29 September 2020

Submissions
Electricity Authority

By email: FTRConsultation@ea.govt.nz

Revocation of Schedule 14.3

Meridian appreciates the opportunity to provide feedback on the Electricity Authority's consultation paper on removing the requirement for the FTR manager to calculate the amount of LCE to be applied to FTRs.

This proposal comes as a surprise to Meridian and we question whether investigating Code changes to try and avoid the costs of a software upgrade for an important part of the market systems should be a priority.

The LCE calculation in Schedule 14.3 exists for good reason. LCE is the surplus created in the wholesale electricity market once purchasers have been invoiced and generators have been paid. This means the price paid by retailers at each load point is higher than the price paid to generators at injection points. In principle, LCE should flow back to the physical wholesale participants that have paid for the surplus and ultimately consumers would benefit from the efficient allocation of LCE. However, the Authority decided in 2011 to establish an FTR market and fund it from the LCE pool. Meridian agrees that the development of an FTR market is important and beneficial to the overall operation of the New Zealand Electricity Market. However, the calculation in Schedule 14.3 was put in place to ensure that the LCE used to fund the FTR market was only the LCE from parts of the grid that were covered by FTRs. Over time the number of FTR nodes has increased but there are still significant parts of the grid not covered by FTRs and in respect of which significant LCE payments are made to transmission customers.

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The Authority now proposes to abandon the calculation in Schedule 14.3 because there is an opportunity to save on software upgrade costs. This has the potential to reallocate significant amounts of LCE and result in costs to consumers that far outweigh any savings.

To understand the cost to consumers of increasing the LCE available to FTR purchasers one must understand who is purchasing FTRs and benefiting from LCE. In the last four financial years $165.7 million from the LCE pool was used to settle FTRs.

FTR Auction Income	**$392,619,362.04**
FTR Payments	$558,350,739.85
LCE used to settle FTRs	-$165,731,377.81

Over the last four financial years, of the total $165.7 million of LCE used to settle FTRs, $62.1 million (37%) was allocated to non-physical participants. The value of LCE used to settle FTRs represents the profit made by these speculators over and above FTR purchase costs. In the last four financial years Haast Energy Trading alone has made $17 million from FTRs net of purchase costs, i.e. funded entirely by LCE that would otherwise have been paid to New Zealand transmission customers and ultimately passed on to New Zealand consumers.

Participant	Total Revenue from LCE	
Haast Energy Trading	$	17,118,156.53
Macquarie Group	$	1,117,006.67
MMAE	$	97,142.79
OMFM	$	43,591,237.83
Smartwin Energy Trading	$	190,072.96
	$	**62,113,616.79**

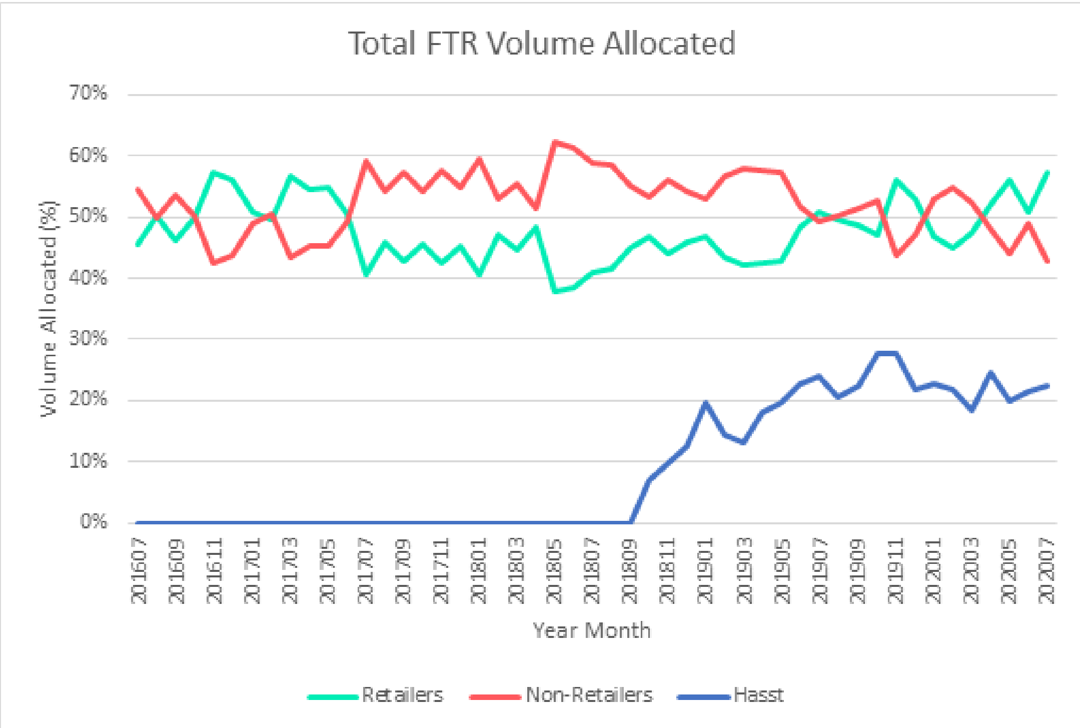
The Authority now proposes to make more LCE available to FTR purchasers, including LCE in respect of parts of the grid that are not covered by FTR products. This is an unjustified reallocation of capital from consumers and physical market participants to speculators and their overseas shareholders.

The Authority's consultation paper has failed to adequately quantify the costs to consumers in the long-term from this reallocation of LCE. There would be both direct and indirect costs to consumers – neither has been accounted for in the Authority's simple cost benefit analysis.

Meridian does not support the proposal in the consultation paper and considers any decision to implement the proposal to be contrary to the long-term interests of the New Zealand electricity market and consumers.

There are broader issues with the operation of the FTR market that should be resolved as a priority, for example:

- **The extent of speculation on the FTR market** – The FTR market was established to enable retailers to manage locational price risk. The extent of speculation in the market is contrary to this intended purpose. On average, physical participants (retailers) make up 48% of the total FTR volume allocated over the past four financial years. Non-retailers (speculators) make up 52% of the Market. Haast Energy Trading alone accounts for between 20% to 30% of total FTR volumes (prior to September 2018, we understand that Haast traded via a broker). As noted elsewhere in this submission there is no benefit as a result of these high levels of speculation. The FTR market is auction based and speculators do not add liquidity – FTRs are a finite pool and thus unlike other products, speculators are not adding liquidity through origination of products, all speculation does is reduce the number of FTRs available for physical participants to hedge locational price risks and extract capital from the LCE pool, which is a surplus from the physical market.



- **The operation of washups** – in January 2019 all the LCE was made available to the FTR market, leaving nothing to offset washups for earlier months. Instead of scaling back FTR settlements, Transpower invoiced transmission customers for the additional revenue needed for the washups. This meant that not only did transmission customers forego all LCE for January 2019 they also had to make additional payments to FTR purchasers. Meridian proposes that washups be resolved ahead of FTR settlements so that FTR settlements would then be scaled and further cross-subsidisation from transmission customers to FTR purchasers would not occur.

These priority issues with the FTR market need to be resolved before the Authority contemplates further harming transmission customers by allowing additional capital to be extracted from the physical market at the long term expense of New Zealand businesses and consumers.

Meridian’s responses to the consultation questions are appended.

Please contact me if you have any queries regarding this submission.

Yours sincerely

Sam Fleming
Manager Regulatory and Government Relations

Appendix: Response to consultation questions

	Question	Response
1	Do you agree the issue identified by the Authority is worthy of attention?	No. The issue identified by the Authority is not worthy of attention. The only issue seems to be that a software investment is on the horizon and the Authority would like to avoid some associated costs. The consultation paper does not make clear why those costs would be passed on to consumers. Under Schedule 1, clause 5 of the FTR manager service provider agreement, the agreed fees already cover all third-party software maintenance and support costs. Under schedule 1, clause 6 fees for new equipment or third-party software including updates are only passed through to the Authority (and therefore consumers via the levy) if pursuant to a change under clause 7; whether that is the case here is entirely unclear. To avoid the cost of the software investment it seems the Authority intends to abandon the agreed process by which the FTR market is funded. This will result in significant wealth reallocation and a net detriment to consumers. As noted by the Authority, FTRs do not cover all the grid electricity flows. The FTR rental is calculated by the FTR manager under Schedule 14.3 and is designed to ensure that the amount of LCE available for the settlement of FTRs is representative of the parts of the grid that FTRs are traded across. There is no reasonable justification for extending the amount of LCE that is available to fund the FTR market. This would involve reallocating LCE from parts of the grid that are not covered by FTR nodes. For example, the Manapouri to North Makarewa circuit is a connection asset paid for exclusively by Meridian. There are no FTRs available for flows over this circuit. Meridian receives significant loss and constraint excess payments in respect of this circuit (up to $800,000 per month). The proposal by the Authority puts that LCE at risk and in some months, it would be reallocated to FTR purchasers. The scale of this wealth transfer in one month alone would far exceed the small benefit identified by the Authority over 10 years as a result of an avoided software investment. The Authority downplays the impact on LCE allocation, but the impacts could be very real and potentially significant in any month of FTR revenue inadequacy, as is expected to occur once per annum. The Authority's proposal would not only result in a wealth transfer; there would be a significant loss to consumers. LCE is the surplus created in the wholesale electricity market once purchasers have been invoiced and generators

have been paid. This means the price paid by retailers at each load point is higher than the price paid to generators at injection points. In principle, LCE should flow back to the physical wholesale participants that have paid for the surplus and ultimately consumers would benefit. In practice, LCE flows back to consumers via transmission customers, for example through:

- payments to grid connected industrial consumers;
- payments to distribution networks (some pass on LCE to consumers, others retain LCE or are not transparent about how LCE is accounted for); and
- payments to connected generators, defraying the cost of doing business as a generator.

Around half of all FTRs are purchased by speculators and reallocation of LCE to FTR purchasers therefore results in a cost to consumers as capital is redirected away from consumers and physical participants in the New Zealand electricity market. In the last four financial years $165.7m from the LCE pool was used to settle FTRs.

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Of the total $165.7m of LCE used to settle FTRs, $62.1m (37%) was allocated to non-physical participants. The value of of LCE used to settle FTRs represents the profit made by these speculators over and above the purchase cost of FTRs.

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There are fundamental issues with the involvement of speculators in the FTR market that need to be addressed before more LCE is allocated to the settlement of FTRs.

Meridian does not consider there to be any consumer benefit as a result of speculation in the FTR market. There is clearly a significant cost to consumers. Generally economic theory says that speculators increase trading activity and improve the accuracy of pricing in markets, i.e. speculators will sell when the price is perceived to be too high and buy when the price is too low, and generally drive more accurate price discovery. However, this theory only applies to markets where participants enter bids to buy and offers to sell at prices at which they have an appetite to

		transact. The volume of transactions on these markets is limited to the willingness of participants to buy and sell at the prices available and upon settlement value is transferred between participants. The FTR market is entirely different and there is no equivalent benefit from speculation activity. This is because the FTR market is largely an auction for a finite volume of instruments that already have value. As noted above, this intrinsic value is funded by physical consumers and wholesale participants. Speculation reduces the availability of the finite FTR instruments and therefore limits the ability of physical participants to manage their locational risk. Speculation reduces the available FTR capacity rather than increases it. There might be liquidity benefits from speculation in the FTR secondary market, however in our experience trading outside of auctions is minimal.
2.	Do you agree with the objectives of the proposed amendment? If not, why not?	The consultation paper states: “The objective of the proposed amendment is to reduce the complexity of the LCE calculation by allocating all LCE to the settlement of FTRs.” Meridian disagrees with this objective. The LCE calculation serves an important purpose. Mathematical calculations are general complex and that is accepted. The complexity is necessary due to the complexity of the physical grid and the need to ensure that the amount of LCE available for the settlement of FTRs is representative of the parts of the grid that FTRs are traded across. If the calculation can be made less complex while still achieving its purpose, then that would be acceptable. However, that is not the case here where it seems the objective of the proposal is not to reduce complexity but rather to do away with the calculation entirely and ignore the reasons why the calculation exists. As noted above, Meridian disagrees with the wealth redistribution that would result and considers the costs to consumers to far exceed of the modest cost savings identified by not carrying out the LCE calculation.
3.	Do you agree the benefits of the proposed amendment outweigh its costs?	No. The Authority seems to think that the $354,000 cost saving over 10 years from removing the FTR calculation has no downside. However, by the Authority’s own calculations transmission customers would have been worse off by $1,330,051 due to one month (out of the 21 months assessed) of FTR revenue inadequacy in November 2018. Revenue inadequacy is part of the design of the FTR market and is expected to occur up to once in a 12 month

		period. The costs to transmission customers of the proposal could therefore be expected to be between $7.6 million and $13.3 million over the same 10 year timeframe as the identified cost saving[1]. This easily outweighs the $354,000 benefit identified in respect of the Authority's proposal. While the Authority attempts to characterise the cost of removing the LCE calculation as a wealth transfer, it is in large part a transfer from consumers to offshore speculators and should rightly be considered a cost to consumers and a cost to the New Zealand electricity market. The cost to consumers will be a direct cost in many cases as a loss of LCE payments. Costs to consumers would results as LCE from consumers' connection assets would be put at risk along with LCE from parts of the interconnected grid not covered by FTRs – for example consumers north of Auckland would be at risk of foregoing LCE that would normally be derived from the interconnection assets north of Auckland and the connection assets of each consumer or offtake customer. The vast majority of connection assets identified by Transpower are for offtake customers and these customers would be directly disadvantaged by the proposal. The wealth transfer away from grid connected generators to FTR purchasers (half of which are speculators) would also have a long term cost to consumers by shrinking the size of the 'economic pie'. Wealth transfers can be excluded from the Authority's assessment only to the extent that a wealth transfer 'nets off' among all electricity consumers in aggregate. That is not the case for the current proposal where additional capital would be extracted from the New Zealand electricity market through the inefficient allocation of LCE to speculators outside the physical market (with no commensurate consumer benefit) and there would likely be a deleterious effect on electricity consumers in the long term.
4.	Do you agree the proposed amendment is preferable to the	No. The FTR system should be upgraded and the LCE calculation retained.

[1] The bookends of that range represent the experience of the 21 months assessed multiplied over 10 years (at the bottom of the range) and the expectation of one revenue inadequate month in every 12 months (at the top of the range) and assuming the same impact of revenue inadequacy as November 2018. Meridian considers this a conservative assessment because the Authority is considering preventing generators from managing locational risk through generation offers. If this change to normal market operations was implemented one would expect more price separation on the grid and therefore more frequent FTR revenue inadequacy.

	other options? If you disagree, please explain your preferred option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.	This will have a greater net benefit to consumers in the long term once the costs associated with the loss of LCE payments are properly accounted for.
5.	Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?	No. The proposed amendment will not support the efficient operation of the electricity industry. The proposed amendment is essentially a cross subsidy from transmission customers on parts of the grid not covered by FTRs to FTR purchasers (over half of which are non-physical participants).
6.	Do you have any comments on the drafting of the proposed amendment?	Meridian disagrees there is any need for Code changes.