

Wholesale Advisory Group

Chair's Half Yearly Report to the Electricity Authority Board

July to December 2013

15 January 2014

Note: This paper has been prepared for the purposes of the Wholesale Advisory Group. Content should not be interpreted as representing the views or policy of the Electricity Authority.

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1 Introduction

- 1.1.1 The Wholesale Advisory Group (WAG) was established by the Electricity Authority (Authority) in May 2011 to provide independent advice to the Authority on the development of the Electricity Industry Participation Code 2010 (Code) and market facilitation measures.
- 1.1.2 The role of the WAG is to investigate, analyse, and make recommendations to the Authority Board (Board) on the matters agreed to it in the WAG's work plan. The scope of WAG advice, as set out in its Terms of Reference, is to advise the Board on:
- a) the development of the wholesale electricity market, including the inter-related markets for energy (spot), ancillary services, and risk management contracts such as financial derivatives for energy and location hedges;
 - b) the development of provisions relating to reliable supply (which includes system security, reliability (security) of supply, and power quality), for the long-term benefit of consumers;
 - c) priorities for developing:
 - i) the Code especially in regard to Parts 4, 5, 7, 8, 9, 13, and 14; and
 - ii) market facilitation measures in regard to wholesale markets services; and
 - d) any other relevant policy matters in regard to wholesale markets services.
- 1.1.3 WAG's terms of reference require the Chair to report every six months to the Board on the Group's progress against its work plan. This is WAG's fifth half-yearly report, and it covers WAG's activities for July to December 2013.

2 Membership and meetings held

2.1 WAG membership during the reporting period

- 2.1.1 The Authority undertook an Advisory Group appointment process midway through the first half of 2013 (the previous reporting period). As a result of that process the Authority appointed a new WAG Chair (John Hancock), reappointed three existing members, and appointed two new members, all

for a term of two years. They joined the remaining members of the group whose terms extend into 2014 (refer Table 1 below).

- 2.1.2 The WAG was deeply saddened by the news of John Woods' passing in September¹. He was acknowledged as being a major contributor to the WAG and the industry and he will be sadly missed. The WAG made a donation to the Mary Potter Hospice in memory of John.
- 2.1.3 The current membership now stands at nine instead of ten. The Chair recommended (and the Board agreed) that the Authority review the number of members and the make-up of the group when three members' terms expire in August 2014.

2.2 Four WAG meetings were held during this reporting period

- 2.2.1 The WAG has met four times during the six month period covered by this report: on 30 July 2013, 5 September 2013, 17 October 2013 and 28 November 2013. Three meetings were held in Wellington, at the offices of the Authority, and one was held in Auckland at the offices of Genesis Energy. Table 1 gives details of WAG membership and members' meeting attendance for the four meetings covered by this report.

Table 1: WAG membership details for 1 January to 30 June 2013

Member	Affiliation	Start of term	Length	End of term	Meeting attendance
John Hancock (Chair)	Independent	April 2013	2 years	April 2015	4 of 4
Bruce Rogers	Pricing Manager, Orion New Zealand	May 2011 June 2013	2 years 2 years	June 2015	4 of 4
Neal Barclay	General Manager Markets and Production, Meridian Energy	May 2011 August 2012	1 year 2 years	August 2014	3 of 4

¹ John Woods had been granted a Leave of Absence from the WAG in April 2013 due to illness.

Member	Affiliation	Start of term	Length	End of term	Meeting attendance
John Carnegie	Manager, Energy, Environment and Infrastructure, Business NZ	May 2011 June 2013	2 years 2 years	June 2015	3 of 4
Graeme Everett	Energy Manager, Norske Skog Tasman	August 2012	2 years	August 2014	3 of 4
Alan Eyes	Energy Manager, NZ Steel	June 2013	2 years	June 2015	3 of 4
Chris Jewell	General Manager of Trading and Portfolio Manager, Genesis Energy	June 2013	2 years	June 2015	3 of 4
Stephen Peterson	Chief Executive, Simply Energy	May 2011 August 2012	1 year 2 years	August 2014	3 of 4
Richard Spearman	Operations Manager, TrustPower	October 2011 June 2013	2 years 2 years	June 2015	3 of 4
John Woods	General Manager, Wholesale, Contact Energy	May 2011 August 2012	1 year 2 years	Leave of Absence April 2013 position vacant from September 2013	-

2.2.2 At the invitation of the WAG Chair:

- Carl Hansen, Chief Executive of the Authority, attended the 5 September meeting in response to a request from the WAG to the Board for members to attend a WAG meeting to convey the context and priority of each of the projects being considered by WAG for its work plan. At that same meeting the Chief Executive also discussed with the WAG its desire to establish a set of principles to guide its approach to formulating advice to the Authority on Code amendments and market facilitation measures.
- Anne Herrington from Smart Power attended the 5 September meeting to discuss pricing alignment issues from the perspective of commercial consumers that have a substantial electricity spend and take an active interest in the prices they are charged.
- A representative from OMF (Daniel Crawford) attended the 17 October meeting to give a presentation on the growth of the futures market for electricity in New Zealand. OMF is a well-established foreign exchange, futures, options and equities brokerage firm.
- Lisa Dhanji of Transpower (system operator) continued her attendance (as invited observer) at WAG meetings.

2.3 The WAG has maintained the Interests Register as required by law

2.3.1 As required by the Crown Entities Act 2004, the WAG maintains an Interests Register. Members are required to disclose any interests to the Chair, and these are recorded in the register.

3 The WAG has completed its 2012/13 work plan and adopted its 2013/14 work plan

3.1 The WAG has now made final recommendations for all three of its 2012/13 work plan projects

3.1.1 This half yearly report is the third since the WAG embarked on its 2012/13 work plan which was agreed in July 2012 following discussions and correspondence with the Authority. It marks the completion of the WAG's 2012/13 work plan.

- 3.1.2 The WAG's work on each of these is briefly summarised here, and set out in more detail later in this report:
- a) **Pricing in pivotal supplier situations** – consultation on the WAG's discussion paper closed on 9 July 2013 and, after considering submissions, the WAG presented its final recommendations to the Board at its meeting on 2 October 2013. The WAG understands that Authority staff are considering the principles recommended by the WAG, testing their applicability to recent pricing events, and developing draft amendments to the Code.
 - b) **Aligning forecast and final prices** – a draft discussion paper was published on 9 July 2013 and submissions closed 23 August 2013. The WAG finalised its recommendations after considering submissions, and presented these to the Board at its meeting on 4 December 2013.
 - c) **National instantaneous reserve market** – the group decided the benefits of a national instantaneous reserve market were sufficiently clear not to require it to release a discussion paper. The WAG's recommendations were made to the Board at its meeting on 7 August 2013.

3.2 The WAG adopted three new projects for its 2013/14 work plan

- 3.2.1 With completion of its existing projects imminent, the Chief Executive presented six prospective projects to the WAG at its meeting of 5 September 2013. After some discussion with the Chief Executive (particularly the importance of each and the relative priorities from the Board's perspective) the WAG agreed to adopt the following projects as its work plan for 2013/14:
- a) Hedge market development
 - b) National market for frequency keeping
 - c) Investigation into alternative reserve arrangements.
- 3.2.2 The WAG has now received preliminary papers on each of these three projects and has begun its work. A brief description of each, and an update on progress, is set out later in this report.

3.3 The WAG maintained a watching brief on past projects

- 3.3.1 The WAG has also maintained a watching brief on the Authority's progress with the two earlier WAG projects through regular updates by Authority staff: the settlement and prudential security review (SPSR) and the wholesale market information project (WMIP).

4 Pivotal pricing project

4.1 Authority sought WAG advice in considering pivotal supplier situations

- 4.1.1 In recent times, some generators have offered and set spot prices at high levels when they have been in a pivotal position. A generator is pivotal when some or all of its generation is needed to meet demand in a region, and is net pivotal when these conditions hold, and it has a short term incentive to favour higher spot prices.
- 4.1.2 High prices are essential when they reflect genuine supply shortages but are of questionable value if they are caused by suppliers exploiting situations where competitive pressure is weak. The key issue with high prices during pivotal supplier situations is that they can undermine confidence in pricing outcomes – and cause efficiency losses as parties take actions to reduce their exposure to pivotal supplier risk.
- 4.1.3 The Authority requested the input and advice of the WAG in considering issues associated with pivotal supplier situations. The WAG agreed in July 2012 to add this project to its work plan.

4.2 Key milestones have been met and the project was completed ahead of time

- 4.2.1 The pivotal pricing project is one of the Authority's top priority market development initiatives, and is referenced as project number B2 in the Authority's 2013/14 work programme. The WAG completed its work on this project during this reporting period. It presented its final recommendations to the 2 October Board meeting, one month ahead of the November target. Key project milestones are recorded in Table 2.

Table 2: Pivotal pricing project – key milestones and target timetable

Activity	Dates	Status
WAG agreed to add project to its work plan	5 July 2012	Complete
Consideration of introductory paper	September 2012	Complete
Consideration of draft discussion paper	17 October 2012, 28 November 2012, 31 January 2013	Complete

Activity	Dates	Status
Authority Board given opportunity to comment on draft discussion paper	March 2013	Complete
Authority Board wrote to WAG suggesting some further issues to consider	April 2013	Complete
WAG consideration of further draft of discussion paper	8 May 2013	Complete
Discussion paper released	28 May 2013	Complete
Submissions due	9 July 2013	Complete
Consideration of next steps/recommendations	30 July & 5 September 2013	Complete
Recommendations presented to Authority Board	November 2013	Complete (in October)

4.3 Objective is to improve confidence in the efficiency of prices when competitive pressures are weak

4.3.1 The Authority's objective in requesting the WAG to consider these issues was

"to improve confidence in the efficiency of prices when competitive pressures in the wholesale market are weak, thereby contributing to the Authority's statutory objective by improving wholesale and retail market competition".

4.3.2 More specifically, the Authority has indicated that for an option to be effective, it should provide:

- consumers with more confidence about the efficiency of prices during pivotal supplier situations, and also
- investors with more confidence to charge prices they need to get a return on their last resort plant.

4.4 The WAG presented its final recommendations in October 2013 after considering submissions received on its discussion paper

- 4.4.1 The WAG discussion paper was published on 28 May 2013 and submissions closed on 9 July 2013, just before the start of this reporting period. Submissions were received from 11 parties.
- 4.4.2 Submitters generally agreed that the status quo was not sufficient to deal with efficiency concerns about pivotal supplier situations and that there was the potential for pivotal pricing behaviour to increase in the future. However, many submitters had reservations about, or were uncertain of, the potential magnitude of the efficiency losses from pivotal supplier situations. Submitters did not uniformly support any of the proposed options for addressing potential efficiency losses associated with pivotal supplier situations. However, the options with the greatest support were introducing a conduct provision into the Code, amending the Outage Protocol to include competition effects, and introducing a temporary capping mechanism on prices or offers in pivotal supplier situations.
- 4.4.3 After considering the issues raised in submissions and further discussion, the WAG finalised its recommendations to the Authority. The WAG Chair presented the group's final report² to the Authority Board at its meeting of 2 October 2013. The WAG recommended that the Authority:
- a) consider the introduction of a trading conduct provision within the Electricity Industry Participation Code 2010 (Code) that applies to gross pivotal suppliers following:
 - i) Principle 1 – all generating capacity expected to be physically available is offered when a plant has been committed to generate
 - ii) Principle 2 – intentions to make changes to offers (prices and/or quantities) should be submitted at the earliest opportunity (to minimise late changes that provide little chance for others to respond)
 - iii) Principle 3 – price and quantity pairs in offers are not materially different between adjacent trading periods, except where there is a bona fide physical factor that alters the participant's capability to generate electricity between those periods

² <http://www.ea.govt.nz/dmsdocument/15953>

- b) clarify the net benefit test used in the Outage Protocol (refer clause 12.150 of the Code) to ensure that competition effects can be taken into account when scheduling transmission outages
- c) consider the publication of information to participants on expected upcoming pivotal supplier situations
- d) continue the active monitoring of market performance during pivotal supplier situations
- e) consider other options if these measures do not adequately address concerns about pricing in pivotal supplier situations, in particular looking at temporary capping mechanisms on pivotal supplier offers or affected prices, and/or making the grid owner responsible for increased spot market costs arising from local pivotal supplier situations during grid outages.

4.5 Next steps

- 4.5.1 The WAG notes that Authority staff are considering the principles and testing their applicability to recent pricing events, which will culminate in a consultation paper proposing an amendment to the Code.
- 4.5.2 The WAG intends maintaining a watching brief on the Authority's progress with the next phase of the pivotal pricing project, and remains available to assist the Authority further as it progresses this initiative.

5 Pricing alignment project

5.1 Authority sought WAG advice in aligning forecast and settlement prices

- 5.1.1 Wholesale market participants receive a series of spot price 'forecasts' over different time horizons. These guide participants about the expected financial consequences of their actions. Actual payments between purchasers and suppliers are based on settlement prices calculated after real time, and these can differ markedly from forecast prices, especially during periods of tight supply. This may inhibit voluntary demand response and provide insufficient certainty to peaking generation stations.
- 5.1.2 In requesting that the WAG consider the potential problem of the misalignment between forecast and settlement prices, the Authority's objective was:

“To publish an economic price for reserve and electricity in advance of and during shortages so wholesale market purchasers and consumers can rely on prices published in the schedules during the widest range of supply situations. Improved forecast and settlement prices would contribute to the Authority’s statutory objectives by improving competition and reliability”.

5.1.3 The Authority further noted that:

“Being able to rely on the prices derived in forecast schedules and settling on a price derived from those provided before or during the trading period would increase investment in voluntary demand response. Greater demand response from consumers and retailers would reduce the prices experienced during tight supply conditions.”

5.1.4 The WAG agreed to add improving forecasting and settlement pricing to its work plan in July 2012.

5.2 The WAG has completed this project within the target timeframe set

5.2.1 This is another of the Authority’s top priority market development initiatives. It is project number B7 in the Authority’s 2013/14 work programme.

5.2.2 The WAG published its discussion paper on 9 July 2013, just before this reporting period commenced. Submissions closed on 23 August. After considering submissions, the WAG made its final recommendations to the Board in December 2013, thereby meeting the milestone of completion before the end of 2013. The key activities and target timetable are set out in Table 3.

Table 3: Pricing alignment project – key milestones and target timetable

Activity	Dates	Status
WAG agreed to add project to its work plan	5 July 2012	Complete
Consideration of an introductory paper	17 October 2012	Complete
Consideration of draft discussion paper	28 November 2012, 31 January 2013, 14 March 2013, 8 May 2013, 12 June 2013	Complete

Authority Board given opportunity to comment on draft discussion paper	3 July 2013	Complete
Discussion paper released (assumes no substantive comments received from Board)	9 July 2013	Complete
Submissions due	23 August 2013	Complete
Consideration of next steps/recommendations	5 September & 17 October 2013	Complete
Recommendations presented to Authority Board	4 December 2013	Complete

5.3 Authority's motivation is to promote competition by supporting demand-side participation where efficient

- 5.3.1 The New Zealand electricity spot market is settled on final prices that are published at least two business days after electricity is consumed. As a result, consumers that buy electricity on the spot market (or at a price that is linked to the spot price) cannot be certain what the price will be until after they have made their consumption decision.
- 5.3.2 To provide guidance about what the final price is likely to be, a series of spot price forecasts are published in the lead up to real-time. These include:
- prices from the price-responsive schedule (PRS) and non-responsive schedule (NRS), both of which are carried out every half hour for the next four hours, and every two hours for the next 36 hours; and
 - 'real-time' prices (RTPs), which are calculated every five minutes and indicate prices for the immediately preceding five minute period.
- 5.3.3 These short-term spot price forecasts are usually quite reliable, but they can occasionally be wildly inaccurate, particularly when the power system is under stress. The unreliability of short-term spot price forecasts discourages parties from responding to them. After buyers have observed several forecast errors, they may conclude that the benefits of responding do not justify the costs. It may also harm the business case and the operational efficiency of peaking generation stations.
- 5.3.4 This inhibits efficient demand side participation, which could substitute for additional generation and associated network investment. Potentially more

seriously, the unreliability in short-term forecasts may also discourage innovation in the demand-side response area and weaken confidence in the wholesale market.

5.3.5 In seeking improved alignment between forecast and settlement prices, the Authority's motivation was to promote competition by supporting demand-side participation, where it is efficient to do so.

5.4 The WAG presented its final recommendations in December 2013 after considering submissions received on its discussion paper

5.4.1 In its discussion paper, the WAG described the problem of misalignment and the resulting efficiency losses, and sought feedback from stakeholders on two options:

- a) whether the Authority should either consider in more detail a potential move to ex ante or real-time pricing (using its normal policy development process) or
- b) only take an incremental approach to improving the alignment between forecast and settlement prices at this stage.

5.4.2 The consultation period closed on 23 August 2013, and eleven submissions were received.

5.4.3 All submitters agreed that, while forecast prices predict settlement prices reasonably accurately under normal conditions, they are less accurate when the system is under stress. Submitters also agreed that addressing this misalignment would lead to an economic benefit, but nearly half the submitters were unsure if the benefit would be significant.

5.4.4 Many submitters thought that, while the current and planned initiatives had the potential to significantly improve alignment between forecast and settlement prices, they were not likely to be enough in themselves.

5.4.5 A majority of submitters supported further consideration of settling on ex-ante or real time prices, and most submitters thought it would be preferable to provide participants with more certainty about spot prices ahead of, or in real time, although some of this support was qualified.

5.4.6 After considering the issues raised in submissions, the WAG finalised its recommendations to the Authority. The WAG Chair presented the group's

final report³ to the Authority Board at its meeting of 4 December 2013. The WAG recommended that the Authority:

- a) proceed with incremental improvements to the spot pricing process already planned or underway including existing work to improve the quality of demand and intermittent generation forecasts
- b) implement new initiatives to:
 - i) align the assumptions used in real-time pricing with those used in settlement pricing as far as possible
 - ii) improve the availability of real time price information to users
- c) consider the merits of other incremental improvements to the pricing process:
 - i) flagging infeasibilities in forecast schedules
 - ii) reducing the gate closure period
- d) investigate options for the spot market design to settle on ex ante or real time prices and also consider other aspects of the design that could improve retail competition, such as zonal pricing
- e) note that settlement on ex ante or real time prices could support efficiency on the supply side as well as the demand side.

5.5 Next steps

5.5.1 The WAG recommendations paper also set out suggested next steps if the Authority agreed with its recommendations. The WAG would welcome an opportunity to have input into these processes, and undertakes to make itself available to provide advice to the Authority as required through the course of the Authority's future work on this matter.

6 National Instantaneous Reserve (IR) market

6.1 The WAG advised on the potential for a national IR market

6.1.1 The Authority asked the WAG to provide advice on the potential for developing a national market for instantaneous reserve (IR) and, if feasible, to develop arrangements to give effect to it. The national IR market is listed as a top priority project in the Authority's work programme 2012/13 (project number B4).

³ <http://www.ea.govt.nz/dmsdocument/16255>

- 6.1.2 The WAG agreed in July 2012 to include this project in its work plan, but deferred the start of its investigations until early 2013, to allow it to focus on the pivotal pricing project and pricing alignment project. The WAG focussed initially on identifying the scope for efficiency savings in IR procurement and provision. It then sought to quantify the potential benefits, and consider these against the likely costs.
- 6.1.3 The WAG concluded that there are clear net benefits of a national IR market so there was little value in completing and consulting on a discussion paper as contemplated in the Authority's 2013/14 work programme and the WAG's terms of reference. Consequently, the WAG by-passed the discussion paper phase and proceeded directly to making its recommendations to the Authority Board at its meeting of 4 September 2013. The key milestones are set out in Table 4 for completeness.

Table 4: National reserves market project – key milestones and target timetable

Activity	Dates	Status
WAG agreed to add project to its work plan	5 July 2012	Complete
Consideration of scoping paper	March 2013	Complete
Consideration of options paper	8 May 2013	Complete
Consideration of draft recommendations	12 June 2013	Complete
Consideration of draft recommendations paper to Board	30 July 2013	Complete
Recommendations presented to Authority Board	4 September 2013	Complete

6.2 Scope for efficiency savings in instantaneous reserves procurement and provision

- 6.2.1 The cost of instantaneous reserves (IR) procurement (i.e. the cost to purchasers) has averaged around \$45 million per year over the last six years. The cost of IR provision (i.e. the cost to the economy) is lower than this, but is expected to also be substantial.
- 6.2.2 There is scope to reduce both procurement and provision costs for IR. In particular, the current practice is to treat the North and South Islands as

distinct IR markets. If these markets were combined into a national IR market, this would be expected to reduce IR costs for two reasons:

- a) IR providers in one island could compete to supply IR in the other island – at times this would result in savings because the least expensive resources would be selected from across New Zealand, rather than the least expensive sources within each island
- b) The total amount of IR that needs to be procured would be lower at times. This arises because each island's need is currently determined on a standalone basis. With a national market, the overall IR requirement will often be the larger of the two island requirements, rather than the sum of individual needs.

6.2.3 In addition, a national IR market is likely to reduce energy procurement costs. This arises because the wholesale market auction process 'co-optimises' to identify the combination of resources from all providers that yields the lowest total procurement cost for IR and energy. At times, energy providers with higher offers may be scheduled ahead of lower cost alternatives for reasons associated with the availability or cost of IR.

6.2.4 The WAG acknowledged however that there are a number of potential costs, risks and technical challenges to be factored into the evaluation.

6.3 The WAG recommended development of a national IR market should proceed as swiftly as possible

6.3.1 Discussions at several WAG meetings concluded that the establishment of a national IR market would present obvious theoretical benefits in the areas of efficiency and competition. Supporting analysis commissioned by the WAG concluded that a national IR market offers conservative NPV benefits of \$70 M, consisting of \$20M reduced economic costs of reserve provision, and \$50M of avoided peak capacity investment cost.

6.3.2 Costs of the project are expected to lie almost exclusively within system operator dispatch and scheduling systems SPD and RMT. While the costs of modifying these systems could be substantial, the WAG concluded that it is highly unlikely that they will exceed the expected benefits.

6.3.3 In summary, the WAG concludes that implementing a national IR market would result in a substantial net economic benefit and that doing so would be consistent with the Authority's statutory objective and Code amendment principles

- 6.3.4 The WAG therefore recommends that the Authority should prioritise the national IR market project and progress it as swiftly as possible. The WAG considers that if necessary it would be appropriate to complete work on this project ahead of some of the other wholesale market projects presently in train that involve changes to market systems.
- 6.3.5 There are several possible paths towards implementation of a national IR market. Some of these paths might take multiple years to complete, but it may be possible to capture some early benefits by proceeding in a staged manner.
- 6.3.6 The WAG recommended that the Authority should engage with Transpower (as the system operator and the transmission asset owner) to identify in more detail the best options for implementing a national IR market. The WAG felt that the Authority and Transpower are best placed to complete this activity as it is primarily technical in nature.
- 6.3.7 Key design questions are likely to include:
- a) whether planned changes to HVDC control systems will be sufficient to enable a national IR market
 - b) how the Reserve Management Tool (RMT) and Scheduling, Pricing and Dispatch (SPD) model will need to be modified
 - c) whether roundpower on the HVDC should be enabled as part of a move to introduce a national IR market, or whether that can be progressed as a separate issue
 - d) how the national IR market should interact with a national frequency keeping market, which would also require the transfer of frequency control over the HVDC link
 - e) whether any changes to IR availability charges and/or event charges will be needed
- 6.3.8 Second-tier issues that the WAG suggested the Authority should keep in mind are that:
- a) there are linkages between the national IR market initiative and the current review of under-frequency management (UFM) arrangements, which should be borne in mind in the course of both projects
 - b) there might be implications for AUFLS settings

c) there might be implications for generator UFM asset owner performance obligations.

6.3.9 The Board supported the WAG's decision to move directly to making its recommendations, and that in this case it was not necessary to first consult via an advisory group discussion paper.

6.4 The next stage of the project will be technical

6.4.1 The WAG is of the view that implementing a national IR market is feasible and recommended that a strawman proposal including costs and timelines be developed as swiftly as possible.

6.4.2 The next stage of the project will be technical, and, in WAG's view, can best be progressed by the Authority working directly with Transpower. However, the WAG is keen to have further input as the Authority's work progresses.

6.4.3 The WAG was pleased to receive a presentation at its meeting of 28 November 2013 giving an update on the Authority's progress. It notes that the project is proceeding with a staged implementation approach in order to capture early benefits and a better understanding of the detailed requirements.

7 The WAG has made initial progress on its 2013/14 work plan

7.1.1 With all three of its 2012/13 work plan projects nearing completion, the WAG invited the Authority to propose a set of potential projects for its 2013/14 work plan.

7.1.2 The Authority Chief Executive presented six prospective projects to the WAG at its meeting of 5 September 2013, providing the members with useful context about the importance of each one and their relative priority from the Board's perspective. After some discussion with the Chief Executive, the WAG agreed to adopt the following three projects for its 2013/14 work plan and has since received preliminary briefings on each:

7.2 Hedge market development

7.2.1 This project (D1 in the Authority's 2013/14 work programme) aims to examine opportunities to further develop the New Zealand electricity hedge market, in order to maintain its current forward momentum and develop its value to the wholesale and retail markets. The project will provide a thorough examination of the extent to which barriers to the hedge market's continued development remain, and how any identified issues might be best

addressed. It is also intended to establish some measures and standards to enable hedge market performance to be objectively assessed.

- 7.2.2 The WAG received a briefing at its 28 November 2013 meeting, which proposed an approach to the initial fact-finding phase of the project. Members welcomed the opportunity to provide feedback on the proposed approach, and provided some initial suggestions on questions for the hedge market survey, which will be a valuable input to the project.

7.3 National market for frequency keeping

- 7.3.1 This project is an initial consideration of a national market for frequency keeping to enhance wholesale market efficiency. It is a high priority project on the Authority's work programme (item B3), and follows on from the Authority's multiple frequency keeper project.
- 7.3.2 The WAG received an initial briefing paper on the national market for frequency keeping at its meeting of 17 October 2013. The presentation was well-received and the discussion included whether or not the allocation of frequency keeping costs should be considered at the same time or after the completion of the project. A follow-up was presented at the 28 November WAG meeting. The WAG indicated a desire to pick up frequency-keeping cost allocation as a subsequent project, after first completing its work on the national frequency-keeping market.

7.4 Investigation into alternative reserve arrangements

- 7.4.1 This project investigates whether the existing reserve products could be improved and/or complemented with an additional reserve product.
- 7.4.2 The WAG received an initial briefing paper at its 28 November meeting. The paper focused on overview of the project including the shortcomings in the current market design and two options identified that might address these. It also set out for WAG's consideration a proposed staged approach for undertaking the investigation together with an intended timeline. The WAG considered various aspects of the project including the potential benefits. The WAG asked the secretariat to prepare a paper for the next meeting considering several issues raised in the meeting including the timing and the way it could be implemented.

8 Other WAG activities

8.1 The WAG developed a set of regulatory strategy principles

- 8.1.1 The WAG decided to establish a set of principles to guide its approach to formulating advice to the Authority on Code amendments and market facilitation measures. This idea of a set of principles was raised at the WAG meeting of 30 July 2013 in the context of the WAG Work Plan. It was followed up with a more substantive discussion at the WAG's meeting of 5 September 2013 which included a discussion with Carl Hansen, Chief Executive of the Authority.
- 8.1.2 Following that discussion the WAG decided to develop a set of regulatory strategy principles based on those in the Authority's "Strategic directions for market development" (page 20) published July 2013.
- 8.1.3 The Authority's regulatory strategy principles, reconciled for the WAG's benefit, are:
- *towards the best*– seek regulatory arrangements that move the problem over time towards enabling the first-best solution
 - *avoid 'one size fits all'* – seek regulatory arrangements that enable choice, particularly when imposing regulation on parties that are able to exit the regulated activity
 - *address the cause* – rather than addressing the symptoms, adopt regulatory approaches that reveal more about the problem over time, enabling more effective regulation in the future
 - *beware the 'slippery slope'* – avoid ever more intrusive interventions arising from poorly designed regulatory interventions
 - *be robust* – avoid regulatory interventions that are not likely to be credible when adverse events occur
 - *predictability* – seek to achieve regulatory predictability which is particularly important when regulating high capital investment industries such as electricity.
- 8.1.4 The WAG also acknowledged the relevance of the Authority's framework for advisory groups, including in key documents such as the Authority's statutory objective and SOI, the Code Amendment Principles and the Charter about Advisory Groups.

8.2 The WAG appreciates updates received on relevant Authority initiatives

- 8.2.1 Through its regular Work Plan update papers, the WAG has maintained a watching brief on the Authority's progress with the two earlier WAG projects, SPSR and WMIP.
- 8.2.2 The WAG has also appreciated the updates it has received on other relevant Authority initiatives such as managing retailer default situations, the FTR market and Within Island Basis Risk consultation, the UTS review, and the distribution pricing review.

9 Chair's commentary on overall performance of the WAG and the Secretariat

- 9.1.1 The WAG has had a productive and successful 6 months, completing all the projects on our work plan and scoping our activities for 2014.
- 9.1.2 The Authority Board was complimentary of the approach taken by the Group through the year, particularly the way it accelerated its recommendations on a national market for Instantaneous Reserve, and the how it developed conduct principles for Pivotal Pricing situations and examples of how they might be applied.
- 9.1.3 Our work in 2014 promises to be as diverse and absorbing as this year. Of particular note is the Hedge Market Development project which will provide an opportunity for the group to work outside the pooling arrangements that constitute the spot market to consider the broader set of markets for electricity in New Zealand that complement it.
- 9.1.4 While both WAG and RAG are given a work programme by the Authority Board, they are independent and so not obliged to follow the Board's current thinking in their deliberations. We have been well supported by the secretariat in our work: they have delivered analysis and research to support our work aligned with our discussions, rather than pre-existing thinking from within the Authority. We rely on their professionalism and focus for our effectiveness as a Group. My thanks to all the members of the secretariat for their work this year and particularly their readiness to accept our timelines even when they coincided with peaks in their individual workloads.
- 9.1.5 I continue to be impressed by the pragmatism and objectivity of the group's members. Their expertise is in no doubt but there have been repeated instances during the last 6 months where individuals have taken positions on issues for the benefit of end-customers and New Zealand as a whole which

did not directly align with the short-term commercial interests of their own organisations. Our recommendations are stronger for it and it is a pleasure to work with the group's members because of it. Many thanks to all of them, and the colleagues who support us all, for the quality of their contributions throughout the year.

John Hancock
January 2014