16 September 2020

Doug Watt
UTS Team
Electricity Authority
By email to UTS@ea.govt.nz

Dear Doug

Consultation on UTS preliminary decision

1. This is a cross-submission by the Major Electricity Users' Group (MEUG) on the submissions by 13 other parties that closed 18th August on the Electricity Authority (EA) paper "The Authority's preliminary decision on claim of an undesirable trading situation" (UTS) 30th June 2020.[1] The UTS claim was lodged by Haast Energy Trading, Ecotricity, Electric Kiwi, Flick Electric, Oji Fibre, Pulse Energy Alliance, and Vocus (Haast et al.). MEUG appreciated the one-week extension to the deadline for cross-submissions

2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Several members intend making submissions.

3. MEUG's submission agreed with the preliminary decision the event was a UTS [5] "subject to considering the submissions of other parties."[2] To test whether to change our view we have focussed on submissions unambiguously disagreeing with the EA's preliminary decision. Those submissions were by Meridian Energy Ltd (MEL), Contact Energy (CEN) and Mercury Energy (MCY). The remaining ten submitters either:

   - Unambiguously agreed with the preliminary decision, refer Nova Energy and NZ Steel.
   - Wanted a wider scope and timing of the UTS decision, refer Haast et al.
   - Discussed policy, process, monitoring and modelling issues without specifically stating a definitive view on the UTS preliminary decision, refer Electric Power Optimization Centre (EPOC), Energy Link, Helen Brookes, Neil Walbran, Trustpower and Vector.
   - Reserved their judgement, refer Genesis Energy.

[1] All materials are on web page https://www.ea.govt.nz/code-and-compliance/uts/undesirable-trading-situations-decisions/10-november-2019/.

[2] References to paragraph numbers in submissions are in square brackets and pages prefaced with "p".

4. The balance of this cross-submission discusses four key themes in the submissions by MEL in particular:

- Nothing abnormal happened and hence this was not a UTS event.
- There was no harm to consumers.
- If there is a perceived problem, then the UTS regime is the wrong tool to use.
- The EA's analytical approach was inappropriate.

and ends with concluding comments on next steps.

Nothing abnormal happened and hence this was not a UTS event

5. MEL's Executive Summary listed four reasons the EA's preliminary decision was wrong. Two of those reasons were [pp8-9] "Spot market outcomes were not unusual" and [p9] "The HVDC risk was not a major factor and generators managing transmission constraints with offers is normal market behaviour."

6. MEUG is not convinced. The physical flood events were at the extreme of historic inflow events, i.e. not normal. The reaction of MEL to manage commercial risks associated with this abnormal physical event was to rely on prior practice of using offers despite the EA's warning that it viewed that as not acceptable. It is normal in New Zealand for regulators to take a light-handed approach and signal to the market behaviour not considered acceptable thereby leaving an opportunity for participants to find non-regulated solutions.

7. It is not normal for a market participant to not heed the warning of a regulator and expect the regulator or other participants to stand by when the participant repeats their behaviour. It is therefore not a surprise to MEUG a UTS claim was lodged reflecting further erosion of already low confidence in the competitiveness of the spot and hedge markets by many smaller retailers and consumers both large and small that are or potentially could be more active wholesale market participants.

8. CEN submitted [30]:

> "Normal operation resumed in the current circumstances without any intervention by the Authority. This raises a question of whether the higher than expected prices in a flood event is a UTS."

9. MEUG does not agree because confidence by end users and small retailers and generators was, in our view, eroded and has not been restored once spilling stopped.

10. Nothing in submissions undermined the fact that as spilling persisted spot prices in the South Island increased. That is not an outcome expected in normal workably competitive markets when lakes are spilling and undermined already low levels of confidence in the competitiveness of the market. MEUG therefore affirms the view in our submission of 18th August that we support the preliminary view of the EA that this event was a UTS.

There was no harm to consumers

11. Under the section titled "Most consumers were not and will not be impacted by 3 to 18 December 2019 pricing" MEL [p27] submitted:

> "As the Authority is aware, consumers do not generally purchase from the wholesale market and are on fixed price contracts with retailers that insulate them from any changes in the wholesale market. Accordingly, regardless of the Authority's final decision, most consumers will not pay higher prices for electricity as a result of the events of December 2019. This is contrary to misrepresentations made by some of Meridian's competitors."

12. MEUG disagrees because the effects of the offer behaviour by MEL during the UTS event had both an immediate direct effect for the trading periods and month the UTS occurred and a longer-time horizon indirect effect. The immediate direct effects relate to impacts on actual spot and hedge positions of participants during the event. MEL's submission focussed on these effects. However, it is the indirect longer longer-time horizon indirect effects that are crucial in understanding the reason why confidence in the market was severely eroded by the UTS event. The important indirect impact on spot prices should the offer behaviour of MEL in the December 2019 spill event not be challenged was succinctly summarised by Nova Energy [p1] commenting on the impact on the retail market:

> "In the medium term, retail prices are set in expectation of the average wholesale spot prices under the full range of market conditions. The natural distribution of market conditions is expected to result in below average prices in the SI most of the time, interspersed with periods of very high prices during dry hydro conditions.
>
> By its actions in December, in the absence of a response by the Authority, Meridian in effect increased expected long term average spot prices across the market, and in the SI in particular. This will have a direct impact on SI consumers through a pass through of higher prices by retailers over the long term, irrespective of whether retailers were hedged in the SI at the time or not."

13. MEUG agrees with Nova Energy's analysis of the harm on spot prices across the market, and in the South Island in particular, if MEL's offer behaviour during the event is not deemed a UTS and remedial action is not taken. Further MEUG believes the same logic would apply to the level of price in the risk management product markets and longer-term effects on investment as summarised by EPOC [6]:

> "EPOC agrees with the Electricity Authority that the observed effects on electricity prices and HVDC rentals that arise from strategic offering have knock-on effects on investment in generation and transmission."

14. An important risk management product is Financial Transmission Rights (FTR). MEL [p28] submitted on FTR as follows:

> "The FTR market is funded from the pool of loss and constraint excess (the surplus created in the electricity market once purchasers have been invoiced and generators have been paid) and there is no obvious justification for allowing FTRs to be purchased as a form of market speculation."

15. The inference by MEL that only suppliers with a physical presence should be able to operate in the FTR market would, in the view of MEUG, reinforce the already perceived or actual oligopolistic modus operandi of the largest vertically integrated suppliers.

If there is a perceived problem, then the UTS regime is the wrong tool to use

16. The last of the four reasons MEL considered the EA's preliminary decision was wrong was summarised in the Executive Summary under the section headed [p10] "The issue of pricing during spill should be addressed by a Code amendment process."[3]

17. MEUG notes that if the EA upholds the preliminary decision that the event was a UTS there is no requirement the action the EA decides to take should be to change prices.

18. MEUG agrees the existing Market Development Advisory Group (MDAG) review of possible changes to the High Standard of Trading Conduct (HSOTC) regime is a process that has and will continue to consider market behaviour including during significant spill events. If the EA decides the event was a UTS then an action the EA could take is to prioritise and speed up the work of MDAG and the follow-on EA consideration of recommendations from MDAG.

19. Speeding up this work could have been decided by the EA:

- Irrespective of any party lodging a claimed UTS; or
- The EA deciding on receipt of a UTS claim, that it was not a UTS.

20. We think the latter case would not have occurred because analysing the claim needed to be robust given the detailed analysis by the claimants, the time needed to obtain confidential information from suppliers, analysis of that information and publication of a draft decision without disclosing confidential information. It was not the choice of the EA to trigger a UTS claim investigation and correctly it did not dismiss the claim at the outset. Having parallel EA workstreams on the same event is not unusual. What matters is that the action(s) the EA decides, should it uphold the preliminary decision that the event was a UTS, improves the long-term benefit of consumers

[3] CEN was not as vociferous as MEL on this point, submitting [34] "Contact would welcome further guidance from the Authority on the interaction between the two processes."

21. A related submission point by Trustpower [pp1-2] was the risk of "double jeopardy," i.e. a party being prosecuted twice for the same offense given multiple concurrent investigations. Having parallel EA workstreams on the same event is not unusual. The EA will be incentivised to avoid making "double jeopardy" decisions because to do so will undermine confidence in the regime. It is premature to consider we have reached the point where changes to the regime suggested by Trustpower need to be considered. It is though helpful of Trustpower to remind the market and Authority of this risk.

The EA's analytical approach was inappropriate

22. MEL in submitting on the EA's analytical approach stated [p10]:

> "The Authority has watered down that test (MEUG note: i.e. the UTS test) by transforming it into a test that looks to whether the market is meeting the Authority's hypothetical and subjective expectations of a workably (or close to perfectly) competitive market."

And later,

> "That approach swaps out the concept of a UTS as an unusual market situation that can be immediately recognised and requires immediate rectification, for the Authority's ex-post constructed and modelled view of how the market should have acted under close to perfectly competitive market conditions, for every trading period, every day."

And later again,

> "The Authority's interpretation of the UTS regime imposes an unrealistic view of competition in a dynamic and complex market. The result of the Authority's view would find aberrant certain differences between its idealised spot market and actual market offers."

23. We agree the EA analysis uses a counterfactual that attempts to estimate a workably competitive market. MEUG would be concerned if the EA's approach differed from that because to do otherwise would deviate from the EA's statutory objective to improve the long-term benefit of consumers. What is important is:

- the analytical tools deployed by the EA to test if a UTS has occurred are relevant to the circumstances of the UTS claim; and
- the EA exercise judgement and does not rely solely on the outputs of a modelled counterfactual.

24. In this case there is no debate that there was an over-supply of hydro into the southern lakes and in a competitive setting spot prices at those lakes would be close to zero and that would have flowed through to spot prices in both islands. We see no evidence the EA intends to make a final decision based solely on the modelled outputs. Given the circumstances of this prolonged flood and over-supply event MEUG agrees that the EA's models were appropriate to inform their decision.

25. The same models would not be appropriate for other claimed UTS for a defined number of Trading Periods where there was no over-supply and, as expected in competitive markets, prices would for some period need to be above short-run-marginal-cost (SRMC) to provide suppliers with a margin for a return on and return of capital, i.e. depreciation and to cover an economic return. In those circumstances two questions arise:

- How do you model SRMC, how should that include depreciation and an economic return, and what other longer-term factors ned to be considered such as the impact on security of supply and sustained market power? Several submitters made useful insights on the complexity of this question such as Energy Link and EPOC.
- Are profits at, below or more than an economic return on capital? MEUG is currently piloting an analysis of the economic performance of MEL over the last two decades that will assist that discussion. We think that analysis will complement the Authority's current work recommended by the Electricity Price Review on retailer profitability and monitoring contract prices and new generation costs.

Concluding comments on next steps

26. We look forward to:

- Considering the EA's final UTS decision and if appropriate, commenting on actions proposed.
- Engaging with MDAG on the review of the HSOTC provisions and follow on consultation by the EA should code amendments be considered.
- Monitoring the concurrent alleged Code breach claim.
- After the UTS decision if finalised, the EA completing and publishing any supplementary analysis from the 2019/20 wholesale market prices review-initiated 19th November 2019 that covers[4]:

  "The focus of this review will be on possible behaviour that may have caused prices to deviate from levels consistent with workable competition.

  Without limiting our review, two areas of focus will be the spot prices during the December 2019 flood event and the 2020 HVDC outage."
- Discussing with the EA and other decision makers, as appropriate, progress on MEUG's pilot analysis of the economic performance of MEL over the last two decades.

Yours sincerely

Ralph Matthes
Executive Director

[4] https://www.ea.govt.nz/monitoring/enquiries-reviews-and-investigations/2019-2020/2019-wholesale-market-prices-review/