

Electricity Authority
By email: uts@ea.govt.nz

15 September 2020

Cross Submission on Preliminary Decision – Undesirable Trading Situation – 12 December 2019

Mercury welcomes the opportunity to cross-submit on the Authority's preliminary decision on the undesirable trading situation (UTS) claim. Any potential remedies should be carefully considered to ensure that they promote competition, reliability and efficiency as well as supporting the right balance for participants in managing the physical and financial risks associated with the wholesale electricity market. The UTS claim has demonstrated the need to further develop and maintain market monitoring capabilities and progress key elements of the Authority's work programme, specifically trading conduct and information disclosure. It has also highlighted ongoing tensions and confusion around spot market dynamics particularly use of assets to manage basis risk.

Using assets to manage basis risk can be efficient and result in long term benefits for consumers

The debate around when it is appropriate to use assets to manage basis risk highlights that some of the nuances around this practice appear to be poorly understood. As we argued in our original submission and consistent with views raised in generator/retailer submissions, there is a distinction between managing risk and exploiting market power. Mercury does not consider the UTS is the appropriate mechanism to provide the necessary analysis of this issue.

Managing nodal price and price separation risk through a mixture of physical asset offers and/or financial products by participants has always been a feature of New Zealand's electricity market design. Financial Transmission Rights (FTRs) were an important introduction but are not available at every node and are subject to scaling which is a particular risk large scale, nationwide generator/retailers must manage. The inability to perfectly hedge all price and basis risk through financial instruments means the use of physical market offers to manage transmission constraints is an important element of risk management for participants. This is particularly the case in response to infrequent, short duration market events which are unable to be hedged in real-time. If this was not the case and generator/retailers only relied on FTRs to manage basis risk, the increased demand for FTR capacity would drive the price up for all participants for all periods and result in a lessening of competition in regions of the market where appropriate hedging instruments are not available. It can be more efficient to manage high volume exposure to basis risk through adjusting generation volumes when transmission constraints signal lines are at capacity.

Regulatory consistency and dynamic analysis are important

Mercury notes several submitters highlighted that the preliminary decision on the UTS claim appears inconsistent with previous Authority decisions which undermines regulatory certainty¹. The decision also relies on static analysis which does not factor in all the variables that influence and impact the generation levels of competing generators. For example, as Meridian points out:

'The ultimate levels of hydro storage were determined by numerous factors, including the generation decisions of other North Island generators, demand levels, and the level of rainfall in

¹ Meridian submission Part D, Contact submission paras 22-28

the Taupo catchment. In that regard, the nexus between the December 2019 situation and the reduction in North Island storage is simply too remote for it to be properly be considered as arising due to (or even contributing to) a UTS finding.’²

We share Genesis’s concern that:

“the Authority’s position could thus be summarised as: “it is unacceptable to structure offers to manage transmission constraints, except when the Authority determines it is acceptable, which will be made clear ex-post.” It should not be controversial to state that this is not a workable standard in practice.”³

In their submission Meridian cites a number of examples of assets being used to manage basis risk including Mercury’s offers at Arapuni 3-7 August 2020.⁴ Our views on the use of offers to manage constraints are clearly outlined above, however we do not consider the Arapuni offer behaviour cited by Meridian as a relevant comparison to the UTS claim. Our offers in this instance reflected our view of the opportunity cost of using scarce water to generate at a more efficient level than would have occurred in our previous offers. As the Authority’s draft decision notes, the opportunity cost of water in the UTS was likely to be at or near zero.

Focus on addressing conduct and improving transparency

The UTS claim raises questions around the appropriate conduct for market participants particularly during hydro spill situations, rather than indicating wider systemic issues or market failure. The initial claim prior to the UTS was a breach of the high standard of trading conduct provisions. An investigation of this breach is still underway. This is unfortunate given there is a clear difference of opinion between Meridian and the Authority with respect to the high standard trading conduct guidelines which, despite work by the Market Development Advisory Group, has yet to be resolved⁵.

If the Authority concludes the actions of participants breached the provisions, then Mercury supports that behaviour being dealt with appropriately using the full remedies available to the regulator under the Code. Mercury does not consider the UTS provisions are the most appropriate arrangements to address issues of market conduct compared to transparent and effective conduct provisions. The UTS mechanism is designed for instances when no other remedies are available. We share Contact’s concern that finding a temporary reduction in competitive pressure, (high price event) as a ground for a UTS will risk creating incentives for those exposed to the spot market to lodge UTS claims whenever high prices occur, not compensate those who have obtained hedges and not provide compensation for generators who are otherwise exposed to low price events for long periods.⁶ We support comments made by Trustpower:

“...if the Authority wishes to introduce a prohibition on generator offers being used to manage transmission constraints, this should be considered as a policy matter rather than indirectly introduced via the Authority’s compliance activities. Any reset of boundaries for behaviour within the market should occur ex-ante through an appropriate regulatory instrument (i.e. code change, issuance of guidelines etc).”⁷

Mercury supports the point made by Nova that if the Authority upholds the preliminary UTS decision it will need to consult on remedies. The usual practice is to reset prices for the period where a UTS is held to have occurred. However, in this case such a remedy would involve the imposition of below short run marginal cost revenues on Nova ex-post, which would not be an outcome expected under normal market conditions.⁸

Information disclosure is part of the Authority’s work programme and progress has been made addressing disclosure of thermal fuel. Mercury agrees with the points made by Vector that, as well as clarifying the high trading

² Meridian submission pg 59-60.

³ Genesis submission para 30.

⁴ Meridian submission pg 37.

⁵ Authority letter to Meridian 8/5/2017.

⁶ Contact submission para 31.

⁷ Trustpower submission pg 2.

⁸ Nova submission pg 1-2.



standard conduct rules the Authority could usefully focus on how to improve information disclosure requirements as they relate to hydro spill. Our view, shared by Vector, is that all types of fuel availability should be disclosed in the electricity market, where that information might otherwise be readily available to some but not all participants. We support Vector's suggestion that the Authority contract for hydro data on the basis that it has significant public good attributes and publish it on the EMI website.⁹

Health and safety is critical when managing extreme events in real-time

Mercury supports the point made by Contact and Meridian that in times of unforeseen, extreme events such as large-scale flooding, the priority must be safety of people, plant and local communities followed by the structural integrity of assets and associated infrastructure. This would also be the case for other events such as earthquakes, fires, explosions, significant plant outages and major landslides. In such circumstances those making offer decisions do not have perfect foresight which should be taken into account in any ex-post review.¹⁰ Mercury would always prioritise the health and safety of people and the local communities it serves in periods of extreme events.

Please direct any questions or feedback on this submission to me at sharron.came@mercury.co.nz.

Yours sincerely



Sharron Came
Regulatory Strategist

⁹ Vector submission pg 1-2 particularly para 13 relating to hydro spill disclosure.

¹⁰ Contact submission para 3 and 14. Meridian submission, Chief Executive's forward para 3 and Part B which details the context around the Nov 2019 events.

