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23 December 2021

Submissions
Electricity Authority
PO Box 10041
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By email: reviewconsultation2021@ea.govt.nz

RE: Consultation Paper – Inefficient price discrimination in the wholesale market – Issues and Options

Nova Energy (Nova) has considered the implications of the options raised in response to the Electricity Authority's assessment of the impact of the contract between Meridian Energy and New Zealand Aluminium Smelters. Nova is extremely concerned that the unique circumstances of that agreement (which expires in 2024) will give rise to regulatory control over commercial negotiations processes. Nova believes that would negatively impact the market by imposing costs and complexity to a wide range of other commercial negotiations.

New Zealand has a comparatively small market, and it is going to require a major growth in generation capacity over coming years in order to transition to a low emissions economy. It is important therefore that the sector has the confidence of investors to attract new capital, just as consumers need to be assured that the electricity market is efficient and competitive. Regulatory intervention into the contractual process is likely to have an adverse impact on new investments.

Nova's response to the specific questions raised in the Discussion Paper are attached.

Yours sincerely

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Nova submission

Consultation Paper: Inefficient price discrimination in the wholesale market – issues and options

Q No.	Question	Response
1	NZAS has a number of unique attributes as a consumer of electricity including size, location, the related potential for stranded water, and capacity to provide demand response. Do you agree that these factors support a discount relative to Benmore prices (as the reference South Island node)? Are there other relevant factors and how might one determine an appropriate level of discount?	NZAS' scale and location means that it is in a unique position for negotiating a continuation of its electricity supply. Further to this, there was sufficient publicly available information for the supplier to assess NZAS' likely margin for smelting aluminium for a given electricity price (albeit it has transpired that since the contract was signed, a number of market changes have resulted in a dramatic recovery in aluminium prices). Other key factors are the term of the contract, the smelter's flat load profile, and the expected impact on the continued availability of thermal generation in the event of the closure of the smelter: i The contract provides an adequate lead time for developing alternative markets for the electricity. If the contract extended significantly beyond fours years at the low price it could be considered an excess transfer of value to NZAS, while a shorter contract term may well have resulted in Meridian remaining under pressure to provide an extension to NZAS. ii The flat seasonal and diurnal demand profile of the smelter provides Meridian with an enhanced capability to allocate its remaining generation capacity to meet peak period demand iii If the smelter closed as originally planned, it seems likely that both Huntly and TCC would have been withdrawn from the market, as has been postulated for some time. Meridian, and NZ, still requires thermal generation capacity in reserve for dry hydro sequences. The NZAS deal provides additional time in the transition, which has also been signalled by the commencement of Tauhara and other new generation projects.

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2	Do you have any additional feedback or information on the efficiency of the existing Tiwai contractual arrangements and their consequences?	The Meridian/NZAS contract also removed the pressure on the Crown to push through a special deal for NZAS on the charges it pays Transpower for electricity transmission. If the smelter closed the entirety of the transmission charges paid by NZAS would have needed to have been recovered from the rest of the market. This does not seem to have been factored into the Authority's analysis.
3	Do you agree that the Authority should investigate price discrimination in relation to wholesale contracts?	No. Even the potential of a contract being reviewed by a regulator can impact on the outcome of negotiations. Negotiations of large contracts are complex and adding the possibility of regulatory interference can be used by parties to manipulate a result to their advantage. Time can also be of the essence in completing negotiations, and the prospect of a regulatory delay may give either party cause for not pursuing discussions to complete an agreement or result in a less satisfactory settlement. Given that a win-win settlement, by definition, creates value for both parties, such failures would represent a net loss of value to the market. The threat of regulatory interference in commercial negotiations may also discourage much needed investment in new generation projects towards a low-emissions economy.
4	Should the Authority's consideration of policy implications from price-discrimination practices extend to situations where electricity is supplied both at discounts and premiums to market prices?	The Authority should focus it efforts on addressing the incidence of circumstances where there is an expected net disadvantage to consumers overall. The NZAS – Meridian agreement is exceptional in size and circumstances. Meridian was only able to benefit from the NZAS contract extension overall because of i) the price impact that NZAS electricity demand has on the overall market, and ii) because the NZAS demand consists of less than 30% of Meridian's and Contact's joint generation capacity. Even that arrangement can only have a temporary impact, as over the longer term third parties will use the higher prices to support new generation builds.
5	Do you agree these baseline assumptions are reasonable? What other assumptions should be tested?	

Q No.	Question	Response
6	Do you agree that any investment issues raised by the Tiwai contracts are best addressed through a review of barriers to new investment more generally, as the Authority intends to undertake in 2022?	Yes. Uncertainty around the future of the Tiwai Point smelter, and more recently the NZ Battery Project have been a barrier to new investment, but this is best covered as a separate exercise. Increased regulatory involvement in contracting would likely become an additional disincentive to new investment.
7	Beyond the Tiwai context, do you consider discriminatory pricing or discriminatory terms and conditions are adversely affecting efficiency and competition in the electricity system? If so, please provide evidence.	No There is no doubt that well informed parties who can engage effectively with the electricity retailers, either directly or through brokers, are more likely to achieve competitive prices. Their position can be further enhanced where they are able to incorporate some form of demand response in the terms of their agreement, or they have favourable demand profiles in relation to the overall pattern of demand. Outside that however, there is no incentive for generators to provide differential pricing to different customers. The only scenario where a generator could potentially gain a benefit is if the agreement secured demand that would otherwise not exist in the absence of a deal, and the price impact for the generator of the increased demand more than offset the discount provided, i.e. as per the NZAS example. Even then however, the duration of that benefit is limited by the length of time it takes for the market to respond by building new generation and competing prices downwards. From another perspective, there are plenty of examples where a new industry has been offered incentives to commence operations in a region or country on the basis that the new business provides benefits for the community in the long run. If a new Southland data centre were to be built, and linked to international communications networks, then it could lead to the substantial expansion of future based-load electricity consumption in the region. Still, given the competitive nature of the electricity market, no retailer could expect to be the sole beneficiary of supporting new investment as the renewal of a supply agreement would still need to be price competitive.
8	Are there other options the Authority could implement to mitigate inefficient price discrimination?	Outside the status quo, the options listed all create risks for the dynamic efficiency of the market which outweigh the benefits of pursuing the options.
9	What are the pros and cons of the status quo?	The key issue around the status quo is the risk of a new agreement occurring that is deemed to be detrimental to the market. The question to be addressed is whether the expected net cost of that occurring is greater than the (almost definite) losses in dynamic efficiency that will occur under increased regulatory control.

Q No.	Question	Response
10	Do you consider that the status quo addresses the problem identified?	Yes, there is a low probability of similar circumstances arising again, and as highlighted in the response to question 1., it is not even definitive that the rest of NZ electricity consumers will be worse off from the Tiwai transaction in the long run.
11	Do use-it-or-lose-it clauses have a legitimate commercial role? What would the effect be of prohibiting them in wholesale electricity markets?	Yes, use-it-or-lose-it clauses are appropriate for fixed price variable volume contracts. They are similar to consumer fair use agreements where the supplier assesses expected usage and reasonably expects the consumers use to be consistent with that. The clause is employed to offset the risk of the purchaser substantially reducing their offtake in the event of changed circumstances, i.e. the intent of the contract is physical supply and not just a financial hedge on prices. In the absence of use-it-or-lose-it clauses the supplier loses if the customer reduces consumption in a low price period, thereby forcing the supplier to accept a lower price by selling the difference elsewhere. The supplier also loses in a high price period if the consumer can on-sell their entitlement and capture any benefit. Under that scenario the contract price would be at a premium to the market price to reflect the option value to the consumer. Where there is a use-it-or-lose-it clause, if electricity prices do spike and it makes sense for the buyer to reduce their load, the parties are still open for the supplier to incentivise the buyer to reduce load at that time. Prohibiting use-it-or-lose-it clauses will necessitate a higher contract price to protect the supplier's position, this may in some cases be a higher price than the buyer can sustain.
12	Which contracts (e.g., minimum size) should be subject to a prohibition on a use-it-or- lose-it clause?	Contract size is largely irrelevant as the same pricing principles apply.
13	What are the pros and cons of prohibiting use-it-or-lose it clauses?	The role of use-it-or-lose it clauses is described above. Regulations that limit the commercial arrangements between a willing buyer and willing seller are likely to, by definition, reduce the net benefit of an agreement to the parties. Competition law should provide adequate protection for competition without prohibiting use-it-or-lose it clauses, particularly now that the reform of section 36 of the Commerce Act has almost been concluded.
14	Do you consider that prohibiting use-it-or-lose it clauses addresses the problem identified?	No, the problem has not been correctly identified.

Q No.	Question	Response
		The problem in the case of the NZAS deal is that Meridian was able to benefit on an aggregate basis by ensuring that NZAS stayed in the market by offering NZAS a much reduced electricity price. This was only possible because Meridian holds a large share of the generation market, and the limited time for which competitors bring new generation to the market to realise the higher market prices for themselves, i.e. if the Meridian-NZAS deal was to extend much beyond four years then Meridian would have been a net loser due to market prices reducing in response to new generation being built. Similarly, if other market participants were aware that NZAS was going to stay for four more years they would likely have advanced their own generation plans earlier.
15	Should this option be limited to pre-approval of contracts, or extended to apply to offers that one party considers are discriminatory?	In Nova's view, there should not be any pre-approval of contracts. Introduction of a pre-approval process for large contracts will likely lead to more contracts that do not balance the benefits to both the buyer and seller. The approval process itself will become a negotiating point and a party that is better placed to accept the risk of a contract being rejected will be able to use that advantage to extract better terms from the other party. Given the nuances of contract negotiation, this will likely result in a loss of economic value.
16	What criteria should the Authority consider in pre-approving large contracts?	This question reflects the crux of the issue of having the Authority becoming involved in approving contracts. For example, if a contract has a 'use-it-or-lose-it' clause plus call and put options to extend the contract for a period with specified prices, the relationship between those clauses is complex and if any one of those clauses is rejected by the regulator, then all of those clauses would need to be renegotiated. If the Authority chooses a high level criterion such as: 'If the transaction is good for the rest of the market', then analysis involved can be quite political and would likely require a significant amount of time. Given that market prices for electricity and commodity products can move significantly over time, even the additional approval time involved becomes an element in the negotiation process.
17	What should the MW or dollar threshold be for contracts requiring pre-approval?	There should be no provision for pre-approval of contracts by the Authority.

Q No.	Question	Response
18	What are the pros and cons of Authority pre-approval?	The concept of the pre-approval process presumes that the Authority can accurately determine if the contract is 'efficient' for the market, but that can only hold true if the Authority has full knowledge of all expected market conditions as well as the circumstances of the contracting parties. A generator may, for instance, be looking to secure sufficient offtake to underwrite a new generation investment, and the final volume commitment may be priced to get the proposed investment 'across the line'. The generator should not have to fully disclose its reasoning to the regulator in order to complete the transaction. Furthermore, a delay on approval may lead to the earlier entry of a competitor's generation project. Or alternatively, a generator may choose to take an increased risk on proceeding with a project without having secured offtake because the uncertainties and time delays associated with negotiating a contract that may not be approved also creates a risk to the project. These are just a few scenarios where the pre-approval process itself leads to market inefficiencies and loss of value.
19	Do you consider that pre-approval of large contracts addresses the problem identified?	No. It creates more issues than it endeavours to solve.
20	Would greater reliance on exchange-traded derivatives provide as much risk mitigation as current arrangements that also encompass over-the-counter risk products? Please explain your reasoning.	No. By design, exchange-traded derivatives require standardisation and significant security to be posted with the clearing agency to cover credit risk. For the use of derivatives to expand there needs to be resolution of the issue of offsetting security required for ASX traded futures contracts with security posted with the wholesale market Clearing Manager.
21	What products would you want to be offered in addition to the existing publicly traded hedge products?	Looking to the future, a traded peak period price cap product is likely to have the greatest impact on opening up opportunities for large consumers and retailers. Pricing on these would also provide a benchmark for valuing demand response. Currently distributors have access to peak period demand management through hot water control, but this is undervalued because their only interest is in RCPD transmission pricing, and occasionally network capacity.
22	What percentage of hedge contracts should be offered publicly?	If hedge contracts were required to be offered publicly, the requirement should only be a minor percentage (10% or so) of the party's generation capacity. That would be more than sufficient to provide a benchmark against which other contracts could be linked.

Q No.	Question	Response
23	What are the pros and cons of public offering of hedge contracts?	In addition to the 'cons' listed in the consultation paper, the imposition of compulsory hedge contracts would likely reduce the availability of fixed price variable volume (FPVV) contracts that are the mainstay of most commercial and industrial supply agreements. Imposing fixed volume obligations on parties that typically have a variable demand would add unnecessary cost and complexity to their risk management processes.
24	Do you consider that public offering of hedge contracts addresses the problem identified?	No
25	How should 'large' hedges be defined?	The aggregate parcel of hedges necessitating a public offer should be at least 2,000 GWh. The maximum size of single 'large' hedges as part of such a parcel could be defined, for example, limited to no more than 263GWh per contract, i.e. equivalent 10MW over a term of 3 years.
26	What are the pros and cons of this option?	The practical issue with hedges is that the commencement date and term required needs to coincide with the requirements of both the buyer and seller. If a party is to have an average duration in its hedge book of two years, then it needs to be holding contracts out to 4 years. These would likely be divided into calendar quarters, so participant's hedge book would have a minimum of 16 contracts if there are to be sufficient counter-parties around at each renewal in a position to make a competitive offer (alternative dates are less likely to find a counter-party). Those individual contracts then need to be of sufficient size to justify the transaction costs, but not so large to restrict the number of counter parties in a position to match offers or bids.
27	Do you consider that the option addresses the problem identified?	No. If a party wishes to make a large capital commitment, then it may need to secure a large hedge contract before proceeding, not least because this may be a requirement from lenders for borrowing purposes. Such arrangements cannot be secured by bidding for smaller contracts in a piecewise fashion because: a) they be likely bidding up the cost, and b) if they cannot secure the total desired level of contracting, they may have to reverse their investment decision and back out of the contracts that were secured at a loss, assuming they can do so in reasonable time. If NZAS had come out publicly and announced it would stay for a further four years if it could secure 572MW of hedge agreements, it is likely that it would have had to include a clause that gave it the right to withdraw from smaller contracts if it failed to meet the target quantity. Apart from the huge uncertainty that would generate in the hedge

Q No.	Question	Response
		market, the net result, if any, would likely require Meridian and probably Contact to commit the same volumes and price that transpired.
28	Which types of contracts should be covered by trading conduct-type provisions?	There is scope for adding trading conduct provisions to all forms of electricity derivative contracts. It would likely be more useful for the types of contracts to be defined in generic terms rather than by category.
29	How would trading conduct-type provisions be monitored: • Where a party to an offer or contract believes they are being disadvantaged? • Where the parties being harmed are not a party to the contract? • Where no offer was received?	Compliance should be pursued when either a 'whistle-blower' or affected party lays a complaint. A complainant should be required to demonstrate the basis for their claim, and to the extent that information may not be available, the Authority can use its powers to gather evidence as appropriate. When the party being harmed is not party to the contract the Authority should be able to pick up the claim on their behalf if they do not have the capability or resources to progress a claim against the transgressor.
30	What are the pros and cons of extending trading conduct-type provisions?	The trading conduct provisions are focussed on ensuring that no party can exercise its market power to extract higher than appropriate margins. It is always difficult to determine when market power exists, and then whether it has been exercised inappropriately on not. Interpretation of the rule is critical to establishing this as a useful guide for market participants. Irrespective of its limitations, a trading conduct-type provision can be expected to enhance market efficiency without having the same negative impacts that direct regulations impacting the formation of large wholesale contracts.
31	Do you consider that extending trading-conduct provisions to hedge contracts would address the problem identified?	Yes, they should help alleviate most of the concerns identified.
32	What attributes of a contract should be permitted reasons for price discrimination? What attributes should be expressly precluded?	The ASX already provides a contract market for electricity futures that has no price discrimination. The counterparty risk normally associated with OTC contracts is overcome by requiring significant security to be provided.
33	What remedies would be appropriate if discriminatory pricing was found?	None.

Q No.	Question	Response
		Even if there is evidence of discriminatory pricing occurring it creates an incentive for others to leverage the same opportunities. This helps drive innovation and creation of value in other ways. So long as those methods do not contravene competition law, then any short term harm is likely to be overtaken by the wider long-run benefits.
34	Are the current penalties under the Electricity Industry Act 2010 sufficient to deter inefficient price discrimination of the scale potentially associated with the Tiwai contracts?	Yes
35	What are the pros and cons of non-discriminatory pricing rules?	There is no simple rule book for defining what terms in an agreement might be termed as discriminatory, and as such proving as a case of discrimination would be very difficult.
36	Do you consider that non-discriminatory pricing rules would address the problem identified?	No
37	What are the biggest risks of implementing this hybrid combination of nondiscriminatory pricing and pre-approval of contracts?	The biggest risk of regulatory intervention is that it would deter investment in new generation at a time when more renewable generation projects are required to transition to a low emissions economy. There would be a significant economic cost in terms of delaying the completion of agreements and creating additional complexity in reaching negotiated agreement as a part of ensuring that any non-discrimination rules are not being broken. This would likely favour regular participants in the market, such as retailers, to the detriment of their customer have may only buy two yearly or less often. It may also require greater participation by intermediaries to assist parties to form agreements that will comply with the regulations.
38	What are the pros and cons of this hybrid option?	As above.
39	Do you consider that this hybrid option would address the problem identified?	No, the costs of compliance and economic inefficiency are likely to exceed the expected benefits.
40	Is inefficient price discrimination best addressed through an amendment to the Electricity Industry Participation Code 2010 or through structural options that would involve other parts of government?	Nova does not believe that structural changes are required to the electricity sector. The size of the large gentailers helps provide economies of scale and the resources to undertake major generation development programmes. They have also been a source of stability in the market with no financial failures outside some small retail companies.

Q No.	Question	Response
41	Which structural options do you think should be considered further? Please explain your reasoning.	If any change is to be made to the market structure it should be to place a cap on the quantity of generation capacity available for internal transfer and require the residual to be sold via long-term power purchase agreements. This could be timed in conjunction with the expiry of the virtual asset swaps and the termination of the supply agreement with NZAS. Such a policy would not prevent the major generators from investing in new generation projects, but it would limit their influence over retail electricity prices.
42	Do you agree with the criteria proposed to assess the options? If not, what additional criteria should be used to evaluate policy options?	Yes