority and its operations), and how those costs fall on various industry parties when the funding framework is applied, are outside the scope of this consideration. However, the interaction of all three (the funding requirement, the funding framework, and the allocation to paying parties) is relevant to determining the efficiency or otherwise of different funding frameworks. This is illustrated in Figure 7.

Figure 7: Interaction between funding need, framework, and cost outcomes



#### 3.2 Incentives and efficiency

3.2.1 The Authority has applied an economic framework to establish a hierarchy of approaches for funding arrangements, based on application of efficiency principles, in particular, facilitating efficient investment (dynamic efficiency) and facilitating efficient operations (allocative and productive efficiency).

3.2.2 Based on first principles, efficient funding arrangements for the Authority should exhibit the following broad characteristics:

- (a) **Allocative efficiency** – arrangements should provide incentives to encourage the most useful mix, volume, and standard of services to be provided and consumed.

- (b) **Productive efficiency** – arrangements should provide incentives to minimise the cost of supply for the services being provided. The structure and incidence of charges will be highly relevant in this context because they affect incentives for cost minimisation. For example, where costs vary with the level of output the charge should generally reflect this rather than being fixed. Keeping transaction costs at a low level will also be an important consideration. Another relevant issue will be the opportunities that payers have to interact with the Authority on service provision decisions. For example, it would be desirable for the Authority as the decision maker on service provision issues to understand the consequential effect those choices will have on users in terms of benefits and costs.
- (c) **Dynamic efficiency** – arrangements should provide incentives to look for new ways to provide services, to increase benefits or lower costs over time. Again, the structure and incidence of charges will be important. However, it is likely that the engagement process between the Authority and payers will be even more important in this context since this process provides the opportunity for users and the Authority to alter the shape of services that are provided over time.

3.2.3 Based on these principles the Authority’s first preference is for funding arrangements to be established under market-based approaches. This would mean that funding arrangements for specific services would be established via negotiation among buyers and sellers in a workably competitive market, or through arrangements that mimic these outcomes.

3.2.4 The Authority recognises that market-based arrangements are likely to be difficult to achieve in some instances, for example where services have public good<sup>6</sup> characteristics. Where market-based approaches are not feasible and an administrative approach to setting funding arrangements is required, the Authority’s preference among administrated approaches is:

- (a) exacerbaters pay, where an ‘exacerbator’ is defined as a party whose action (or inaction) leads to the cost in question. Making exacerbators face the full costs of their decisions should improve economic efficiency by reducing wasteful activities;
- (b) beneficiaries pay, where a ‘beneficiary’ is defined as a party for whom the private benefits of the service exceed the cost and would therefore be willing to pay for it. If beneficiaries pay for services, this should lead to improved service provision decisions and more durable outcomes because

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<sup>6</sup> In technical terms, these are services where consumption by one party does not reduce the benefit available to others, and it is not possible to exclude non-payers from benefiting. The provision of the Code would be expected to fall into this category.

parties using the service should be willing to pay up to the private value they obtain from the service;

- (c) where neither of these is feasible, an alternative approach is required which should limit any adverse incentives (e.g. distorting decisions simply to avoid charges).

3.2.5 Lastly, the funding arrangements should not expose the Crown to undue fiscal risk as this could in turn create adverse efficiency effects. This means that arrangements should recover the Authority's total costs over time.

3.2.6 The Controller and Auditor-General has set out a definition of efficiency in the 'Good practice guide – Charging fees for public sector goods and services' which is consistent with the points set out above. The Controller and Auditor-General states<sup>7</sup>:

*“By “efficient” we mean producing as many goods or services as possible to the desired level of quality from a given quantity of resources, and thereby achieving value for money.”*

3.2.7 It goes on to state:

*“We would usually expect a public entity to disclose its costs and charging practices to give the public an opportunity to comment on and question them. This imposes a discipline on the entity not to pass on inefficient costs to consumers. [...] The entity should consult in a way that is practical and appropriate to the nature and significance of the changes. .. Consultation with consumers can also provide the entity with information to help tailor what it produces in response to consumers' needs.”*

### 3.3 Yardsticks for assessing funding framework

3.3.1 From the principles and the Controller and Auditor-General's definition in section 3.2 above, the Authority has derived a set of yardsticks for assessing whether the current funding framework will allow efficient outcomes to be achieved<sup>8</sup>. These are:

- (a) **Identification of exacerbators/beneficiaries** – the funding framework should allow costs to be recovered from the party or class of parties that cause costs to arise, and/or benefit from the provision of the good or service. If the funding framework is too inflexible to allow appropriate targeting of cost recovery, then parties will face costs that are too high or

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<sup>7</sup> *Controller and Auditor-General, 'Charging fees for public sector goods and services', June 2008*

<sup>8</sup> The Authority has also considered the Treasury "Guidelines for setting Charges in the Public Sector" (2002), and it has formed the view that these yardsticks are broadly consistent with the Treasury guidelines.

too low. This will undermine incentives for the efficient use of goods and services, and for efficient service provision over time.

- (b) **Incentives on exacerbators/beneficiaries** – being able to recover costs from the correct party or class of parties is not sufficient to ensure efficiency. The funding framework must allow for the incentives relating to service use to be appropriate. For example, if costs/benefits are closely related to the volume of service used by each entity within a class of parties, it would generally be more efficient to employ a volume-related cost recovery approach rather than apply a uniform charge across all users. Similarly, some services may be more appropriately funded by a user-pays charge set in advance to reflect the cost of accessing that service. This issue is important in both near term and over time.
- (c) **Incentives on providers** – the funding framework should provide opportunities for the exacerbators/beneficiaries to scrutinise and influence prospective work programmes and service offerings. This assists in ensuring that decisions on work programmes and services take account of user views, and also sharpens the incentives for efficient delivery of services. The funding framework should also support flexibility in the structuring of service provider arrangements, for instance to enable a close link between the payment for certain services and the manner in which the costs are recovered from the exacerbators/beneficiaries of those services.
- (d) **Degree of certainty** – the funding framework should balance any increase in uncertainty against the incentives created for efficient service provision and efficient service usage. For example, if the funding framework did not provide sufficient certainty to allow for lumpy costs to be recovered over time, this could drive a provider to rely more on variable cost inputs even though it raises overall costs. On the other hand allowing full cost recovery removes any incentive for efficient use of services.
- (e) **Transaction costs** – the funding framework should not impose undue administration costs or inflexibilities on funders or the body receiving funds. For example, a funding framework that was unnecessarily complex could raise costs for all parties.

## **4. Fees could improve efficiency of funding framework**

### **4.1 Key Authority conclusions**

4.1.1 The Authority has assessed its current funding framework against each of the yardsticks set out in Section 3.3 above to examine the extent to which it facilitates or hinders efficient outcomes.

4.1.2 The assessment has highlighted three areas of concern with the current funding framework where the Authority considers the introduction of fees into the funding framework could deliver efficiency gains:

- (a) difficulties with introducing user-pays charging structures under levy arrangements;
- (b) inflexibility of the appropriations process; and
- (c) engagement with users on service provision decisions.

4.1.3 The Authority's findings in each area are discussed in the following sections.

### **4.2 Difficulties with introducing user-pays charging structures under levy arrangements**

4.2.1 The Authority has reviewed existing costs against a set of principles for efficient cost recovery. The analysis suggests that usage related fees may be superior to levy-funding in some areas, in particular where there is a strong user-pays driver to the costs incurred.

4.2.2 For instance, analysis of the cost drivers for reconciliation services might show that the relevant service provider was incurring additional expense whenever an industry participant submitted poor quality data. If this were the case, then it could be more efficient to:

- structure the monthly payments to the service provider in question to include a fixed payment for regular data handling, and an extra payment for any data file received that month that did not meet an agreed quality standard;
- establish a fee reflecting the costs of handling a poor data file, and charge that as a specific fee to any industry participant that failed to meet the required standards for data quality, alongside their share of the regular data handling costs.

- 4.2.3 Introducing user-pays charges in such a situation is likely to produce efficiency gains, as it sends a direct signal to each participant if they are imposing additional costs, and recovers those costs just from those who are causing them, rather than spreading them across all industry participants.
- 4.2.4 However, the Authority has concluded that user-pays charges would be complex to implement within the existing appropriations and levy arrangements. For instance, in the example above it would likely require the Authority to establish a class of levy payer consisting of industry participants who submit poor quality data, then allocating a portion of the total cost of the data handling service to that class. If this allocation were made ex ante, then, as part of its process to set levy rates for the year, the Authority would need to make a prior estimate of which parties would fail to meet the data quality standard and how often they would do so. Any error in this assumption could be addressed via the end-of-year levy reconciliation, but this would weaken the signal to improve data quality and would mean that “good data providers” would have been subsidising “bad data providers” in the meantime. Alternatively the allocation could be ex post as part of the levy reconciliation, which would lower the transaction costs associated with the user-charge, but would also significantly dilute its ability to incentivise improved behaviour.
- 4.2.5 The introduction of user-pays charges would be more readily achieved with a fee regime than under the appropriation and levy arrangements, and would be more likely to achieve the efficiency gains identified. The monthly invoice could include an extra charge just for those who had submitted poor quality data files that month, alongside the standard monthly fee for data handling. This would provide a direct and timely signal to improve standards, without incurring significant transaction costs.

### **4.3 Inflexibility of the appropriations process**

- 4.3.1 The need to conform to the annual appropriations process (with its significant lead times) imposes some rigidity that can be problematic at times. For example, the introduction of a new service or function might need to be delayed until it can be addressed within the appropriations cycle.
- 4.3.2 While there is the ability to seek a mid-year appropriation, any such request must still conform to Parliament’s timetable, and if the timing is missed, then another six month delay will likely result. The Authority is not able to borrow as an interim funding arrangement until the appropriation is received, as this is prohibited under the Public Finance Act. The Authority may be able to reprioritise other funds within the appropriation but only to the extent that the funds are able to be diverted and are sufficient, which is unlikely in the case of a substantive new service or function.

- 4.3.3 The ability to fund certain activities through fees (with suitable consultation and approval requirements) could facilitate greater flexibility than the appropriation mechanism affords. Although making or amending fee regulations requires effective consultation and Cabinet approval, the process is not linked to the appropriations cycle and is therefore more flexible.
- 4.3.4 The Authority acknowledges that if fees were to be introduced, the costs recovered by such fees would not be visible to stakeholders in the annual appropriation request (since no appropriation would be required if fees are paid directly to the Authority). For this reason, the Authority considers that any amendment to the Act to allow for fees should also include suitable requirements around consultation and disclosure on the Authority's expected level of fee income and associated costs for the coming year. It should also ensure that the Authority's combined funding from the levy and fees should not exceed its total estimated expenditure.

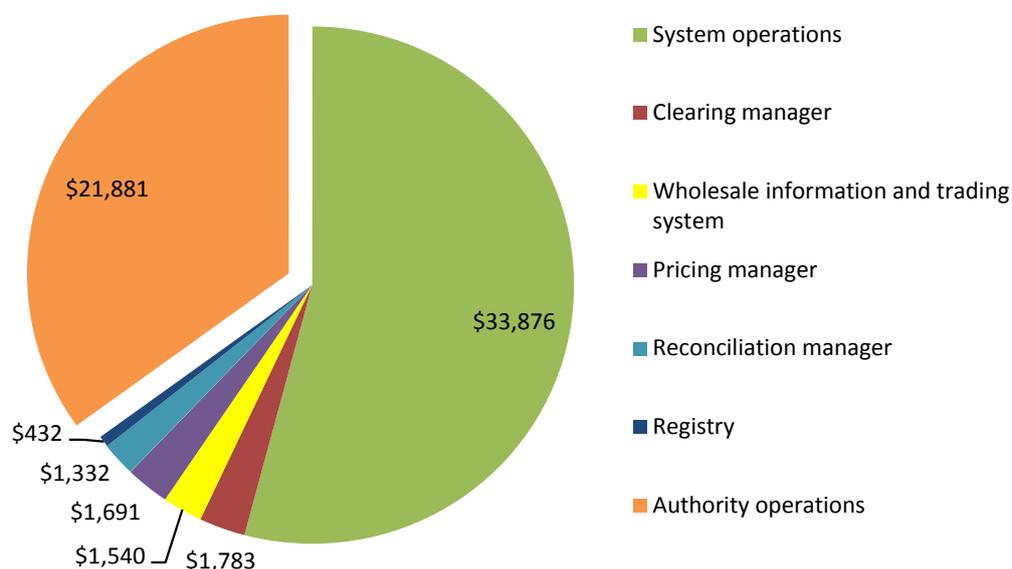
## 4.4 Engagement on service provision

- 4.4.1 A sound funding framework should provide opportunities for the users/beneficiaries to scrutinise and influence prospective work programmes and service offerings to help ensure that they are appropriate and provide value for money. In theory, the annual consultation process on the Authority's work programme, forecast expenditure, and indicative levy rate should meet this need. However, the Authority considers that the effectiveness of this mechanism could be improved.
- 4.4.2 As shown in Figure 8, the majority of the Authority's costs<sup>9</sup> are in the form of payments to external market services providers, with over 50% of the budget being allocated to one service provider alone (the system operator). The Authority's own operations account for around 35% of this budget.

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<sup>9</sup> This focuses on the ongoing core operations of the Authority.

Figure 8: Electricity Authority budget for 2011/12 (governance and market operations) \$ 000



Source: Annual report for year to 30 June 2011

- 4.4.3 In many respects the Authority undertakes its market operations functions on behalf of industry participants (for example, the provision of reconciliation and registry services). The current process, which is primarily geared around Parliamentary scrutiny of annual appropriations, is not well suited to obtaining effective engagement between the Authority as purchasing agent, and its ‘client’ industry users on key issues.
- 4.4.4 Furthermore, a very significant proportion of Authority expenditure is ‘locked in’ over much longer timeframes through its multi-year service provider contracts. The mismatch between the timeframes for major expenditure decisions and the annual budget consultation process is likely to weaken stakeholders’ ability to effectively engage with the Authority in relation to contracting processes for market service providers. As an analogy, (albeit more extreme), the current process would be akin to scrutinising major grid upgrade proposals via Transpower’s annual budget requests, rather than considering each proposal’s merits as a discrete investment.
- 4.4.5 A fee mechanism could also improve the Authority’s ability to enter into longer term commitments with service providers. The Authority considers that longer term commitments are efficient for some services, such as where relying on repeated shorter term commitments could raise costs or where a provider needs to make an upfront investment (such as development of software). A fee mechanism could assist the Authority to enter longer term commitments as it is

not driven by the Crown's annual appropriations cycle and can directly fund a multi-year commitment.

- 4.4.6 Another feature of the current process is that it may reduce effective scrutiny of the Authority's core operational costs because they are to some extent obscured by the much larger market service provider costs. Funding market service provider costs through a fee mechanism could make the appropriation process more relevant, because it would focus scrutiny on the annual work programme and costs of the Authority's industry governance functions.
- 4.4.7 In reviewing the arrangements in other jurisdictions (including electricity regulators overseas and the NZ gas co-regulator), achieving a higher level of engagement on provision of market operational services appears to be one of the key reasons that fee-based arrangements have been favoured.

## **4.5 In conclusion**

- 4.5.1 The Authority's funding arrangements are unusual when compared to those of other bodies undertaking similar functions. In particular, the costs of market operations (as distinct from governance or regulatory functions) are met largely or wholly from user fees in the New Zealand gas sector, and in the electricity and gas markets in Australia and Great Britain. By contrast, the Authority is funded entirely by Crown appropriations with a requirement that all of this cost (for both market operations and governance functions) be recovered via the industry levy.
- 4.5.2 The Authority acknowledges that there may be some scope to address the issues it has identified within the existing legislative framework. For example, the Authority could facilitate increased user input when contracting with external providers for market services, and could structure aspects of service provider payments to be more reflective of the underlying costs drivers. However, it would be very difficult for the Authority to introduce tailored user-pays type charges under the levy arrangements because the appropriation and levy processes do not permit sufficient flexibility for fees to deliver the efficiencies identified, in particular incentivising improved participant behaviour.
- 4.5.3 The Authority's inability to charge and receive user fees for any functions carried out under the Act significantly constrains opportunities to create a more direct and transparent link between payments made by industry participants and the payments made to service providers. In particular, the Authority would like the ability to introduce usage related fees for services where usage is a strong driver of the costs incurred. This would be more readily achieved with a fee regime than under the current appropriation arrangements, and would be more likely to achieve the efficiency gains identified.

- 4.5.4 Introducing fees would enable more transparent and immediate reflection of costs through to the users of the services, thereby incentivising more efficient behaviours. Further efficiency gains could be achieved if these user fees were then reflected in the payment structure of the relevant service provider contracts. This would create a stronger and more transparent link between the fees collected by the Authority and the payments that service providers receive.
- 4.5.5 Furthermore, the focus on annual appropriations is not especially well suited to obtaining effective engagement between the Authority as purchasing agent, and its 'client' industry users on issues such as multi-year market service provider contracts. The annual nature of most appropriations may also make it harder for the Authority to enter into longer term commitments with market service providers, even though this may yield benefits to all stakeholders.
- 4.5.6 For these reasons, if a suitable opportunity arises on the legislative schedule, the Authority sees merit in Parliament considering an amendment to the Act to enable the possibility of funding some Authority activities from user fees, rather than relying entirely on levy funding.
- 4.5.7 In conclusion, the Authority considers that:
- the benefits of amending the Act to allow for fees would be in the efficiency improvements discussed above;
  - the incremental costs of amending the Act to allow for fees would be relatively minor if the amendment could be progressed as part of an existing Bill; and
  - the risks of amending the Act to allow for fees are constrained by the fact that the fee-making provisions could only become operable if the Authority can demonstrate to the Minister that regulations should be made to provide for fees.

## 5. Enabling a mixed fee and levy funding arrangement

### 5.1 Amending the Act to allow for fees

- 5.1.1 The requirement under the Act that the Authority's statutory activities are fully funded by the Crown via the levy mechanism means that the Authority is not able to charge fees unless the Act is amended.
- 5.1.2 An Amendment Bill would be drafted and would proceed through the usual legislative process. However, in general terms, enabling the introduction of fees would likely involve amending the Act as follows:
- (a) removing the requirement in section 128 of the Act that the Authority's statutory functions are fully funded by the levy, and instead providing for the Authority's costs, other than those recovered via fees, to be met from the industry levy;
  - (b) authorising the making of fee regulations covering such matters as the manner in which fees are set, which parties are obliged to pay the fees, and to whom fees should be paid; and
  - (c) including suitable requirements around consultation with fee payers, and disclosure regarding the Authority's expected level of fee income and associated costs for the coming year.
- 5.1.3 Enabling the Authority to include fees in its funding arrangements would bring it into line with a number of other independent Crown entities and comparable energy sector regulators/market operators which recover their costs via a mixture of industry levy and fees. Where relevant, the statutory framework for such entities may also provide some guidance in the drafting of suitable amendments to the Act.
- 5.1.4 It is important to note that the proposal to amend the Act would only enable the possibility of fees. Further regulatory amendments, including the making of fee regulations and amendment of the existing Levy Regulations, would be required before any fees could be introduced.
- 5.1.5 Regulations can only be made/amended by the Governor-General, by Order-in-Council on the recommendation of the Minister, and this process includes stringent requirements around Regulatory Impact Assessment and consultation with affected parties.
- 5.1.6 The Authority would also like to emphasise that enabling some of the Authority's activities to be funded by fees would not, per se, affect the total level of the Authority's funding, only the mechanisms by which it is collected.

## **5.2 The process from here**

- 5.2.1 The submissions period closes at 5pm on Friday 21 December 2012.
- 5.2.2 The Authority will consider submissions in January and early February. If the Authority determines it wishes to proceed after considering submissions, it will make a recommendation to the Minister of Energy and Resources in February.
- 5.2.3 If the Minister agrees to the Authority's proposal, it could take up to a year before the Amendment Bill goes through the Parliamentary process and becomes law. The usual Parliamentary process includes a Select Committee considering the Amendment Bill, which will provide opportunity for further stakeholder input.



## References

Document	Source
AEMC 2010 – 2011 Annual Report	AEMC, Australia
AEMO Electricity Final Budget and Fees 2011/12	AEMO, Australia
AEMO Annual Report 2011	AEMO, Australia
AEMO Structure of Participant Fees in the National Electricity Market - Determination and Report	AEMO, Australia
Balancing and Settlement Code (GB)	Elexon Limited, UK
BSCCo Business Plan 2012/13	Elexon Limited, UK
Charging Fees for Public Sector Goods and Services (2008)	Controller and Auditor- General
Guidelines for setting Charges in the Public Sector (2002)	The Treasury
Electricity Industry Participation Code 2010	Electricity Authority
Electricity Authority Statement of Intent 2012/15	Electricity Authority
Commerce Commission 2010 / 2011 Annual Report	Commerce Commission
Electricity Industry Act 2010	Parliament
Gas Act 1992	Parliament
Gas (Downstream Reconciliation) Rules 2008	Gas Industry Co
Gas (Switching Arrangements) Rules 2008	Minister of Energy
Estimates of Expenditure : Vote Energy	Parliament
Films, Videos, and Publications Classification Act 1993	Parliament
Consultation on Proposed Gas (Levy of Participants) Regulations 2011	Gas Industry Co
Gas Governance (Critical Contingency Management) Regulations 2008	Gas Industry Co
A Guide to the Public Finance Act – August 2005	The Treasury
National Electricity Rules – Version 49	AEMO, Australia
Annual Report and Accounts 2010 – 2011	Ofgem, UK
Proposed Corporate Strategy and Plan 2011-16	Ofgem, UK
Treasury Instructions 2011	The Treasury



## Appendix A Format for submissions

- A.1 Submissions close at 5pm on Friday 21 December 2012. Information on how to make a submission is set out in Section 1.3 of this consultation paper.
- A.2 Submitters are invited to consider the questions in Table 1 when formulating their feedback to the Authority on the proposal to amend the Act to introduce a fee mechanism into the Authority’s funding arrangements alongside the industry levy, and thereby enable the possibility of funding some Authority activities from fees.

Table 1: Questions for submitters

	Question
1.	What comment do you have on the Authority’s view that the introduction of fees could deliver efficiency gains as it would more readily support the introduction of efficient user-pays charges to recover some costs?
2.	What comment do you have on the Authority’s view that the introduction of fees to recover some costs could deliver efficiency gains through the enhanced flexibility that a fee arrangement can provide relative to the rigidity of the annual Crown appropriations process?
3.	What comment do you have on the Authority’s view that the introduction of fees to recover some costs could deliver efficiency gains through more effective engagement between the Authority as purchasing agent and its “client” industry users on key issues relating to service provision and the engagement of service providers?
4.	What other comments do you have on the Authority’s proposal to seek an amendment to the Electricity Industry Act 2010 to allow for the Authority’s activities to be funded by a mixture of fees and the industry levy?

## Appendix B Current levy and fee provisions in the Act

### Section 128 Levies

- (1) Every industry participant (or prescribed class of industry participant) must pay to the Authority on behalf of the Crown a levy prescribed by regulations.
- (2) The Governor-General may, by Order in Council made on the recommendation of the Minister, make regulations providing for the levy.
- (3) The levy must be prescribed on the basis that the following costs should be met fully out of the levy:
  - (a) the costs of the Authority in performing its functions and exercising its powers and duties under this Act and any other enactment; and
  - (b) the costs that are associated with the Whirinaki agreement referred to in section 127, and any costs incurred by the Crown that are associated with the Whirinaki generating plant after the Whirinaki agreement is terminated; and
  - (c) a portion of the costs of the Energy Efficiency and Conservation Authority in performing its functions and exercising its powers and duties under the Energy Efficiency and Conservation Act 2000 in relation to the encouragement, promotion, and support of electricity efficiency, where the size of the portion to be met by levies under this Act is determined by the Minister; and
  - (d) the costs incurred by the Crown before 1 May 2014 in promoting to customers the benefits of comparing and switching retailers, subject to both of the following limits:
    - (i) a limit of \$5 million per financial year; and
    - (ii) an overall limit of \$15 million for the period commencing on 1 November 2010 and ending with 30 April 2014; and
  - (e) the costs of the Rulings Panel; and
  - (f) the costs of establishing and operating any regulated dispute resolution scheme in respect of the electricity industry under Schedule 4; and
  - (g) the costs incurred by the Crown in relation to developing and publishing regional electricity supply and demand forecasts and scenarios, and related information and analysis, for the purpose of assisting investment planning by industry participants; and
  - (h) for the first financial year to which the levy applies, the costs incurred by the Crown on or after 1 January 2010 relating to establishing the Authority, disestablishing the Electricity Commission, transferring functions to other agencies, and preparing the initial Code; and
  - (i) the costs of collecting the levy money.
- (4) The levy may be prescribed on the basis that any actual cost that could have been, but has not been, recovered as a levy shortfall for a year may be recovered (along with any financing charge) over any period of up to 5 years.
- (5) The regulations may—
  - (a) specify the amount of the levy or method of calculating or ascertaining the amount of the levy;
  - (b) include or provide for including in the levy any shortfall in recovering the actual costs;
  - (c) refund or provide for refunds of any over-recovery of those actual costs;
  - (d) provide for different levies for different classes of industry participants;
  - (e) specify the financial year or part financial year to which a levy applies, and apply that levy to that financial year or part financial year and each subsequent financial year until the levy is revoked or replaced;
  - (f) provide for the payment and collection of levies;

- (g) require payment of a levy for a financial year or part financial year, irrespective of the fact that the regulations may be made after that financial year has commenced:
  - (h) exempt or provide for exemptions from, or provide for waivers of, the whole or any part of the levy for any case or class of cases.
- (6) The levy for a financial year that starts after the Authority begins to carry out any additional function under this Act or any other Act may cover the costs of performing that additional function, irrespective of the fact that the regulations may be made and come into effect after the start of the financial year.
  - (7) The amount of any unpaid levy is recoverable in any court of competent jurisdiction as a debt due to the Authority on behalf of the Crown.
  - (8) The Authority must pay into a Crown Bank Account, and separately account for, each levy payment.

### **Section 129 Consultation about request for appropriation**

- (1) The Authority and the Energy Efficiency and Conservation Authority must, before submitting a request to the Minister seeking an appropriation of public money for the following year, or any change to an appropriation for the current year, that relates to costs that are intended to be recovered by way of levies under section 128, consult about that request with—
  - (a) those industry participants who are liable to pay a levy under that section; and
  - (b) any other representatives of persons whom the Authority believes to be significantly affected by a levy.
- (2) Each Authority must, at the time when the request is submitted, report to the Minister on the outcome of that consultation.
- (3) The Ministry must consult in a like manner in respect of a levy to recover costs referred to in section 128(3)(g).
- (4) This section applies to requests in respect of the financial year beginning 1 July 2011 and later financial years.

### **Section 115 General regulation-making power**

The Governor-General may from time to time, by Order in Council, make regulations for all or any of the following purposes:

- (a) prescribing the matters in respect of which fees or charges are payable under this Act or the regulations, the amounts of those fees or charges, or the method or rates by which they are to be assessed, the persons liable for payment of those fees or charges, and the circumstances in which the payment of the whole or any part of those fees or charges may be refunded or waived:
- (b) providing for such other matters as are contemplated by, or are necessary for giving full effect to, this Act and for its due administration

## Appendix C Current funding arrangements

C.1 This Appendix sets out further information on the current funding arrangements overviewed in Section 2 of this consultation paper.

### Appropriation of Crown funding

C.2 All of the Authority's activities are funded by the Crown via Parliament's appropriations process. This process is summarised in Section 2.3 and described in more detail here.

C.3 Table 2 shows the appropriations for the 2011/12 – 2014/15 years, as approved in May 2012 by the Crown through the 2012/13 appropriation process.

C.4 The *Electricity industry governance and market operations* output class in Table 2 covers the Authority's costs of oversight of the operation and governance of the New Zealand electricity market under the Act, Code, and regulations, including the following:

- operation of the electricity system and markets (including service provider costs);
- market development;
- compliance and supporting the Rulings Panel;
- industry monitoring and information;
- security of supply governance;
- costs for the Security and Reliability Council and advisory groups; and
- members' costs for the Authority Board and Rulings Panel.

C.5 The *Security management* output class covers the system operator responsibilities for emergency management, including monitoring security levels and taking progressively escalating actions, if necessary. It also includes funding required in the event that emergency actions are required, such as planning and initiating a public savings campaign. It is worth noting that, as the Authority does not expect any costs to be incurred in the normal course of events, this appropriation is not included in the indicative levy rates that are used for invoicing during the year.

C.6 The *Promote and facilitate customer switching* output class is a result of the 2010 electricity reforms which included establishment of a \$15m fund covering the period from November 2010 to April 2014 to promote customer switching. Of this, \$10.5m is administered by the Authority to encourage consumers to compare the benefits of switching retailers. The remaining \$4.5m is administered by the Ministry of Consumer Affairs in a multi-year appropriation through Vote: Consumer Affairs for upgrading and promoting the Powerswitch website, and is not included in Table 2.

C.7 Also funded by the levy but not included in Table 2 is the Electricity efficiency appropriation which covers a portion<sup>10</sup> of EECA’s costs in performing its functions under the Energy Efficiency and Conservation Act 2000 in relation to the encouragement, promotion, and support of electricity efficiency.

Table 2: Authority’s appropriations and output classes for 2012/13 financial year

Appropriations and output classes	\$ million			
	2011/12 appropriations	2012/13 appropriations	2013/14 forecast	2014/15 forecast
Electricity industry governance and market operations	62.535	63.906	64.873	65.593
Reserve energy and emergency measures – availability costs*	10.670	NA	NA	NA
Reserve energy and emergency measures – variable costs**	4.662	NA	NA	NA
Security management	NA	6.000 over 5 years (2012/13 to 2016/17)		
Promote and facilitate customer switching	3.501	3.500	2.000	NA
Authority litigation fund***	0.444	0.444	0.444	0.444
Notes:				
* Appropriation ended in 2011/12. This appropriation previously funded the Whirinaki supply agreement with the Crown.				
** Appropriation ended in 2011/12. Replaced by the security management appropriation to take effect from 1 July 2012.				
*** The Electricity Authority litigation fund provides funding to ensure that the Authority is able to participate in litigation effectively and without delay. This is a Crown expense appropriation, which is drawn on only for major litigation. There is no output class for this appropriation.				

Source: Electricity Authority Statement of Intent 2012-15

## Industry levy

C.8 The levy is made under the Levy Regulations, in accordance with provisions set out in the Act (refer Appendix B). The current levy arrangements are summarised in Section 2.4, and described in more detail here.

C.9 The Governor-General may, by Order in Council made on the recommendation of the Minister, make or amend regulations providing for the levy. The empowering provisions in the Act allow the regulations to (among other things):

- (a) specify the amount of the levy or method of calculating or ascertaining the amount of the levy;

<sup>10</sup> The size of the portion to be met by the levy is determined by the Minister.

- (b) include or provide for including in the levy any shortfall in recovering the actual costs; and
- (c) provide for different levies for different classes of industry participants.

C.10 The Levy Regulations set out the formulae for allocating annual costs to levy payers and the process by which levy payers are invoiced for the amounts they are each liable to pay. The key steps can be summarised as follows:

- 1) Determine the cost of each activity by allocating the estimated costs to the activities listed in Table 1 of the Levy Regulations (e.g. common quality operations, market operations, registry and consumer operations, supply reliability operations, transmission operations, electricity efficiency operations, customer switching fund, etc.).
- 2) Determine the costs payable by each participant class for each activity by allocating the costs of each activity to the classes of industry participants according to the proportions set out in Table 1 of the Levy Regulations (e.g. one third each to generators, purchasers, and distributors for common quality operations, one half each to generators and purchasers for market operations).
- 3) Determine the annual levy rate per unit of electricity generated/purchased/conveyed, or per consumer connection, as the case may be, by dividing the costs payable by each class of participant per activity by the relevant number calculated in accordance with Table 2 of the Levy Regulations. Where a cost is allocated to generators, the per unit cost is based on the estimated total quantity of electricity to be generated by generators during the financial year. Where a cost is allocated to purchasers/distributors, the per unit cost is usually based on the estimated total quantity of electricity to be purchased/conveyed during the financial year, but in some cases is based on the estimated average total number of consumer connections during the financial year.

C.11 The result of these steps is the annual levy rates for the financial year. The Authority is required to publish a notice in the Gazette setting out the annual rates as soon as practicable after they have been calculated. The Authority generally makes the calculation once the appropriation has been received (end of May) and gazettes the rates in June for the financial year beginning 1 July.

C.12 As part of its annual appropriations consultation in November/December, the Authority also calculates and publishes indicative levy rates based on estimated expenditure. A copy of the current annual levy rates applying through to 30 June 2012, as gazetted in June 2012 is reproduced below as Figure 9.

- C.13 The annual levy is payable to the Authority in monthly instalments in arrears. The formulae for calculating each participant’s monthly instalment are prescribed in the Levy Regulations. Each participant is liable to pay the amount invoiced each month, and any unpaid levy is recoverable through the Courts as a debt due to the Authority on behalf of the Crown.

Figure 9: Current annual levy rates to 30 June 2013

**Notice of Annual Levy Rates for the Financial Year Ending 30 June 2013**

Pursuant to Regulation 8 of the Electricity Industry (Levy of Industry Participants) Regulations 2010 (“Regulations”), the Electricity Authority (“Authority”) gives the following notice.

**Notice**

1. **Title**—This notice is the Notice of Annual Levy Rates for the Financial Year Ending 30 June 2013.
2. **Levy rates**—The Authority has calculated the annual levy rates for the financial year ending 30 June 2013 in accordance with Regulation 7 of the Regulations, as follows:

	Generators	Purchasers	Retailers	Distributors (including Transpower)	Distributors (excluding Transpower)	Transpower
Common quality operations	\$0.1603/MWh	\$0.1603/MWh		\$0.0894/MWh		
Market operations	\$0.4027/MWh	\$0.4027/MWh				
Registry and consumer operations			\$0.8756/ICP		\$0.8758/ICP	
Supply reliability operations		\$0.0095/MWh				
Transmission operations						\$0.0146/MWh
Electricity efficiency operations		\$0.3724/MWh				
Customer switching fund			\$2.4823/ICP			
Other activities	\$0.0505/MWh	\$0.0505/MWh		\$0.0282/MWh		

Dated at Wellington this 8th day of June 2012.

- C.14 Levy rates may, at the Authority’s discretion, be adjusted (and gazetted) during the financial year in certain circumstances:
- the estimated costs change significantly;
  - the costs of an activity change significantly;
  - the amount of levy money estimated to be collected is too much or too little because the quantity of electricity generated/purchased/conveyed is significantly different to what was estimated, or the number of consumer connections has significantly changed; or
  - the Authority’s costs are reallocated between activities.
- C.15 The levy is reconciled after the end of the financial year, using actual costs, actual quantities of electricity generated/purchased/conveyed, and actual numbers of consumer connections. Under- and over-recoveries identified in the reconciliation are addressed with invoices or refunds for each participant. If there is a subsequent significant change in the quantities of electricity generated/purchased/conveyed (for instance as the result of a significant metering error identified after the reconciliation process) then a further reconciliation and associated levy recalculation may be required.

## Appendix D Funding arrangements for other entities

D.1 This Appendix sets out further information on the funding arrangements of other entities, overviewed in Section 2.6 of this consultation paper. It focuses on the funding arrangements for the following key energy market operators/regulators:

- the Gas Industry Company – this entity is the co-regulator of the gas industry and has regulatory and market operations functions comparable to those of the Authority, but operates as a company incorporated under the Companies Act 1993 with an industry-appointed Board;
- the Australian National Electricity Market (NEM) – the regulatory and market operation functions that in New Zealand are undertaken by the Authority, are split in the NEM and carried out by the Australian Energy Market Commission (AEMC) and Australian Energy Market Operator (AEMO) respectively; and
- electricity and gas markets in Great Britain – these are principally regulated by the Office of Gas and Electricity Markets (Ofgem), which operates under the governance of the Gas and Electricity Markets Authority.

### Gas Industry Company Limited

D.2 In many respects, Gas Industry Company (Gas Industry Co) Limited's functions in the gas sector are analogous to those of the Authority in the electricity sector, although there are differences in the governance framework.

D.3 Gas Industry Co makes recommendations to the Minister of Energy and Resources on gas governance regulations, administers and enforces those regulations, and can establish, operate, and facilitate markets for gas industry participants.

D.4 Gas Industry Co is not an independent Crown entity but is instead a company incorporated under the Companies Act 1993, with an industry-appointed Board. Its constitution sets out its objectives and functions. Gas Industry Co has been named as the co-regulatory industry body in the Gas Act 1992.

D.5 Gas Industry Co has three principal sources of funding:

- **Annual levies** – Gas Industry Co can recommend regulations to the Minister to provide for annual levies on classes of industry participant. Levies are payable directly to the Gas Industry Co and over or under

recovery of costs in one year can be (and are) carried forward via a levy adjustment in a subsequent year. The Minister must accept a levy recommendation if he or she is satisfied that it is reasonable, conforms with the Gas Act 1992, and that Gas Industry Co has consulted with participants on the levy rate<sup>11</sup>;

- **Market fees** – gas governance regulations and rules can include provisions for market fees to recover the cost of developing and/or operating related provisions. For example, the cost of registry services to enable retail competition and switching can be recovered under the Gas (Switching Arrangements) Rules 2008. These rules allow the recovery of external registry operator costs and Gas Industry Co’s internal costs associated with the registry and its role under the rules in the payment year;
- **Annual fees** – the company constitution allows the Board to set an annual fee payable by all shareholders. Industry participants are not required to be shareholders, but do not have voting rights at board elections unless they are shareholders. Gas Industry Co has set the annual fee at a relatively low level and it has historically provided a small proportion of total revenue.

- D.6 The Authority understands that in practice Gas Industry Co has used the market fees to recover the costs of external providers engaged to undertake specific market services, such as running the registry and downstream reconciliation platforms that enable retail competition.
- D.7 The service provider contracts involve relatively long term commitments (five years with rights of renewal), and the Authority understands that Gas Industry Co took the view that, rather than levy funding, it is more appropriate to recover these costs via specific fees that are expected to have a stable structure through the life of the contract. Furthermore, the Authority understands that Gas Industry Co actively sought involvement by prospective fee payers (i.e. users) when it was awarding these contracts. For example, Gas Industry Co appointed a panel of ‘users’ to assist in structuring each service provider contract, evaluate service provider proposals, and identify a preferred supplier.
- D.8 Gas Industry Co’s approach can be seen as a recognition that it is acting as agent for market participants when negotiating and awarding these contracts. The Authority considers that this would have benefits in ensuring appropriate focus by users on the importance of the contracting process, especially as it creates multi-year commitments which they ultimately bear. This is likely to result in greater transparency and accountability in the contracting process.

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<sup>11</sup> Section 43ZZD of the Gas Act.

It seems unlikely that managing the expenditure via the annual levy process would achieve the same level of engagement and focus from stakeholders.

- D.9 By contrast, where commitments are shorter term, the Gas Industry Co has relied on the annual levy for funding. This appears entirely appropriate, since there is more consistency between the term of proposed work programme and the associated funding 'request'. Gas Industry Co's policy development work is also funded from the levy.

## **Australian National Electricity Market**

- D.10 The Australian National Electricity Market (NEM) covers the Australian Capital Territory (ACT), New South Wales, Queensland, South Australia, Tasmania, and Victoria.

- D.11 The regulatory and market operation functions that in New Zealand are undertaken by the Authority, are split in the NEM and carried out, respectively, by:

- the Australian Energy Market Commission (AEMC); and
- the Australian Energy Market Operator (AEMO).

### **Regulatory functions - AEMC**

- D.12 The AEMC is directly funded by the participating jurisdictions in the NEM and does not derive any income from market fees. The AEMC's principal functions are to make market rules and undertake reviews into energy sector issues at the request of the Ministerial Council on Energy. The AEMC is therefore largely focussed on the provision of public goods, and its broad based funding arrangements reflect this.

### **Market and system operations - AEMO**

- D.13 By contrast, the AEMO carries out functions for which specific causers or beneficiaries can be more readily identified. These include:
- day-to-day management of wholesale and retail energy market operations in the NEM (scheduling, dispatch, pricing, clearing, switching, registry, reconciliation services);
  - real time operation of the NEM's electricity power system;
  - operation of the Victorian gas transmission system;
  - long-term market planning via demand forecasting and scenario analysis; and
  - planning and procurement of electricity transmission expansions and connections in Victoria.

- D.14 AEMO is a company limited by guarantee incorporated under the Corporations Act (2001). As a not-for-profit company, it must ultimately recover all of its costs from market participants via fees. The National Electricity Rules and National Gas Rules set out a framework within which AEMO must develop and apply its fee structure. For example, Chapter 2 of the National Electricity Rules (version 49) requires that:
1. the structure of Participant fees should be simple;
  2. Participant fees should recover the budgeted revenue requirements for AEMO;
  3. the components of Participant fees charged to each Registered Participant should be reflective of the extent to which the budgeted revenue requirements for AEMO involve that Registered Participant;
  4. Participant fees should not unreasonably discriminate against a category or categories of Registered Participants.
- D.15 While AEMO is required to periodically consult on its prospective fee structure, it makes the final decision on the allocation of fees. The last electricity fee structure applied for a five year period.
- D.16 Once the overall fee structure is in place, AEMO determines the level of specific fee(s) required to ensure revenue adequacy over time. In this context, it is important to note that the Rules permit AEMO to undertake some 'smoothing' of fees, by over or under recovering revenue categories in any given year. AEMO maintains banking facilities to bridge periods when it is under-recovering revenue.
- D.17 In practice, the framework provided by the National Electricity Rules and National Gas Rules is broad, and the AEMO Board has a reasonable degree of flexibility in determining the structure of fees and timing of cost recovery. The AEMO Board itself comprises nine non-executive directors appointed by Ministers on the basis of defined skill sets, and the Managing Director appointed by the non-executive directors.
- D.18 AEMO's current fee structure for electricity market activities provides for:
- registration fees to intending market participants;
  - throughput fees which are charged to generators, market network service providers and market purchasers based on energy throughput (i.e. \$/MWh);
  - fees at daily rates based on capacity or energy; and
  - fees charged for specific services or activities.

## Electricity and gas markets in Great Britain

- D.19 Electricity and gas markets in Great Britain are principally regulated by the Office of Gas and Electricity Markets (Ofgem), which operates under the governance of the Gas and Electricity Markets Authority. While Ofgem regulates these markets, market services (such as clearing and settlement functions) are provided by Elexon, and National Grid is the system operator.

### Regulatory functions - Ofgem

- D.20 In the year to March 2011, Ofgem's income was £58 million, of which £30 million was from licence fees paid by regulated entities. The balance came from a variety of sources such as government grants to fund work associated with environmental objectives.
- D.21 Ofgem's annual report to March 2011 states that "All of the above operating income was appropriated in aid. Appropriations in Aid represent income due to Ofgem that can be retained to offset against other public expenditure. This contrasts with Consolidated Fund Extra Receipts, which are remitted by us to the Consolidated Fund"<sup>12</sup>. This indicates that all of Ofgem's income is subject to Parliamentary appropriation, and that some of this cost is recovered via licence fees. In short, it appears that all of the policy development and enforcement costs of Ofgem are provided by Parliamentary appropriation, and a portion of these costs are recovered from industry.

### Market operations - BETTA

- D.22 The British Electricity Trading and Transmission Arrangements (BETTA) are based on the trading of bilateral contracts (rather than a spot market or pool), combined with a balancing market to settle any on-the-day imbalance positions between a party's actual and contracted purchases/sales.
- D.23 The balancing market operates in accordance with the Balancing and Settlement Code (BSC) which must be approved by Ofgem. The BSC is governed by a panel appointed by different industry interests (consumers, generators, transmission company) and chaired by a person appointed by the Gas and Electricity Markets Authority<sup>13</sup>.
- D.24 The BSC panel appoints an organisation to act as the Balancing and Settlement Code Company (BSCCo). The BSC requires this entity to be a company with a not-for-profit objective and be owned by the transmission company (National Grid Electricity Transmission Plc). The BSCCo role is currently fulfilled by Elexon.
- D.25 Elexon receives fee income for providing market services in accordance with provisions in the BSC which set out how fees are to be calculated and

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<sup>12</sup> Note 8 to departmental resource accounts, Ofgem Annual Report to 31 March 2011.

<sup>13</sup> The chair may also appoint two further members.

apportioned among market users. The BSC also requires Elexon to submit an annual budget request to the panel for approval. Elexon's budgeted income was £35 million for the year to March 2012.

- D.26 In short, Elexon is completely funded by market fees which are defined in the BSC.

### **System operation – National Grid**

- D.27 The system operation function in Great Britain is carried out by National Grid in accordance with a licence issued by Ofgem. The function is regarded as a monopoly service and is subject to price control by Ofgem. Historically, this has taken the form of revenue limits set on a five year horizon. This is intended to provide incentives for National Grid to be productively efficient in the provision of its services.
- D.28 In addition, National Grid is exposed to incentive arrangements which are intended to encourage efficient dispatch, i.e. to minimise the real time cost of generating and transporting electricity to consumers. In broad terms, these arrangements provide for National Grid to share some of the gains (or losses) from cost reductions (or increases) relative to a defined dispatch baseline. The detail of these arrangements (especially how they interact with transmission incentives) has recently been under review.
- D.29 Ultimately, the costs of system operator services are recovered as fees payable to National Grid, which must be paid by users as a condition of their own licences.
- D.30 The Authority understands that Ofgem is currently considering significant changes to the way that price controls operate at the broader level. It is not clear whether these changes have taken effect, or whether they will materially alter the way that system operation costs are managed and recovered.
- D.31 For present purposes, the key points to note are that system operator costs are met entirely from regulated fees charged to users, and that these fees are not subject to any Parliamentary process.