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16 September 2013

Mike Collis
Electricity Authority
2 Hunter Street
WELLINGTON

By email: submissions@ea.govt.nz

Dear Mike

Simplification does not necessarily equate to market efficiency

Genesis Energy Limited welcomes the opportunity to provide a submission to the Electricity Authority ("the Authority") on the consultation paper titled "Removal of the in-band frequency keeping constrained on and off compensation" dated August 2013.

Genesis Energy supports the Authority promoting market efficiency towards the frequency keeping market, however, until a comprehensive cost benefit analysis has been completed we are unable to support the current proposal. This is because the proposed simplification is likely to:

1. Fail to facilitate market efficiency as the frequency keeping market's cost components become less transparent to the market.
2. Impose new costs on all market participants as participants need to modify their systems to reflect the changes.

We discuss these issues in more detail below. Our responses to the specific questions are outlined in Appendix A.

Cost structure becomes less transparent and efficiency gain is questionable

In the view of Genesis Energy, it is very important for there to be transparency of the underlying cost structures in the electricity market. Participants need to understand cost structures when they interact in the market – be it when they offer services or when they purchase services.

The current proposal bundles two of the three cost frequency keeping cost components into one. In our view, this “bundling” will significantly reduce the transparency in the frequency keeping market’s cost. The in-band frequency keeping constraint on and off compensation is very difficult to estimate accurately *ex ante*. This is because it is an inherently volatile cost, as it largely depends on the market demand and the system operator’s dispatch behaviour in a given period. Therefore, estimates are unlikely to represent the actual “in-band” cost of providing frequency keeping service.

The bundled costs components are also inherently different. The availability fee is a relatively static cost, whereas the in-band cost is volatile. Combining these different costs into one will reduce the ability of market participants, and the Authority, to understand how those individual costs influence electricity prices.

The proposal imposes new costs on all market participants.

We strongly suggest the Authority conducts a more comprehensive cost benefit analysis before any code amendment is approved. This comprehensive cost benefit analysis should take into account implementation costs for participants, as well as the potential market inefficiencies.

In our view, the cost for market participants to modify their systems to reflect the new methodology will not be insubstantial. The current proposal simply shifts the operational complexity from the system operator to industry participants. This imposes new implementation costs on participants – such as adjusting IT systems, developing new strategies for the complexity and adding additional managerial inputs. New on-going costs, such as the time required to make more-complex frequency keeping bids, will also add up across participants.

At the very least, these implementation costs need to be taken into account in the Authority’s cost benefit analysis. In the case of where there is no or only marginal benefit, these costs may be determinative for the Authority when considering whether the proposal is appropriate.

If you would like to discuss any of these matters further, please contact me on 04 495 6357.

Yours sincerely



Daisy Shen

Regulatory Advisor

Appendix A: Responses to Consultation Questions

QUESTION	COMMENT
<p>Q1: Are there any interdependencies between the timing of the introduction of MFK in the North and South Islands and the date when the Code amendment proposal should be brought into effect?</p>	<p>If the code amendment is implemented, we suggest such changes to be implemented simultaneously for both the North Island and the South Island.</p>
<p>Q2: Do you have any comments on the Objective of this Code change proposal?</p>	<p>Please refer to the cover letter.</p>
<p>Q3: Do you think there is a reduced incentive for the generators to participate in the frequency keeping market after the proposed amendment?</p>	<p>Unintended consequences of this change may further dis-incentivise the generators during peak periods.</p> <p>The proposal allows market participants to build their in-band frequency constraint on and off compensation into the availability fee. As such, the market price no longer will be required to reflect two different cost components. In our view, this could potentially push the market price higher.</p> <p>Under the proposed simplified approach, it is likely that the risk premium will be higher during high cost trading periods to reflect the increased risk exposure between energy reserve and frequency markets. If these costs are not likely to be recovered in the frequency market, the generators would be less inclined to participate in that market. Consequently, there is a risk that the simplification may reduce the competition in the frequency keeping market.</p>
<p>Q4: Do you have any comments on the</p>	<p>As noted in our cover letter, in our view</p>

<p>assessment presented?</p> <p>Q5: Are there any additional costs or benefits that need to be considered?</p>	<p>the cost and benefit assessment is too generic and not specific enough to justify the proposed changes.</p> <p>In our view, the Authority must conduct a more comprehensive cost benefit analysis as part of any code amendment proposal.</p>
<p>Q6: Are there any other alternatives the Authority should consider apart from the status quo?</p>	<p>No.</p>
<p>Q7: Do you have any comments on the Authority's assessment of the proposed amendment against the requirements of section 32(1) of the Act?</p>	<p>Please refer to Q3.</p>
<p>Q8: Do you have any comments on the Authority's assessment of the proposed amendment against the Code amendment principles?</p>	<p>We do not have comments on the Principle 1.</p> <p>Please refer to the cover letter for the Principle 2 and 3 for more information.</p>
<p>Q9: Do you have any comments on the Authority's proposed code amendment?</p>	<p>It is too early to comment until an industry consensus is reached.</p>