

Alleged UTS 26 March 2011 – Response to draft decision

Submission to the Electricity Authority



This submission by Contact Energy Limited (“Contact”) responds to the *Consultation Paper – Draft decision of the Electricity Authority under Part 5 of the Electricity Industry Participation Code regarding an alleged UTS on 26 March 2011* paper (the “consultation paper”) issued by the Electricity Authority (“the Authority”) on 6 May 2011. References to the “draft UTS decision” relate to the decisions outlined in the consultation paper.

Our general comments are provided in response to the specific consultation questions, although we also provide brief answers in Appendix 1.

For any questions relating to our submission, please contact:

John Woods | General Manager Wholesale

Contact Energy | DDI: 04 462 1167 | Mobile: 021 409 418

Contact wants a sustainable electricity market

The impacts on Contact's financial position of alternative resolutions to the events of 26 March are immaterial. Accordingly, our comments on the draft UTS decision are made from the point of view of a participant with significant capital invested in making this a sustainable market, but limited financial interest in this specific event.

Contact supports clear price signals created by the Code

Contact is pleased that, in its draft UTS decision, the Authority has recognised the fact that prices fluctuate to reflect underlying supply and demand conditions. This provides signals for investment or other risk management activity.

This recognition aligns with Contact's position on scarcity pricing; that mechanisms such as price caps and cumulative thresholds would help create an environment within which these price signals can emerge, and to which participants can respond.

Importantly, the Authority's work on scarcity pricing recognised the need to create the framework for scarcity pricing within the Code¹. This allows individual participants to operate and manage risk within that framework as they see fit.

The draft UTS decision distorts these signals, and doesn't stop another '26 March' happening

Although the UTS claims relate to a narrow set of factors driven by a transmission constraint, Contact's main concern with the draft UTS decision is that it risks distorting similar price signals arising from other events such as supply shortfalls, and limits the incentives for participants to manage their own risk.

In particular, by identifying problems relating to *information*², yet addressing an outcome relating to *price* (i.e. the revision of Huntly offers), not only does the draft UTS decision interfere with the price signal, it does not prevent the same information issue occurring again.

Regulatory intervention should not mitigate exposure from poor risk management decisions

All participants should be aware of, and responsible for, the risks they take. Participants need to have a realistic expectation of incurring costs if they don't take appropriate steps to identify and

¹ Electricity Industry Participation Code.

² In particular the ability to foresee, or expect, prices to be a certain level.

manage that risk. If exposure to these costs is mitigated by regulatory interventions, participants will see less need to manage this risk themselves, and will not be incentivised to seek contracts which improve their ability to respond to certain market outcomes. The sale of market exposed energy products by some participants appears to have been a major factor in the outcomes that emerged on 26 March 2011.

Contact considers that serious, and unintended, consequences could potentially arise from the draft UTS decision if it is confirmed. Where participants are not incentivised to manage risk appropriately, this will be detrimental to the development of a liquid hedge market; the facilitation of which the Authority has identified as one of its key goals. Similarly, investment and operational signals could be affected if participants perceive risk of regulatory intervention to 'correct' what are normal market risks. This will impact appetite for investment and ultimately security of supply, which will not be in the long-term interests of consumers.

An efficient market will determine who is best placed to manage risk

The Authority's comments on generator offers and plant availability in the draft UTS decision reinforce Contact's concerns.

The draft UTS decision states that Contact's decision to remove capacity at Stratford (the Taranaki Combined Cycle plant ("TCC")) was a factor in the outcomes of 26 March 2011. Contact's decisions to offer plant, or not, are based on price signals and an assessment of market conditions. The market price indicated was insufficient for Contact to operate TCC on 26 March 2011. In making this assessment, Contact had considered its risk position in the event that prices changed; we did not expect to rely on regulatory intervention if adverse outcomes emerged.

The Authority's decision to determine 'remedial prices' for Huntly offers is also concerning. Contact believes the role of the Authority should not lie in determining what offers are appropriate, but in managing and developing the Code to facilitate market outcomes. Further, Contact is not satisfied that the offer range derived by the Authority is an accurate estimate of the return required from low capacity factor thermal plant.

UTS process may not have captured important contextual information

It is disappointing that some important contextual information does not appear to have been a factor in the Authority's assessment of events. Contact indicated a desire to meet the Authority to discuss a number of issues³ but this offer was not taken up. Contact is particularly disappointed that the option of an interview⁴ was not extended to all participants.

What Contact wants from the process

Contact would still like the opportunity to discuss its concerns with the Authority. We believe that there are significant unintended consequences that could potentially result from the draft UTS decision being confirmed unchanged.

³ Email (and letter attachment) to Bruce Smith and Carl Hansen dated 6 April 2011.

⁴ Refer paragraph 66 of the draft UTS decision.

Appendix 1 - specific answers to consultation questions

<p>Q1 - Has the Authority accurately recorded and interpreted all of the salient facts in regard to this matter? If not, please detail the inaccuracies.</p>	<p>Contact believes the Authority may not have adequately considered the flow-on effects of their decision to related markets (e.g. the hedge market) which are likely to contradict the Authority's statutory objective.</p> <p>The Authority has also speculated on actions taken by Contact, without the benefit of understanding the context surrounding those actions.</p>
<p>Q2 - Do you agree with the Authority's draft decision that the situation existing on 26 March 2011 constitutes a UTS? Please give reasons for your answer.</p>	<p>Contact believes that some participants would have, or should have, been able to foresee the potential risks arising from conditions on 26 March 2011. Some will have made conscious decisions to manage (or dismiss) that risk. Contact believes that where this occurred, or where participants took on risk and did not manage it appropriately (including not making reasonable assessments of risk based on information available), intervention to limit participants' risk via the remedial outcomes proposed is inappropriate.</p> <p>Contact also believes there is some misalignment between the issues identified as contributing to the UTS, and the proposed action.</p>
<p>Q3 - Do you agree with the draft remedial actions that the Authority intends to take to correct the UTS? Please give reasons for your answer.</p>	<p>Contact submits that by identifying problems relating to information, yet imposing remedial actions relating to price (i.e. the revision of Huntly offers), not only does the draft UTS decision mask price signals, it means that the same issue which led to the UTS claims could occur again.</p> <p>Contact believes the draft UTS could have serious unintended consequences that do not support the Authority's statutory objective.</p>
<p>Q4 - Are there any other remedial actions that the Authority should take to correct the UTS? If so, please detail the other actions and give reasons for your answer.</p>	<p>No, but there are alternative actions which should be considered by the Authority in addressing any information issue.</p>