# Clearance application - Meridian/NZAS demand response agreement

Decision paper

8 June 2023

ELECTRICITY AUTHORITY
TE MANA HIKO

# 1. Executive Summary

1.1. Meridian Energy Ltd (Meridian) has applied for clearance under the materially large contract (MLC) code provisions in place at the time of the application (subpart 7 of Part 13 of the Electricity Industry Participation Code (Code)) (MLC Urgent Code).

1.2. The application was triggered by Meridian and the New Zealand Aluminium Smelter (NZAS) entering into a new Demand Response Agreement (DR Agreement) and contemporaneous amendment letter (Amendment Letter). These documents were subsequently further supplemented by a second amendment letter (Second Amendment Letter). Together these three agreements modify the existing supply contract between Meridian and NZAS (Tiwai Agreement) to provide for the addition of a demand response arrangement. Taken together this combination of four agreements is referred to as “the Electricity Agreement” in this Decision Paper.

1.3. The DR Agreement and the Amendment Letter were entered into on 4 April 2023 and announced to the public on 5 April 2023. Both are conditional on clearance from the Electricity Authority (Authority). The Second Amendment letter was entered into on 15 May 2023 and is also effectively conditional on clearance being granted.

1.4. The Authority has decided to provide clearance under clause 13.273 of the MLC Urgent Code for the Electricity Agreement for such period as the DR Agreement and the resulting amendments to the Tiwai Agreement remain in force and effect as it is satisfied that clause 13.269(1)(b) of the MLC Urgent Code is met. Specifically, the Authority is satisfied that for so long as the DR Agreement and the amendments made under the two Amendment Letters remain in force and effect the Electricity Agreement allows NZAS to on-sell any un-used MW quantities without being subject to any worse terms than if it had consumed the relevant quantity itself.

1.5. The DR Agreement, when called upon by Meridian, means that NZAS reduces consumption, and that proportion of electricity (up to 50MW) can then be sold for its highest value use. When the DR Agreement is called on, NZAS’s demand is reduced, which will benefit consumers by lowering prices, all else being equal. This is not the basis on which clearance was sought nor the basis on which clearance has been granted and so is not directly relevant to the decision to provide clearance. However, the Authority notes that this outcome is also aligned with the policy underpinning the MLC Urgent Code and is in the long-term benefit of consumers.

# 1. Purpose

1.1. The purpose of this paper is to explain the reasons for the Authority's decision to provide clearance to Meridian for the Electricity Agreement under clause 13.273 of the MLC Urgent Code.

# 2. Introduction

2.1. The Authority made an urgent amendment to the Electricity Industry Participation Code 2010 (Code), in August 2022, to address the potential for inefficient price discrimination in very large contracts (MLC Urgent Code). The MLC Urgent Code was revoked and replaced by a permanent (and very similar) Code amendment on 19 May 2023.[1]

2.2. The MLC Urgent Code defines materially large contracts and prohibits a generator giving effect to them unless it can be demonstrated that the MLC passes one of two tests. These are:

(a) Under clause 13.269(1)(a) of the MLC Urgent Code, an economic test of whether the value of the MLC to the generator is greater than the value to the generator of its best alternative (**net value test**).

(b) Under clause 13.269(1)(b) of the MLC Urgent Code, a legal test of whether the MLC allows any un-used MW quantities of electricity to be on-sold by the buyer without being subject to any worse terms than if the buyer had consumed the relevant quantity itself (**on-selling test**).

2.3. A clearance can be sought to provide parties with comfort that their MLC falls within one of these tests and is therefore not prohibited.

2.4. On 5 April 2023, Meridian made an application to the Authority for clearance under the MLC Urgent Code in relation to a demand response agreement (DR Agreement) and an amendment letter (Amendment Letter) which, for the duration of the DR Agreement, modifies the existing supply contract between Meridian and NZAS (Tiwai Agreement). A further amendment letter which also modifies the Tiwai Agreement for the duration of the DR Agreement was entered into between Meridian and NZAS dated 15 May 2023 and provided to the Authority that same day (Second Amendment Letter). That Second Amendment Letter also forms part of the clearance application.

2.5. The clearance application from Meridian relies on the Electricity Agreement falling within the on-selling test.

2.6. Meridian's application has been considered under the MLC Urgent Code, which applies to any applications made prior to 19 May 2023, when the permanent Code amendment became effective.

[1] Decision_paper_-_Inefficient_price_discrimination_in_very_large_electricity_contracts.pdf (ea.govt.nz)

## 3. Background

3.1. Meridian has a contract to supply electricity to NZAS (the Tiwai Agreement[2]) and has negotiated a DR Agreement[3] and two Letter Amendments[4] to the Tiwai Agreement. Taken together these four agreements fall for consideration under the MLC Urgent Code as a materially large contract.

3.2. Meridian entered into the DR Agreement and Amendment Letter with NZAS on 4 April 2023. It subsequently entered into the Second Amendment Letter dated 15 May 2023. The DR Agreement will commence on Authority clearance and expires on 31 December 2024, when the Tiwai Agreement also expires. The two amendment letters apply from the same effective date as the DR Agreement and end either on the expiry of the DR Agreement or its termination. All are conditional on the Authority providing clearance.

3.3. In short, the DR Agreement gives Meridian the ability to require NZAS to reduce consumption by up to 50MW. Meridian would pay NZAS a premium as well as a fixed price for each MWh reduced by NZAS under the DR Agreement.

3.4. The Amendment Letter sets out a number of changes to the Tiwai Agreement that are required to give effect to the DR Agreement and some other matters.

3.5. Importantly for the clearance process, and the provisions of the Code relied on by Meridian for clearance, the Amendment Letter also removes clause 12.8B(b) of the Tiwai Agreement for the duration of the DR Agreement, which may have indirectly prevented NZAS from on-selling. Prior to its deletion, clause 12.8B(b) would have given Meridian the right to terminate the Tiwai Agreement if NZAS reduced consumption below 540MW for a 3-month period.

3.6. In the course of the clearance process, Meridian advised that it had agreed with NZAS (in the Second Amendment Letter) to further amend the Tiwai Agreement for the duration of the DR Agreement by the addition of clauses 7.9F, 7.9G and 7.9H to clause 7.9 of the Tiwai Agreement. The addition of the new clauses modifies the payment provisions of the Tiwai Agreement to provide for a scenario where NZAS has on-sold un-used MW quantities under that Agreement.

## 4. Reasons for decision

4.1. The DR Agreement, the Amendment Letter, the Second Amendment Letter and the Tiwai Agreement, taken together, constitute an MLC under the MLC Urgent Code. That is, the Electricity Agreement falls within the definition in clause 13.268(1) as it is not entered into through a derivatives exchange, relates to the physical consumption of electricity, and relates to a net quantity of electricity that equals or exceeds 150 MW consumed at a point in time.

4.2. While the original Tiwai Agreement could not be retrospectively considered under the MLC Urgent Code, the entry into the DR Agreement, the Amendment Letter and the Second Amendment Letter trigger consideration of the Electricity Agreement under clause 13.269(3) on the basis that a modification of the Tiwai Agreement has occurred after the date on which the MLC Urgent Code came into force. The

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[2] NZAS contract | Meridian Energy
[3] Meridian and NZAS Demand Response Agreement (meridianenergy.co.nz)
[4] The first Amendment Letter is published on the Meridian website (meridianenergy.co.nz)

prohibition and disclosure requirements contained in the MLC Urgent Code are therefore engaged.

4.3. A generator cannot give effect to an MLC unless it meets the i) net value test; or ii) the on-selling test set out in clause 13.269(1) as described above.

4.4. In its clearance application, Meridian relies on the on-selling test, i.e. that NZAS is allowed to on-sell any unused MW quantities without being subject to worse terms than if NZAS had consumed the electricity itself. The ability to on-sell relied on by Meridian is that NZAS could reduce consumption and sell a contract for difference (CFD) to a third party, or simply take the difference between the spot price and the contract price.

4.5. Having considered Meridian's application and the terms of the Electricity Agreement, the Authority is satisfied that it allows for such a CFD to be entered into by NZAS (should NZAS choose to do so on terms that are acceptable to it and a third-party purchaser) and accordingly that clause 13.269(1)(b) is satisfied.

4.6. The Authority has therefore decided to provide clearance for the Electricity Agreement. This clearance remains in place for so long as the DR Agreement, and the amendments under the Amendment Letter and the Second Amendment letter, remain in force and effect, after which time it shall cease to apply. This includes where the DR Agreement is terminated earlier than its specified Expiry Date of 31 December 2024 including by virtue of clause 15 of the DR Agreement.

4.7. In reaching this view that Authority notes that in clause 13.269(1)(b) the reference to "on-selling" can include a back-to-back CFD (as is contemplated here by Meridian as the means of on-sale) and need not be a physical on-sale. This is discussed further below. The Authority further notes that the reference to "allow" does not necessarily require the MLC to include express on-sale provisions. However, the Authority needs to be otherwise satisfied with appropriate evidence and rationale that an on-sale could indeed occur under the contract (on no worse terms). The Authority is so satisfied in this case.

## On-selling can happen via a contract for difference or through a physical arrangement

4.8. A "buyer" can on-sell electricity either through physical or CFD arrangements to achieve efficient outcomes consistent with the policy intent of the MLC Urgent Code.

4.9. Where the MLC allows on-selling (on no worse terms), then a buyer who does not value the electricity as highly as other prospective users may redistribute that through both physical and CFD type arrangements. In some instances, a CFD may be the lower risk and easier option for the original buyer to on-sell un-used electricity. On-selling could also be achieved in a more physical sense by the buyer either building a retail book, or more likely, simply reducing consumption and taking the margin between the CFD price and the spot price. In either scenario, the policy goals of the MLC Urgent Code are achieved.

4.10. Take for example a buyer, which has 500 MW demand profile. They enter a 500 MW contract which provides for on-selling. Consider that at some point over the life of the contract they realise they can make more profit from selling the electricity than from consuming it themselves.

4.11. The buyer's financial situation is broadly the same if they execute this through either a physical sale or a CFD. In both cases they earn the sale price from the on-selling agreement, and their electricity exposure is net zero if they cease production (500 MW from the MLC + 0 consumption – 500MW sold to third party = net zero).

4.12. In both cases the third-party buyer adds 500MW of exposure to electricity to their net positions. Whether the third party consumes the electricity or is simply a speculator doesn't impact the analysis – the prevailing spot and forward market prices are efficient in all cases (with no subsidised demand). Nor does it matter whether the contract is for physical sale or CFD – though in most instances these parties would prefer CFD structures as these are simpler.

4.13. In both cases, future spot prices reflect the original buyer's decision to curtail consumption, which reduces generators' spot revenues across their generating portfolios and they have potentially foregone revenues on the 500MW (if sold at a subsidy).

# 5. Decision

5.1. The Authority has decided that the Electricity Agreement (being the Tiwai Agreement as modified by the DR Agreement, the Amendment Letter and the Second Amendment Letter) satisfies the "on-selling test" in clause 13.269(1)(b).

5.2. The Authority has therefore decided to provided clearance for the Electricity Agreement under clause 13.273 of the MLC Urgent Code. This clearance remains in place for so long as the DR Agreement, and the amendments under the Amendment Letter and the Second Amendment Letter, remain in force and effect, after which time it shall cease to apply.