



meridian

19 May 2011

Carl Hansen
Chief Executive
Electricity Authority
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Wellington

By email: submissions@ea.govt.nz

Dear Carl

Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission

1. Meridian welcomes the opportunity to cross-submit on the other party submissions in relation to the Authority's draft decision dated 6 May 2011. Meridian's cross submission comprises this letter and the accompanying memorandum prepared by Professor Lew Evans.
2. In Meridian's view:
 - (a) The cross-submissions highlight the fact that, unless a UTS is confirmed in this case, it will be a case of "anything goes" - that is, taking advantage of transient market power to set arbitrarily high prices will become an established feature of the electricity market.
 - (b) Under an "anything goes" regime, generators would face a completely different set of incentives from those they have previously assumed. It is difficult to predict exactly what the future would hold, but it can safely be assumed that, because being net pivotal would attract economic rents, generators would actively seek that position. That is, being long on generation and earning hedge revenues based on the threat of \$20,000/MWh prices (or \$100,000/MWh prices) would likely be much more profitable than being a balanced gentailer facing competitive retail markets. As a result, net pivotal situations and exercise of market power would be likely to be much more frequent - the past would not be a good guide to the future.
 - (c) In those circumstances, trading on the wholesale market will be threatened, and orderly trading and proper settlement are likely to be precluded, unless a UTS is confirmed. As set out in our earlier submission and Professor Evans' report:
 - (i) Participants will lose confidence in the integrity of the market if prices are divorced from efficient supply-demand conditions and excessively higher than underlying costs. This could result in both inefficient investment signals and inefficient consumption by individual consumers, as well as reducing the potential level of demand-side

management through deterring demand-side participation in the wholesale market.

- (ii) Unless the interim prices are remedied, the reputation of the market may be damaged to the point where trading is threatened and the adverse financial impact on some parties may preclude the orderly trading and the proper settlement of trades.
 - (iii) Unless situations such as occurred on 26 March are remedied through the declaration of a UTS, incentives are created for all participants to take advantage of transient market power, resulting in a reduction of the dynamic efficiency and wider credibility of the New Zealand electricity market.
- (d) The issue for the Authority is therefore whether, in the absence of a transient market power mitigation regime in the Code¹:
- (i) "anything goes" is an acceptable outcome, or
 - (ii) the UTS regime can act as a "gap filler"

in circumstances where there is no energy or capacity shortage and a net pivotal generator takes advantage of its market power situation without any view to the public interest. Most if not all wholesale electricity markets have mechanisms to moderate the potential illegitimate exercise of market power when a participant could otherwise name its price. However, at the moment the only mechanism available to the Authority is the UTS.

- (e) It is inaccurate to suggest that 26 March was a "normal" outcome where supply and demand were balanced in accordance with market forces. The prices on 26 March did not equilibrate supply and demand in any meaningful sense - rather, they were effectively set by Genesis at unprecedented levels.
- (f) It is also no answer to the above to say that high, very high or excessive prices are a necessary part of an efficient spot market because they signal the need for investment and allow generators to recover fixed costs. While prices above SMRC are necessary for the recovery of fixed costs, there is no reason to think that such prices *caused by the taking advantage of transient market power* are necessary to ensure efficient investment or recovery of costs.
- (g) Similarly, it is no answer to say that the risk of high spot prices can be managed in the hedge market. When high prices result from market power, hedge prices will also reflect market power - the same rents are extracted, but in a different way. This is illustrated by the events of 2 April (and now 14 May).
- (h) It is misleading to suggest that there will be no cost implications to retail customers under an "anything goes" regime. If economic rents are being extracted by generators, these will ultimately be passed on to consumers.
- (i) Finally, Meridian agrees with Genesis and other submitters that a price cap is not an appropriate remedy in this case. Rather, and as outlined in our submission, the remedy in this case should be a normalisation of prices, not an investigation into LRMC/cost of demand response that would result in unnecessarily punitive prices for consumers. The issue of whether price caps

¹ See comments in paragraph 8(e) of Meridian's 13 May 2011 submission regarding the range of possible regime designs.

or other mitigation measures are appropriate should be left to a Code amendment process.

3. The remainder of this submission:
 - (a) comments on the legal framework proposed in the Genesis submission;
 - (b) reviews the justifications advanced by Genesis for its conduct;
 - (c) explores the likely consequences if a UTS is not confirmed in this case; and
 - (d) responds to other submissions in terms of the Authority's proposed remedy.

Legal framework

4. In order to correctly frame the remainder of this submission, we first briefly comment on the legal framework in relation to the finding of a UTS.
5. Clause 5.2(1) of the Code provides that "[i]f the Authority finds that an undesirable trading situation is developing or has developed", the Authority may take any of the steps listed in clause 5.2(2) that it considers necessary to correct the UTS. "Undesirable trading situation" is defined in Part 1 of the Code as any contingency or event:
 - (a) that threatens, or may threaten, trading on the wholesale market for electricity and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades; and
 - (b) that, in the reasonable opinion of the Authority, cannot satisfactorily be resolved by any other mechanism available under this Code; and
 - (c) includes, without limitation,—
 - (i) manipulative or attempted manipulative trading activity; and
 - (ii) conduct in relation to trading that is misleading or deceptive, or likely to mislead or deceive; and
 - (iii) unwarranted speculation or an undesirable practice; and
 - (iv) material breach of any law; and
 - (v) any exceptional or unforeseen circumstance that is at variance with, or that threatens or may threaten, generally accepted principles of trading or the public interest

6. Meridian notes that:
 - (a) Clause 5.2 is phrased subjectively rather than objectively - if the Authority "finds" that a UTS has developed, it may take any of the steps listed in clause 5.2(2) "that it considers necessary" to correct the UTS. That is, similar to the position with other expert regulatory bodies, it is the Authority's role as decision-maker to weigh the relevant evidence and make the appropriate finding.
 - (b) The definition has a strong prospective element: an event can be a UTS if it "may" threaten trading and "would be likely to" preclude orderly trading or proper settlement.

- (c) The Authority has approached the matter on the basis that both paragraphs (a) and (b) must be made out before a UTS is found (see [15] of the draft decision). This may too conservative a view: in particular, paragraph (c) of the definition of UTS appears to contemplate that some conduct may be deemed to be a UTS even though it may not otherwise fall within paragraph (a). However, on any view, paragraph (c) colours the interpretation of paragraph (a): that is, paragraph (c) lists a number of matters likely to result in trading in the wholesale market being threatened and orderly trading and proper settlement being precluded, and therefore acts as a guide to the proper interpretation of paragraph (a).

7. It follows that:

- (a) Statements such as:
 - (i) "the test for a UTS establishes a very high legal threshold" (Genesis, [19]);
 - (ii) "[p]roperly construed, the UTS provisions provide the Authority with a very narrow discretion to intervene with the operation of the market in a very confined set of circumstances" (Genesis, [20]); and
 - (iii) the UTS powers "are only to be used in extraordinary circumstances" (Genesis, [22]),

are not supported by the relevant provisions of the Code. Rather, the Authority has a broad discretion, subject to it being satisfied of the relevant factual matters.

- (b) Similarly, it is incorrect to suggest that the UTS provisions cannot be used with an eye to the future (Genesis, [9-10, 92-98]). The definition of UTS clearly contemplates nipping potential problems in the bud. There is no necessary bright line between what may properly be the subject of a UTS decision and what may properly be the subject of a Code amendment process (compare Genesis [22-25]) - rather, the EIA and the Code provide the Authority with a basket of remedies when an undesirable trading situation arises, to be employed in accordance with the EIA and the Code as the Authority sees fit.
- (c) If any of the subparagraphs of paragraph (c) apply, that is a guide to whether paragraph (a) of the definition is made out. Here, the relevant subparagraphs include asking whether Genesis's offer behaviour:
 - (i) constitutes an undesirable practice; or
 - (ii) is an exceptional or unforeseen circumstance that is at variance with, or that threatens or may threaten, generally accepted principles of trading or the public interest.

Consistent with the above, it is for the Authority to reach a conclusion on the relevant factual matters.

Relevance of effect on end users

- 8. In its submission, Genesis suggests that the effects on end users who do not directly participate in the wholesale market cannot be taken into account in deciding whether a UTS has occurred (Genesis, [35-38]).

9. In Meridian's view, this is an artificial approach. While it is true that the UTS definition centres on the effects on the wholesale market, the actions of end-users who are exposed to spot prices is an important facet of the wholesale market (hence the various initiatives to promote demand side participation). To the extent that the Authority is satisfied that that is the case, the effects on end users may properly be taken into account. This is also consistent with the Authority's statutory objective to "promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers" (EIA 2010 s 15, emphasis added).

High prices and "entirely legitimate" activity cannot constitute a UTS

10. It is also inaccurate to suggest that, because the Electricity Commission has previously found that *some* instances of high prices do not amount to a UTS, it follows that *this* instance cannot be a UTS (Genesis, [29]). Rather, each case must be approached on its merits, having regard to the words and context of clause 5.2 and the UTS definition and the overall statutory purpose. Previous UTS findings cannot fetter the Authority's discretion - particularly where, as here, none of those findings are on all fours with the current case, in that none involved taking advantage of transient market power by a net pivotal generator to this extent in circumstances where there was no energy or capacity shortage.
11. It is worthwhile at this point to make the point that the events of 26 March did not just result in "high prices" - they resulted in *unprecedented* prices. To illustrate:
- (a) Vodafone calculated that the cost of the seven-hour price spike exceeded 8% of its historical annual electricity expenditure - i.e. it spent more in 7 hours than it typically would in a month (Vodafone, UTS claim).
 - (b) PMP Print submitted that over the price spike it paid 693 times what it would expect to pay for electricity in a normal competitive market situation (PMP Print, UTS claim).
 - (c) Assuming the interim prices stand, the events of 26 March significantly changed the March, and even the Q1, average price at the OTA node. Replacing the 26 March interim prices with the final prices for the previous Saturday results in a drop in the average March price from \$261.87 to \$62.23/MWh, and a drop in the Q1 price from \$121.86 to \$53.10/MWh. Another way of looking at these figures is to note that, for a buyer of a flat load over Q1, electricity provided on 26 March would have represented 57% of their bill for the entire quarter.
 - (d) There was a significant drop in futures market prices when the Authority's draft decision declaring a UTS was released (see paragraph 26 below).
12. In Meridian's view, these prices were not just high, but were an abuse of market power. While Meridian accepts that the dividing line between acceptable and unacceptable offers when a party is in a position of transient market power will not always be easy to draw, in this case that line was well and truly crossed.
13. Likewise, the submission that the Code does not regulate offer levels, and that "entirely legitimate" market activity cannot be a UTS (Genesis, [6, 100]), is based on a misinterpretation of the UTS definition. If conduct that does not breach the Code cannot be a UTS, then the definition would be of no practical use, particularly in light of paragraph (b) of the UTS definition.

Overall result

14. The overall decision for the Authority is thus whether, in the absence of a transient market power mitigation regime in the Code, "anything goes" is an acceptable outcome in these circumstances, or whether, as described by Professor Evans, the UTS regime can act as a "gap filler" in circumstances where there is no energy or capacity shortage and a net pivotal generator excessively exercises its market power. Most if not all wholesale electricity markets have mechanisms to moderate the potential exercise of market power when a participant could otherwise name its price. However, at the moment the only mechanism available to the Authority is the UTS.
15. In Meridian's view, in light of the above the Authority can and should find a UTS has occurred given that:
- (a) transient market power has been used in an extreme manner by a net pivotal generator in circumstances where there was no energy or capacity shortage;
 - (b) in the absence of a UTS, participants are likely to lose confidence in the integrity of the market because prices are divorced from efficient supply-demand conditions and excessively higher than underlying costs. This could result in both inefficient investment signals and inefficient consumption by individual consumers, as well as reducing the potential level of demand-side management through deterring demand-side participation in the wholesale market;
 - (c) unless the interim prices are remedied, the reputation of the market may be damaged to the point where trading is threatened and the adverse financial impact on some parties may preclude the orderly trading and the proper settlement of trades;
 - (d) unless a UTS is declared, rent-seeking incentives are created for all participants to take advantage of transient market power, resulting in a reduction of the dynamic efficiency and wider credibility of the New Zealand electricity market; and
 - (e) implicitly sanctioning this kind of behaviour will ultimately lead to higher prices for consumers, because participants will have no choice but to pass on the economic rents collected by net pivotal generators.

Analysis of Genesis's submission

16. Aside from the legal arguments set out above, Genesis's principal submissions as to why there is no UTS are that:
- (a) contrary to the draft decision, there was no "price squeeze" ([49-51]);
 - (b) prices on 26 March just reflected the normal operation of supply and demand ([71-72]);
 - (c) price spikes are an essential feature of an efficient spot market and signal the need for investment as well as allowing generators to recover fixed costs ([29]);
 - (d) market participants should have been aware of the risk of higher prices and should have hedged accordingly ([65-67]); and
 - (e) finding a UTS in these circumstances rewards poor risk management, and would have a range of undesirable consequences including risking creating a

moral hazard whereby those exposed to the spot market socialise their losses while retaining their profits.

17. Meridian comments on these submissions as follows:

(a) *Price squeeze*

As we have previously submitted, the concept of a price squeeze is not a necessary part of or a substitute for the application of the UTS test in the Code. The technical requirements of a price squeeze are not relevant in this case.

(b) *Normal operation*

Although the prices of 26 March resulted in a technical sense from the interaction of supply and demand, in an economic sense they resulted from a situation where a participant could name its price and (as set out in paragraph 11) choose to offer at an unprecedented level. It is this exercise of transient market power that lies at the heart of the reason 26 March was a UTS.

(c) *Price spikes an essential feature*

The issue in this case is not whether price spikes are an essential feature of an efficient spot market, but whether price spikes *caused by the exercise of transient market power* with no view to the public interest, integrity and reputation of the wholesale electricity market are necessary to ensure efficient investment or recovery of costs. As discussed above, this was not a "normal" price spike as might result (for example) from natural risks such as weather events or fuel availability, but was rather the result of extreme use of transient market power.

It is odd to suggest that generators with transient market power should have unconstrained ability to take advantage of that power, or that the resulting price outcomes are an essential feature of an efficient spot market.² Rather than signalling the need for investment, as set out by Professor Evans such outcomes are likely to result in a loss of dynamic efficiency. That is, there is no reason to think that high prices caused by the illegitimate exercise of transient market power are necessary to ensure efficient investment or recovery of costs. Investment has occurred in New Zealand in the past without the need for any such illegitimate exercise of market power, and many overseas countries have market power mitigation regimes.

(d) *Buyers should have hedged*

Meridian disagrees that market participants should have been aware of the risk of higher prices. Based on the information observable at the time, until it was too late there appeared to be little more occurring than adjustments to offers that may or may not have constituted real intent. That is, Genesis did nothing other than submit its offers and remain quiet. Although the events of 26 March are obvious to all with the benefit of hindsight, and (as Meridian has previously submitted) advance warning is not relevant in any case, it is worth pointing out that market participants had no reason to believe that Genesis was about to take advantage of its market power in the unprecedented manner that it did. For example, Contact's actions in withdrawing Stratford presumably show that it cannot have thought that prices were going to be as high.

² We note that offers at \$20,000/MWh extended to e3p as well as Huntly units 1-4.

Meridian also rejects Genesis's suggestion that it is imprudent for end-users to have spot market exposure and that such customers are somehow at fault for electing supply that is priced in this way. The reality is that customers have a right to choose the products that best fit their business model. All customers can possibly be blamed for expecting spot market participants to act reasonably and not abuse any transient market power they may have.

In any case, it is no answer to say that the risk of high spot prices can be managed in the hedge market when those high prices are a result of transient market power. When high prices result from market power, hedge prices will also reflect market power - the same rents are extracted, but in a different way. This is illustrated by:

- (i) the hedge prices offered by Genesis to Meridian mid-afternoon on 26 March (\$10,000/MWh) - noting that both Genesis and Contact had earlier refused to offer Meridian hedges at all; and
- (ii) the events of 2 April (and now 14 May), which show that Genesis has been collecting rents by offering hedge cover, allowing it potentially to lock in premium prices on 100% of its Huntly capacity (in place of achieving a higher spot price but on a smaller portion of its capacity).

That is, it makes little sense to suggest that it is prudent, efficient or reasonable practice to hedge with the party that could and in this instance did set excessive prices.

18. In terms of the final submission, Genesis asserts that finding a UTS in these circumstances:
- (a) rewards poor risk management and reduces incentives to hedge;
 - (b) risks creating a moral hazard whereby those exposed to the spot market socialise their losses while retaining their profits;
 - (c) creates uncertainty by setting a "low bar" for a UTS; and
 - (d) will potentially have an adverse effect on new investment in peaking plant.
19. In Meridian's view, these submissions carry little weight:
- (a) As above, it makes little sense to suggest that it is prudent to hedge against excessive prices, and therefore little sense to suggest that prudent risk management practices will be affected if a UTS is declared.
 - (b) Similarly, there can be no "moral hazard" created by mitigation of market power. That is analogous to suggesting that burglars should not be jailed, because otherwise homeowners won't be security conscious.
 - (c) Any uncertainty about what is or is not a UTS going forward will be limited to a consideration of what offer prices are appropriate when a generator is net pivotal. If that results in uncertainty, then it is uncertainty that falls only on the generator with the market power. Previous market prices will provide guidance, and, in the period before any Code amendments are developed, any uncertainty is likely to be of limited consequence.
 - (d) There is no reason to think that efficient new investment will be deterred by this ruling.

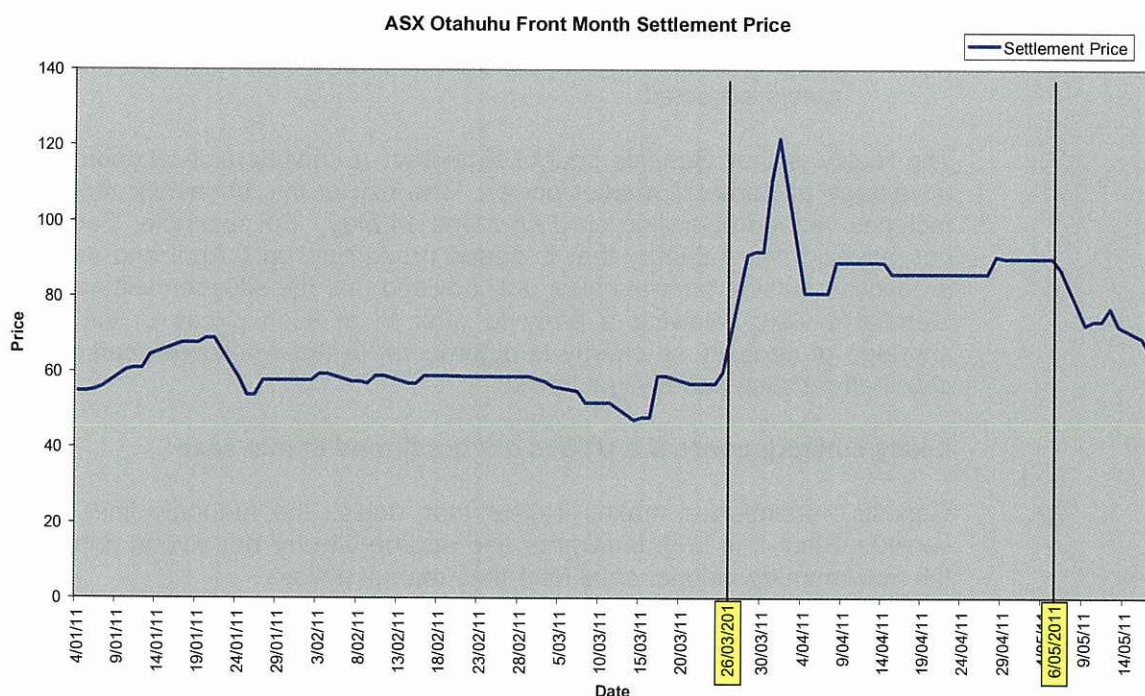
20. In summary, Meridian does not consider that the events of 26 March represented "normal" trading. In Meridian's view:
- (a) the ability to set an arbitrarily high price cannot be said to be an equilibration of supply and demand in any meaningful sense;
 - (b) similarly, there is no economic justification for spot-exposed end users to face the risk of incurring a month's worth of average electricity charges in a 7 hour period in the absence of any shortage of capacity or energy; and
 - (c) hedging does not avoid the problem, but merely shifts the means by which the rent is extracted.

21. The reality is that Genesis sought to extract a considerable economic rent by taking advantage of transient market power. The risk of this behaviour recurring meant that factories ceased operation on 2 April and 14 May. For example, Goodward Industries has advised the Authority that it closed production on 2 April and will not commence production outside normal hours until advised that the situation will not occur again. In Meridian's view, allowing a party to offer in at such prices in the absence of any shortage of capacity or energy is detrimental to the wholesale market - New Zealand can ill afford such deadweight losses.

Likely consequences if a UTS is not confirmed in this case

22. Genesis's submission makes it clear that, unless the Authority finds a UTS, Genesis considers that it is both legitimate and appropriate for net pivotal generators to extract the maximum economic rental from their market power.
23. In Meridian's view, it follows that, should a UTS not be declared, it will be a case of "anything goes" - that is, extreme use of transient market power will become an established feature of the electricity market. If there is no consequence for such behaviour, then it would be irrational for generators not to consider doing so, particularly when they would be feeling the pinch from being charged economic rents by other participants in that position.
24. It is difficult to predict exactly what the future would hold in this scenario, but it can safely be assumed that, because being net pivotal would attract economic rents, generators would actively seek that position. This could result in bidding strategies designed to increase the prospect of being net pivotal, or more structural changes where generators seek to shed customers in order to improve their chances of being net pivotal. As noted in the draft decision (Box 1 after [107]), it is relatively common for a generator to be pivotal - currently, being net pivotal is less common, but that could easily change if there are rents to be extracted.
25. Situations such as appeared to be the case between Contact and Genesis on 2 April where both offered upper North Island generation at prices close to \$20,000/MWh - could also become more common. That is, it may become increasingly common to see behaviour that would not be expected to be observed in workably competitive markets. This would be an extremely negative development for both competition in and the efficiency of the New Zealand electricity market.
26. Whatever the outcome, it is clear that:
- (a) it would be unsafe to assume that the relative frequency of net pivotal situations in the past would be repeated in the future - generators would have every incentive to engineer situations of transient market power; and

- (b) the economic costs would be borne by consumers, either through higher spot prices or higher hedge or contract prices. In this regard, it is relevant to note that, when the Authority's draft decision was released on 6 May, there was an immediate and significant drop in OTA ASX futures contract prices (see graph below) - clearly indicating that the market's view is that restrictions on inappropriate exercise of transient market power via the UTS regime are likely to result in lower spot prices.



Note that:

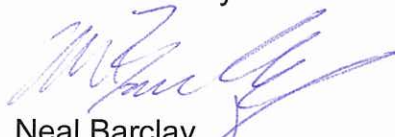
- (i) the price rise following the events of 26 March was even more abrupt than shown on the chart, which is a piecewise linear plot linking daily settlement prices;
- (ii) the apparent fall in price on 1 April was caused by the change of front month contract (i.e. from the March 2011 to the June 2011 contract).

Proposed remedy

27. As set out in our previous submission, Meridian would support a remedy which normalises prices for the relevant trading periods.
28. Genesis's position is that:
- the remedy proposed by the Authority would set a precedent that effectively amounts to a price cap, which would be contrary to the Authority's statutory purpose;
 - the Authority should not cap prices or administer offers when there was no manifest error and the market operated in accordance with the Code, and no inappropriate conduct from participants (to do so would cause uncertainty in the operation of the markets in the future);
 - the uncertainty of outcome and absence of opportunity to change offers may turn net producers to net buyers, who would incur significant penalties; and

- (d) the price range proposed by the Authority is significantly lower than the \$20,000 VoLL used in the grid investment test.
29. Meridian agrees with Genesis that, in the context of a UTS investigation, the Authority should refrain from setting prices at what the Authority considers the "right" level or prescriptively describing the boundary between acceptable and unacceptable offers.
30. However, in Meridian's view:
- (a) It would be inappropriate to refer to VoLL as suggested by Genesis given that the current UTS investigation deals with issues and situations which are quite distinct from those being considered in the Authority's scarcity pricing consultation.
- (b) In addition, the use of VoLL or LRMC would be unnecessarily punitive to customers given that there was no energy or capacity shortage. Meridian is not suggesting that the Authority speculate what prices would have been. While participants may not be able to change offers in response to the proposed reset Huntly offers, there is a need for a workable and practical solution that does not encourage similar situations in the future. Normalising prices by adjusting the offers of the participant causing the UTS would be a simple remedy to the "mischief".
31. Meridian maintains that prices should be reset to something close to what they would have been under normal trading at the relevant nodes. Normalising prices in such a way would not be setting a price cap - it would just be returning to an outcome consistent with a competitive market.
32. If you have any questions regarding this cross submission please contact either myself or Gillian Blythe (gillian.blythe@meridianenergy.co.nz, mobile 021 388 469).

Yours sincerely



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