Summary of decision on actions to correct 26 March 2011 UTS

Following its consideration of industry submissions, the Electricity Authority's UTS Committee confirmed it will direct the resetting of offer prices at the Huntly power station on Saturday 26 March 2011 to a maximum of $3,000/MWh (megawatt-hour), to correct the Undesirable Trading Situation (UTS) on that day. This compares to Huntly offer prices of around $19,000/MWh that would have stood if the UTS Committee had taken no action to correct the UTS.

The UTS Committee delegated to the Chair of the UTS Committee and the Chief Executive of the Authority, or to any two UTS Committee members, the power to approve final prices for every node in the wholesale market for electricity for trading periods 22 to 35 on 26 March 2011 consistent with the inputs specified in its decision. Those prices are the prices specified for the purposes of clause 5.2(2)(c) of the Electricity Industry Participation Code (Code).

The revised offer prices are intended to reflect the prices wholesale electricity market purchasers would have incurred with their own demand response or would have paid for demand-side response, had they received continuing forecasts of exceptionally high prices in the hours leading up to the UTS.

Further details on the decision on actions to correct UTS

The decision is that final prices for trading periods 22 to 35 on 26 March 2011 are established on the basis of Genesis Energy's offers for its Huntly power station being reduced to a maximum of $3,000/MWh in those trading periods.

The $3,000/MWh offer price cap removes the effects of the market squeeze[1] component of the UTS, while retaining incentives on participants that are aligned with those in a workably competitive market. In a situation where there is a willing buyer and a willing seller, a net pivotal generator[2] should be able to price up to the economic alternative of the buyer, which would approximate the long-run marginal cost of a new entrant generation option or the opportunity cost of electricity for consumers (i.e. the price at which demand response occurs). The Code restricts the remedies for a UTS to only those interventions necessary to correct the UTS. The UTS Committee considered that setting a cap on Huntly offer prices at short-run marginal cost would go further than just correcting the squeeze component of the UTS, while setting a cap on Huntly offer prices above $3,000/MWh would not go far enough to correct the squeeze.

The UTS Committee considered the possibility that resetting offer prices in those circumstances may have the effect of creating a price cap or distorting incentives in the wholesale market for electricity. However, the UTS Committee emphasised its actions in regard to price-setting are specific to these circumstances. Moreover, by way of context, the UTS Committee noted circumstances such as those that arose on 26 March 2011 can be expected to arise only rarely. As the UTS Committee noted in its decision that a UTS existed on 26 March 2011, an analysis of the net pivotal status of Genesis Energy in the Auckland region from 2007 to 2011 only identified five half hour trading periods when it might have been net pivotal (apart from 26 March 2011).

In regard to the impact of its actions on the hedge market, the UTS Committee considered the final prices arising from its actions provide an incentive for parties to manage their risk that is consistent with the incentive those parties would face in a workably competitive market. The final prices should enhance hedge market activity as participants can be confident that hedge market prices do not reflect a market squeeze in the wholesale market for electricity. Market squeezes in the wholesale market for electricity would hamper

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[1] A market squeeze occurs when a generator is in a position whereby it is able to "name its price" but parties exposed to that price are unaware of the price until it is too late for them to curtail their demand or increase their own generation or arrange for someone else to undertake these activities for them.

[2] A generator is net pivotal when it is the marginal generator supplying a region and the amount of electricity it can produce is greater than that required to supply its own customers' load in the region.

hedge market activity, which in turn may lessen spot market activity, due to a reduced ability for spot market participants to manage risk.

In particular, market squeezes in the wholesale market for electricity are likely to undermine the development of an active hedge market because any party that is unable to significantly influence prices in the wholesale market for electricity, such as financial intermediaries, but also other parties, are left totally exposed to the price-setting decisions of the party able to execute the squeeze, as the latter can set the wholesale market price at whatever level it chooses.

Similarly, a generator-retailer that is short on generation is highly exposed to the price setting decisions of the squeezer and will become very conservative regarding the volume of hedges it offers to the market. The end result is that allowing market squeezes to occur in the wholesale market for electricity is likely to stifle competition in the hedge market.

Although it may appear that market squeezes in the wholesale market for electricity should increase demand for hedges, this is not necessarily the case. At the margin, hedge purchasers will be left dealing in the hedge market with the same party or parties that exercise market squeezes in the wholesale market for electricity. As a result they are likely to face higher hedge prices than would occur without market squeezes in the wholesale market for electricity, and may view the relative attractiveness of the hedge and wholesale electricity markets as unchanged.

The UTS Committee gave consideration to the issue of whether the actions to correct the UTS will increase regulatory uncertainty in the market. While ex-post regulatory intervention in the wholesale market for electricity may create uncertainty in many circumstances, the intervention only occurred because a UTS had occurred and it was targeted specifically at correcting the UTS. The Code restricts the remedies for a UTS to only those interventions necessary to correct the UTS.

The UTS Committee’s view was that it exercised its regulatory discretion in a manner consistent with the Code and the Authority’s interpretation of its statutory objective, and therefore it should reduce regulatory uncertainty for industry participants. In contrast, allowing the interim prices for 26 March 2011 to become final prices would have increased uncertainty in the wholesale market for electricity, as it would have signalled that generators in a net pivotal position had total discretion in setting prices, regardless of whether a market squeeze occurred or not.

While the UTS Committee noted that certain parties south of the transmission constraint on 26 March 2011 took actions in response to the exceptionally high prices, setting remedial market prices at the level at which those parties were incentivised to respond as they did on 26 March 2011 would not be directed at correcting the market squeeze, and therefore was inconsistent with the requirements of Part 5 of the Code. Similarly, the UTS Committee noted that the payment of constrained off compensation to those parties was not possible under the UTS provisions in Part 5 of the Code.