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Submissions
Electricity Authority
PO BOX 10041
WELLINGTON

To whom it may concern,

Proposed actions to correct an Undesirable Trading Situation that occurred on 26 March 2011

Introduction

1. Vector is submitting in response to the Electricity Authority's (Authority) decision to declare an undesirable trading situation (UTS) for parts of 26 March 2011 and the consequent consultation paper "Proposed actions of the Authority under Part 5 of the Electricity Industry Participation Code to correct an Undesirable Trading Situation that occurred on 26 March 2011", 15 June 2011.

2. While Vector is not directly impacted by the UTS decision we have some major concerns about it; in particular:

    a. Vector is a major investor in electricity infrastructure and requires regulatory certainty across the whole supply chain to minimise its regulatory risk. The UTS decision will heighten the perceived regulatory risk and uncertainty of investing in the New Zealand electricity sector;

    b. Vector believes insulating market participants from poor commercial decisions[1] sets a bad precedent which will encourage future lobbying and UTS complaints; and

    c. While Vector considers the use of a workably competitive market test to be a useful tool, Vector is concerned about the way the Authority has applied it and the implications this has for other Authority decisions.

3. No part of our submission is confidential and we are happy for it to be publicly released.

[1] Submissions on the UTS are stark in that those participants that acted prudently objected to the draft UTS decision and those that did not supported it.

Was there a UTS?

4. Vector does not believe there was a UTS on 26 March and was somewhat surprised by the Authority’s decision.

5. Vector agrees with Genesis Energy that “the Authority's decision rewards businesses who made poor commercial decisions about exposure to the wholesale spot prices, while at the same time penalising a number of supply and demand side participants who took action during the event to manage their risk.”[2] Vector also agrees with Mighty River’s previous criticism of the Electricity Commission for “subsidising/rewarding generators and large-users who did not take out adequate hedge cover, incentivising the same behaviour in the future”.[3] Vector finds it interesting that Mighty River has now taken the opposite view, after finding itself exposed due to inadequate hedge cover. Vector points this inconsistency out, in the interests of transparency, as it is suggestive that the positions held by some parties are driven by their short-term commercial positions and opportunistic behaviour at the expense of the efficient long-term operation of the wholesale electricity market. A review of the submissions made to the Authority did not disavow Vector of that view.

6. Electricity retailers and large end-users could have readily avoided exposure to high prices, whether adequately forewarned or not, through prudent risk management, including the use of hedges etc. Many market participants such as Norske Skog in fact did take out adequate hedge protection. Norske Skog pointed out that "the draft UTS decision penalises those who have taken prudent risk management steps and entered into hedge contracts, and rewards those who have not."

7. Exposure to the spot market is a commercial decision and risk that should not be socialised amongst other market participants. All market participants are aware that the very nature of the electricity industry in New Zealand means there will be periods of time (eg during dry years and transmission constraints) where generators will be in a net pivotal position and rational profit maximising behaviour can result in higher prices. Reliance on a “gentlemen’s agreement”, as suggested by Meridian, is not an appropriate risk management strategy.

8. It would appear that market participants that had left themselves financially exposed learnt from their mistake and hedging activity accordingly increased after 26 March. This is what should be expected from a workably competitive market.

[2] Genesis Energy press release “Genesis Energy responds to Authority final UTS decision”, 15 June 2011.
[3] Paragraph 28 of Mighty River Power’s “Submission to the Electricity Commission on: Market Design Review – Options Paper”, 8 September 2008.

Implications of the UTS decision for identifying other UTSs

9. The UTS decision is consistent with the findings of the Commerce Commission's "Investigation Report" 21 May 2009 into electricity generation pricing, and the related "Wolak Report".[4]

10. The Commerce Commission found that:[5]

> "… each of the four largest gentailers - Contact, Genesis, Meridian and Mighty River Power - is likely to have held substantial market power on a recurring basis, particularly during dry years", with Professor Wolak concluding that "there are at least three sustained periods of between three to six months in duration during our sample period [2001 to mid-2007] when the average difference between actual prices and competitive benchmark prices is extremely large."
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> "Each of these companies has the ability and incentive unilaterally to exercise market power and increase wholesale prices during certain periods. The price increases in dry periods are well above any increases in input costs, including the higher opportunity cost of water when hydro storage is low."
>
> "By comparing the actual wholesale prices with hypothetical competitive benchmark prices, Professor Wolak estimated that the wholesale prices charged over the period 2001 to mid-2007 resulted in an extra $4.3 billion in earnings to all generators over those that they would have earned under competitive conditions. This suggests that wholesale prices were, on average, 18 per cent higher than they would have been if the wholesale market had been more competitive, and the gentailers had not been able to exert market power. Less competition was especially evident in the wholesale market during the dry years of 2001 and 2003, when additional earnings attributable to the exercise of market power are estimated at $1.5 billion in each of those years."

11. Essentially both the Commerce Commission and Authority UTS decision found that there were periods when generators had substantial market power which, when combined with a net pivotal supplier position, resulted in extremely high prices that were well above competitive levels. Prime facie this would suggest that there could be a lot more UTSs, than just 26 March 2011.

12. The arguments presented in submissions in support of declaring a UTS could generally be adopted in support of declaring the periods of extremely high spot prices identified by the Wolak Report as also being UTSs. For example, Mighty River's cross-submission on the UTS draft decision expresses concern about (i) generators being in a net pivotal position; and (ii) being able to "charge whatever price it likes in the wholesale markets (and by extension hedge markets) and to

[4] Commerce Commission media release "Commerce Commission finds that electricity companies have not breached the Commerce Act", 21 May 2009.

[5] Frank Wolak "An assessment of the performance of the New Zealand wholesale electricity market", 19 May 2009.

somehow think that this doesn't constitute a UTS."[6] This is exactly the situation described in the Wolak Report.

13. Similarly, Meridian state "While prices above SRMC are necessary for the recovery of fixed costs, there is no reason to think such prices caused by the taking advantage of transient market power and necessary to ensure efficient investment or recovery of costs."[7] Somewhat contradictory, but entirely aligned with the Wolak Report Meridian argue spot prices should be capped at SRMC "final prices should be based on what they would have been in normal trading circumstances and should approximate SRMC not LRMC."[8] This is consistent with the tests used by the Wolak Report to identify excessive prices.

14. The only difference of substance is that while generators generally benefit from spot prices being higher than competitive market levels Meridian and Mighty River left themselves financially exposed in this particular instance.

15. The only basis for making a distinction between Wolak's findings and 26 March, as far as Vector can see from the Authority's decision, is if:

    a. there is a (presently undefined) threshold whereby prices in excess of workably competitive market prices are acceptable as long as they are not too far in excess; and

    b. it is acceptable for prices to be "exceptionally high" and well in excess of the price levels justified by scarcity so long as there is "genuine scarcity".

16. Vector would not consider these to be sound distinctions for the Authority to rely on. They would be akin to arguing that it is acceptable to burgle a house as long as you do not take too many possessions (point a.) or you have done so because you are poor and starving (point b.).

Concerns about the implications of the decision

17. Contrary to the views expressed by the Authority, Vector considers that the UTS decision creates uncertainty around regulation in the New Zealand electricity sector.[9]

18. We agree with the view expressed by Trustpower that: "The need for (and use of) intervention creates massive uncertainty for market participants, which only serves to deter long-term commitment to the market and decrease its efficiency. If such events in future lead instead to further UTS claims, settled by further

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[6] Paragraph 1b of Mighty River Power's "UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011", 19 May 2011.
[7] Paragraph 2f of Meridian's "Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission", 19 May 2011.
[8] Paragraph 2f of Meridian's "Draft Decision regarding alleged UTS on 26 March 2011", 13 May 2011.
[9] This is likely to have a negative impact on the Government's plan to partially privatise Genesis Energy, Meridian Energy and Mighty River Power.

arbitrary price capping, then that in itself is a considerably undesirable situation."[10]

19. Vector is particularly concerned about the Authority's approach to the concept of a workably competitive market. The Authority's decision to cap spot prices suppresses workably competitive market dynamics.

20. The most likely outcome of Genesis Energy's strategy would have been a better understanding of the need for prudent risk strategies, stimulation in interest in the hedge market and encouragement of new entry into the generation market. Market participants that failed to take out adequate hedge arrangements would have incurred a financial loss, which they would not have been able to recover through higher prices, putting them at a competitive disadvantage compared to competitors who acted more prudently. These are all desirable outcomes consistent with the outcomes of a workably competitive market. In a workably competitive market firms are not compensated by the regulator for losses they incurred when they make poor business judgements.

21. Vector does not believe UTSs should be used as a form of price regulation to address transient market power. Problems of transient market power should be dealt with through policies aimed at promoting greater competition and removing impediments to market entry. Vector agrees with Mighty River that "Regulatory intervention should be limited to addressing durable market failures; and should aim to address the market failures as directly as possible, i.e. address the causes of the problems rather than just the symptoms."[11] By regulating spot prices on 26 March the Authority is addressing the symptom (high prices) only and doing nothing to rectify the cause of the problem (the existence of transient market power).

22. Mighty River Power has previously commented that "Consideration of market power issues would normally fall under the jurisdiction of the Commerce Commission."[12] The tests for whether price control should be introduced under Part 4 of the Commerce Act were amended in 2008 to reflect that price control should not be introduced where competition could develop. The competition test changed from "the goods or services are, or will be, supplied or acquired in a market in which competition is limited or is likely to be lessened" to "the goods or services are supplied in a market where there is both (i) little or no competition; and (ii) <u>little or no likelihood of a substantial increase in competition</u>".

23. By using the UTS mechanism as a way of capping spot prices, however tightly defined the circumstances are, the Authority has concluded Genesis Energy's

[10] Trustpower "Draft decision regarding an alleged UTS on 26 March 2011 – Trustpower submission", 13 May 2011.
[11] Paragraph 20 of Mighty River Power's submission "Market Design Review: Issues Paper - Survey of Market Performance", 22 July 2007.
[12] Mighty River Power "Submission to the Finance and Expenditure Committee on the Electricity Industry Bill 2009", 26 February 2010.

conduct gave rise to undesirable prices ("inconsistent with the requirements of a workably competitive market"[13]) and this is sufficient justification for the prices to be unwound.

24. There should be no presumption that just because prices or behaviour is "inconsistent with the requirements of a workably competitive market"[14] that regulatory intervention is warranted as any regulation comes at a cost. The approach the Authority signals a low and uncertain threshold for future regulatory intervention. This will heighten the risk for investment and entry in the electricity industry, and, from an external perspective, increases the cost of funding from offshore investors.

25. The UTS decision has undesirable implications for the operation of the electricity market.

26. Vector is very concerned about the implications of the decision for peaking plant, including Genesis Energy's Huntly power station. Genesis has previously indicated that Huntly power station may not be commercially viable. The Authority's UTS decision is liable to further damage the viability and could result in it being moth-balled earlier than otherwise. This could place security of supply into the Auckland electricity market at risk. It could also, perversely, result in higher average spot market prices. Neither outcome would be to the long-term benefit of end-users.

27. The Electricity Commission has previously pointed out that regulatory intervention that suppress spot prices (such as pricing Whirinaki below SRMC) could mean generators (or potential generators) "may be concerned that they will not recover their total costs during short periods of high spot prices".[15] The Electricity Commission's Market Design Review Options Paper made multiple references to the need for "spot prices reaching high levels (albeit for short periods)".[16] Vector doubts the Authority's distinction between high prices due to "genuine shortage" and due to transient market power would alleviate such concerns, particularly as it is not clear how such a distinction would be made in practice.

28. Vector is also concerned about the moral hazard implications of the Authority's decision. Vector was surprised that some large gentailers choose to expose themselves to such high commercial risk (Mighty River claimed they would incur a loss of $25m off full-year profits). The fact that the Authority has responded to retailers and end-users that did not take out adequate hedges, by removing a set of high prices they were exposed to as a consequence, will dampen future

[13] Paragraph 19 of the Authority's "Questions and Answers relating to the Authority's decision that the events of 26 March 2011 constitute an undesirable trading situation (UTS)".
[13] Paragraph 13 of MEUG's submission to the Electricity Commission "Submission on appropriation proposal for reserve energy", 2 July 2008.
[14] Paragraph 19 of the Authority's "Questions and Answers relating to the Authority's decision that the events of 26 March 2011 constitute an undesirable trading situation (UTS)".
[14] Paragraph 13 of MEUG's submission to the Electricity Commission "Submission on appropriation proposal for reserve energy", 2 July 2008.
[15] Paragraph 295 of the Options Paper.
[16] Paragraph 329 of the Options Paper.

incentives to take out hedges. Vector accordingly does not agree with the Authority that "the interim prices for 26 March would undermine the hedge market …"[17] Vector believes the opposite is true and agrees with Genesis Energy that "This decision tells wholesale market participants and contracted parties to take risks without facing the consequences of their actions."[18]

29. Vector is reminded of the comments made in relation to the Electricity Commission's strategy of pricing Whirinaki below SRMC which we consider to be salient to the UTS decision. MEUG expressed concern that the Electricity Commission's strategy "creates … inefficient incentives to hedge, invest or change behaviour to offset price risks by altering the financial consequences of not doing so."[19] Contact Energy also observed "large industries are likely to believe that the Electricity Commission will now step in to suppress prices in future tight supply periods. They are therefore less likely to take appropriate actions such as hedging their risk or building in flexibility into their operations to be able to reduce demand."[20] The UTS decision will only serve to heighten such views.

30. The Authority has suggested that "Had electricity consumers been aware of the exceptionally high prices in advance, they would have, in many instances, reduced demand or secured other sources of generation, as occurred on Saturday, 2 April 2011, at the prospect of a repeat of the exceptionally high prices of 26 March." It is precisely this kind of uncertainty which hedges are designed to protect against.

31. Likewise, a key part of the Authority's decision was that "parties exposed to those spot prices had good reason to believe Genesis Energy's offer prices would not translate into spot market prices". "Good reason" does not translate to "surety" or "guarantee" which, again, could have been obtained by taking out hedge contracts. It is disappointing that the Authority, on the one hand, expresses concerns that Genesis Energy's actions were inconsistent with a workably competitive market but, on the other hand, was concerned that Genesis Energy had not given its competitors adequate warning of its actions. It would be highly unusual, and certainly inconsistent with outcomes of a workably competitive market, for one firm to warn its competitors of actions that may be to their detriment.

32. The Authority has, effectively, penalised prudent electricity retailers and end-users who took out hedge contracts or responded to the potentially high prices through demand-side management. Vector is sure some of these market participants will regret such actions, given the final price of $3,000MWh rather than $20,000/MWh and this will have implications for their future decisions.

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[17] Paragraph 29 of the Authority's "Questions and Answers relating to the Authority's decision that the events of 26 March 2011 constitute an undesirable trading situation (UTS)".
[18] Genesis Energy press release "Genesis Energy responds to Authority final UTS decision", 15 June 2011.
[19] Paragraph 13 of MEUG's submission to the Electricity Commission "Submission on appropriation proposal for reserve energy", 2 July 2008.
[20] Page 4 of Contact Energy's "Submission to the Electricity Commission on its Proposed Appropriation Change: Reserve Energy and Emergency Measures: June 2008", 2 July 2008.

33. The Authority has created uncertainty about what pricing strategies, and what level of prices, in the wholesale market will be acceptable to the Authority. This is likely to have negative implications for investment decisions, bid strategies in the spot-market, demand-side management and the development of the hedge market.

Actions the Authority should take

34. Vector believes, if the UTS decision is to stand, the Authority should provide clarity around the following matters:

    a. Would the Authority consider the periods of time where the Wolak Report alleged there was excessive pricing in the wholesale electricity market to be UTSs?

    b. What price is an "exceptionally high price"?

    c. How long do market participants need to be forewarned of the potential for exceptionally high prices to avoid a UTS?

    d. What is the definition of "genuine scarcity"?

    e. In a scarcity situation, would the Authority declare a UTS if it considered prices went above that which could be explained by the scarcity? How would the Authority make the distinction?

35. The Authority has stated that part of the (alleged) problem was caused by "inaccurate forecast market prices (caused by inaccuracies in the underlying demand forecasts used to generate them)".[21] It would seem reasonable to conclude that the Authority should take action to improve the accuracy of its forecasts, or at least preface its forecast with a warning that market participants that rely on the Authority's forecasts, rather than their own, do so at their own risk.

36. Vector also believes, the level of financial exposure some retailers and end-users were willing to leave themselves vulnerable to, has direct implications for the level of prudential requirements that are appropriate for the wholesale electricity market and use-of-system agreements. A number of submissions have stated that the high prices could give rise to solvency issues for participants. Even with the Authority's decision to compensate participants that did not take out prudent levels of insurance, these participants would presumably be exposed to exactly the same risk in relation to high prices arising from scarcity (which the Authority would presumably not deem to be a UTS).

[21] Paragraph 12 of the Authority's "Questions and Answers relating to the Authority's decision that the events of 26 March 2011 constitute an undesirable trading situation (UTS)".

37. Just as a car owner who does not take out car insurance exposes other road-users to greater financial risks, participants that do not take out adequate hedges to protect themselves against high spot prices create risks for other market participants, including Electricity Distribution Businesses who face risk that retailers and direct connection customers may not be able to pay their distribution charges.

Concluding remarks

38. If 26 March is a UTS then it would be logical to argue that the Commerce Commission's Wolak Report was fundamentally right, and that the large gentailers take advantage of transient market power to extract high prices in the spot market when they are in a net pivotal position. The Wolak Report identified periodic excess pricing in the generation market with accumulated rents of $4.3 billion over less than 10 years. Each of these periods could be UTSs too so surely this must be revisited or justified as to why these situations were not taken into account. From a consumer perspective the Authority should relook at all previous situations as reported by the Commerce Commission.

39. Vector considers it to be undesirable for the Authority to protect retailers and large end-users from high spot prices when they could have done so themselves through prudent use of hedge products. The Authority should not have any sympathy for market participants that expose themselves to excessive spot market risk and then complain about outcomes unfavourable to their commercial interests.

40. Vector considers the Authority has misapplied a workably competitive market test to its statutory objective.

41. The Authority has stated that exceptionally high prices arising from transient market power is inconsistent with a workably competitive market, while failing to consider whether the response to those prices would be consistent with the outcomes of a workably competitive market or not.

42. If the interim prices were left intact, Vector would expect to see the following outcomes all of which would be consistent with a workably competitive market:

    a. Investment in new electricity generation would be attracted which, over-time, would limit the potential for transient market power;

    b. Those firms that did take a prudent approach to risk management would have a competitive advantage over those that did not; and

    c. Demand for hedge and other insurance products would be encouraged (as evidenced by the change in market behaviour post 26 March).

43. The Authority's decision to cap spot prices suppresses these workably competitive market dynamics.

44. Furthermore, the Authority appears to assume that taking regulatory intervention on the basis that outcomes are "inconsistent with the requirements of a workably competitive market" is justified on the grounds of consistency with the Authority's interpretation of its statutory objective. This can only be true if regulatory intervention is costless otherwise, the costs could outweigh the benefits to end-users. The Authority's approach signals a bias towards regulation.

45. This is likely to create a bias in favour of regulation and liable to heighten the perceived regulatory risk from investing in the electricity industry.

46. If the Authority has any queries regarding Vector's submission or would like further information please contact Robert Allen, Senior Regulatory Advisor, on 04 803 9036 or robert.allen@vector.co.nz.

Kind regards

Bruce Girdwood
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