



12 May 2011

The Chair  
UTS Committee  
Electricity Authority  
PO Box 10041  
Wellington

By email to: [submissions@ea.govt.nz](mailto:submissions@ea.govt.nz)

Dear Dr Layton

### **DRAFT DECISION ON UTS OF 26 MARCH 2011**

New Zealand Steel Limited (*NZS*) refers to the draft decision of the UTS Committee of the Electricity Authority (the *Authority*) appointed to investigate the alleged 26 March 2011 Undesirable Trading Situation (*UTS*). That decision was released on 6 May 2011.

In this letter and the accompanying submission in the form required by the Authority, *NZS* offers its views on the Authority's draft decision and draft remedial actions to correct the *UTS*.

#### **NZS Supports the Draft Decision**

*NZS* notes that in its draft decision, the Authority has found that the events leading to spot market prices of around \$20,000/MWh on 26 March 2011 were a *UTS* in terms of the Electricity Industry Participation Code 2010. *NZS* agrees with and continues to support that finding.

*NZS* supports the overall reasons cited for that draft decision, particularly the undermining of confidence in the wholesale market for electricity and damage to the integrity and reputation of that market. The many submissions received by the Authority, including that of *NZS*, explain in some detail why offer behaviour such as that of Genesis on 26 March cannot be tolerated.

#### **Comments on Specific Aspects of the Draft Decision**

We would like to offer a few comments on points made in the draft decision, in addition to the specific answers provided in our attached submission:

- A final decision is not expected until mid-June. Whilst trades in the relevant 26 March periods will generally not have been settled, the time that it has taken the Authority to respond to the *UTS* and the time that will elapse until the issues are resolved present a period of some considerable uncertainty for business. The sums involved are large, further decisions on power pricing strategy cannot be finalised or implemented until the market knows how the Authority will treat events such as these both now and in the future, and the resulting disruption to business is not insignificant.

New Zealand Steel Ltd  
Mission Bush Road  
Glenbrook  
South Auckland  
Private Bag 92121  
Auckland  
New Zealand  
Telephone +64 9 375 8999  
Facsimile +64 9 375 8959  
[www.bluescopesteel.com](http://www.bluescopesteel.com)  
A BlueScope Steel Company

- We recognise there are several overlapping Authority workstreams at play here, including the work on scarcity pricing. The UTS investigation needs to coordinate with these but must not become mired in bigger market structure issues.
- The Authority points out in its draft decision that exceptionally high offer prices, and exceptionally high market prices, do not necessarily constitute a UTS. As a matter of principle we cannot support that statement. The Authority says the economic rationale for the UTS provisions is to achieve operationally efficient and competitive markets. Buyers and sellers have to have confidence in the market. Our response to this is simply that, by definition, if prices are "exceptionally high", purchasers will not have confidence in the market and the Authority will have failed in the discharge of its functions.
- The Authority has placed a good deal of weight on the lack of forewarning of the 26 March pricing to the market. From a purchaser's perspective, however, advance knowledge of extreme prices is not a total panacea. There have to be, at the same time, an ability to take counteractive steps operationally on the demand side as well as availability of realistically priced financial options (including through a liquid hedge market).
- The Authority has expressed a preliminary view that Genesis did not materially breach the law. Whilst the Electricity Industry Participation Code is within the Authority's ultimate jurisdiction and the Authority is required to reach a view on breach of law, we have to point out that there may be divergent views as to whether there might have been any breach of the Commerce Act 1986 or other laws, and that this question would need to be finally resolved by a Court of competent jurisdiction.
- The Authority refers to other pro-competitive and pro-hedging initiatives for amending the market rules by the end of the year, and that had they been in place they would have materially affected the events of 26 March. We would have to reserve our view on that. Whether, say, hedging might have been available or not, the reality is that pricing has to be realistic rather than opportunistic, there has to be equal knowledge and information, and any demand side steps have to be both available and recompensed. Absent such features, confidence in the wholesale electricity market will be entirely lost.

### **Comments on the Draft Remedial Action**

The Authority proposes that the interim prices for trading periods 22 to 35 (inclusive) on 26 March 2011 not stand, and instead that new offer prices be set at between \$1,500 and \$3,000/MWh. It says that pricing in this range will address the UTS, while preserving incentives for purchasers to hedge their spot price risk. Pricing at these levels is supposed to reflect the cost to purchasers of alternative sources of supply or the cost of curtailing demand. Put differently, these are the estimated costs purchasers would have incurred to avoid the exceptionally high spot market prices had they received accurate price forecasts.

NZS submits that final offer pricing in a range of \$1,500 to \$3,000/MWh remains too high. Such pricing cannot be condoned, with or without any ability to hedge.

The Authority assumes that customers will have an alternative source of supply and will have had access to adequate hedging. As we have explained to the Authority already, NZS was not offered hedging for the 26 March events.

Further, the spot price levels at which NZS would elect to forego steel production by turning off some significant load is much lower than the bottom end of the pricing range proposed by the Authority. NZS does as much as it can to manage its spot price exposure, but like other industrial and business customers, there are limits to what it can do, particularly where there has been a lack of proper notice, while focussing on its core business.

Other workstreams in which the Authority is engaged, in addition to the current work on scarcity pricing, recognise the demand side's limited ability to manage spot price risk. The reality is these are still but workstreams; they are not yet an available feature of the electricity market.

The counterbalance of scarcity pricing, as discussed in the Authority's recent Consultation Paper (refer NZS submission of 29 April 2011), proposes spot price floors in the range of \$3,000 to \$10,000/MWh for some supply emergency events. We have opposed these floors both philosophically and on the basis they are too high. We suspect that the Authority's thinking around final offer prices for the 26 March UTS has been influenced by the type of floor that it is proposing for some situations of supply emergency. This does not necessarily make them appropriate, and in both scenarios insufficient weight is given to the actual effect on the demand side of the market, and the present limited ability of the demand side to manage spot risk.

We set out in our attached formal submission other remedial steps and questions for the Authority to investigate as part of its work arising out of the 26 March events.

#### **General**

We look forward to continuing to work with the Authority with regard to resolution of the 26 March UTS. In due course, we will be interested to suggest and comment on proposed Code changes to emerge out of these events.

Yours sincerely



Simon Linge  
President  
New Zealand Steel & Pacific Islands

**Attachment: Submission of NZS on Draft UTS Decision**

## New Zealand Steel Limited Submission on Electricity Authority's UTS Committee Draft Decision on UTS of 26 March 2011

Question	General comments in regards to the question:	Response
<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>NZ Steel does not have access to all of the information made available to the Authority.</p>	<p>We believe the Authority's interpretation of the salient facts with regard to the 26 March 2011 UTS is accurate in all material respects, subject to two points:</p> <ul style="list-style-type: none"> <li>• We are somewhat perplexed at the degree to which the Authority has emphasised the importance of market participants' lack of notice and appreciation of the likely effect of proposed Huntly pricing on 26 March. Advance knowledge of extreme opportunistic behaviour is of little use if participants – particularly purchasers – are unable to take out hedges or drop sufficient load to deal with it, in time;</li> <li>• We believe the Authority has paid insufficient attention to the lack of acceptably priced hedge cover offered to consumers. It focuses more on what hedge cover was offered between generators. In our view, this is an oversight.</li> </ul>
<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>No comment.</p>	<p>NZ Steel supports the Authority's draft decision that the situation existing on 26 March constituted a UTS, for the following reasons:</p> <ul style="list-style-type: none"> <li>• The offer behaviour of Genesis on 26 March was opportunistic and cannot be rationalised or defended in an efficient market. Its effect is to undermine confidence in the wholesale market for electricity and damage the integrity and reputation of that market.</li> <li>• The resulting costs incurred by many other market participants will be extremely high, unless the UTS is reversed. The incidence of such pricing may also artificially inflate hedge prices, at a time when a liquid hedge market needs to be encouraged. Many businesses have been severely and adversely affected, and that this be at the hands of a state-owned enterprise does little for New Zealand's reputation as a country in which to invest.</li> </ul>

Question	General comments in regards to the question:	Response
		<ul style="list-style-type: none"> <li>• Spot purchasers of electricity can have no confidence that the market mechanisms are working properly, absent clear steps being taken to restrain such a serious abuse of market power.</li> <li>• The fact that the Authority may have found for now that Genesis' actions were not unlawful can only ever represent the Authority's view. The Authority itself has recognised, both implicitly and explicitly, that the Code needs changing. Whether other unlawful behaviour actually occurred is ultimately a matter for a Court of competent jurisdiction, and that question must remain at large.</li> <li>• No other mechanism under the Code will satisfactorily resolve the issues created by the 26 March events.</li> </ul>
<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>No comment.</p>	<p>NZ Steel supports the Authority's re-setting of prices during trading periods 22 to 35 (both inclusive) on 26 March, but submits that the \$1,500 - \$3,000/MWh price range suggested by the Authority is still too high. Prices in this range would fail to achieve the economic rationale for the UTS provisions, namely, achieving operationally efficient and competitive markets. Our reasons for this are as follows:</p> <ul style="list-style-type: none"> <li>• NZS is of the view that such prices exceed by some significant margin Genesis' costs of sales and production (including any selling, administrative and capital charges).</li> <li>• Such pricing should be unheard of and we cannot condone it, with or without any ability to hedge.</li> <li>• The Authority assumes that customers will have an alternative source of supply and will have had access to adequate hedging. As we have explained to the Authority already, NZS was not offered hedging for the 26 March events. Further, the spot price levels at which NZS would elect to forego steel production by turning off some important load is significantly lower than the bottom end of the pricing range proposed by the Authority. NZS does as</li> </ul>

Question	General comments in regards to the question:	Response
		<p>much as it can to manage its spot price exposure, but like other industrial and business customers, there are limits to what it can do, particularly with a lack of proper notice, while focussing on its core business.</p> <ul style="list-style-type: none"> <li>• Other workstreams in which the Authority is engaged, in addition to the current work on scarcity pricing, recognise the demand side's limited ability to manage spot price risk. The reality is these are still but workstreams; they are not yet an available feature of the electricity market.</li> <li>• The counterbalance of scarcity pricing, as discussed in the Authority's recent Consultation Paper (refer NZS submission of 29 April 2011), proposes spot price floors in the range of \$3,000 to \$10,000/MWh for some supply emergency events. We have opposed these floors both philosophically and on the basis they are too high. We suspect that the Authority's thinking around final offer prices for the 26 March UTS has been influenced by the type of floor that it is proposing for situations of supply emergency. This does not necessarily make them appropriate, and in both scenarios insufficient weight is given to the actual effect on the demand side of the market, and the present limited ability of the demand side to manage spot risk.</li> </ul>
<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>The Authority needs to focus not only on the permitted remedial steps under Part 5 of the Code but also on wider remedial steps and how these issues affect other workstreams being undertaken by it.</p>	<p>Yes, there are other remedial actions that the Authority should take. The Authority needs to pursue its Market Performance Investigation pursuant to s. 16(1) (g) of the Electricity Industry Act 2010, which is being undertaken in parallel to the UTS inquiry.</p> <p>In addition, the Authority needs to consider:</p> <ul style="list-style-type: none"> <li>• Whether generators could have acted more promptly and proactively in informing major industrial customers and other demand side participants of the risks looming with the planned transmission outage.</li> <li>• Whether Contact Energy should not share some of the blame for failing to appreciate (it seems) that Genesis had bid in Huntly at these outrageous prices, right at</li> </ul>

Question	General comments in regards to the question:	Response
		<p>the time that Contact chose not to bid in 425MW of Stratford generation. How could this be allowed to occur at a time that generators should have known to be potentially precarious? The Authority mentions this issue in its Draft Decision but then expresses no judgment on it and draws no conclusions from it.</p> <ul style="list-style-type: none"> <li>• What if anything can be read into the fact that the same behaviour from Genesis did not occur the following weekend when another planned identical or very similar transmission outage was due to occur, and to what extent the obvious inference from this changed behaviour underscores the opportunistic nature of Genesis' behaviour on 26 March.</li> <li>• The effect that events such as a UTS can have on pricing in the hedge market going forward. The "fear" of a repeat incident the weekend after 26 March saw several participants take steps, and incur cost, they would not otherwise have taken or incurred, and this may have included agreeing to higher than necessary hedge prices.</li> <li>• What improvements can be made to demand and price forecasting?</li> <li>• Why should alleged sufficient prior notice of prices well above SRMC mean that pricing behaviour of the 26 March variety is not a UTS? Why does notice make it tolerable when in fact there are few measures that much of the demand side can usefully take to manage spot risk?</li> <li>• What changes can be made to ensure that the whole market has access to, and can appreciate the significance of, line outage and other relevant transmission data? Is there a role for the Authority here? It is unrealistic to expect consumers to be able to devote huge resource to this area, at the expense of core business.</li> </ul>

Question	General comments in regards to the question:	Response
		<ul style="list-style-type: none"> <li>• Would a UTS have occurred if Huntly had been bid in at \$5,000/MWh? \$15,000/MWh? \$10,000/MWh? Where is the floor and where is the cap for a UTS? How can a market efficiently plan and how can the economy tolerate such uncertainty in spot electricity pricing?</li> <li>• What Code changes are necessary to ensure both that the Authority can achieve its statutory objective under the Electricity Act (refer para 26 of the Draft Decision) and the UTS provisions properly reflect their economic rationale (refer para 29 of the Draft Decision)? In particular, is there a case for a cap on spot prices? Should the Code require the participant guilty of causing the UTS to disgorge all revenues earned from the UTS, these to be distributed among affected participants at the Authority's direction, taking into account the respective losses suffered and steps taken to avoid or mitigate adverse effects? Whatever the changes, steps must be taken to prevent a recurrence of events such as those of 26 March.</li> </ul>

12 May 2011