

# Chair's Half Yearly Report to the Electricity Authority Board

July 2016 to May 2017

4 July 2017

**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.

## Contents

<b>1</b>	<b>Introduction</b>	<b>3</b>
<b>2</b>	<b>This is the WAG's final report</b>	<b>3</b>
<b>3</b>	<b>Membership and meetings held</b>	<b>4</b>
3.2	Six WAG meetings were held during the reporting period	4
3.3	WAG has maintained the Interests Register as required by law	6
<b>4</b>	<b>Wholesale market information: review of clause 13.2 exclusions</b>	<b>6</b>
4.1	The Authority sought further WAG advice on wholesale market information issues	6
4.2	WAG considered submissions on its discussion paper and finalised its recommendations to the Board	6
4.3	WAG completed the project several months ahead of target	7
<b>5</b>	<b>Review of instantaneous reserve event charge and cost allocation</b>	<b>7</b>
5.1	The Authority sought the WAG's advice on instantaneous reserve cost allocation	7
5.2	The WAG actively engaged with stakeholders during the reporting period	7
5.3	The WAG determined that the existing arrangements are not consistent with the statutory objective	8
5.4	The WAG sought to identify an alternative approach that would be more consistent with the statutory objective	8
5.5	The WAG provided its recommendations to the Authority Board	9
<b>6</b>	<b>Chair's commentary on overall performance of the WAG and the Secretariat</b>	<b>9</b>

## 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 focus for the WAG in this reporting period was the completion of the two projects on its work plan:
- a) Wholesale market information: review of clause 13.2 exclusions
  - b) Review of instantaneous reserve event charge and cost allocation.

### *Role of the WAG*

- 1.1.3 The role of the WAG is to investigate, analyse, and make recommendations to the Authority Board (Board) on matters agreed to and included 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 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
  - d) any other relevant policy matters in regard to wholesale markets services.
- 1.1.4 The WAG's terms of reference require the Chair to report every six months to the Board on the WAG's progress against its work plan.

## 2 This is the WAG's final report

- 2.1.1 In August 2016, following a review of the existing advisory group structure, the Authority announced its intention to disestablish the WAG once it had completed its work plan. It also set out its proposal to establish two new advisory groups, re-orientated around key industry challenges and issues, rather than along the traditional industry structure lines.
- 2.1.2 Accordingly, this is WAG's final report, and it covers the WAG's activities for July 2016 to May 2017. The WAG has now completed the remaining items in its work plan (as adopted at its September 2015 meeting following engagement with the Authority Board).

### 3 Membership and meetings held

3.1.1 The list of current WAG members for the period covered by this report, and the term of their membership, is set out in Table 1 below.

#### 3.2 Six WAG meetings were held during the reporting period

3.2.1 The WAG met six times during the eleven month reporting period, of which:

- a) five meetings (18 August 2016, 21 September 2016, 14 December 2016, 8 February 2017 and 15 March 2017) were held at the Authority's offices in Wellington
- b) one meeting (17 November 2016) was held at Te Mihi Power Station and included site visits in the area.

3.2.2 Table 1 gives details of WAG membership and members' attendance for the six meetings. The Authority extended the terms of four members early in the period covered by this report to enable the existing WAG to complete its work plan. Their updated membership terms are included here for completeness.<sup>1</sup>

**Table 1: WAG membership details for 1 July 2016 to 31 May 2017**

Member	Affiliation	Date and term of appointment(s)		Current term end	Meeting attendance
John Hancock (Chair)	Independent	April 2013 reappointed April 2015	2 years 2 years	April 2017 (extended to June 2017)	6 of 6
John Carnegie	Manager, Energy, Environment & Infrastructure, Business New Zealand	May 2011 reappointed June 2013 reappointed June 2015	2 years 2 years 2 years	June 2017	6 of 6
Alan Eyes	Energy Manager, New Zealand Steel	June 2013 reappointed June 2015	2 years 2 years	June 2017	5 of 6
Chris Jewell	Chief Financial Officer, Genesis Energy	June 2013 reappointed June 2015	2 years 2 years	June 2017	3 of 6

<sup>1</sup> One member, Graeme Everett, was granted a leave of absence in August 2015 due to illness. Mr Everett's term as a WAG member expired on 31 July 2016. In light of his leave of absence, the Authority did not ask Mr Everett to extend his term of membership.

Member	Affiliation	Date and term of appointment(s)		Current term end	Meeting attendance
Neal Barclay	General Manager Retail, Meridian Energy	May 2011 reappointed August 2012 reappointed August 2014	1 year 2 years 2 years	August 2016 (extended to June 2017)	3 of 6
Stephen Peterson	Chief Executive, Simply Energy	May 2011 reappointed August 2012 reappointed August 2014	1 year 2 years 2 years	August 2016 (extended to June 2017)	3 of 6
Phillip Anderson	Portfolio Manager, Asia-Pacific Energy, Cumulus Energy Fund	August 2014	2 years	August 2016 (extended to June 2017)	6 of 6
James Collinson-Smith	Secondary Systems Asset Manager Planning Manager, Transpower	1 June 2015	2 years	June 2017	6 of 6
Stephen Drew	Manager, New Zealand, EnerNOC ( <i>until February 2017</i> )  Senior Advisor, EnerNOC ( <i>from February 2017</i> )	1 June 2015	2 years	June 2017	6 of 6

### 3.2.3 At the invitation of the WAG Chair:

- a) System operator staff from Transpower (Phil Yao and Mike Phethean) joined the 18 August 2016 meeting to present on the system operator's Reserves and Frequency Management programme
- b) Twelve stakeholder representatives (from Contact Energy, EnerNOC, Genesis Energy, Mercury Energy, Meridian Energy, Transpower and Trustpower) joined the 21 September 2016 meeting to discuss key issues relating to the instantaneous reserve event charge and cost allocation project.

3.2.4 Erich Livengood of Transpower (system operator) was invited to attend all WAG meetings as an observer, and did so for all six meetings in the reporting period.

### **3.3 WAG has maintained the Interests Register as required by law**

3.3.1 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.

## **4 Wholesale market information: review of clause 13.2 exclusions**

### **4.1 The Authority sought further WAG advice on wholesale market information issues**

4.1.1 The Code imposes a 'continuous disclosure' obligation for information that is relevant to the wholesale electricity markets. It also includes a specified set of exclusions, where such information does not have to be disclosed.

4.1.2 The Authority asked the WAG to conduct a review of the clause 13.2 exclusions in the Code to determine if they are appropriate and efficient. It is item 2.15 in the Authority's 2016/17 work programme and is a priority 2 initiative. The key goal is to facilitate an active hedge market by enhancing the disclosure of information that influences the forward price curve.

### **4.2 WAG considered submissions on its discussion paper and finalised its recommendations to the Board**

4.2.1 The WAG reviewed the exclusions, and published a discussion paper on 28 June 2016 for a six-week consultation period, immediately prior to this reporting period.

4.2.2 The WAG received seven submissions on its discussion paper. The WAG completed its consideration of those submissions and its own further analysis. The discussion paper and summary of submissions are available in full from the Authority's website.<sup>2</sup>

4.2.3 Based on a case study assessment and its consideration of submissions, the WAG assessed that the existing commercial disadvantage exclusion:

- a) allows participants to legitimately avoid disclosing wholesale market information that would support an orderly and efficient wholesale market
- b) risks undermining confidence in the wholesale market
- c) is frustrating the effectiveness of the WMI disclosure regime in delivering the outcomes the Authority seeks
- d) may lead to disclosure outcomes that do not optimally support the Authority's statutory objective
- e) is likely to create difficulties in enforcing compliance with clause 13.2A due to uncertainty around application of this exclusion.

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<sup>2</sup> <http://www.ea.govt.nz/development/work-programme/risk-management/wholesale-market-information-clause-13-2-and-fuel/consultation/#c16099>.

- 4.2.4 Having considered various options to address the issues, the WAG recommended that the Authority replace the commercial disadvantage exclusion with a reasonable person exclusion. The WAG's qualitative assessment led it to conclude that this Code amendment would yield a net public benefit, support the Authority's statutory objective and be consistent with the Code amendment principles.
- 4.2.5 The WAG also recommended that the Authority:
- a) increase its focus on monitoring and enforcement of clause 13.2A, and, in particular, use of its 'please explain' power under clause 13.2A(5)(a)
  - b) improve the WMI disclosure guidelines
  - c) raise participant awareness and understanding of the WMI disclosure regime
  - d) encourage improvements in the use of POCP
  - e) consider amending the WMI disclosure guidelines to clarify its expectations regarding disclosure of confidential aspects of a participants' contract book.
- 4.2.6 The WAG considered that these developments would have benefits that would be independent of, and incremental to, the benefits of the Code amendment.

### **4.3 WAG completed the project several months ahead of target**

- 4.3.1 The WAG was pleased to finalise its recommendations paper in early December 2016, more than three months ahead of the target timetable. The Authority Board received the WAG's recommendations paper, available on the Authority website, in February 2017.<sup>3</sup>

## **5 Review of instantaneous reserve event charge and cost allocation**

### **5.1 The Authority sought the WAG's advice on instantaneous reserve cost allocation**

- 5.1.1 In May 2015, the Authority requested the advice of the WAG on whether the current arrangements for allocating instantaneous reserve (IR) costs and the event charge regime are optimally consistent with the Authority's statutory objective.
- 5.1.2 The WAG has completed a 'first principles' review of the arrangements.
- 5.1.3 This project is item 2.9 in the Authority's 2016/17 work programme and a priority 2 initiative.

### **5.2 The WAG actively engaged with stakeholders during the reporting period**

- 5.2.1 The WAG engaged with stakeholders in three ways during the reporting period:
- a) It published a discussion paper in October 2016, seeking feedback on the WAG's thinking to that point in time. Eleven stakeholders submitted feedback in response to the paper.

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<sup>3</sup> <http://www.ea.govt.nz/development/work-programme/risk-management/wholesale-market-information-clause-13-2-and-fuel/advisory-group/wag-recommendations-paper-published/>.

- b) At its September 2016 meeting, it held a joint session with representatives from key stakeholders—being Meridian Energy, Genesis Energy, Contact Energy, Mercury Energy and Trustpower. The aim of the session was to better understand the incentives on traders under the new national market for IR, and how different ways of allocating IR costs might influence those incentives.
- c) The Chair and secretariat met individually with key stakeholders to test aspects of its recommendations, prior to finalising them. This was to ensure the WAG's recommended approach would not create perverse incentives that it had not recognised.

5.2.2 The WAG's final recommendations reflect the valuable input of stakeholders, and the group is thankful to those stakeholders for contributing their time and energy.

### **5.3 The WAG determined that the existing arrangements are not consistent with the statutory objective**

5.3.1 The WAG's engagement with stakeholders led it to realise that the new national market for IR would significantly impact incentives for IR market participants. It determined that the status quo would not be efficient in the long term, because it would prevent full realisation of the significant benefits of the national market for IR, and could contribute to inefficient investment decisions in the longer term.

5.3.2 The WAG therefore determined that continuing with the status quo was not a viable approach.

### **5.4 The WAG sought to identify an alternative approach that would be more consistent with the statutory objective**

5.4.1 The WAG considered that the only enduring approach to IR cost allocation would be a principled one. It drew on the Decision-Making and Economic Framework that the Authority had used in other projects.

5.4.2 Members considered various options and agreed a simple allocation method was viable, which comprised two modes depending on whether the HVDC was fully self-covering its risk or not:

- a) when the HVDC was fully self-covering its risk, costs would be allocated:
  - i) on a national basis for IR that was shared nationally, or an island basis for IR that wasn't shared
  - ii) to all assets that are subject to dispatch by the system operator
  - iii) on a 'going dutch' basis per trading period
- b) when the HVDC is only partially self-covering, all costs attributable to the HVDC would be allocated to sending-island generators on a pro rata basis per trading period.

5.4.3 The group agreed that participants contributing to additional IR costs should pay for their impact on the quantity of IR procured. The group also considered that the event charge regime should be removed.

5.4.4 One member of the WAG disagreed with the rest of the group that HVDC-related IR costs should be allocated to sending-island generators. The group made every effort to bridge the difference in perspectives on this issue. While the WAG was unable to overcome these differences, the dissenting view was limited to one aspect of its recommendations.

## 5.5 The WAG provided its recommendations to the Authority Board

5.5.1 The Authority Board received the WAG's recommendations paper, available on the Authority website, in May 2017.<sup>4</sup>

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

6.1.1 This is my final report to the Board as the Chair of the Wholesale Advisory Group. In January the Authority Board confirmed a decision to disestablish both the Wholesale and Retail Advisory Groups and to replace them with an Innovation and Participation Advisory Group (IPAG), focussing on issues specifically related to new technologies and business models, and consumer participation, and a Market Development Advisory Group (MDAG) focussing on further evolving the 'machinery' of the electricity markets.<sup>5</sup>

6.1.2 At its September meeting, the Authority Board approved term extensions until May 2017 for WAG members whose terms were up for expiry to provide time for us to complete our work on both Information Disclosure Exclusions and Reserve Cost Allocation. Rather than producing a 6-monthly report to the end of 2016, we agreed to delay this until the completion of the WAG's work.

6.1.3 Over the past 11 months, the Group has made strong recommendations on both of its active projects – that the "Commercial Disadvantage" exclusion for Information Disclosure be removed, and that the methodology for Reserve Costs be replaced by an entirely different approach derived from a principled analysis of the service being procured and the alignment of incentives on parties to those best able to manage risks.

6.1.4 In both projects, we have sought input from industry participants to inform our investigations. As well as seeking comments on Discussion Papers, we interacted directly with the main risk setters and insurance providers to develop our understanding of reserve management in a national market. This continued engagement was extremely helpful in what is, as I have noted before, a highly complex and multi-layered topic. The transition from island-based to national procurement in the middle of the project made real the need for a change to the methodology and the Jekyll-and-Hyde characteristics of the HVDC in reserve management.

6.1.5 Most notable of our work over the period is the form of our IRECCA recommendations paper which was quite different from anything we have produced before. We found that our discussions were repeatedly clouded by technical terms and the baggage that goes

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<sup>4</sup> <http://www.ea.govt.nz/development/work-programme/pricing-cost-allocation/review-of-ir-event-charge-and-cost-allocation/advisory-groups/wag-recommendations-paper-irecca/>.

<sup>5</sup> <https://www.ea.govt.nz/about-us/corporate-projects/administrative-changes-to-advisory-groups/development/decision-to-reorient-advisory-groups/>.

with them, and decided we needed to explain the concepts as simply as possible in order to see through the fog of technicality to the principles behind the market.

- 6.1.6 The style is pictorial rather than textual. It has anthropomorphised balls of demand balancing with anthropomorphised blocks of supply on see saws and springs. We are proud of the end result and the paper has been widely praised. Quite unprompted, Hayden Green, who is a Director at Axiom Economics, posted on LinkedIn:

*“The latest offering from the Electricity Authority's Wholesale Advisory Group is one of the best examples I've ever seen of how to explain a highly technical subject in an easily accessible way. You don't need to know a thing about "instantaneous reserve event charge and cost allocation" (and I'm guessing that's most people) to follow what's going on, which is a rare thing in my line of work.”*

- 6.1.7 The Authority has signalled that members of the new IPAG *will ideally have a diverse array of backgrounds*. I hope that the success of the approach we have taken in tackling reserve cost allocation may prove useful for that group in enabling non-specialists to tackle problems in other technical areas.
- 6.1.8 I always thank the Secretariat for their support of our work and would like to do so again, particularly for their openness to following new approaches.
- 6.1.9 Equally I am grateful to all the group members who I have worked with during my 4 years as Chair. The group has changed over time but maintained a balance between theorists and pragmatists, which I am sure has helped us develop stronger and more durable recommendations for the Authority Board. Particular thanks to Neal Barclay and Chris Jewell, who stayed on as members of the group for 6 months despite both moving into new and busy roles.
- 6.1.10 It has been an enormous privilege to chair this group. The experience has reinforced my belief in the merits of industry-led solutions where consensus is achievable. The Advisory Groups seem to me to work well and have positive incentives on participants to compromise in order to influence rule changes. In turn this creates an incentive on the Board to accept their recommendations in order to maintain the incentive for compromise.

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John Hancock  
**Chair, Wholesale Advisory Group**  
10 May 2017