

Review of Electricity Authority Funding Arrangements

June 2012



Concept Consulting Group Limited
Level 6, Featherston House
119-123 Featherston St
PO Box 10-045, Wellington, NZ
www.concept.co.nz

Concept Consulting Group

Concept Consulting Group (Concept) is a New Zealand-based consultancy specialising in energy-related issues. Since establishment in 1999, Concept has advised clients in New Zealand, Australia, Ireland, Singapore and the United States. These clients have included energy businesses, governments, international agencies and regulators.

Concept has undertaken a wide range of assignments, including market development, market analysis, technical evaluations, regulatory and policy analysis, and project management. The firm's directors all have extensive backgrounds in executive management positions with energy companies in New Zealand, and the consulting team collectively offers practical hands-on experience across a wide range of disciplines.

Preparation of this Report

This report was prepared by David Hunt, Victoria Coad and Lee Wilson. Our report makes reference to a number of the legal issues. These references are based on existing legislation and information we have received from the Authority. However, we note that consistent with the terms of reference for this work, our report does not constitute legal advice. Accordingly, the Authority may wish to seek specific legal advice as part of its consideration of this report.

Disclaimer

Concept Consulting Group believes the information and opinions expressed in this report to be accurate and complete at the time of writing.

However, Concept and its staff shall not, and do not, accept any liability for errors or omissions in this report or for any consequences of reliance on its content, conclusions or any material, correspondence of any form or discussions arising out of or associated with its preparation.

Contents

| | |
|--|----|
| Executive Summary..... | 6 |
| 1 Introduction | 10 |
| 1.1 Purpose..... | 10 |
| 1.2 Structure of Report..... | 10 |
| 1.3 Terminology..... | 11 |
| 1.4 Information sources | 11 |
| 2 Current funding framework for Authority | 12 |
| 2.1 Overview..... | 12 |
| 2.2 Appropriation of Crown funding | 13 |
| 2.3 Industry levy | 17 |
| 2.4 Key implications of current arrangements | 20 |
| 3 Funding arrangements for other entities..... | 21 |
| 3.1 Independent Crown entities | 21 |
| 3.2 Commerce Commission | 23 |
| 3.3 Financial Markets Authority | 24 |
| 3.4 Gas Industry Company Limited..... | 25 |
| 3.5 Australian National Electricity Market..... | 27 |
| 3.6 Electricity and gas markets in Great Britain | 29 |
| 3.7 Key observation from comparison of funding arrangements | 31 |
| 4 Assessment of current funding arrangements..... | 33 |
| 4.1 Incentives and efficiency | 33 |
| 4.2 Yardsticks for assessing arrangements..... | 35 |
| 4.3 Identification of beneficiaries/users..... | 35 |
| 4.4 Incentives on beneficiaries/users..... | 36 |
| 4.5 Incentives on providers | 37 |
| 4.6 Degree of certainty | 40 |
| 4.7 Transaction costs | 41 |
| 4.8 Key observations | 41 |
| 5 Issues for consideration | 43 |
| 5.1 Option 1 – introduce an ability to charge fees for certain services..... | 43 |
| 5.2 Alternative approach | 45 |
| 5.3 Overall assessment of options..... | 45 |
| Appendix 1. List of Abbreviations and Terms | 47 |

| | |
|---|----|
| Appendix 2. Information sources | 48 |
| Appendix 3. Current levy and fee provisions in the Act..... | 49 |

List of Figures:

| | |
|--|----|
| Figure 1: Overview of existing funding arrangements..... | 13 |
| Figure 2: Annual appropriations cycle | 15 |
| Figure 3: Components of Authority's forecast expenditure | 17 |
| Figure 4: Current annual levy rates..... | 19 |
| Figure 5: Allocation of levy across classes of industry participant for the current year | 19 |
| Figure 6: Proportion of revenue derived from service fees or equivalent | 21 |
| Figure 7: Commerce Commission – funding sources (2011) | 23 |
| Figure 8: Interaction between funding need, framework and cost outcomes | 33 |
| Figure 9: Electricity Authority budget for 2011/12 (governance and market operations) \$ 000 | 38 |
| Figure 10: Electricity Authority operating commitments as at 30 June 2011 | 39 |

List of Tables:

| | |
|---|----|
| Table 1: Authority's appropriations and output classes for 2012/13 financial year | 16 |
| Table 2: Funding sources for independent Crown entities..... | 22 |
| Table 3: Gas Industry Company operating income..... | 26 |
| Table 4: AEMC income..... | 27 |
| Table 5: AEMO Budget and Fee Structure for 2011/2012 (electricity related activities) | 29 |
| Table 6: Summary of funding arrangements for Authority and other bodies | 32 |
| Table 7: Key observations about current arrangements | 41 |

Executive Summary

This report reviews funding arrangements for the Electricity Authority (Authority) with a view to exploring whether they could be amended or augmented to improve their effectiveness.

Current funding arrangements

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 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, even where funding is for market services being provided to a clearly identifiable set of users or beneficiaries.

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 (i.e. the allocation among industry participants) can be varied by regulations, made on the recommendation of the Minister.

Although section 115 of the Act 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 mechanism inoperable for recovery of costs arising in relation to the Authority's statutory functions¹.

The practical effect of these arrangements is that:

- All of the Authority's funding² is ultimately determined by Parliament through the annual appropriation process.
- The Authority is not able to charge and receive a fee direct from users for any statutory function carried out pursuant to the Act – but the levy can exhibit some of the characteristics of a fee.

Funding arrangements for 'similar' bodies

Funding arrangements for independent Crown entities in New Zealand vary widely. In broad terms, activities where specific causers or beneficiaries can be identified are often (at least in part) funded by fees paid directly to the independent Crown entity by users, and activities with diffuse causers or beneficiaries (for example quasi-judicial functions) typically rely on Crown revenue (sometimes with levy cost recovery).

The Authority's funding arrangements are relatively unusual compared to other independent Crown entities. The market operations functions it undertakes have clearly identifiable users and beneficiaries in many cases, but the Authority does not have any ability to charge and receive fees for these services.

¹ For completeness, we note that regulations could be made under section 115 to provide for fees in respect of any costs that are *not required* to be fully funded by the levy under section 128, i.e. for functions not specified in the Act.

² In respect of statutory functions.

The Authority's counterpart in the New Zealand gas sector has a mix of fee income (broadly to recover market operations costs) and levy income (to recover market governance costs). This mixed funding model is also evident in the electricity and gas markets in Australia and Great Britain, with market operations funded by users fees, and governance functions funded by the government (sometimes with cost recovery from industry)³.

Assessment of current arrangements

While the Authority's funding arrangements appear to be materially different from those of comparable bodies, the differences are more subtle than first appears. In particular, while the Authority's market operations functions are wholly Crown funded (unlike in comparable bodies which rely wholly or largely on fees), the levy used for cost recovery can mimic many of the characteristics of a fee-based approach.

That said, there are some areas where the appropriation/levy recovery mechanism is likely to perform less effectively than a fee-based approach. In particular, we note that:

- **Engagement on service provision** – the market operations functions of the Authority are in many respects undertaken on behalf of the industry (for example provision of reconciliation and registry services). The current process is primarily geared around Parliamentary scrutiny of annual appropriations, and is not especially well suited to obtaining effective engagement between the Authority as purchase agent, and its 'client' industry users. In reviewing the arrangements in other jurisdictions (including electricity regulators/market operators 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.
- **Inflexibility** – the need to conform to the annual appropriations process (with its significant lead times) imposes some rigidity which may 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.
- **Certainty** – it is important for the Authority to have a clear ability to enter into longer term commitments, particularly for service provider contracts and capital development such as software. Driven by the Crown's annual appropriations cycle, the current funding arrangements (at least in the way that they are operating) may make this more difficult.

Options for consideration

We see two broad ways that these issues could be addressed. One approach would be to introduce the ability for the Authority to charge fees in certain circumstances. The other would be to operate in a modified way within the existing legislative framework.

³ In these cases, the market operations and governance activities themselves are carried out by different bodies in each market.

A fee-based approach is the more conventional model for funding operational services in electricity and gas markets. The introduction of fees for these activities would directly address the concerns identified with current arrangements. To allow for fees, an amendment to the Electricity Industry Act 2010 would be required (as well as the making of fee regulations per se). In particular:

- a. Section 128 would need to be amended to remove the requirement that the costs associated with statutory functions must be met fully out of the levy. Instead, it should provide for costs, other than those recovered via other means, to be met from the levy;
- b. Fee regulations would need to be made to specify matters such as the level of fees, which parties are obliged to pay the fees, and to whom fees should be paid etc. We understand the existing general power under section 115 of the Act would be sufficient for the Governor-General by Order in Council to make such regulations⁴. We also understand that any proposed legislative amendment to allow for the Electricity Authority (as distinct from the Governor-General by Order in Council) to directly impose fees would be unlikely to survive the legislative process⁵; and
- c. To better align incentives on users, the Act could also be amended to provide for costs awarded by the Rulings Panel under the compliance regime to be paid to the Authority (rather than the Crown which is the situation at present) to offset the costs of any investigations or proceedings.

The other broad alternative would be to operate within existing legislation, but seek to address the concerns by other means. The key areas would be:

- **more specificity and granularity in Levy Regulations** – the Authority could consider reviewing the levy activities identified in Table 1 of the Levy Regulations. For example, we understand that financial transmission rights (FTR) market funding was one driver for this review of funding mechanisms. FTR market operations costs could be ring-fenced and allocated to a newly established class of levy payers “FTR Traders” to enable costs to be allocated just to those parties participating in the FTR market. There may be other examples where more specificity and/or granularity could deliver a better fit with the beneficiaries/users of particular services⁶;
- **improved scrutiny of market service provider contracts** – even though the appropriation and levy process continues on an annual cycle, the Authority could seek to obtain deeper stakeholder engagement when contracting with external providers for market services. For example, it could seek input from a ‘user group’ when contracting for registry or reconciliation services. An increased level of stakeholder engagement should help to ensure that services are well tailored to industry needs, and also assist the Authority in making decisions where trade-offs are required (such as cost versus risk); and

⁴ Email from Buddle Findlay to Electricity Authority dated 11 June 2012.

⁵ Letter from Buddle Findlay to Electricity Authority dated 24 April 2012.

⁶ We also note that some of the activities identified (e.g. establishment costs relating to transition of functions to Commerce Commission) appear to be no longer relevant and could be removed

- **multi-year appropriations** – although it would likely be difficult to obtain multi-year appropriations, there may be scope to pursue this as a way to get more funding certainty, particularly for activities that require a multi-year commitment to obtain efficient cost structures.

Overall assessment of options

Operating in a modified way within the existing framework could achieve some gains, and has the advantage that it could be readily implemented by the Authority. However, this approach is likely to be second best to some extent, because it involves less direct means of addressing the underlying issue – which is that the Authority cannot charge and receive user fees for any functions carried out under the Act. For this reason, if a suitable opportunity arises, we see merit in Parliament considering an amendment to the Act, to remove the requirement that the Authority's costs be fully recovered by the levy. This would allow the existing fee-making provisions in the Act to become operable, provided that the Authority can demonstrate to the Minister that regulations should be made to provide for fees.

1 Introduction

1.1 Purpose

This report reviews funding arrangements for the Electricity Authority (Authority) with a view to exploring whether they could be amended or augmented to improve their effectiveness.

In particular, the terms of reference specify that the review should:

- examine the current funding arrangements and their implications for efficiency;
- investigate alternative funding models, including considering relevant funding models used by other New Zealand regulators (e.g. Gas Industry Company, Commerce Commission) and overseas regulators;
- review the legal ability and requirements to make any changes to how the Authority funds its activities, including: the Electricity Industry (Levy of Industry Participants) Regulations 2010; Public Finance Act; Crown Entities Act and Electricity Industry Act 2010 (drawing on the Authority for assistance with legal issues);
- consider alternative funding options and their potential efficiency benefits; and
- make recommendations to the Authority on any alternative arrangements that are likely to provide superior outcomes in efficiency terms.

1.2 Structure of Report

This report is structured as follows:

| Section | Description |
|---------|--|
| 1. | Outlines the purpose of this review, the issues it addresses and the approach used |
| 2. | Describes the current funding framework for the Authority |
| 3. | Describes the funding arrangements that apply to other bodies with similar functions |
| 4. | Assesses the current arrangements |
| 5. | Presents the key issues arising from this review and options for addressing them |

1.3 Terminology

It is important to be clear about the terminology regarding different funding options, especially as some terms have multiple meanings. Unless otherwise stated, we have adopted the terminology set out below for the purposes of this report, which is based on the identity of payers and payees.

| Funding option | Crown revenue | Levy | Fee/charge |
|----------------|---------------|-----------------------|---------------------|
| Paid by | Government | Industry participants | Users/beneficiaries |
| Paid to | Funded entity | Government | Funded entity |

We note that, in practice, there are some exceptions to the nomenclature set out above. Nonetheless, we consider this terminology is useful in highlighting key differences and similarities among the options⁷.

1.4 Information sources

Appendix 2 lists the main information sources used in compiling this report. In addition, we have had discussions with personnel from the Authority, Commerce Commission and Gas Industry Co. We thank those parties for their time and insights.

Our report makes reference to a number of legal issues. These references are based on existing legislation and information we have received from the Authority. However, we note that consistent with the terms of reference for this work, our report does not constitute legal advice. Accordingly, the Authority may wish to seek specific legal advice as part of its consideration of this report.

⁷ We also note that the table is not exhaustive and other differences may arise, for example whether sources are treated on a consistent basis for the purposes of assessing liability for value added tax, and how the different options may be treated in contracts between buyers and sellers (e.g. prices may allow for pass-through of levies but not fees).

2 Current funding framework for Authority

2.1 Overview

The Electricity Industry Act 2010 (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 (called 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.

Section 128 of the Act provides for the Crown (via appropriations in Parliament) to be the sole funder of all the Authority’s statutory functions⁸. The Act requires the Crown to fully recover its actual costs via a levy on industry participants (refer Appendix 3 which sets out in full the Act provisions relating to the levy).

Although section 115 of the Act 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 recovery of costs arising in relation to statutory functions⁹. Section 115 of the Act is also included in Appendix 3 of this report. We note that 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) and that it makes no specific reference to the Authority or the Minister¹⁰.

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

⁸ For completeness, we note the Authority could charge a fee for activities outside those set out in the Act. As stated by the Controller and Auditor-General in the Good Practice Guide – Charging fees for public sector goods and services, “Public entities do not need statutory authority to enter into contracts for commercial transactions. Such transactions are voluntary for both parties rather than being a matter of statutory duty. An example of a normal commercial transaction is the Department of Internal Affairs’ provision of professional translation services to businesses, central and local government, and private individuals. The Department is not obliged to provide these services. The amount charged by the Translation Service is a contractual payment agreed to by the recipient, and not a fee within the scope of this guide”.

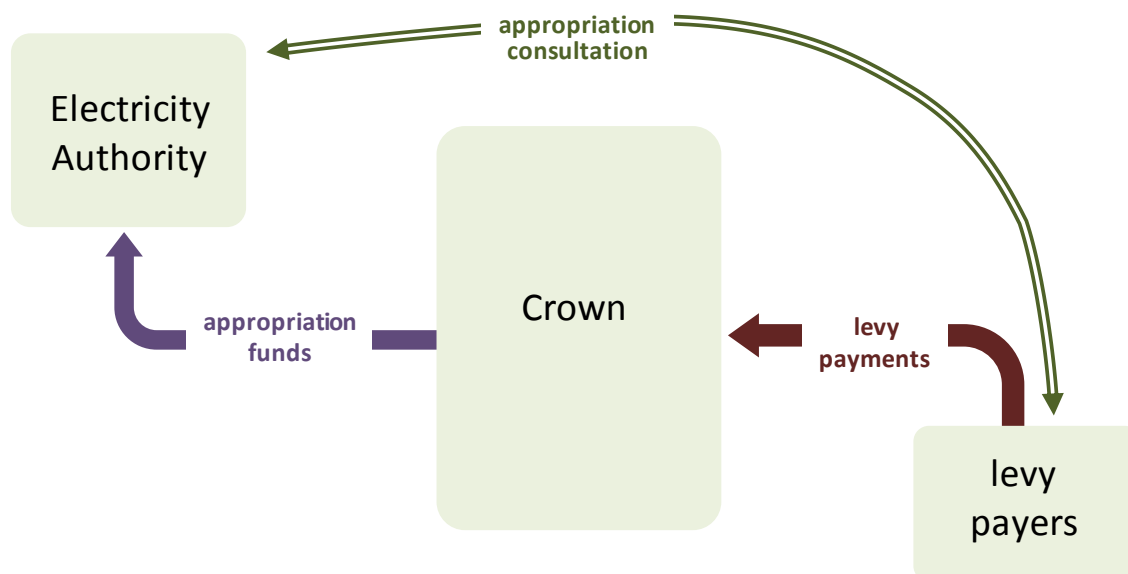
⁹ We note regulations could be made under section 115 to provide for fees in respect of costs that are not required to be fully funded by the levy under section 128. An example of the Act allowing for charging a fee relates to applying for approval of a dispute resolution scheme in Schedule 4 section 4 (2)(c).

¹⁰ We also note that section 115 appears to have been carried over from the Electricity Industry Reform Act 1992 (section 87(2)(k)) and that the forerunner of section 128 was in the Electricity Amendment Act 2004 (section 22). To the extent that may be a tension between sections 115 and 128 around fees versus levies in the (current) Act, this tension existed in earlier legislation (albeit in different Acts).

Authority (EECA), and facilitating customer switching through the Powerswitch website overseen by the Ministry of Consumer Affairs (MCA).

The funding flows are shown in Figure 1. The key aspects of the current Authority funding arrangements are discussed in more detail in the following subsections.

Figure 1: Overview of existing funding arrangements



2.2 Appropriation of Crown funding

The Authority is funded by appropriations in Vote: Energy. The Ministry of Economic Development acts as the purchase adviser to the Minister of Energy and Resources.

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.

The Public Finance Act 1989 specifies the appropriation-related documents to be presented to the House of Representatives at the time of the Government's Budget. These documents are:

- an Appropriation Bill: this sets out the details of each annual and multi-year appropriation in accordance with the Public Finance Act. In addition to the main Appropriation Bill presented in conjunction with the Budget, there may be additional Appropriation Bills during the financial year.
- the Estimates and any other supporting information: the Estimates is a document that provides information on each appropriation in an Appropriation Bill. For each appropriation the Estimates include details of the Vote, Minister(s) responsible for appropriations, administering department and appropriation type, amount, scope and period.

The Authority's annual appropriations and levy setting process must meet the Government's annual timetable and requirements for the Estimates, Appropriations and Budget. It must also meet the specific requirements set out in the Electricity Industry Act and Levy Regulations. The Authority's financial year begins on 1 July, in line with Government's financial year.

The annual process is depicted in Figure 2 and the key features are summarised below¹¹.

- 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 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 2.3 below); in the past the Authority and EECA have published a combined consultation paper;
- appropriations and work priority consultation paper is published in October; submissions close in November; the Authority (and before it the Electricity Commission) typically receive 8 to 15 submissions from a mix of consumers, consumer representatives, generators, retailers, lines companies and Transpower;
- the Authority (and EECA) consider submissions received; the Authority then reports on proposed appropriations (as does EECA) to the Minister; in 2012 this is intended to be completed by Christmas;
- relevant information is subsequently included in the Estimates 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; Parliamentary approval of appropriations does not occur until after the beginning of the new financial year; in the interim, financial authority for expenditure is provided in an Imprest Supply Bill, which is passed before the beginning of the financial year;
- 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 rates were

¹¹ Some aspects of the timetable, particularly the timing of the appropriations consultation, can vary from year to year. The timetable described is our understanding of the Authority's intended approach to this year's appropriations consultation.

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; in certain circumstances a subsequent reconciliation may be required (refer to the following subsection for further discussion of the reconciliation process).

Figure 2: Annual appropriations cycle

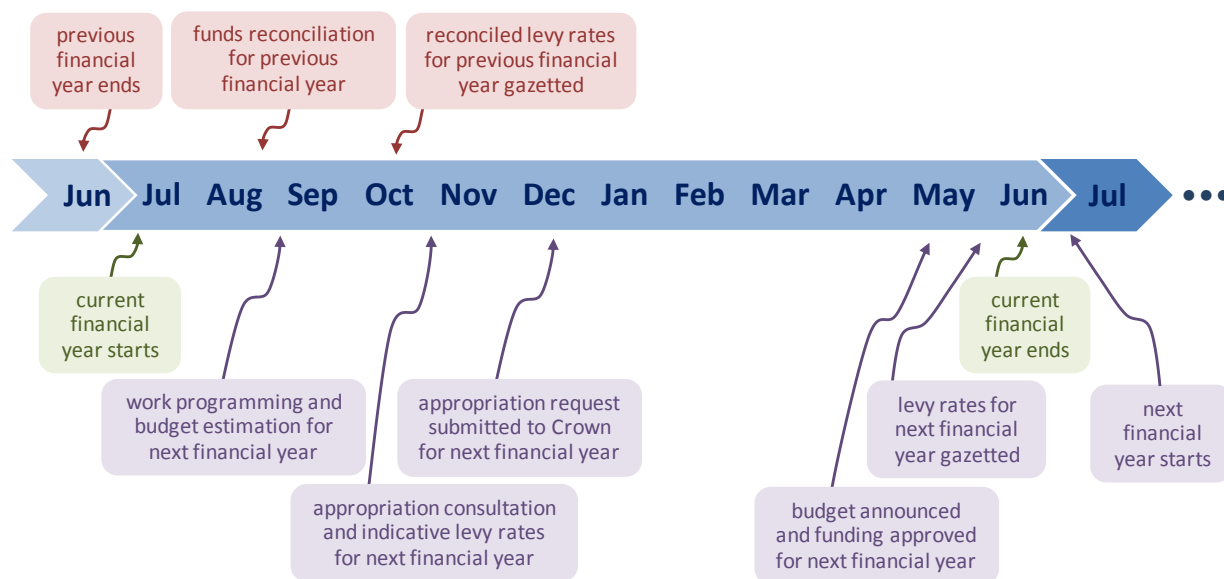


Table 1 shows the appropriations for the 2011/12 – 2014/15 years. The *Electricity industry governance and market operations* output class covers the Authority's costs of oversight of the operation and governance of the New Zealand electricity market under the Act, Code and regulations, including the 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.

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.

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 1.

Also funded by the levy but not included in Table 1 is the *Electricity efficiency* appropriation which covers a portion¹² 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 1: Authority's appropriations and output classes for 2012/13 financial year

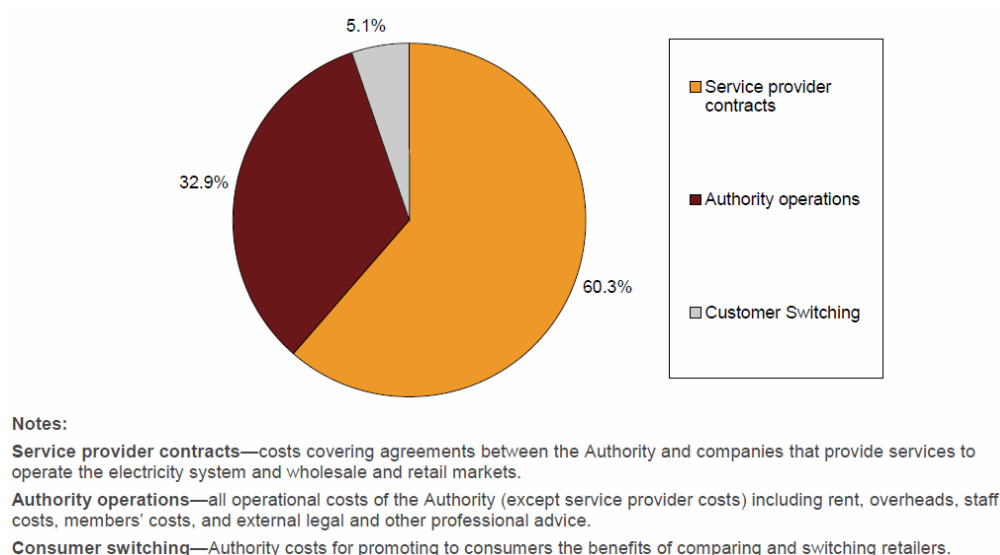
| Appropriations and output classes | \$ million | | | |
|--|------------------------|--|------------------|------------------|
| | 2011/12 appropriations | 2012/13 appropriations | 2013/14 forecast | 2014/15 forecast |
| Electricity industry governance and market operations | 62.535 | 63.906 | 64.873 | 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

¹² The size of the portion to be met by the levy is determined by the Minister.

Figure 3 shows the broad areas of the Authority's planned expenditure for 2012/2013. 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). As we discuss later, these contracts typically extend for multiple years.

Figure 3: Components of Authority's forecast expenditure



Source: Electricity Authority Statement of Intent 2012-15

2.3 Industry levy

This levy is made under the Electricity Industry (Levy of Industry Participants) Regulations 2010 (the Levy Regulations) pursuant to the Act. The Governor-General may, by Order in Council made on the recommendation of the Minister, make or amend regulations providing for the levy. Every industry participant (or prescribed class of industry participant) must pay to the Authority on behalf of the Crown the levy prescribed by regulations.

The levy must be prescribed on the basis that all of the Authority's costs should be met in full out of the levy. The levy also funds certain other electricity sector costs including in particular the electricity efficiency programmes delivered by EECA, and facilitating customer switching through the Powerswitch website overseen by MCA (see Appendix 3).

The empowering provisions in the Act allow the regulations to (among other things):

- specify the amount of the levy or method of calculating or ascertaining the amount of the levy;
- include or provide for including in the levy any shortfall in recovering the actual costs; and
- provide for different levies for different classes of industry participants.

The Authority sets the levy rate 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.

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.

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. It should be noted that, 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 2011 is reproduced below as Figure 4.

Figure 4: Current annual levy rates

Notice

1. Title—This notice is the Notice of Annual Levy Rates for the Financial Year Ending 30 June 2012.

2. Levy Rates—The Authority has calculated the annual levy rates for the financial year ending 30 June 2012 in accordance with Regulation 7 of the Regulations, as follows:

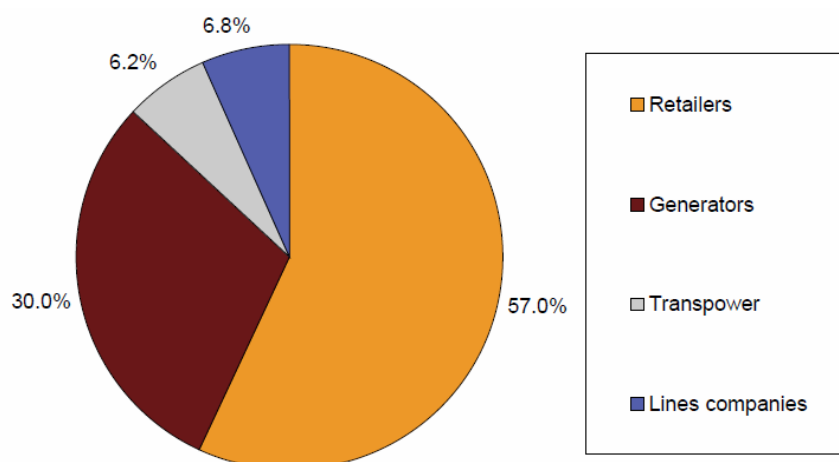
| | Generators | Purchasers | Retailers | Distributors (including Transpower) | Distributors (excluding Transpower) | Transpower |
|-----------------------------------|--------------|--------------|--------------|-------------------------------------|-------------------------------------|--------------|
| Common quality operations | \$0.1526/MWh | \$0.1545/MWh | | \$0.0853/MWh | | |
| Market operations | \$0.3946/MWh | \$0.3994/MWh | | | | |
| Registry and consumer operations | | | \$0.8440/ICP | | \$0.8433/ICP | |
| Supply reliability operations | | \$0.2048/MWh | | | | |
| Transmission operations | | | | | | \$0.0226/MWh |
| Electricity efficiency operations | | \$0.3114/MWh | | | | |
| Customer switching fund | | | \$2.3879/ICP | | | |
| Other activities | \$0.0452/MWh | \$0.0457/MWh | | \$0.0252/MWh | | |

Dated at Wellington this 27th day of June 2011.

For and on behalf of the Electricity Authority:

The levy allocation to each class of industry participant that results from the annual levy calculation is shown in Figure 5 below. This is drawn from the Authority's 2012-15 SOI and therefore applies to a different financial year to the rates set out in Figure 4, but is nevertheless indicative of the proportion each participant class bears each year. It appears that the Purchaser and Retailer levy components have been combined in the graph reproduced in Figure 5 below. Note also that levy funding for EECA and MCA is not included.

Figure 5: Allocation of levy across classes of industry participant for the current year



Source: Electricity Authority Statement of Intent 2012-15

The annual levy is payable to the Authority in monthly installments in arrears. The formulae for calculating each participant's monthly installment are prescribed in the Levy Regulations. The Authority

must invoice industry participants for each monthly installment as soon as practicable after the start of the following month.

Each participant is liable to pay the amount invoiced, and any unpaid levy is recoverable through the Courts as a debt due to the Authority on behalf of the Crown. The Authority must deposit into a Crown bank account, and separately account for, each levy payment. It is important to note that, although the Authority administers the levy, no levy payments go through the Authority's accounts.

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.

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. 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. Under- and over-recoveries identified as a result of reconciliation are addressed with invoices or refunds as the case may be for each participant.

2.4 Key implications of current arrangements

All of the Authority's funding is ultimately determined by the annual appropriation process in Parliament. The Authority is not able to charge any fee for undertaking its functions set out in the Act, however the levy arrangements are reasonably flexible and can mimic many of the characteristics of a fee-based approach.

As we discuss later, the appropriation process is relatively inflexible in some respects, and is not particularly well suited to addressing some of the funding issues that arise with the Authority. In particular, the market operations functions of the Authority are in many respects undertaken on behalf of the industry (for example provision of reconciliation and registry services). The current process, which is primarily geared around Parliamentary scrutiny of annual appropriations, is not especially well suited to obtaining effective engagement between the Authority as purchase agent, and its 'client' industry users.

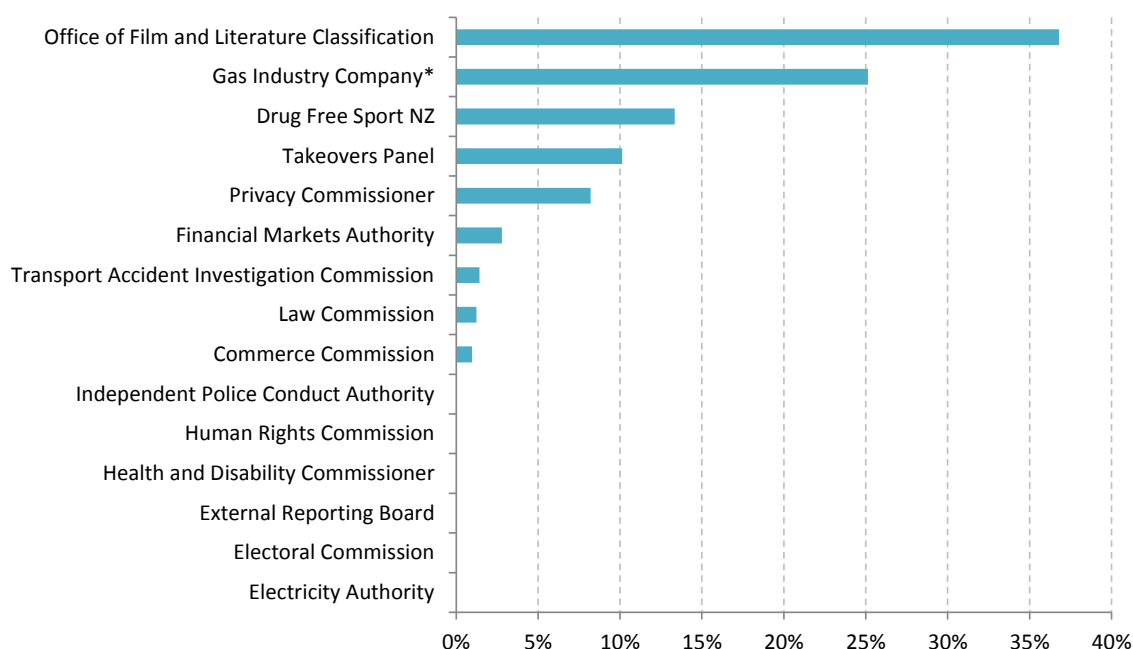
3 Funding arrangements for other entities

3.1 Independent Crown entities

The Authority is an independent Crown entity, the organisational form in the Crown Entities Act 2004¹³ 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.

We have reviewed all of the independent Crown entities existing at 30 June 2011 to identify the extent to which these bodies received revenue from fee-based arrangements. The results are summarised in Figure 6¹⁴.

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



Sources: Annual reports for year to 30 June 2011

Table 2 sets out more detailed information on the nature of fee-based funding sources for the independent Crown entities shown in Figure 6.

¹³ 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).

¹⁴ Data for the Financial Markets Authority is based on budget for year to June 2011. In some cases, organisations reported non-Crown revenue sources (e.g. interest), but this has not been classified fee-based.

Table 2: Funding sources for independent Crown entities

| Organisation | Fees | Total income (\$ 000) | Fee as % total | Fee source |
|--|-------|-----------------------|----------------|--|
| Electricity Authority | | 55,970 | 0% | |
| Electoral Commission | | 14,743 | 0% | |
| External Reporting Board | | 1,385 | 0% | |
| Health and Disability Commissioner | | 9,356 | 0% | |
| Human Rights Commission | | 10,537 | 0% | |
| Independent Police Conduct Authority | | 3,834 | 0% | |
| Commerce Commission | 429 | 44,163 | 1% | Fees and recoveries |
| Law Commission | 60 | 4,855 | 1% | Sale of publications and other |
| Transport Accident Investigation Commission | 60 | 4,186 | 1% | Sale of documents |
| Financial Markets Authority | 402 | 14,385 | 3% | Exemption and authorisation fees |
| Privacy Commissioner | 285 | 3,473 | 8% | Seminars and other |
| Takeovers Panel | 172 | 1,698 | 10% | Application fees and recovery of costs |
| Drug Free Sport NZ | 318 | 2,384 | 13% | Contracted income |
| Office of Film and Literature Classification | 1,141 | 3,101 | 37% | Labelling body revenue |
| Gas Industry Co* | 1,501 | 5,971 | 25% | Market services and annual fees |

Sources: Annual reports for year to 30 June 2011

* Note: Although it is not strictly an independent Crown entity, Figure 6 and Table 2 also include data for Gas Industry Company for comparative purposes, and this organisation is discussed further in section 3.3.

The key observations from examination of the funding of independent Crown entities are:

- There is significant variation in the proportion of funding derived from fees rather than from the Crown.
- 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 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

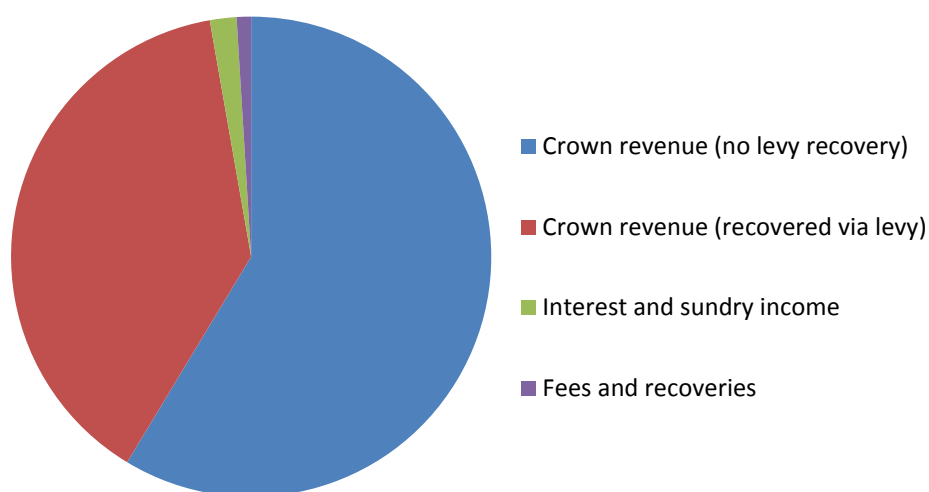
performance or exercise by the FMA of any function, power, or duty under this Act or any other enactment¹⁵”.

- By contrast with the other independent Crown entities we have reviewed, the Authority is unusual given that it has no fee income, but much of its role is focussed on the provision of transactional services with clearly identifiable causers/beneficiaries.

3.2 Commerce Commission

Although the Commerce Commission does not deliver market services to stakeholders, it is similar to the Authority in some respects, given that both have responsibility for economic regulation (albeit with very different scopes). As noted in Table 2, around 1% of the Commerce Commission’s income in 2011 came from fees and recoveries. Crown appropriations made up around 97% of total income in 2011¹⁶. That said, we understand the costs arising from the Commerce Commission’s specific regulatory responsibilities in the dairy processing, electricity lines, gas pipelines, airports and telecommunications industries are ultimately recovered via industry levies¹⁷, leading to a mix of funding sources as shown in Figure 7.

Figure 7: Commerce Commission – funding sources (2011)



Source: Annual report for year to 30 June 2011

¹⁵ Section 67, Financial Markets Act, 2011.

¹⁶ The annual accounts also show some interest and “sundry income”, but together these are around 2% of total income.

¹⁷ See Note 3 to Financial Statements of Commerce Commission, year ended 30 June 2011.

This levy arrangement appears to operate in a manner that is different to that applying to the Authority. The levies are managed by the Ministry of Economic Development (as the departmental body with responsibility for Vote Commerce), and the money collected via levies is paid directly to the Crown. Furthermore, the Commerce Commission does not need to consult with levy payers on its intended work programme, the levy structure or its specific levels¹⁸.

We understand that the current arrangements give rise to some practical challenges. For example, the workload associated with some of the Commerce Commission's specific regulatory responsibilities can be quite lumpy, such as dealing with a specific request for approval by a regulated party. In some cases (for example a request for a customised price path determination by a lines company), the Commerce Commission can recover costs through a specific fee, which ensures there can be a close match between the timing of expenditure and the receipt of income to cover the expenditure.

However, in some other areas (for example the processing of grid upgrade project applications) current arrangements require that costs be met from an appropriation (with Crown costs subsequently recovered via the relevant industry levy). This can present difficulties where work flows are lumpy, leading to a pattern of over and under-expenditure relative to appropriations. For this reason, the Commerce Commission is currently considering the potential merit of moving more toward a fee based approach rather than appropriation/levy in some areas.

3.3 Financial Markets Authority

The funding arrangements for the Financial Markets Authority (FMA) have some parallels and contrasts with those of the Authority. The common elements (at least in broad terms are):

- the legislation governing the FMA provides for Crown funding via appropriations, with an ability for levies to be applied to industry participants (via regulation) so the Crown can recover its costs;
- where the FMA intends to utilise a Crown appropriation which will be recovered by a levy, it must first consult with levy payers, and report the results of this consultation when submitting an appropriation request to the Minister of Commerce; and
- the legislation includes an empowering provision in relation to fees. This allows regulations to be made to require industry participants to pay fees and charges to the FMA¹⁹.

The key difference between the arrangements for the Authority and the FMA is that the latter is not required to recover all of its costs fully out of levies. Instead, the legislation governing the FMA states:

“Levies must be prescribed on the basis that the following costs should be met fully out of the levies:

¹⁸ However, the Ministry of Economic Development has consulted on proposed changes to levy arrangements.

¹⁹ Section 67(1)(a)(i) of Financial Markets Authority Act 2011.

(a) *a portion of the costs* of the FMA in performing or exercising its functions, powers, and duties under this Act and any other enactment, *where the size of the portion to be met by levies under this Act is determined by the Minister [of Commerce]*” (emphasis added).²⁰

This means that the FMA is potentially able to charge and receive fees, provided the total sum collected does not exceed the portion of the FMA’s costs not recovered by levies²¹. The legislation also makes it clear that revenue received in the form of fees is not subject to the annual appropriation and levy consultation process (since it is received directly by the FMA).

3.4 Gas Industry Company Limited

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.

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.

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.

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;
- 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

²⁰ Section 68(4)(a) of Financial Markets Authority Act 2011.

²¹ Some shorter term timing differences are permitted, but the sums must not exceed the FMA’s costs over time.

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.

Table 3 sets out the breakdown of revenues for the last two years²².

Table 3: Gas Industry Company operating income

| Year ended June | 2011 | | 2010 | |
|------------------------|--------|-----|--------|-----|
| | \$ 000 | | \$ 000 | |
| Wholesale levy | 2,807 | 47% | 2,862 | 39% |
| Retail levy | 1,663 | 28% | 1,649 | 22% |
| Market fee revenue | 1,421 | 24% | 2,474 | 34% |
| Annual fees | 80 | 1% | 80 | 1% |
| Total operating income | 5,971 | | 7,340 | |

Source: Gas Industry Co, Annual Report for year to 30 June 2011

We understand 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.

The service provider contracts involve relatively long term commitments (five years with rights of renewal), and we understand 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, we understand 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.

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

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.

²² We understand that the FY2010 market fees included a recovery for the establishment costs of the allocation agent systems (\$1.05m). Net of this, the business as usual market fees in FY2010 were \$1.7m.

3.5 Australian National Electricity Market

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

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 Authority (AEMC) and Australian Energy Market Operator (AEMO) respectively.

Regulatory functions - AEMC

As shown in Table 4, the AEMC is directly funded by the participating jurisdictions in the NEM and does not derive any income from market fees²³. 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.

Table 4: AEMC income

| Year ended June | 2011 | 2010 |
|---|---------|---------|
| | A\$ 000 | A\$ 000 |
| Contributions from participating jurisdiction | 14,953 | 13,990 |
| Interest | 292 | 258 |
| Other | 253 | 231 |
| Total | 15,498 | 14,479 |

Source: AEMC, Annual Report for year to 30 June 2011

Market and system operations - AEMO

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.

²³ The 'other' category does not include fees, and is mainly the recovery of administrative support costs for the Consumer Advocacy Panel.

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 structure²⁴. 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.

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.

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.

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.

Table 5 shows AEMO’s allocation of fees for its major functional categories for the 2011/2012 budget year²⁵.

²⁴ 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.

See www.aemc.gov.au for more detail.

²⁵ This AEMO and Electricity Authority budgets are not directly comparable because there are some important differences in organisational roles. For example, the Electricity Authority also has responsibility for rule making (carried out by the AEMC in the NEM). Similarly, while the Electricity Authority procures system operations services on a national basis in New Zealand, some system operations activities in the NEM are undertaken by the state-based transmission bodies

Table 5: AEMO Budget and Fee Structure for 2011/2012 (electricity related activities)²⁶

| Category | A\$ 000 | Share |
|--|---------|-------|
| Wholesale - General (MWh) | 22,975 | 23% |
| Wholesale - Purchasers (MWh) | 27,631 | 28% |
| Wholesale - Generators/MNSPs (MWh, MW) | 23,537 | 24% |
| Registration (various) | 225 | 0% |
| Specific fees (various) | 1,396 | 1% |
| Retail - Retailers (MWh) | 9,841 | 10% |
| Consumer advocacy - Purchasers (MWh) | 2,227 | 2% |
| Transmission planning - Purchasers (MWh) | 7,018 | 7% |
| Smart meters - Purchasers (MWh) | 3,577 | 4% |
| | 98,427 | 100% |

Source: AEMO, Final Budget and Fees for 2011/2012

3.6 Electricity and gas markets in Great Britain

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

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.

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

(rather than AEMO). Conversely, AEMO has a transmission planning role that is not undertaken by the Electricity Authority.

²⁶ MNSP refers to Market Network Service Providers, which are transmission providers that offer capacity between NEM regions on a merchant basis, and do not receive regulated revenues.

the Consolidated Fund”²⁷. 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

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.

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. The chair may also appoint two further members.

The BSC panel appoints an organisation to act as the Balancing and Settlement Code Company (BSCCo). This 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. 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 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. In short, Elexon is completely funded by market fees which are defined in the BSC.

System operation – National Grid

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 horizon²⁸. This is intended to provide incentives for National Grid to be productively efficient in the provision of its services.

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

²⁷ Note 8 to departmental resource accounts, Ofgem Annual Report to 31 March 2011.

²⁸ For example see www.ofgem.gov.uk/NETWORKS/TRANS/Pages/trans.aspx

these arrangements (especially how they interact with transmission incentives) has recently been under review²⁹.

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.

We understand 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.

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.

3.7 Key observation from comparison of funding arrangements

Table 6 compares the funding arrangements for the Authority with other broadly similar bodies. The key observation from the comparison is that 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.

²⁹ See paras 2.6 to 2.9 of www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/SystOpIncent/Documents1/SO%20incentives%20from%20April%202013%20Initial%20Views%20Consultation.pdf

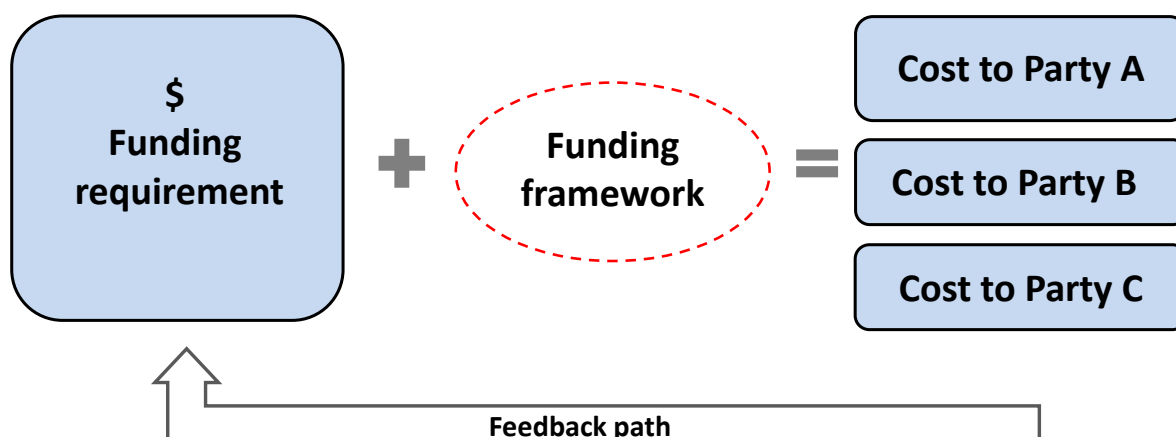
Table 6: Summary of funding arrangements for Authority and other bodies

| | Funding source | Who proposes expenditure level | Who decides expenditure level | Who proposes cost allocation | Who decides cost allocation | Consultation with affected parties |
|------------------------------|---|--------------------------------|---|------------------------------|---|---|
| Electricity Authority | 100% Govt (100% levy recovered) | Electricity Authority | Parliament on Minister's recommendation | Electricity Authority | Minister via levy regulations | Annual for work programme, budget and indicative levy |
| ComCom | 99% Govt & 1% fees (40% levy recovered) | ComCom | Minister | MED | Minister via regs | Annual budget process – ad hoc on fees |
| Gas Industry Co | Levy (~75%) | Gas Industry Co | Minister – levy regulations | Gas Industry Co | Minister – levy regulations | Annual for work programme, budget and indicative levy rates |
| | User fees (~25%) | Gas Industry Co | Gas Industry Co | Gas Industry Co | Minister via market regs/rules | At time governance regs/rules made |
| AEMO | 100% user fees | AEMO Board | AEMO | AEMO Board | AEMO (subject to NEL and NGL) | Periodic on fee structure (3-5 yrs) & annual for budget |
| AEMC | 100% government | AEMC? | Ministers (Participating jurisdictions) | State and Territory Govt | Ministers (Participating jurisdictions) | Not apparent |
| Ofgem | 100% government (partly recovered via licence fees) | Ofgem | Parliament on Minister's recommendation | Ofgem | Minister | Five year plan including work programme and expenditure forecasts |
| Elxon | 100% user fees | Elxon Board | BSC Panel | BSC Panel | Ofgem | Annual budget, ad hoc for fees |
| National Grid | 100% user fees | National Grid | Ofgem | National Grid | Ofgem | Yes |

4 Assessment of current funding arrangements

In this chapter, we assess the efficiency of the current funding arrangements for the Authority. It is important to emphasise that we are assessing the *framework* of the funding arrangements to determine whether it facilitates or constrains the attainment of efficient outcomes, as shown in Figure 8.

Figure 8: Interaction between funding need, framework and cost outcomes



4.1 Incentives and efficiency

Based on first principles, we would expect efficient funding arrangements for the Authority to exhibit the following broad characteristics:

- **Allocative efficiency** – arrangements should provide incentives to encourage the most useful mix, volume and standard of services to be provided and consumed. This generally means that where costs can be clearly attributed to causers and/or beneficiaries³⁰, those parties (or classes of parties) should pay for the service. Furthermore, in these cases, it is generally desirable to apportion total costs among payees on the basis of their relative contribution to risk/benefits. In cases where it is not possible to clearly identify specific causers/beneficiaries, the aim should be to recover costs in the way that causes the least amount of distortion to decisions and minimises so-called deadweight losses. These broad principles are very relevant in determining who should pay for services, the time period to which charges apply and the structure of charges (e.g. volume, peak usage, fixed etc).

³⁰ In more technical terms, these are private goods and club goods. Private goods involve situations where consumption by one party reduces the benefit available to others, and it is possible to exclude non-payers from benefiting (e.g. air travel). Club goods refers to situations where consumption by one party does not reduce the benefit available to others (at least not until congestion occurs) and it is possible to exclude non-payers from benefiting (e.g. satellite television).

- **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.
- **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. Another important issue is the extent to which arrangements provide certainty to the Authority and wider stakeholders. If funding arrangements provided little certainty, this could undermine efficiency because it would drive the Authority toward a shorter term focus, even where this resulted in higher costs and/or poorer service delivery.

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 total costs of the Authority over time.

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 states³¹:

“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.”

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.”

³¹ *Controller and Auditor-General, ‘Charging fees for public sector goods and services’, June 2008*

4.2 Yardsticks for assessing arrangements

We have used the economic principles and Controller and Auditor-General's definition above to derive a set of yardsticks for assessing whether the current funding framework will allow efficient outcomes to be achieved. These are:

1. **Identification of beneficiaries/users** – the 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 which are too high or too low. This will undermine incentives for the efficient use of goods and services, and for efficient service provision over time.
2. **Incentives on beneficiaries/users** – being able to recover costs from the correct party or class of parties is not sufficient to ensure efficiency. The 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. This issue is important in both near term and over time.
3. **Incentives on providers** – the framework should provide opportunities for the users/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. Again, this issue is important in both the near term and over time.
4. **Degree of certainty** – the framework should minimise any unnecessary uncertainty. For example, if the 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. Likewise, the funder will want to avoid unpredictable changes in the level of cost recovery.
5. **Transaction costs** – the funding framework should not impose undue administration costs or inflexibilities on funders or the body receiving funds. For example, a framework that was unnecessarily complex could raise costs for all parties.

In the following sections we assess the current funding framework for the Authority against each of these criteria to examine the extent to which it facilitates or hinders efficient outcomes.

4.3 Identification of beneficiaries/users

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

We consider that the levy provisions in the Act and the Levy Regulations, although computationally complex in places, afford a reasonable degree of flexibility to allocate costs to appropriate classes of participants on an appropriate per unit basis, and to adjust the allocation where required. The Authority is also able to exempt parties from paying the levy if provided for in the Levy Regulations.

Although the levy can only be recovered from industry participants, the Act allows for new classes of industry service providers (a subset of industry participants, currently including market operations service providers (e.g. system operator), load aggregators and electricity traders) to be added by the making of regulations. A recent example was the creation of the FTR Manager as an industry service provider as part of the introduction of the new FTR trading regime.

If the Authority wished to, say, ring-fence the costs of the FTR market operations and allocate these to FTR traders, it could pursue this under the existing regulatory framework (provided it could meet the requirements under the Act for recommending regulations) by proposing amendments to the Levy Regulations to include FTR market operations as an activity in Table 1 and allocating the costs of the activity to FTR Traders on an appropriate basis.

If any relevant users/beneficiaries were not already industry participants, then an additional step would be required. The Authority would need to seek a regulation under section 109 of the Act defining the relevant parties as new industry service providers.

These proposals would be considered by the Minister in accordance with the Act, and, if appropriate, the Governor-General would make the regulations, by Order in Council made on the recommendation of the Minister, after consulting the Authority.

For these reasons, the levy provisions themselves appear to provide a reasonable level of flexibility to target specific parties³² (assuming beneficiaries or causers can be identified). However, we note that the appropriations process means that the targeting may be somewhat inflexible in a temporal dimension. For example, if the Authority wished to introduce a new service for users, it could not do so until the cost of this service was reflected in the appropriation. This might cause some delay given the requirements of the appropriations cycle.

4.4 Incentives on beneficiaries/users

Being able to recover costs from the correct party or class of parties is not sufficient to ensure efficiency. The 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.

³² It would not, however, seem possible under the current Act to fund the FTR scheme from FTR auction proceeds, an option which was raised in the FTR Code amendment proposal dated 28 Apr 2011. Such an arrangement would appear to run counter to the Act requirement that the levy fully funds market operations etc

The levy provisions in the Act provide a high degree of flexibility around the structure and form of the levy. For example, the Act allows for the levy regulations to:

1. specify the:
 - a. amount of the levy; or
 - b. method of calculating the levy;
2. provide for different levies for different classes of industry participants;
3. 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; and
4. 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.

In short, it does not appear that the levy provisions would unduly inhibit the design of arrangements to provide appropriate incentives for users.

4.5 Incentives on providers

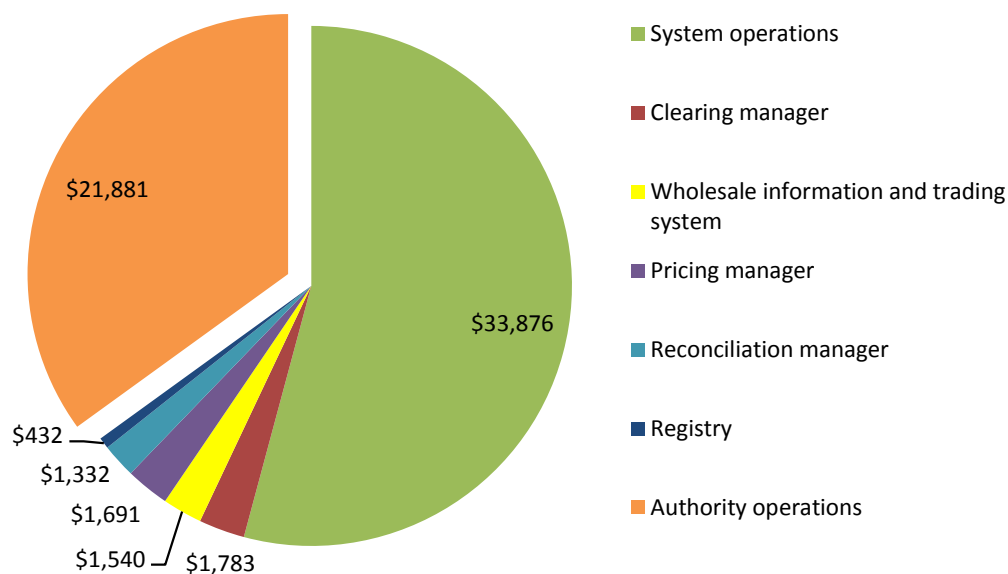
A sound framework should provide opportunities for the users/beneficiaries to scrutinise and influence prospective work programmes and service offerings to help ensure that they are appropriate and provide value for money. In theory, the annual consultation process on the Authority's work programme, forecast expenditure and indicative levy rate should meet this need.

However, we believe the effectiveness of this mechanism could be improved. The main weakness we see with current arrangements is that it is based on the annual appropriations cycle, but a very large proportion of Authority's expenditure becomes 'locked in' over much longer timeframes.

As shown in Figure 9, the majority of the Authority's costs³³ 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 only account for around 35% of this budget.

³³ This focuses on the ongoing core operations of the Electricity Authority.

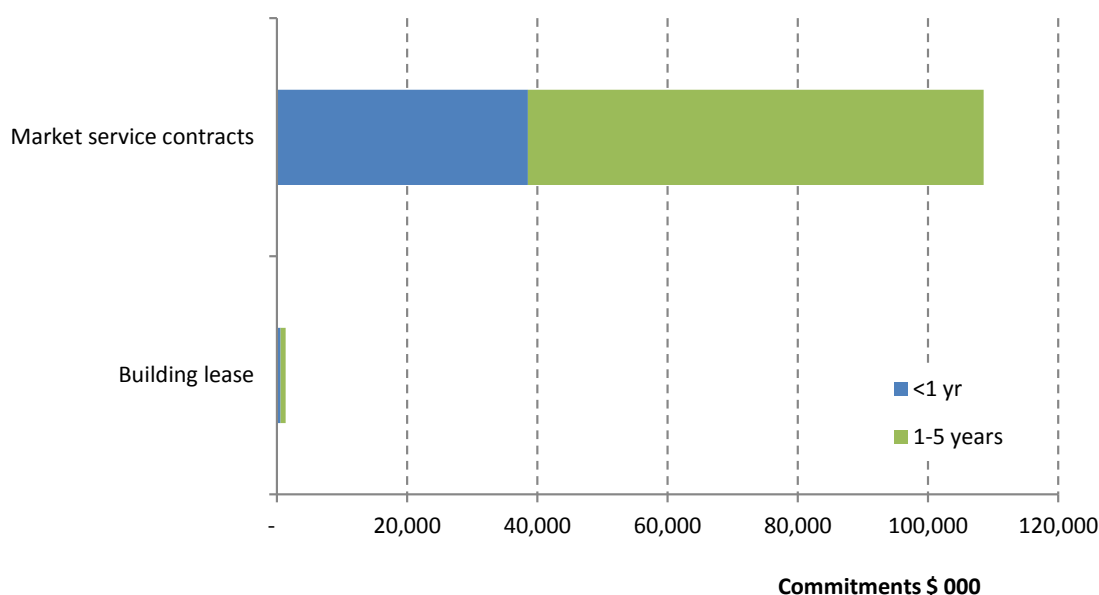
Figure 9: Electricity Authority budget for 2011/12 (governance and market operations) \$ 000



Source: Annual report for year to 30 June 2011

More importantly, market service provider contracts are typically for multi-year terms. These commitments are sizeable as shown in Figure 10, especially when compared to the Authority's core operations budget of around \$22 million per year.

Figure 10: Electricity Authority operating commitments as at 30 June 2011³⁴



In our view, 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 Transpower's major grid upgrade proposals via annual budget requests, rather than considering each proposal's merits as a discrete investment.

We also note that in relation to market services procurement decisions, the Authority is to a large extent acting as agent to purchase club goods for participants. We would expect that engagement with these parties would help to inform the Authority's decisions on issues such as:

- the division of functions among different service provider contracts;
- the allocation of risk between the purchaser and provider;
- the incentive structures within contracts relating to cost and quality outcomes; and
- the term structure of contracts (duration and extension rights).

³⁴ The Annual Report to 30 June 2011 states "service provider agreements exist for the clearing manager, pricing manager, reconciliation manager, registry, wholesale and information trading system, and system operator. The system operator service provider agreement commenced on 1 July 2009. The agreement has no fixed expiry date. The figures [below] represent the minimum three year notice period. The other service provider contracts all end during the 2012/13 financial year."

The present arrangements with the underlying focus on annual appropriations are not well-suited to addressing these types of issues. The timeframe mismatch may also weaken ongoing incentives to scrutinise service provider performance and Authority management of its contracted service providers.

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. Arguably, this may be a less significant issue than obtaining more effective engagement on service provider arrangements (due to the relative size differences in cost terms), but it is still an issue to consider.

It is difficult to judge the extent to which the effects described above actually arise in practice. Nonetheless, we believe the potential for weakened incentives is real. In Section 5 we set out some options for addressing these concerns.

4.6 Degree of certainty

The overall framework should minimise uncertainty to the extent this is feasible. In general, we consider that current arrangements provide a reasonable degree of certainty for the Crown, the Authority and wider stakeholders.

The only area where we think some uncertainty may arise is in relation to longer term commitments. In this context, we would expect that it will be efficient for the Authority to enter into longer term commitments for some services if a provider needs to make an upfront lumpy investment (such as development of software). Absent the ability to enter into a longer term commitment, we would expect the cost of service provision to be driven upward because a less efficient (but shorter term) alternative is adopted and/or the service provider will require a premium for risk.

Under current arrangements, it may be somewhat difficult for the Authority to provide longer term commitments because of the requirement that all of the Authority's revenue come from the Crown. In particular, we note that the Public Finance Act 1989 provides that the "the Crown or an Office of Parliament must not incur expenses or capital expenditure, except as expressly authorised by an appropriation, or other authority, by or under an Act"³⁵. The Act also provides "the Crown is not liable to contribute towards the payment of any debts or liabilities of [...] a Crown entity"³⁶.

The Public Finance Act 1989 does allow for multi-year appropriations to be made, to a maximum term of five years. We note that the Authority's current appropriations for industry governance and market operation are for single years³⁷. We further understand that multi-year appropriations are relatively difficult to obtain.

In short, we think it is important for the Authority to have a clear ability to enter into longer term commitments (including the possibility of contracts beyond a five year term). Current arrangements (at

³⁵ Section 4(1) of Public Finance Act 1989.

³⁶ Section 49(1) of Public Finance Act 1989.

³⁷ The customer switching fund has had a multi-year appropriation, as does the security management output class.

least in the way that they are operating) may make this more difficult. In particular, there is a potential issue with funding certainty in the out years of the annual appropriations approach. That said, we understand that all of the Authority's appropriation requests to date have been approved.

4.7 Transaction costs

The funding framework should not impose undue administration costs or inflexibilities on funders or the body receiving funds.

The levy aspect of current arrangements appears to have relatively low transactions costs for the Authority and levy payers. Furthermore, if a fee-based arrangement were used instead, it would have to be based on regulations, and would therefore give rise to similar transactions costs whenever a modification to the fee regime was required.

However, the need to conform to the annual appropriations process (with its significant lead times) imposes some rigidity which may 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. While there is the ability to seek a mid-year appropriation, we understand that this is not a straightforward exercise. 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 reallocate other funds 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.

4.8 Key observations

We have drawn together our key observations on the current funding arrangements under each of the yardsticks discussed in the subsections above. This is set out in Table 7.

Table 7: Key observations about current arrangements

| Yardstick | Key observations |
|---|---|
| Identification of beneficiaries / users | <ul style="list-style-type: none"> • reasonable degree of flexibility in targeting levy to particular categories of industry participant • may be computationally complex in places, but workable • appropriations cycle constrains ability for funding to respond quickly to changing circumstances |
| Incentives on beneficiaries / users | <ul style="list-style-type: none"> • high degree of flexibility in structure of levy should allow for efficient incentives on beneficiaries/users |

| | |
|-------------------------|--|
| Incentives on providers | <ul style="list-style-type: none"> • mismatch between the timeframes for major expenditure commitments and the annual budget consultation is likely to weaken stakeholders' incentives and ability to effectively engage on market services contract structure issues (e.g. risk allocation, incentive structure, contract term), and may weaken ongoing incentives to scrutinise service provider performance and Authority management of contracted market services |
| Degree of certainty | <ul style="list-style-type: none"> • reasonable degree of certainty • area of weakness is Authority's ability to enter longer term commitments |
| Transaction costs | <ul style="list-style-type: none"> • relatively low transaction costs • requirement to conform to annual appropriations process (with its significant lead times) imposes some rigidity which may be problematic |

5 Issues for consideration

In the previous chapter we identified three areas where the current appropriation/levy recovery funding arrangements could be improved in our view. In brief, they are:

- **Engagement on service provision** – the market operations functions of the Authority are in many respects undertaken on behalf of the industry (for example provision of reconciliation and registry services). The current process, which is primarily geared around Parliamentary scrutiny of annual appropriations, is not especially well suited to obtaining effective engagement between the Authority as purchase agent, and its ‘client’ industry users on key issues. 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.
- **Inflexibility** - the need to conform to the annual appropriations process (with its significant lead times) imposes some rigidity which may 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.
- **Certainty** – It is important for the Authority to have a clear ability to enter into longer term commitments (including the possibility of contracts beyond a five year term), as the alternative route of relying on repeated shorter term commitments could raise costs in some circumstances. Driven by the Crown’s annual appropriations cycle, the current funding arrangements (at least in the way that they are operating) may make this more difficult.

We see two broad ways that these issues could be addressed. One approach would be to introduce the ability for the Authority to charge fees in certain circumstances. The other would be to operate in a modified way within the existing legislative framework. We discuss each in more detail below.

5.1 Option 1 – introduce an ability to charge fees for certain services

As discussed in Section 3, a fee-based approach is the more ‘conventional’ model for funding the operational aspects of electricity and gas markets. If this model were to be adopted, the Authority would be able to charge a fee where:

- a. It provides a service to an identifiable user or set of users; and
- b. Recovering the cost of providing that service by a fee or fees rather than a levy would better meet the objective of the Electricity Industry Act 2010.

For the balance of its functions, the Authority would continue to rely on Crown funding (with the levy for cost recovery).

The introduction of a fee approach should address the concerns identified with current arrangements because it would:

- facilitate more effective engagement with stakeholders on the longer term market operations issues (where the Authority is purchaser for the industry), noting that such costs make up the majority of the Authority's expenditure;
- 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;
- provide more flexibility to make changes to market service provision; and
- make it easier for the Authority to enter into longer term commitments (where it judges this to be in the long term interests of consumers).

To allow for fees, an amendment to the Electricity Industry Act 2010 would be required (as well as the making of fee regulations per se)³⁸. In particular:

- a. Section 128 would need to be amended to remove the requirement that the identified costs must be met fully out of the levy. Instead, it should provide for costs, other than those recovered via other means, to be met from the levy;
- b. Fee regulations would need to be made to specify matters such as the level of fees, which parties are obliged to pay the fees, and to whom fees should be paid etc. We understand the existing general power under section 115 of the Act would be sufficient for the Governor-General by Order in Council to make such regulations³⁹. We also understand that any proposed legislative amendment to allow for the Electricity Authority (as distinct from the Governor-General by Order in Council) to directly impose fees would be unlikely to survive the legislative process⁴⁰; and
- c. To better align incentives on users, the Act could also be amended to provide for costs awarded by the Rulings Panel under the compliance regime to be paid to the Authority (rather than the Crown which is the situation at present) to offset the costs of any investigations or proceedings.

Certain other independent Crown entities (e.g. Commerce Commission, Financial Markets Authority) have the ability to charge fees (subject to an empowering regulation being made) and a change of the type discussed above would essentially mirror these arrangements.

We are conscious 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, we consider that the annual appropriation request should separately disclose the Electricity Authority's expected level of fee income and

³⁸ We have not considered related issues such as the treatment of GST on fees, nor the ability of parties such as lines companies to pass through fees as well as levies under existing regulatory and contractual arrangements.

³⁹ Email from Buddle Findlay to Electricity Authority dated 11 June 2012.

⁴⁰ Letter from Buddle Findlay to Electricity Authority dated 24 April 2012.

associated costs for the coming year. A similar approach is adopted by Gas Industry Co and appears to operate in an effective manner.

5.2 Alternative approach

The alternative approach would operate within existing legislation, but seek to address the concerns noted above by other means.

Options that the Authority could consider are:

- **more specificity and granularity in Levy Regulations** – the Authority could consider reviewing the levy activities identified in Table 1 of the Levy Regulations. For example, we understand that FTR market funding was one driver for this review of funding mechanisms. FTR market operations costs could be ring-fenced and allocated to a newly established class of levy payers “FTR Traders” to enable costs to be allocated just to those parties participating in the FTR market. There may be other examples where more specificity and/or granularity could deliver a better fit with the beneficiaries/users of particular services⁴¹;
- **improved scrutiny of market service provider contracts** – even though the appropriation and levy process continue on an annual cycle, the Authority could seek to obtain deeper stakeholder engagement when contracting with external providers for market services. For example, it could seek input from a ‘user group’ when contracting for registry or reconciliation services. An increased level of stakeholder engagement should help to ensure that services are well tailored to industry needs, and also assist the Authority in making decisions where trade-offs are required (such as cost versus risk); and
- **multi-year appropriations** – although it would likely be difficult to obtain multi-year appropriations, there may be scope to pursue this as a way to get more funding certainty, particularly for activities that require a multi-year commitment to obtain efficient cost structures.

5.3 Overall assessment of options

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 Britain⁴². 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.

⁴¹ We also note that some of the activities identified (e.g. establishment costs relating to transition of functions to Comer Commission) appear to be no longer relevant and could be removed

⁴² In these cases, the market operations and governance activities themselves are carried out by different bodies in each market.

There is some scope for the Authority to use the existing levy making powers to create incentive structures which more closely mimic fee-based arrangements. In particular, the levy making powers provide a reasonable degree of flexibility in relation to the targeting of payment obligations to specific parties or classes of party, and to link levy payment size to the drivers of costs or benefits for particular parties.

The principal inflexibility with existing arrangements arises not from the levy provisions per se, but instead from the requirement that funding for all of the Authority's statutory functions must be provided by Crown revenues. This fosters a focus on annual appropriations, and is not especially well suited to obtaining effective engagement between the Authority as purchase 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.

Again, there appears to be some scope to address these issues within the existing legislative framework. For example, the Authority could facilitate increased user input when contracting with external providers for market services, and could seek use of multi-year appropriations.

That said, the mechanisms set out above are likely to be second best to some extent, because they are less direct means of addressing the underlying issue – which is that the Authority cannot charge and receive user fees for any functions carried out under the Act. For this reason, if a suitable opportunity arises, we see merit in Parliament considering an amendment to the Act, to remove the requirement that the Authority's costs be fully recovered by the levy. This would allow the existing fee-making provisions in the Act to become operable, provided that the Authority can demonstrate to the Minister that regulations should be made to provide for fees.

Appendix 1. List of Abbreviations and Terms

| | |
|----------------------|---|
| ACT | Australian Capital Territory |
| AEMC | Australian Energy Market Authority |
| AEMO | Australian Energy Market Operator |
| Authority | Electricity Authority |
| BETTA | The British Electricity Trading and Transmission Arrangements |
| BSC | Balancing and Settlement Code |
| BSCCo | Balancing and Settlement Code Company |
| Concept | Concept Consulting Group Ltd |
| EECA | Energy Efficiency and Conservation Authority |
| FMA | Financial Markets Authority |
| FTR | Financial Transmission Rights |
| Gas Industry Co | Gas Industry Company Ltd |
| MCA | Ministry of Consumer Affairs |
| NEM | The Australian National Electricity Market |
| Ofgem | Office of Gas and Electricity Markets |
| Rules | National Electricity Rules (in the NEM) |
| SOI | Statement of Intent |
| the Act | Electricity Industry Act 2010 |
| The Levy Regulations | Electricity Industry (Levy of Industry Participants) Regulations 2010 |

Appendix 2. Information sources

| Document | Source |
|--|---------------------------------|
| AEMC 2010 – 2011 Annual Report | AEMC |
| AEMO Electricity Final Budget and Fees 2011/12 | AEMO |
| AEMO Annual Report 2011 | AEMO |
| AEMO Structure of Participant Fees in the National Electricity Market - Determination and Report | AEMO |
| Balancing and Settlement Code (GB) | Elxon Limited |
| BSCCo Business Plan 2012/13 | Elxon Limited |
| Charging Fees for Public Sector Goods and Services | Controller and Auditor- General |
| 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 (Downstream Reconciliation) Rules 2008 | Gas Industry Co |
| Gas (Switching Arrangements) Rules 2008 | Minister of Energy |
| Estimates of Expenditure : Vote Energy | NZ Parliament |
| Films, Videos, and Publications Classification Act 1993 | NZ 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 |
| Annual Report and Accounts 2010 – 2011 | Ofgem |
| Proposed Corporate Strategy and Plan 2011-16 | Ofgem |
| Treasury Instructions 2011 | The Treasury |

Appendix 3. 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