

**The Electricity Commission:
Contracting with
service providers**

July 2005

This is the report of an inquiry we carried out under sections 16 and 18 of the Public Audit Act 2001.

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Foreword

This report presents the results of an inquiry into the role of the Electricity Commission and the Ministry of Economic Development in contracting with service providers in December 2003.

My inquiry was prompted by a complaint that the Commission and the Ministry, in appointing service providers, did not follow good practice in procuring public sector services.

This report describes events leading up to the decision to appoint contractors, and analyses the practices followed. It also sets out my expectations of public entities involved in sole source procurement in circumstances where contestable procurement is impracticable.

I thank the Electricity Commission, the Ministry of Economic Development, and the Commission's current service providers. They all co-operated fully with my inquiry.

K B Brady
Controller and Auditor-General

22 July 2005

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Glossary

Electricity Governance Establishment Committee (EGEC): An oversight body of industry representatives, set up to establish a governance structure for the electricity industry under the oversight of an Electricity Governance Board. The EGEC was disestablished after the Government's decision to set up the Electricity Commission.

Electricity Commission Establishment Unit (ECEU): A unit within the Ministry of Economic Development set up to establish the Electricity Commission.

Electricity Commission Establishment Unit Steering Group (ECEU Steering Group): The ECEU Steering Group was comprised of staff of the Ministry of Economic Development, who oversaw the work of the ECEU.

Electricity Governance Regulations 2003: Statutory Regulations covering the operation of the electricity market, and required under the Electricity Act 1992. They provide for the monitoring and enforcement of the Electricity Governance Rules, and specify other matters relating to those rules, including liability, appeals, and exemptions.

Electricity Governance Rules: Rules made by the Minister of Energy covering the operation of the electricity market, and required under the Electricity Act 1992. They set out the responsibilities of various market participants, the Commission's duties and responsibilities, as well as a number of decisions relating to Transpower and the transmission grid.

New Zealand Electricity Market Rules: The rules established between market participants, by multilateral contract under the electricity industry's self-governing arrangements, before the Electricity Commission was established.

Service providers: Parties providing services to the Electricity Commission for the operation of the New Zealand electricity market.

Sole source procurement: When the purchaser of services negotiates with only one party for the provision of those services.

Summary

The Electricity Commission (the Commission), a new Crown entity set up to oversee the electricity industry and markets, was formally established in September 2003. One of its first major tasks was to contract with service providers to perform specific functions relating to the operation of the electricity market.

To avoid delaying the introduction of the regulated electricity market, the Electricity Commission Establishment Unit (the ECEU) – a unit within the Ministry of Economic Development (the Ministry) – did a significant amount of preparatory work. This meant that contract negotiations were well advanced by the time the new Commission first met on 7 October 2003.

On 15 December 2003, we received a complaint about how the Commission and the Ministry had contracted with service providers. The complainant claimed that the Commission and the Ministry had not followed good practice in procuring public sector services. Essentially, the complaint was that the contracts should have been contestable, but were not.

As we have a role in ensuring that public entities are performing effectively and efficiently and complying with their statutory obligations, and because of the seriousness of the complaint, we decided to conduct an audit and inquiry.

It was not for us to form a view on whether the contracts should have been contestable or not. That decision was for the Commission to make. However, if a public entity decides upon sole source procurement, we would expect that decision to be made very carefully, based on sound analysis and due consideration of all the alternatives. Accordingly, we examined how the decision to use sole source procurement was reached – the adequacy of the procedures leading up to the appointment of the contracted service providers.

We found no evidence to suggest that the Ministry and the Commission had failed to comply with their statutory obligations in contracting with service providers, or that they had showed any lack of probity or financial prudence. However, we did find deficiencies. The documentation and procedures of the Ministry and the Commission were not of the standard we would expect of public entities engaged in sole source procurement.

The Commission lacked both a clear procurement policy and adequate procedures for documenting its contracting decisions, which exposes those decisions to the risk of challenge. We recommend that the Commission establish a clear and unambiguous procurement policy, which can be used to guide its decisions when the remaining service provider contracts come up for renewal.

Part 1 – Background

The establishment of the Electricity Commission

- 1.1 In December 2000, after a Ministerial inquiry into the electricity industry¹, the Government released a policy statement² setting out its plans for a new governance structure to manage the electricity market. The industry then set up an Electricity Governance Establishment Committee (EGEC).
- 1.2 The task of the EGEC was to rationalise the industry's existing structures³; establish rules governing wholesale and retail prices, security of supply, and transmission and distribution, and get the industry to agree to those rules. In April 2003, the EGEC proposed a new set of rules to govern the industry.
- 1.3 About this time, inflows to hydro lakes were low and the country was dealing with a potential energy shortage for the second time in 3 years. This prompted the *Target 10%* advertising campaign, which called for a 10% voluntary reduction in power usage. Issues around the continuity of supply, supply and demand management, and the need for backup reserves in a dry year were widely debated.
- 1.4 The first stage in implementing the proposed new rules was a referendum to gauge the level of support for the rules. Votes were allocated equally to each of 3 classes: consumers, traders (generators and retailers), and transporters (lines companies and Transpower New Zealand).
- 1.5 As widely expected, the referendum (in April and May 2003) failed to achieve the support needed to allow the new rules to proceed, and the Government moved quickly to establish its own governance arrangements for the electricity industry. The Electricity Amendment Act 2001 empowered the Government to set up, without consultation, a Crown entity to manage the industry if the

¹ The inquiry was set up by the Government to examine whether the regulatory arrangements for the transmission, distribution, wholesale and retail sectors were best suited to ensuring that electricity was delivered in an efficient, reliable, and environmentally sustainable manner to all classes of consumer. Its recommendations included strengthening and making mandatory the governance framework for the electricity industry, and replacing the existing governance bodies with a new single market structure.

² *Government Policy Statement: Further Development of New Zealand's Electricity Industry, December 2000*. A revised statement was released in February 2002, after a review of the way the electricity system functioned during the winter of 2001. A new statement was published in October 2004.

³ NZEM (New Zealand Electricity Market), MARIA (Metering and Reconciliation Information Agreement), and MACQS (Multilateral Agreement on Common Quality Standards, which deals with the security and quality of the electricity transported by the national grid).

Minister considered it necessary, or desirable, in the public interest that such an entity be established. The Government decided it was, and the Electricity Commission (the Commission) was formally established on 15 September 2003.

- 1.6 In setting up the Commission, the Government was moving away from a voluntary model based on industry contracts to a statutory, regulation-based model. As well, rather than creating a new organisation from an already established unit within an existing public sector agency, an entirely new entity was being established, with functions not previously performed by such an agency.

What the Electricity Commission does

- 1.7 The principal objectives of the Commission are –
- *to ensure that electricity is produced and delivered to all classes of consumers in an efficient, fair, reliable, and environmentally sustainable manner; and*
 - *to promote and facilitate the efficient use of electricity⁴.*
- 1.8 The specific functions of the Commission are to –
- a. *formulate and make recommendations concerning electricity governance regulations and rules in accordance with [the Electricity Act 1992]:*
 - b. *administer, monitor compliance with, investigate, enforce, and apply penalties or other remedies for contraventions of electricity governance regulations and rules:*
 - c. *establish, operate, and facilitate the operation of markets for industry participants or consumers, or both:*
 - d. *use reasonable endeavours to ensure security of supply (including contracting for reserve energy), without assuming any reduction in demand from emergency conservation campaigns, while minimising distortions to the normal operation of the market:*
 - e. *undertake forecasting and modelling of future electricity supply and demand:*
 - f. *promote and facilitate the efficient use and conservation of electricity (including funding programmes that provide incentives for cost-effective energy efficiency and conservation):*
 - g. *manage emergency conservation campaigns to avoid material risk of supply shortages:*

⁴ Section 172N of the Electricity Act 1992 (as amended by the Electricity Amendment Act 2004).

- h. *approve 1 or more complaints resolution system for the purpose of section 158G:*
- i. *develop best practice methodologies and other standards and model agreements for use by industry participants:*
- j. *give effect to [Government Policy Statement on Electricity Governance] objectives and outcomes:*
- k. *provide advice to the Minister [of Energy] on matters concerning the electricity industry.*⁵

1.9 The Commission’s functions may be performed “*by contracting with other parties, entering into a joint venture or contractual arrangement in respect of reserve energy and other things, or by other means.*”⁶

1.10 The Commission’s task is to oversee the operation of the electricity market in line with specific regulations and rules. The rules set out the various responsibilities of the market participants, the Commission’s duties and responsibilities, and a number of decisions relating to Transpower and the transmission grid. The regulations are the mechanism by which those rules are enforced. The electricity market began operating under these regulations and rules on 1 March 2004.

The Electricity Commission Establishment Unit

1.11 The Electricity Commission Establishment Unit (ECEU) was set up on 1 May 2003 to bring the new Commission into being. It was part of the Ministry of Economic Development (the Ministry), and its functions included writing statutory regulations or rules, negotiating service contracts, obtaining premises, and appointing staff.⁷

1.12 The ECEU reported to a steering group (the ECEU Steering Group), which consisted of Ministry staff. The ECEU Steering Group met 2 or 3 times a month, and service provider contracts were an agenda item at most meetings. The ECEU Steering Group continued to meet regularly (until just after the Electricity Commission was set up), and was then disestablished.

⁵ Section 172O(1) of the Electricity Act 1992 (as amended by the Electricity Amendment Act 2004).

⁶ Section 172O(2) of the Electricity Act 1992 (as amended by the Electricity Amendment Act 2004).

⁷ Report to Cabinet Economic Development Committee, *Proposal to Establish an Electricity Commission*, 13 May 2003, page 9.

Service provider contracts

1.13 The Electricity Commission contracts 7 service providers under the Electricity Governance Regulations 2003. Regulation 30 states –

Appointment of service providers

(1) The Board must appoint a person or persons to act as the following service providers:

(a) a system operator:

(b) a registry:

(c) a reconciliation manager:

(d) a pricing manager:

(e) a clearing manager:

(f) a market administrator.

(2) The Board must appoint Transpower as the system operator.

(3) The Board may also appoint a person or persons to act as any other type of service provider.

1.14 These services are essential to the efficient delivery of electricity to its end consumers:

- The system operator is responsible for scheduling and dispatching electricity, to avoid fluctuations in frequency or disruption of supply.
- The registry is a database that identifies every point of electricity connection, enabling energy flows between retailers to be reconciled. The registry also tells retailers when a customer switches to another electricity supplier.
- The reconciliation manager facilitates the monthly reconciliation process and is responsible for reconciling metering data against a register of contracts.
- The pricing manager calculates and publishes final electricity prices.
- The clearing manager is responsible for monitoring security, invoicing, and setting electricity and ancillary service payments.
- The market administrator provides operational administration under the rules, rule change administration and analysis, education and advisory services, and enforcement.

1.15 The seventh service contract awarded was an information system contract.

1.16 Our inquiry specifically excluded the system operator contract because Regulation 30 requires Transpower New Zealand to perform this function. Figure 1 shows the value and term of each contract for the service providers appointed through the Commission's sole source procurement process.

Figure 1
Service provider contracts

Service provider contract	Contract with	Value (including GST) each year *	Term *
System operator	Transpower New Zealand Limited	Base fee: \$25.84m Possible variations: up to \$1.20m	Minimum of 5 years, with 2 years' notice of termination
Registry	Jade Direct NZ Limited	Base fee: \$0.61m Possible variations: \$0.07m	The agreement can be cancelled on 6 months' notice
Reconciliation manager	d-Cypha Limited (now Energy Market Services Limited)	Base fee: \$2.27m Possible variations: \$0.14m	Minimum term 18 months, with 6 months' notice of cancellation
Pricing manager	The Marketplace Company Limited	Base fee: \$2.12m Possible variations: \$0.04m	Minimum term 2 years. Agreement can be cancelled on 3 months' notice
Clearing manager	Energy Clearing House Limited	Base fee: \$1.36m Possible variations: \$0.43m	Minimum term 2 years. Subsequently, agreement can be cancelled on 6 months' notice
Market administrator	The Marketplace Company Limited	Minimum fee: \$4.20m Possible additional variations: up to \$1.37m	Nine months***
Information system****	The Marketplace Company Limited	Minimum fee: \$1.65m Possible additional variations: \$0.12m	Minimum of 2 years, with 6 months' notice of termination

* From *Recommendations to enter into service provider agreements*, paper to Electricity Commission Board, 15 December 2003.

** With The Marketplace Company Limited as guarantor. Energy Clearing House Limited is a 100% owned subsidiary of The Marketplace Company Limited.

*** The Market Administrator Service Provider Agreement expired on 1 December 2004. The Commission reviewed the services provided under this agreement and decided to seek tenders in 2 areas:

- market governance and operational support services in relation to the Commission's 5 key work streams (retail, wholesale, system operation/common quality, transmission, and security of supply); and
- membership of a preferred consultants' panel to ensure that the Commission has access to specialist consulting support as and when required so that it can operate efficiently and achieve its key objectives.

The Commission also decided to bring in-house some of the services previously provided under the Market Administrator Service Provider Agreement.

**** The Information system function is not a specified service provider under the Regulations, but the agreement with The Marketplace Company Limited for this function was structured as a service provider contract under Regulation 30(3).

The scope of our inquiry

1.17 Under the original terms of reference for our inquiry (see Appendix 1), we examined the actions of the Commission and Ministry that led to the

Commission's decision in December 2003 to contract with 4 of its service providers.

- 1.18 Our inquiry set out to determine whether any act or omission had occurred that showed, or appeared to show:
- that the Ministry or the Commission had not complied with its statutory obligations; and
 - a lack of probity or financial prudence by the Ministry or the Commission.
- 1.19 We did not examine whether the service provider contracts should have been contestable. That decision was for the Commission to make. The focus of our inquiry was on the procedures followed by the Ministry and the Commission in deciding to use sole source procurement. If a public entity decides upon sole source procurement, we would expect that decision to be made very carefully, based on sound analysis and due consideration of all the alternatives.
- 1.20 One service provider was concerned that our inquiry was not focusing on all of the Commission's service provider contracts. Because of those concerns, we expanded our terms of reference to include 2 other contracts awarded by the Commission in December 2003. The expanded terms of reference are set out in Appendix 2.
- 1.21 We use the term "sole source procurement" to describe the steps that the Commission followed in contracting with its service providers. Under sole source procurement, the purchaser of the services negotiates a contract with only one party. This is a legitimate form of procurement in certain circumstances, and we discuss it further in Part 2.
- 1.22 Our inquiry considered good public sector procurement practice. We did not examine the merits or otherwise of the appointed service providers.

How we carried out our inquiry

- 1.23 We conducted our inquiry by:
- interviewing staff and members of the Commission, and staff from the Ministry;
 - reviewing all documentation requested by us from the Commission, the Ministry, and the complainant; and
 - meeting the Commission's current service providers.
- 1.24 We circulated a draft of this report to all affected parties for comment.

Part 2 – Our expectations

- 2.1 In this Part we discuss our published guidelines, and those of the Ministry, relating to sole source procurement. We set out our expectations, and indicate whether the Commission met them.

Our procurement guidelines

- 2.2 In June 2001, we published *Procurement – A Statement of Good Practice*⁸, which sets out our expectations of a public entity when it is purchasing goods or services. The guidelines state –

*Procurement from a selected supplier, without inviting competing tenders from any other suppliers, should be the exception rather than the rule, and should be justified only in certain limited circumstances.*⁹

The Ministry's procurement guidelines

- 2.3 The Ministry's document *Policies and Procedures for Buying Goods and Services for the Ministry of Economic Development* refers to sole source procurement as “selective purchasing”. It notes that –

Selective purchasing is the exception, not the norm. Where a manager considers a selective purchase is appropriate, it must be endorsed by the Deputy Secretary/General Manager and the decision must be well documented. The selective purchase method should only be used in the following circumstances:

- *for one-off purchases of goods or services of minor value (threshold \$5,000 plus GST) where competitive purchasing procedures would not be cost-effective, and where a period supply contract is not appropriate;*
- *when stores or services are available only from a specific source of supply (such as proprietary brands where there is no technically acceptable equivalent);*
- *when a supplier has unique expertise or knowledge;*
- *where compatibility/standardisation with existing equipment (or office furniture/fittings) is required;*
- *when acquiring spare parts or accessories for existing equipment;*
- *for development or prototype work;*

⁸ Available from www.oag.govt.nz. See also Appendix 4.

⁹ Page 36.

- *when a tender for other stores or services has recently been accepted from a supplier; or*
- *when making purchases from a public auction or from another government department or agency.*

Selective purchase may also be appropriate if a successful tenderer fails to supply. In these circumstances, it can be appropriate to approach one of the unsuccessful tenderers on a selective-purchase basis.

Our expectations with sole source procurement

2.4 Both these publications have helped to shape our expectations of the steps that a public entity should follow in opting for sole source procurement. Our expectations are:

- **Expert advice on procurement options.** We would expect to see an analysis of the different procurement options, and why sole source procurement was the preferred one. In the case of new service provider contracts for the Electricity Commission, this analysis was not undertaken.
- **Capability assessment of potential suppliers.** We would expect to see evidence of analysis to determine if a market (or possible market) existed. If so, we would expect a capability assessment of the potential suppliers that make up that market (public entities should consider a Request for Proposal to test for this). In the Commission’s case, timing was a significant issue and therefore the pool of potential suppliers may have been limited. Regardless, an analysis of the capability of those suppliers should have been undertaken, but was not.
- **An analysis of industry or market expectations.** Where appropriate, we would expect an analysis of the expectations of the parties likely to be affected by the service or good procured. In the Commission’s case, the views of existing industry participants on what they needed from the service providers could have been taken into account. This analysis was not undertaken.
- **An analysis of key risks.** As sole source procurement should be “the exception, not the norm”, we would expect an analysis of the main risks associated with this option, and how those risks would be managed. It might consider issues such as minimising conflicts of interest. Again, this analysis was not undertaken.
- **An analysis of current provider performance.** Where an existing provider is reappointed to deliver a service or provide a good, we would expect to see an analysis of that provider’s performance before any contracting decisions were made (a due diligence process may be appropriate). No analysis was undertaken, and all existing providers were reappointed to deliver services to the Commission.

- **An analysis of cost versus benefit.** We would expect to see a documented analysis of the cost versus the benefit of retaining (or the feasibility of replacing) an existing supplier. Such an analysis would have helped the Ministry and the Commission to explain why sole source procurement was a suitable option. Again, no analysis was undertaken.

2.5 The Commission's procurement decision was not well documented, even though good practice requires that all procurement decisions be well documented. A public entity using sole source procurement for significant contracts – which are likely to involve public scrutiny, and possibly review by other agencies – should exceed the usual standard, not fail to meet it.

Part 3 – Deciding on sole source procurement

- 3.1 In this part of the report, we focus on the events leading to the decision to use sole source procurement in the appointment of the service providers. We exclude details of the negotiations that the Ministry and the Commission went through to reach these points.

The Electricity Commission Establishment Unit

- 3.2 The proposal to establish the Commission was first advanced in *Cabinet Economic Development Committee Minute EDC (03) 86* (13 May 2003). In relation to service provider contracts, the Cabinet paper noted –

Services to the electricity market are presently provided through eight contestable contracts. New contracts (or extensions of existing contracts) will need to be negotiated. Provision for service contract negotiations has been included in the budget proposal, but there is a risk that negotiations could become more complex and more expensive than budgeted...Delays in completing service contract negotiations also have the potential to cause a delay to the proposed 1 August start up. A further financial risk exists with the costs of converting the industry rulebook into statutory regulations or rules.

- 3.3 The first meeting of the ECEU Steering Group took place on 23 May 2003, but not until its fifth meeting on 4 July was the issue of service provider contracts substantially discussed.

- 3.4 A paper discussed at that meeting noted¹⁰ –

One of the key requirements of successfully establishing the Electricity Commission (EC) and launching the Electricity Governance Regulations and Rules (EGRs) is the negotiation and execution of Service Provider Contracts (SPCs). The deadline for achieving this is tight, given the number of contracts, the relative complexity of the contracts, the cautious outlook of existing service providers, and the limited amount of time available. However, to our advantage, progress has already been made negotiating similar contracts under the EGEC [Electricity Governance Establishment Committee] rule set. It is our intention to use these contracts as a template that will be updated and then used as the starting point for negotiation on behalf of the EC.

¹⁰ *Discussion Paper: Service Provider Contract Issues and Plan.*

3.5 The paper went on –

While the service provider roles are contestable (except for the System Operator role in the initial stages), it has been decided, given the time constraints and the specialist knowledge and systems required to perform the service provider roles, that only the current Service Providers under the NZEM [New Zealand Electricity Market] and MARIA [Metering and Reconciliation Information Agreement] rules will be approached to provide these services.¹¹

3.6 Based on the documentation we saw, this was the first point at which it was decided that only existing providers would be contracted to deliver services to the Commission.

3.7 The subject of service provider contracts came up at subsequent meetings of the ECEU Steering Group, but it was the 4 July meeting that determined that the ECEU would approach existing service providers (and opt for sole source procurement) rather than make these contracts contestable.

The Electricity Commission

3.8 By the time the Commission was formally established on 15 September 2003, negotiations with service providers were well advanced. The regulated market was scheduled to come into being on 1 December 2003, with the Electricity Governance Rules gazetted and the service provider contracts signed some time before that.¹²

The Electricity Commission's first informal meeting

3.9 The Commission's first informal meeting was held on 19 September 2003. At this meeting, the Commission was briefed on the progress of the negotiations for service provider contracts, and the decisions already made by the ECEU.

3.10 The briefing notes recorded the following –

Terms of Reference

- *Use the contracts template developed under the industry process*
- *Don't lock the EC [Electricity Commission] into long term contracts*
- *Deal with current industry Service Providers*
- *Complete by 19th September*

Negotiating Mandate

- *Develop a key term sheet with the Service Providers*

¹¹ *Discussion Paper: Service Provider Contract Issues and Plan*, page 2.

¹² There were a number of delays to the establishment of the regulated market. The Electricity Governance Rules eventually took effect from 1 March 2004.

- *Provide for a term which doesn't expose the Board to risk (i.e. neither too long nor too short) or inhibit structural preferences*
- *Require pricing or fee base to be transparent*
- *Recognise interdependence between Service Provider Contracts and EGRs [Electricity Governance Rules]*
- *Ensure that a robust process has taken place to enable EC [Electricity Commission] to sign off*
- *Strive to maintain good relations with Service Providers*

3.11 The briefing notes show the ECEU's clear intention to negotiate with existing service providers to the electricity industry, and also to give the Commission the flexibility to restructure service provider contracts when they came up for renewal.

The Electricity Commission's first official meeting

3.12 The Commission's first official meeting occurred on 7 October 2003, and considered:

- a paper by the ECEU, *Service Provider Contract Negotiation Update*, dated 29 September 2003; and
- a paper by the ECEU, *Service Provider Contract Recommendations*, dated 3 October 2003.

3.13 The first of these papers provided an update on the status of the contract negotiations with existing service providers. The second recommended that the Board approve the main terms of the service provider contracts and the associated negotiation limits. The minutes simply noted –

The Board approved in principal the key terms of the Service Provider Contracts (SPCs) and associated negotiation limits as set out in Schedule 1 [as set out in the second of the papers referred to above] subject to the guidance provided by the Commissioners.

3.14 While not explicitly stated in the minutes, it is clear that the Commission approved the method for contracting with service providers at that meeting on 7 October. This was the second point at which it was decided that contracts for the delivery of services to the Commission would be negotiated with existing service providers, rather than contested.

3.15 The Commission told us that the decision reflected:

- an earlier Government decision to base the Electricity Governance Rules as closely as possible on the New Zealand Electricity Market rules. The existing service providers had been closely involved with that self-reform and were therefore better placed than other parties to commit to new contracts based on those rules; and
- a concern to ensure the “safe” operation of the electricity market through the transition period – that is, without disruption or interruption. Existing

service providers were considered to be familiar with their roles in that market, and to have systems in place that worked.

- 3.16 The Commission said it was aware that it needed to make its own decision on the approach to contracting, but it was also aware that that decision would be considerably influenced by the earlier decisions of the Government and its advisers. Taking account of all relevant factors, the Commission concluded that it would be prudent and responsible to confirm the approach to the service provider contracts recommended to it by the ECEU on 7 October.

NZX Limited

- 3.17 On 17 September 2003, NZX Limited (NZX, formerly the NZ Stock Exchange) wrote to the ECEU expressing interest in several of the service provider functions to be managed by the Commission. Specifically, it proposed taking responsibility for the market administrator, pricing manager, clearing manager, information services provider, and registry manager functions.

- 3.18 When the Ministry and the Commission became aware of the NZX proposal, no contract decisions had been made. It may then have been appropriate to revisit the contract method that the 2 agencies had chosen—that is, sole source procurement.

- 3.19 The ECEU's project manager replied to NZX on 25 September –

Given the timetable we are dealing with, our current thinking is to contract with existing Service Providers for the initial phase of the EC [Electricity Commission]. However, as the EC moves beyond the establishment phase I believe it is likely that it will favour a more contestable approach to the appointment of Service Providers.

I suggest that we leave matters on this basis for the time being.

- 3.20 On 7 October, NZX formally advised the Commission of its interest in being a service provider to the New Zealand electricity market, and during the next 2 months met the Commission and various other parties in the electricity industry. Prompted by NZX's interest, the Commission sought legal advice from the Ministry on the approach it should follow in appointing service providers.

- 3.21 The Ministry's advice was that –

... the Commission should be following processes that meet the standards set in the Statement of Good Practice¹³. They should be demonstrably acting fairly and reasonably, and they need to be in a position to justify a “selective procurement” strategy for their service providers.

¹³ *Procurement – A Statement of Good Practice*, June 2001, Office of the Controller and Auditor-General.

This process should include a fair and reasonable assessment of the NZX proposal, considered in the context of the statutory functions of the Commission. The government's requirement that the Commission take responsibility for the operation of the electricity market, and the timing of the establishment of the Commission and the making of the EGRs [Electricity Governance Rules] are obviously critical factors for the Commission to take into account. The risk inherent in the proposal from any new provider at this time is also clearly a critical issue for the Commission.

- 3.22 On 27 November, NZX presented a formal application to the Commission for the 5 service provider functions it had nominated on 17 September.

The final decision

- 3.23 On 15 December, the ECEU put a paper to the Commission. The paper, *Recommendations To Enter Into Service Provider Agreements*, noted –

Public sector guidelines and commercial good practice both suggest that the Commission should choose service providers through a contestable tender process (i.e. not just one involving parties known at the time). Contestable processes have the potential to offer similar services for lower prices and/or to offer improved service standards that benefit participants and the Commission.

However, using tender processes during the Commission's establishment phase would have:

- a Meant that it was not possible to introduce the EGRs [Electricity Governance Rules] in accordance with the Minister's timetable. That is because only a limited, or "pseudo-contestable", process could have been conducted in the time available. A full tender process could have taken at least 9 months to complete. A contestable process would involve the following steps*
 - i announcement of a contestable process (including; [this point is incomplete in the paper];*
 - ii development of service specifications (including consultation) and standardised contracts (without incumbent service provider input);*
 - iii development of requests for proposals;*
 - iv responses to and evaluation of proposals; and*
 - v negotiating a contract with the chosen provider.*

If a new service provider were chosen, it is likely that the timeframe for negotiation, developing and testing the systems needed for the role would also have to be agreed to. This would further extend the timeframe. All of the above would have led to a complex and new phase in the appointment of service providers.

- b Created significant risks to the operation of the market, and the Commission's credibility, if new service providers did not have sufficient time to develop, implement and test their systems and procedures.*

Given these constraints, the Commission decided in October 2003 that the only practical approach during the Commission's establishment phase was to use the service providers who are currently contracted to MARIA [Metering and Reconciliation Information Agreement] and NZEM [New Zealand Electricity Market] (and who would have continued to provide services if the EGENC [Electricity Governance Establishment Committee] proposals had been implemented). These service providers are known in the market, have demonstrated expertise and are familiar with existing rules, the majority of which are continued.

3.24 On the NZX proposal the paper noted –

The 27 November NZX proposal is not of itself a fully developed proposal that could have been used as a base to make a decision to choose NZX. Rather, it required that the Board undertake a contestable process. Therefore, the decision that needs to be taken is whether the Board should stop the current process and instigate a contestable process.

We expect that a range of organisations would participate in a thorough process. These organisations could include the existing service providers, other organisations that have shown interest to date (including NZX and others), and a wider group that would likely respond once a process were made public (e.g. Australian companies with relevant expertise).

The process could only be undertaken once a thoroughly developed service specification was drawn up and agreed by the Commission. Given the significance of the service providers to the successful operation of the market, it would be desirable if the specifications were consulted on prior to the Commission agreeing to them.

The choice for the Commission is either to use existing service providers (as is currently proposed) or to introduce a contestable process that would significantly delay the start date for the EGRs [Electricity Governance Rules].

We believe that the Commission should introduce a thorough contestable process once the EGRs are fully operational. Overall, there is little downside for market participants from contestable processes being initiated after the EGRs are implemented. There would be significant costs and risks as a result of delays to the EGRs if contestable processes were initiated at this stage.

3.25 The ECEU paper recommended that the Commission reconfirm its “resolution” of 7 October 2003 that it would be impractical to initiate a contestable selection of service providers at this time. It also recommended that, once the Electricity

Governance Regulations and Rules were in place, the Commission negotiate agreements with its service providers under existing contract arrangements.

- 3.26 In our view, the paper provided a reasoned argument for why the Commission should proceed with sole source procurement, and at its meetings on 16 and 17 December it confirmed its decision to do so.¹⁴

¹⁴ Minutes of board meeting of the Electricity Commission, held on 16 and 17 December 2003.

Part 4 – Analysis and recommendation

- 4.1 In this Part, we give our view of the events that took place, and our recommendation to the Ministry and the Commission.
- 4.2 We found no evidence to suggest that the Ministry or the Commission had not complied with their statutory obligations, or that there was any lack of probity or financial prudence on the part of either.
- 4.3 However, the Ministry and the Commission did not meet our expectations of a public entity in opting for sole source procurement.

Tender or status quo?

- 4.4 The proposal to set up an Electricity Commission was first advanced on 13 May 2003 in a report to the Cabinet Economic Development Committee. The report was silent, however, on the issue of whether the ECEU should tender the service provider contracts or renegotiate contracts with the existing providers to the electricity industry.
- 4.5 The report simply noted that –
- An establishment unit has now been set up. Its functions include making recommendations on Board members, developing statutory regulations or rules, negotiating service contracts, obtaining premises, appointing staff, and so on.*¹⁵
- 4.6 The first document we saw that recorded a decision to renegotiate contracts with existing providers was the paper prepared for the ECEU Steering Group on 4 July (see paragraph 3.5). Some time before this date, therefore, the decision was first made to renegotiate contracts with the existing providers.

Decision unavoidable

- 4.7 The Electricity Governance Regulations provided authority for the Electricity Commission to enter into service provider contracts. The Commission had not been established at the time the ECEU began negotiations, and the ECEU had no explicit authority to negotiate on its behalf. However, we note that:
- to meet the deadline for the regulated market to come into effect, decisions had to be made on service provider contracts; and

¹⁵ Report to Cabinet Economic Development Committee, *Proposal to Establish an Electricity Commission*, page 9.

- service providers were negotiating on the understanding that, once formed, the Commission might have a different view of the arrangements for providing its services.
- 4.8 By the time the Commission was established on 15 September 2003, a significant amount of work had been done on the contracts. The ECEU continued negotiating with the existing service providers to bring their contracts to a stage where the Commission could sign them.
- 4.9 By advancing so far down the negotiation path, the ECEU put the Commission in a difficult position had it wanted the contracts to be contested. Any attempt to change the contracting approach at that point would have created legal risks (because of the intellectual property and sensitive business information provided by the existing service providers).
- 4.10 It was difficult for the Commission to do anything other than proceed with sole source procurement, because the time taken to manage a contested approach to the contacts would have further delayed the establishment of a regulated market.

A procurement policy was lacking

- 4.11 An unambiguous procurement policy reduces the risk of challenges to the decisions made, and helps retain credibility with suppliers. Clear procedures can also help to ensure that the procurement process is followed consistently.
- 4.12 The Commission had no procurement policy, which – at the very least – leaves its procurement decisions open to challenge.

Improved procedures are needed

- 4.13 Part 3 of this report identified the 2 points when, in our view, the procurement approach should have been fully considered, and the final decision fully and clearly documented. Those points were the 4 July 2003 meeting of the ECEU Steering Group, and the 7 October 2003 meeting of the Commission.
- 4.14 In our view, a compelling argument for sole source procurement could – and should – have been advanced. Such documentation was missing:
- when the ECEU began renegotiating with existing providers; and
 - when the Commission was formed and reconfirmed the approach adopted by the ECEU.
- 4.15 That lack of documentation exposes the Ministry and the Commission to the risk of having its procurement approach challenged, and is not consistent with the expectations we set out in Part 2 of this report.

- 4.16 As outlined in Part 3, the Ministry's publication *Policies and Procedures for Buying Goods and Services for the Ministry of Economic Development* includes a guide to sole source procurement, or "selective purchasing". These policies and procedures require various conditions to be present before sole source procurement becomes the preferred option. There was no documentary evidence that these conditions had been taken into account.
- 4.17 The Commission did tell us what it considered the risks of a contestable approach to be, but it did not document them. In our view, the risks should have been documented.

The proposal by NZX Limited

- 4.18 The NZX proposal did prompt the Commission to consider a contestable approach. After meeting NZX on 17 September to discuss its possible involvement in the electricity market, the ECEU's project manager replied –

Given the timetable we are dealing with, our current thinking is to contract with existing Service Providers for the initial phase of the EC [Electricity Commission]. However, as the EC moves beyond the establishment phase I believe it is likely that it will favour a more contestable approach to the appointment of Service Providers.

I suggest that we leave matters on this basis for the time being.

- 4.19 Despite this letter, the chairperson of the Commission met an NZX representative on 4 November 2003 to discuss the NZX proposal, and consider a contested approach to the service provider contracts. On 11 November, the full Commission met, focusing, we are told, on whether it was feasible to establish such an approach, rather than on the substance of the NZX proposal. The Commission concluded that it would not be possible to conduct a robust process in the time available.
- 4.20 The Commission's legal advice on its obligations in appointing service providers came from a member of the ECEU Steering Group. When we asked why it did not seek external advice, we were told this was the closest available source.
- 4.21 The NZX proposal was a useful lever in negotiations with the existing service providers as, without it, the issue of contestability would not have been seriously considered. The decision to opt for sole source procurement was justified in the paper prepared for the Commission meeting on 16 and 17 December 2003. In our view, this was too late.

Our recommendation

- 4.22 We understand that the Commission has now agreed to select its service providers through a contestable approach, when the contracts of its existing

providers end. The market administrator contract was the first to be renegotiated, and the Commission invited tenders on those parts of the original contract that it has decided to outsource.

- 4.23 We recommend that the Commission establish a clear and unambiguous procurement policy, which can be used to guide its decisions when the remaining service provider contracts come up for renewal.

Appendix 1 – Original terms of reference

Audit and inquiry into awarding of certain service provider contracts by the Electricity Commission

The Auditor-General has decided to audit and inquire into the actions of the Electricity Commission (the Commission) and the Ministry of Economic Development (the Ministry) in relation to the Commission's awarding of certain service provider contracts in December 2003.

The Auditor-General is the auditor of both the Commission and the Ministry, with powers to independently audit, inquire and report.

Scope of the Audit and Inquiry

The work will be conducted under sections 16(1) and section 18 of the Public Audit Act 2001, and will involve an examination of the procurement process followed and actions of the Commission and the Ministry that lead to the Commission's decision, in December 2003, to award the following service provider contracts:

- Market Administrator Service Provider Agreement;
- Pricing Manager Service Provider Agreement;
- Clearing Manager Service Provider Agreement; and
- Information System Service Provider Agreement.

The audit and inquiry will examine the actions and behaviour of the Commission or any of its Members or any Ministry employee or representative that assisted in the establishment of the Commission to determine whether any act or omission has occurred that shows, or appears to show:

1. That the Ministry or the Commission has not complied with its statutory obligations;
2. A lack of probity or financial prudence by the Ministry or the Commission.

The audit and inquiry will take into account recognised good public sector procurement practice with regard to the making of appropriate procurement decisions.

Limitation of Scope

The audit and inquiry will not examine or report on the merits or otherwise of the service providers who were awarded the above-mentioned contracts.

Report on Audit and Inquiry

The Auditor-General will report the results of the audit and inquiry, and any other matter arising out of it that the Auditor-General considers it desirable to report on, under sections 20 to 22 of the Public Audit Act 2001.

In accordance with usual practice and the requirements of natural justice, all affected parties will be given an opportunity to comment on the report in draft.

Timeframe

It is likely that the audit and inquiry will have been completed and its report finalised by the end of July 2004.

Approved:

Kevin Brady
Controller and Auditor-General

4 June 2004

Appendix 2 – Final terms of reference

Audit and inquiry into awarding of certain service provider contracts by the Electricity Commission

The Auditor-General has decided to audit and inquire into the actions of the Electricity Commission (the Commission) and the Ministry of Economic Development (the Ministry) in relation to the Commission's awarding of certain service provider contracts in December 2003.

The Auditor-General is the auditor of both the Commission and the Ministry, with powers to independently audit, inquire and report.

Scope of the Audit and Inquiry

The work will be conducted under sections 16(1) and section 18 of the Public Audit Act 2001, and will involve an examination of the procurement process followed and actions of the Commission and the Ministry that lead to the Commission's decision, in December 2003, to award the following service provider contracts:

- Reconciliation Manager Service Provider Agreement;
- Registry Service Provider Agreement;
- Market Administrator Service Provider Agreement;
- Pricing Manager Service Provider Agreement;
- Clearing Manager Service Provider Agreement; and
- Information System Service Provider Agreement.

The audit and inquiry will examine the actions and behaviour of the Commission or any of its Members or any Ministry employee or representative that assisted in the establishment of the Commission to determine whether any act or omission has occurred that shows, or appears to show:

1. That the Ministry or the Commission has not complied with its statutory obligations;
2. A lack of probity or financial prudence by the Ministry or the Commission.

The audit and inquiry will take into account recognised good public sector procurement practice with regard to the making of appropriate procurement decisions.

Limitation of Scope

The audit and inquiry will not examine or report on the merits or otherwise of the service providers who were awarded the above-mentioned contracts.

Report on Audit and Inquiry

The Auditor-General will report the results of the audit and inquiry, and any other matter arising out of it that the Auditor-General considers it desirable to report on, under sections 20 to 22 of the Public Audit Act 2001.

In accordance with usual practice and the requirements of natural justice, all affected parties will be given an opportunity to comment on the report in draft.

Approved:

Kevin Brady
Controller and Auditor-General

31 August 2004

Appendix 3 – Chronology of events

- 1-2 May 2003** Senior members of the Electricity Commission Establishment Unit (ECEU) are appointed under contract by the Ministry of Economic Development (the Ministry).
- 13 May 2003** Cabinet paper [EDC (03) 86], *Proposal to Establish Electricity Commission*. The paper states that new contracts (or extensions to existing contracts) need to be negotiated. It refers to possible risks that may cause a delay to the 1 August 2003 establishment of the Electricity Commission, one of which is delays in service contract negotiations. The paper notes that provision for service contract negotiations has been included in the budget proposal, but there is a risk that negotiations could become more complex and expensive than budgeted for.
- 20 May 2003** The Minister of Finance and the Minister of Energy publicly announce that the Government will form the Electricity Commission.
- 23 May 2003** First meeting of the ECEU Steering Group.
- May-August 2003** Negotiations with existing service providers begin and continue throughout this period. Progress on service provider contracts is on the agenda at most meetings of the ECEU Steering Group.
- 22 August 2003** Tenth meeting of the ECEU Steering Group. (The last meeting of the group for which minutes were kept. The group continued to meet about every 2 weeks through to 28 November 2003, but the Ministry told us that these meetings were mainly to update the Deputy Secretary of the Resources and Networks Branch.)
- 8 September 2003** MED Cabinet paper [EDC (03) 186] notes that:
It is anticipated that the initial service providers will be those currently providing services under MARIA and NZEM, and those who would have continued if the EGEC proposals had been implemented. Given the timetable for implementing the EGRs, this is the only practical approach available. It is anticipated, however, that the Commission will undertake a

phased approach to tendering service provider contracts over the next 5 years.

- 14 September 2003** Media statement from the Minister of Energy announces the formation of the Commission, and its membership.
- 15 September 2003** Commission formally established by Order in Council.
- 29 September 2003** Paper to the Electricity Commission prepared by the ECEU (*Service Provider Contract Negotiation Update*) updates Commission on contract negotiations with incumbent service providers.
- 3 October 2003** Paper to the Electricity Commission prepared by the ECEU (*Service Provider Contract Recommendations*) recommends that the Commission approve the main terms of the service provider contracts, and the negotiation limits as set out in the paper.
- 7 October 2003** First meeting of Electricity Commission Board held.
- 17 October 2003** Paper to the Electricity Commission by the ECEU (*Service Provider Contract Negotiation Update*) updates the Commission on contract negotiations with incumbent service providers.
- 22-24 October 2003** Commission Board meets.
- 15 December 2003** ECEU recommends to the Commission that it proceed with contracts and a non-contestable regime.
- 18 December 2003** Electricity Governance Regulations 2003 gazetted with Rules to come into force 1 March 2004, and a requirement to appoint certain service providers.

Appendix 4 – Extract from *Procurement – A Statement of Good Practice*

The following text is from the Office of the Auditor-General's publication *Procurement – A Statement of Good Practice*.

3.2 Selective Procurement

Principles

Procurement from a selected supplier, without inviting competing tenders from any other suppliers, should be the exception rather than the rule, and should be justified only in certain limited circumstances.

Selective procurement may be justified where:

- tendering is not practicable – for example, in an emergency;
- the required goods or services are available from only one source, or only one supplier has the capacity to deliver at the time required, and this can be adequately attested;
- standardisation or compatibility with existing equipment or services is essential, and can only be achieved through one supplier;
- there is a legal requirement or directive to use one supplier*^{*}; or
- the cost of any other form of procurement would be out of proportion to the value of the procurement or the benefits likely to be gained.

Detailed guidance in your own manual may cover:

Procedures for a selective procurement

Each decision to make a selective procurement should be:

- taken systematically, by staff who have the necessary knowledge and experience of the procurement environment – assisted, as required, by external expert advice; and
- fully documented, reviewed, and endorsed by a more senior person in the entity before being implemented.

The procedures required to identify a supplier

A public entity should identify a supplier using information about all known possible alternative suppliers.

* For example, legal services from the Crown Law Office.

The procedures required to confirm the supplier's capability to deliver the goods or services

Before deciding to make a selective purchase, a public entity should take adequate steps to ensure the supplier's suitability, and to document what information was obtained in this check.

Steps might include obtaining references (with the supplier's consent) that attest to the standards of the supplier's past performance.

Assessing the supplier's performance

A public entity should regularly assess the performance of a selective supplier against established criteria.

Market testing

A public entity should satisfy itself from time to time that a selective supply is still justified. This might include advertising to seek expressions of interest from other suppliers in tendering for the goods or services.