

**IN THE MATTER of the Electricity Act 1992
and the Electricity Amendment Act 2001**

AND

**IN THE MATTER of the Electricity
Governance Regulations 2003**

**DECISION OF THE ELECTRICITY COMMISSION PURSUANT TO
PART 3 OF THE ELECTRICITY GOVERNANCE REGULATIONS 2003
REGARDING AN ALLEGATION OF AN UNDESIRABLE TRADING SITUATION
MADE ON 12 JULY 2005**

DECISION DATED [9] SEPTEMBER 2005

**IN THE MATTER of the Electricity Act 1992
and the Electricity Amendment Act 2001**

AND

**IN THE MATTER of the Electricity
Governance Regulations 2003**

**Decision of the Electricity Commission pursuant to
Part 3 of the Electricity Governance Regulations 2003
regarding an allegation of an undesirable trading situation
made on 12 July 2005**

General Context of this Decision

1. Under Part 3 of the Electricity Governance Regulations 2003 (“the Regulations”) the Electricity Commission is given powers to investigate and take action in respect of undesirable trading situations (“UTSs”). This decision concerns a claim made on 12 July 2005 that a UTS existed.
2. This decision has been made by a committee of the Commission, comprising all of the members of the Commission (“the Committee”), to which decision making regarding UTSs has been delegated in the interests of operational efficiency. Except where expressly provided otherwise, references in this decision to the Commission include references to the Committee acting as delegate on behalf of the Commission.

Background

3. In a letter sent by email to the Commission at 12 noon on Tuesday, 12 July, the Major Electricity Users’ Group (“MEUG”) gave notice that it believed a UTS existed.
4. MEUG considered that certain aspects of the basis upon which the System Operator procures and pays for frequency keeping services, and in particular what MEUG saw as the potential exposure of electricity purchasers to “very large or indeed infinite” prices for such services, constituted a UTS.
5. Given the nature of the alleged UTS, being a concern about future potential liability of purchasers rather than a concern as to a situation existing in the electricity market at the

time, consideration of the alleged UTS was scheduled for the then next Commission meeting. MEUG was advised of that decision.

6. The Commission considered the issues raised by MEUG on 27 July. As announced to the market on 3 August, the Commission concluded that the matters raised by MEUG did not satisfy the test for a UTS under the Regulations.
7. This is the Commission's full decision on these matters.

Frequency keeping and the issues raised by MEUG

8. The System Operator purchases frequency keeping services from generators with the technical capability to provide the service (capacity exceeding 100 MW and high ramping rates) and who have an ancillary service contract with the System Operator as service providers.
9. There are two such service providers in the North Island, Genesis Energy and Mighty River Power, and two in the South Island, Meridian Energy and Contact Energy. Currently there are no other frequency keeping service providers in either island.
10. One frequency keeping service provider is selected for every trading period, based on the lowest offered base price, for each of the North and South Islands.
11. Payments for frequency keeping services are formed by four components:
 - (a) base frequency keeping reserve offer cost;
 - (b) metered energy at final price;
 - (c) System Operator constrained off costs based on service provider offer price; and
 - (d) System Operator constrained on costs based on service provider offer price.
12. Frequency keeping generators are compensated for constrained on and constrained off generation. The amount of compensation is calculated in accordance with part G of the Electricity Governance Rules ("EGRs"). The constrained on/off compensation is paid to the relevant generators by the System Operator, who then recovers this from all purchasers.

13. Frequency keeping charges are paid by electricity purchasers in proportion to their share of national load on a monthly basis.
14. MEUG was concerned with what it saw as spiralling frequency keeping and associated constrained on/off charges. MEUG submitted that every purchaser of electricity in New Zealand was theoretically exposed to an unlimited liability to pay charges for frequency keeping services. This was due to the significance in calculating compensation for frequency keeping of a service provider's next tranche offer price.
15. MEUG alleged that this situation constituted an undesirable trading situation as defined in regulation 55 of the Electricity Governance Regulations 2003 for the following reasons:
 - (a) it threatened trading on the wholesale market for electricity and, if it occurred, would preclude orderly trading and proper settlement of trades;
 - (b) it existed within the current market rules and, in the view of MEUG, represented a significant loophole in the EGRs;
 - (c) it opened the possibility for manipulative trading activity, since frequency keeping agents who were appointed frequency keepers had a complete monopoly position with respect to constrained on charges; and
 - (d) it threatened generally accepted principles of trading and the public interest.
16. MEUG requested an urgent rule change to remove this unlimited liability.
17. In discussion with Commission staff, MEUG stressed the following points:
 - (a) the main concern of MEUG on behalf of purchasers was not in relation to a particular situation associated with an immediate threat to the market, but in relation to a risk of undesirable future behaviour by frequency keeping service providers;
 - (b) MEUG recognised that the current frequency keeping methodology had been a feature of the market since 1 March 2004, and that there were no particular signals of undesirable behaviour except, in MEUG's view, high constrained on amounts for certain frequency keeping services paid to NI frequency keeping service providers for April and May 2005.

- (c) MEUG was also concerned that a lack of information regarding, and transparency of, frequency keeping costs during a month deprived the main energy purchasers of the possibility of adjusting their position against high charges; and
 - (d) MEUG sought as a possible solution an urgent rule change to limit the liability of electricity purchasers by capping the constrained on frequency keeping monthly charges going forward.
18. Frequency keeping charges have, historically, risen in line with final prices, particularly during the drier years of 2001 and 2003.
 19. Frequency keeping charges for the 12 months to March 2005 were relatively stable, in the range of \$2.03 million per month. They increased to over \$4 million in March and April 2005, and reached \$6.357 million in May 2005. Total frequency keeping charges for June 2005 were \$3.8 million.

The UTS Regime

20. In its decision of the Tauranga UTS of 24 April 2004, the Commission considered issues relating to the operation of SPD in the context of “unusual” pricing outcomes. In that decision, the Commission made the following comments, which the Commission considers are also relevant to the application of the UTS regime in these circumstances:

- “44. The Commission notes that regulation 55 contemplates particular outcomes on trading. The concepts used are “threats to trading that preclude its orderly maintenance”, and “circumstances that are at variance with or threaten generally accepted principles of trading or the public interest”.
- 45. The Commission considers, therefore, that the Part 3 UTS regime is not directed at the process where, in general terms, improvements may be made to Rules over time. The Commission notes, in this context, its role pursuant to section 172O(1)(a) of the Act in formulating and making recommendations to that end.
- 46. Rather, the Commission considers that the Part 3 UTS regime provides the Commission with a way of responding to unexpected events that have or may have significant adverse effects for trading. The Commission sees this role as being more part of its function under section 172O(1)(b) of the Act. It notes that such effects are to be assessed in light of the importance of the maintenance of orderly trading, and the observance of generally accepted principles of trading, for the operation of the wholesale market, as the wholesale market in turn contributes to the overall objectives of the construct of the electricity industry in New Zealand created by the Act, the Regulations and the Rules.”

21. The issue for the Commission, in considering whether a UTS exists, is therefore to determine whether the relevant circumstances threaten trading, preclude orderly trading and the proper settlement of trades, and/or are at variance with or threaten generally accepted principles of trading or the public interest.
22. In this instance, of particular relevance to MEUG's claim were the questions of whether there was, in fact, any evidence of manipulative or attempted manipulative trading activity (r 55(2)(a)) or of any other exceptional or unforeseen circumstances that met the UTS threshold tests.
23. Given:
 - (a) MEUG's confirmation that its concern was not so much with the immediate situation, unusual price outcomes in and of themselves, but with the potential for possible manipulative behaviour in the future;
 - (b) that there was no indication that the circumstances identified by MEUG would in and of themselves meet the thresholds of regulation 55 and thereby constitute a UTS;
 - (c) in particular, that there was no evidence of manipulative or attempted trading activity; and
 - (d) the fact that the principal remedy sought by MEUG was a rule change, a matter the Commission would recognise as a potentially valid concern, but not one which of itself indicated that the underlying circumstances constituted a UTS,the Commission considered that the circumstances in question did not constitute a UTS.
24. In reaching that decision, the Commission was also mindful that:
 - (a) it has recently agreed in principle, in the context of the development plan for the Common Quality Advisory Group ("CQAG"), to an investigation, in the short term, into a national frequency keeping market and, in the longer term, to a strategic study of frequency related issues; and
 - (b) the Commission is reviewing the information disclosure requirements relating to frequency keeping services.

25. As a first step, the System Operator has been asked to develop material to assist Commission staff and the CQAG to consider issues relating to the constrained on and off methodology relative to frequency and the determination of compensation for frequency keeping activities.
26. The Commission considered that the substantive issue of concern to MEUG could be addressed in these contexts, while recognising that the timelines associated with those processes might not be as proposed by MEUG, given the Commission's responsibility to balance and prioritise demands on its resources.



Electricity Commission
Wellington
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