4 July 2022

Tom George
Manager Wholesale Markets
Electricity Authority
PO Box 10041
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By email: WholesaleConsultation@ea.govt.nz

Alpine Energy Limited's submission on Financial Transmission Rights market observations

Dear Tom,

Alpine Energy Limited (AEL) appreciates the opportunity to submit to the Electricity Authority (Authority) on its Financial Transmission Rights market observations issues paper. Our submission is not confidential.

We were pleased that the Authority thoroughly examined the Financial Transmission Rights market, its current state and performance and provided well-rounded observations, considering all the evidence gathered.

Our submission responds to all the consultation questions raised (refer to Appendix A), from the perspective of an electricity distribution business (EDB) who does not actively trade in Financial Transmission Rights, and whose main purpose is to ensure that we deliver the long-term benefit to consumers on our Network.

If the Authority has any questions or requires clarification on any information provided in our submission, please do not hesitate to contact us.

Yours sincerely

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Appendix A – Detailed responses to consultation questions

Observation 1

Changes in the make-up of renewable generation will see Locational Price Risk continue to change over the next 10 years.

Q1 What is your view on how Locational Price Risk might evolve over the next decade?

Locational Price Risk is statistically predictable for less predictable disturbance events, indicating that the hedging of risk related to the cost of purchasing electricity is driven by an evaluation of the risk of the underlying causal events rather than the Locational Price Risk itself.

An advanced and skilled market participant will hedge against the cause, not the symptom.

Locational Price Risk could become progressively bigger, and substantially so, depending on the scale of change related to the underlying sources of volatility, for example:

- More renewable energy will result in increased naturally occurring variations in output.
- The uptake of electric vehicles will result in individual or collective participation as a load or a source on the system.

Q2 Do you see Locational Price Risk as a genuine risk to your business? Why/why not?

It is a risk, but it is generally manageable without having to buy short-term hedging instruments. Locational Price Risk might present very high locational prices, which generally last for relatively short periods. If a large price anomaly is presented for an extended period, declaring Force Majeure could be an option, because such a scenario would most likely play out because of a significant underlying event.

Observation 2

Retail competition has increased over time, however it is difficult to determine the influence that Financial Transmission Rights have on retail competition.

Q3 What influence has the availability of Financial Transmission Rights had on your decision to compete for consumers?

As a non-exempt EDB we do not participate in the retail industry, However, we have provided our general observations to this question in our response.

The Authority has indicated in the issues paper, Financial Transmission Rights are not generally used by participants in the electricity market who might benefit from it. Furthermore, over three quarters of the result is based on the cost of losses, not constraints. Therefore, we believe that the Financial Transmission Rights do not feature significantly in the decision-making process.

Q4 What benefits do you see the Financial Transmission Rights market providing in terms of consumer outcomes? Why/why not?

Considering the explanations and observations the Authority provided in the issues paper, the Financial Transmission Rights market does not provide benefits for the consumer. The value of Financial Transmission Rights seems to depend more on the cost of losses – which is as predictable as the cost of energy, than on the cost of constraints – which is much less predictable but not well covered by Financial Transmission Rights, or not as significant in cost for consumers over the longer term.

Observation 3

There has been no apparent impact on generator competition due to Financial Transmission Rights.

Q5 What influence has the availability of Financial Transmission Rights had on your generation investment decisions?

AEL has not invested in generation facilities during the period under review.

However, should we consider investment in generation assets in the future, it would be in battery technology and/or distributed renewable energy facilities. In these cases, proximity to consumers, as well as periodic price variations would be the major factors influencing any investment decision.

Q6 Has the Financial Transmission Rights market allowed your business to build new generation plant in new geographic areas? Why/why not?

N/A

Observation 4

Financial Transmission Rights currently use an average of $5.29 million per month from Loss Constraint Excess (~47% of total Loss Constraint Excess) to settle.

Q7 Does the current use of Loss Constraint Excess to support the settlement of the Financial Transmission Rights market deliver the best outcomes for consumers? Why/why not?

Possibly not. The buyers of Financial Transmission Rights are most likely paying less than fair value for the Financial Transmission Rights they buy, resulting in constant profits for the participant of the Financial Transmission Rights market, which reduces the amount available for the Loss Constraint Excess that would have reduced the cost of transmission for consumers over the longer term.

Observation 5

Some parties may be consistently profiting from Financial Transmission Rights without a clear benefit to consumers.

Q8 Why do you think some Financial Transmission Rights participants are profiting from Financial Transmission Rights more than others?

The Financial Transmission Rights market is complicated and opaque, resulting in a relatively low uptake of participants, and auctions that does not produce the full efficient price for the instrument.

It is also possible (though not confirmed) that day traders outside of the electricity supply industry are participating in the Financial Transmission Rights market, based on research into how the market operates and from a purely speculative motive.

A technical analysis of the past price movements (both purchase price and eventual pay-out) would be valuable to understand the reasons why the market has remained attractive.

Observation 6

The Locational Price Risk due to losses is highly correlated with energy prices while Locational Price Risk due to constraints is not.

Q9 Is it for the benefit of consumers to use loss rentals, constraint rentals and auction income to support the settlement of the Financial Transmission Rights market? Why/why not?

AEL does not believe it will benefit consumers to have profits in the Financial Transmission Rights market paid out to experienced day traders outside of the electricity supply industry, since the money will then be permanently taken out of this industry.

Observation 7

Many parties (particularly direct connect consumers and independent retailers) who are subject to Locational Price Risk are not using the Financial Transmission Rights market.

Q10 Why do you think organisations that are exposed to Locational Price Risk are not participating in the Financial Transmission Rights market (directly or indirectly)?

Two main reasons:

- Firstly, Financial Transmission Rights would be a complicated instrument to understand in addition to the business of trading electricity, and
- Secondly, it is not providing the hedge it is intended to provide, namely a protection against the cost of constraints. It protects mainly against the cost of losses, which is well understood and highly correlated with the variations in the cost of energy.

Participants in the energy market would not gain much benefit from Financial Transmission Rights if they were already trading responsibly on the energy market.

Furthermore, the cost of constraints (over a long period, across the whole country) is not significant, and insurance against it would generally cost more than the expected benefit for the average market player.

Q11 What do you think can be done to maximise the efficient use of Loss Constraint Excess for the benefit of consumers?

Fund the pay-out for Financial Transmission Rights out of only the auction revenue.

Q12 Do you consider Locational Price Risk to be an impediment to effective retail and generation competition? Why/why not?

It should not be an impediment to effective retail and generation competition if the same signals of high locational prices are instead channelled into incentives to invest in transmission assets to relieve the constraints that cause the high prices. Transmission infrastructure should be the enabling infrastructure for economic activity in any region, and the first objective should be to solve the issues which prevent effective retail competition. Short term measures to manage constraints should not be seen as the solution.

Q13 How does the Financial Transmission Rights market allow you to manage Locational Price Risk? What non-Financial Transmission Rights market tools do you use to manage Locational Price Risk?

Locational Price variations are statistically well understood and are even predictable over a long time period. The risk associated is therefore easily managed by a small uplift in the prices charged to customers to cover the spikes in prices above normal levels for the periods when underlying conditions causes the higher locational prices.

Q14 Are changes required to the Financial Transmission Rights market for the long-term benefit of consumers? Why/why not?

Changes are required. The current Financial Transmission Rights market is not providing the hedge it was designed to provide, and many participants in the energy market does not use it at all.

Observation 8

Financial Transmission Rights tend to trade somewhat below 'fair value.'

Q15 Do you agree with the view that Financial Transmission Rights are currently traded below 'fair value'? If yes, why do they trade below fair value?

Yes, we agree with the Authority's view that the Financial Transmission Rights are currently trading below fair value, as indicated by the constancy of profits for the average participant.

This is likely the result of insufficient numbers trading, and insufficient knowledge or profit motive of some of the participants.

Q16 Should Financial Transmission Rights be traded at/closer to 'fair value?'

Yes. It would however be challenging to force the price up in a free-market situation. It could be argued that the final pay-out for Financial Transmission Rights should be scaled to match the income from auctions, resulting in net profit for all players in this market being zero.

Observation 9: Some features of the Financial Transmission Rights market appear to be unintended and have no direct link to consumer benefit.

Q17 Are there other features of the Financial Transmission Rights market that appear unintended or to have no clear consumer benefit?

The Financial Transmission Rights market seems to have mostly unintended results which are not for the benefit of the electricity consumer.

Q18 Does the feature of the Financial Transmission Rights market identified by the Authority negatively impact consumers? How?

It is like a small negative impact, related to the $5.29 million per month reduction of the Loss Constraint Excess. We acknowledge that the treatment of the Loss Constraint Excess also varies between EDBs and may not eventuate in a benefit for the consumer at all.

Observation 10

The Financial Markets Authority does not regulate trading conduct in the Financial Transmission Rights market.

Q19 Do you think there is a requirement for enhanced oversight of the Financial Transmission Rights market?

A change to the current market would be more effective than enhanced oversight.

Observation 11

Revenue adequacy settings of the Financial Transmission Rights market contribute to the profitability of Financial Transmission Rights.

Q20 What are your views on speculators benefiting from the design of the Financial Transmission Rights market?

If a market is in existence, it is fair to allow day traders and speculators to participate. These participants provide the lubrication for markets to be more efficient. However, the market needs to be designed to achieve the objectives sought, which is not currently occurring.

Q21 What benefit does speculation provide to the Financial Transmission Rights market, and what link does this provide to consumer benefit?

These participants provide the lubrication for markets to be more efficient. If the market was selling the correct product for the benefit of the consumer, the improved efficiency would have provided Financial Transmission Rights at a fair price, hedging the constraint risks for the benefit of consumers.