

# Review of stress test regime

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Decision

13 June 2017



# Contents

1	Decision	3
2	Background	3
3	Why the Authority made this decision	4
	The Authority consulted on its findings from its review of the stress test regime	4
	The options promote operational efficiency and reliable supply	4
	The proposals benefits are greater than its costs	4
	The amendment is consistent with regulatory requirements	5
4	Matters the Authority considered in making this decision	5
	Querying the rationale for the regime	6
	What was in the consultation paper	6
	Operational improvements	8
	What was in the consultation paper	8

# 1 Decision

- 1.1 The Electricity Authority (Authority) has decided to make the following improvements to the stress test regime:
- (a) Improve the content and format of quarterly stress test reports (option 2 in the consultation paper).
  - (b) Provide a facility for disclosing participants to be informed when the latest quarterly report is published (variation of option 4 in the consultation paper).
  - (c) Amend clause 13.236E of the Electricity Industry Participation Code 2010 (“Code”). The amendment will provide that, if a disclosing participant is not exposed to spot price risk in a particular quarter, the spot price disclosure statement it submits for that quarter need not contain all the information ordinarily required in a spot price disclosure statement.

# 2 Background

- 2.1 The Authority’s statutory objective is to promote competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers.
- 2.2 The stress test regime encourages wholesale market participants to take accountability for their risk management decisions. Appropriate risk management encourages investment in generation and demand response capacity. The regime therefore contributes to meeting the second limb of our statutory objective—promoting a reliable supply of electricity.
- 2.3 On 18 October 2016, the Authority published a consultation paper that identified 13 possible operational changes to the stress test regime and proposed to pursue two:
- (a) Option 2: Improve quarterly stress test report content and format
  - (b) Option 10: Simplify reporting for disclosing participants not exposed to spot prices.
- 2.4 Option 2 requires only a relatively minor operational change and does not require any Code amendment. Option 10 requires a minor amendment to the Code that will reduce compliance costs for disclosing participants not exposed to spot prices, such as those that purchase electricity at a fixed price under a variable volume contract.
- 2.5 Submissions revealed another option the Authority has decided to pursue, which is a variation of option 4 in the consultation paper. Under this option, the Authority would provide a facility for a disclosing participant to be informed when the latest quarterly report is published.
- 2.6 This paper explains why the Authority has decided to pursue these three options and not the others.
- 2.7 More information about this project is available from the Authority’s website at: <http://www.ea.govt.nz/development/work-programme/risk-management/review-of-stress-testing-regime/>.

### 3 Why the Authority made this decision

#### **The Authority consulted on its findings from its review of the stress test regime**

- 3.1 After considering submissions on the consultation paper, the Authority is satisfied the stress test regime continues to support better risk management decision-making, which promotes the reliability limb of the Authority's statutory objective.
- 3.2 The Authority also considered whether any action was required to improve the regime. It identified thirteen potential options and consider two to be beneficial:
- (a) Option 2: Improve quarterly stress test report content and format
  - (b) Option 10: Simplify reporting for disclosing participants not exposed to spot prices.
- 3.3 Option 2 is a relatively minor operational change that does not require any Code amendment. Option 10 would reduce compliance costs for disclosing participants not exposed to spot prices, such as those with a fixed price variable volume contract.
- 3.4 The Authority did not receive any objections to pursuing these options.
- 3.5 However, the Authority received submissions in support of option 4—Increase visibility of quarterly reports by sending them to disclosing participants. The Authority agrees with the submissions on this option and will provide a facility for a disclosing participant to be informed when the latest quarterly report is published.

#### **The options promote operational efficiency and reliable supply**

- 3.6 After considering all the submissions it received, the Authority is satisfied the options chosen will promote operational efficiency in the electricity market, for the long-term benefits to consumers. The options would:
- (a) reduce compliance costs associated with the stress test regime (option 10)
  - (b) increase the value of the stress test reports (options 2 and 4).
- 3.7 It is likely that grid connected consumers are the parties that would directly benefit from reduced compliance costs.
- 3.8 Increasing the value of the stress test reports would contribute to a more efficient level of reliability of supply if the changes lead to improvements in risk management including hedging decisions of all parties. This benefits consumers in the long-run because it is less likely consumers would get more or less reliability than they were willing to pay for.
- 3.9 Pursuing these options is not expected to improve competition in the electricity market in a material way.

#### **The proposals benefits are greater than its costs**

- 3.10 The cost of making changes associated with the three options is minimal and they consist mostly of Authority staff time. Consequently, the Authority expects the benefits to outweigh the costs.
- 3.11 The external costs associated with making the changes are expected to be no more than \$6,000.

- 3.12 The benefits of the changes are expected to exceed both these categories of costs as the benefits are likely to total over \$715 per annum for the next 10 years (assuming discount rate of 8%) from a combination of:
- (a) lower time and cost to prepare file returns
  - (b) improvements in stress test reports leading to more efficient levels of hedging.

**The amendment is consistent with regulatory requirements**

- 3.13 The Code amendment associated with option 10 is consistent with the Authority’s statutory objective and with the requirements of section 32(3) of the Electricity Industry Act 2010 (Act).
- 3.14 The Authority is making the amendment under section 39(3)(c) of the Act, on the basis it is satisfied there has been adequate prior consultation so that all relevant views have been considered. The Authority has therefore not prepared and publicised a regulatory statement or consulted on a regulatory statement.
- 3.15 A copy of the amendment and the Code are available on the Authority’s website [www.ea.govt.nz/code-and-compliance/the-code/](http://www.ea.govt.nz/code-and-compliance/the-code/)
- 3.16 A copy of the amendment and the Code may also be inspected free of charge or purchased from the Electricity Authority, Level 7, ASB Bank Tower, 2 Hunter Street, Wellington.

## 4 Matters the Authority considered in making this decision

- 4.1 Parties that made submissions are listed in Table 1 (below).
- 4.2 All submissions and a summary of submissions can be found on the Authority’s website at <http://www.ea.govt.nz/development/work-programme/risk-management/review-of-stress-testing-regime/consultation/#c16205>.

**Table 1 List of submitters**

Generators/Retailers	Demand-side participants
Flick Energy Limited (Flick) Meridian Energy Limited Nova Energy Limited (Nova) Pioneer Energy Limited Trustpower Limited (Trustpower)	Major Electricity Users Group (MEUG) New Zealand Steel Limited (NZ Steel)

- 4.3 The Authority has considered the issues raised by submitters, which it has grouped under the following headings:
- (a) querying the rationale for the regime
  - (b) operational improvements.

4.4 Each of these issues is discussed below.

## **Querying the rationale for the regime**

### **What was in the consultation paper**

4.5 The Authority identified three objectives behind the rationale for the stress test regime in the 2016 consultation paper, which came from the original consultation paper published in 2011:<sup>1</sup>

- (a) reduce the scope for opportunistic lobbying by adversely affected participants to socialise the cost of poor risk management decisions
- (b) enhance incentives for participants to appropriately manage their spot price exposure
- (c) enhance access to information on spot price exposure for participants and for the Authority.

### **Submitters' views**

4.6 Three submitters (Meridian Energy, Nova Energy, and Trustpower) provided conditional support for the rationale. Flick, MEUG and NZ Steel provided alternative suggestions.

4.7 Flick provided a comprehensive consideration of the three objectives.

4.8 On objective (a), it stated that 'minimising lobbying' (opportunistic or otherwise) is a peculiar objective for any regulator. Even if the lobbying was by 'participants to socialise the cost of poor risk management decisions', regulators should always be open to feedback and contact with industry participants and consumers—not looking to reduce future scope of lobbying.

4.9 While Flick appreciated the Authority's aim to encourage parties to make time consistent choices, it felt the way this objective is worded (and the way it would commonly be understood) serves the needs of the Authority rather than the industry or consumers.

4.10 Flick suggested objective (b) should be reworded to read "Enhance information for participants to appropriately understand and manage their spot price exposure". It felt the stress test regime did not enhance incentives for participants to manage exposure to spot prices.

4.11 On objective (c), Flick suggested this objective might be improved by the inclusion of the words: 'accurate and relevant information' as the inclusion of inaccurate or irrelevant information in the stress test regime is arguably worse than no information at all.

4.12 It suggested the stress test regime scenario, both for the energy test and the capacity test, should be based on scenarios that have a very low probability of occurring and a very high impact on prices, but should not be purely theoretical. Flick believed the current scenarios were too abstract.

4.13 MEUG agreed that in 2010-11, there was a legitimate public policy concern about the scope for opportunistic lobbying by adversely affected participants to socialise the cost of poor risk management decisions. The stress test regime as a tool to reduce that risk was a feasible option, albeit controversial and not universally agreed, at that date. However, MEUG questioned whether that risk was still a legitimate concern. Even if it was still a concern, MEUG was uncertain whether the magnitude of the risk warrants

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<sup>1</sup> <https://ea.govt.nz/dmsdocument/11096>

what they considered to be the relatively heavy handed intervention of mandatory stress test disclosures.

- 4.14 MEUG's view was that the substantial changes to the governance and structure of the industry between 2008 and 2010 significantly changed how retailers and generators behaved in the 2012 dry period. The continuous disclosure requirements in the environment they now work in means they are acutely aware that involving politicians in the sector may open the door to other political interference in the market that would undermine the value to their shareholders.
- 4.15 MEUG advised that all the large market participants are actively using hedge markets, including bespoke bilateral negotiations, to manage events such as the near-term future of the Rankine units discussed in section 3 of the consultation paper. MEUG did not think having to comply with the stress test obligations affects the focus of those companies or any of the companies required to comply with those disclosures to use hedge markets to manage spot price exposure.
- 4.16 MEUG also doubted any of the parties required to disclose stress tests view the information they compile for their own company, or the aggregated stress test results published by the stress test manager, as an essential component of the data they need to better improve managing their spot price exposure.
- 4.17 NZ Steel supported a regime that "...encourages wholesale market participants to take responsibility for their risk management decisions" and can understand that the Authority sees the stress test regime as contributing to security of supply. However, it felt the consultation paper perpetuated "the current narrow focus on where electricity fits into demand-side business operations". It noted that electricity is one of many components that are managed in a dynamic production environment and that risk management, as part of international business activities, is far wider than contractual arrangements relating to price of electricity.

#### **The Authority's decision**

- 4.18 The Authority acknowledges the comments submitters have made regarding the rationale for the stress test regime. However, it remains of the view that the rationale for the stress test regime continues to be valid and that the regime contributes to efficient security of supply. In particular, the Authority continues to hold the view that adversely affected participants can have strong incentives to apply pressure for policy changes in periods when supply conditions tighten, and the stress test regime mitigates these incentives.
- 4.19 Nevertheless, while we do not agree the objectives are different, the Authority agrees it could focus on the positive ("facilitate time-consistent decision-making by participants, the Authority and other regulators") rather than the negative ("reduce the scope for opportunistic lobbying by adversely affected participants to socialise the cost of poor risk management decisions").
- 4.20 The Authority also agrees that the second objective ('enhance incentives for participants to appropriately manage their spot price exposure') might be improved by the extension 'and take responsibility for their risk management decisions'.
- 4.21 The Authority also agrees the information referred to in the third objective ("enhance access to information on spot price exposure for participants and for the Authority") should be accurate, relevant and timely.

- 4.22 As for the doubts MEUG expressed in the value of the stress test reports, the Authority is open to exploring ways to improve their value but is not concerned that some participants may value them less highly than others. However, the value of the reports does not lie entirely with participants but also to the Authority and others within the industry (and potentially to those outside it, such as politicians). The expectation is that they might reveal changing trends, which could indicate a further need for policy changes.
- 4.23 The Authority also acknowledges the NZ Steel's point that electricity is only one component in the wider risk management activities of businesses. The Authority will continue to do its best to reduce the transaction costs involved in running the regime while making sure it continues to fulfil its purpose.

## **Operational improvements**

### **What was in the consultation paper**

- 4.24 Having concluded that the stress test regime should be retained, the Authority then considered whether any action was required to improve the regime. In the consultation paper we identified thirteen potential options:
1. Provide quarterly 'You are here' reports to each disclosing participant
  2. Improve quarterly stress test report content and format
  3. Lift anonymity - publish individual disclosures
  4. Increase visibility of quarterly reports by sending them to disclosing participants
  5. Include 'risk meter' to indicate likelihood of stress test scenarios
  6. Add qualitative questions into the stress test regime
  7. Add a scenario for a specific plant-related event such as Huntly closure, sustained HVDC outage or gas supply disruption
  8. Incorporate dynamic stress test parameters
  9. Extend reporting requirement beyond the coming quarter
  10. Simplify reporting for disclosing participants not exposed to spot prices
  11. Increase or decrease the frequency of disclosure
  12. Remove qualitative aspects of stress test regime
  13. Introduce threshold for being subject to stress test reporting.
- 4.25 The consultation paper identified only two of the thirteen options that would be of net benefit:
- Option 2: Improve quarterly stress test report content and format. This would be a relatively minor operational change that does not require any Code amendment.
- Option 10: Simplify reporting for disclosing participants not exposed to spot prices. This would require the Code to be amended and would reduce compliance costs for disclosing participants not exposed to spot prices, such as those with a fixed price variable volume contract.

### **Submitters' views**

- 4.26 There was broad support for the two options (options 2 and 10) the Authority proposed to pursue. However, the Authority also received submissions containing arguments in support of other options and for other suggestions.
- 4.27 MEUG suggested two new options:
- (a) unwind the disclosure requirements, keeping only highest value/lowest cost elements
  - (b) rely on enquiry and powers of discovery to reveal parties' past choices.
- 4.28 Trustpower believed the stress tests could be simplified but accepted there was merit in retaining the existing ones to maintain consistency with past results. It also asked the Authority to reconsider pursuing option 1 (to provide 'you are here' reports) because it would:
- (a) be useful for the Authority to provide something back to disclosing participants, particularly to some of the smaller parties in the industry. Trustpower felt this would ensure useful insights are available consistently to all parties, enhancing their exposure risk management and thus contributing to the Authority's statutory objective as it relates to reliability of electricity supply
  - (b) ensure that the results submitted by disclosing participants were not inadvertently sent to the wrong party, which was noted as a concern, and it could be fairly readily implemented.
- 4.29 In contrast, NZ Steel accepted the rationale for not proceeding with option 1 but suggested the quarterly reports be provided to participants (option 4) when they are published each quarter. In its words, "To go to all the trouble and cost of collecting the information and preparing improved reports, and then not taking the small, and we would expect very low cost, step to email everyone a link to the report to say it is published, seems to be false economy and cuts across the arguments outlined elsewhere in the consultation paper".
- 4.30 MEUG supported the proposal to pursue option 10 (simplify reporting for disclosing participants not exposed to spot prices) but argued it should be extended to parties who have a mix of contracts-for-difference and proven demand response.
- 4.31 Nova suggested the calculation of the spot exposure should be simplified. It argued that the amount of effort and complexity involved in completing the stress test should be minimal. Nova also considered there was no significant benefit gained by requiring participants to apply spurious accuracy in the calculations. It felt that applying location factors to the prices used in the test scenarios, which are nominal in any case, adds complexity without improving the value of the exercise. Nova considered that direction and magnitude are the most important factors and the application of location factors does not add any material value to the process.
- 4.32 Nova also disagreed with the Authority's dismissal of Option 12 (replacing quantitative answers with qualitative ones). It suggested the effectiveness of this option depended on the nature of the declaration required. Nova believed the stress test regime should be altered to allow disclosing parties to make one of two choices:
- (a) completing and submitting the quantitative test each quarter

- (b) providing an annual declaration that it had systems and procedures in place to monitor and manage its exposures on an ongoing basis and had adequate financial capital to cover the types of risks envisaged by the stress test.
- 4.33 Nova argued that such a regime would allow organisations to focus on their internal reporting and controls rather than having to duplicate them by applying the assumptions specified by the Authority. It would also reduce the complexity for those parties that simply cover their risks with a fixed price variable volume contract.

### **The Authority's decision**

- 4.34 The Authority notes the broad support (and supporting rationale) among submitters for the two options it proposed in its consultation paper—options 2 and 10—and has decided to pursue both of these options. The Authority has already enhanced the content and format of the quarterly stress test aggregate reports. The reports are now available through the Authority's Energy Market Information system (EMI).<sup>2</sup> The Authority remains open to receiving suggestions from parties that further improve the format of the reports.
- 4.35 The Authority has approved the minor amendment to the Code to give effect to option 10.
- 4.36 The Authority considered the other possible improvements to the stress test regime provided in submissions.
- 4.37 The Authority agrees with NZ Steel's arguments in favour of option 4 (providing disclosing participants with the quarterly report once published) and note that it would contribute to the outcomes Trustpower suggested in its support of option 1. Consequently, the Authority intends pursuing option 4 and hopes to be able to implement it by the June 2017 disclosure round.
- 4.38 However, the arguments in submissions in support of other options have not persuaded the Authority to pursue those options.
- 4.39 The Authority thinks the proposal to simplify reporting for disclosing participants not exposed to spot prices (option 10) already accommodates MEUG's suggestion to extend it to parties with a mix of contracts-for-difference and proven demand response. Under the new provision, disclosing participants would not have to complete a disclosure statement if they certify that the stress tests would not affect cash flow from operating activities in the quarter. The provision does not stipulate the reason why the stress tests would have no effect.
- 4.40 The Authority does not agree with MEUG's suggestion to unwind the disclosure requirements and rely on the Authority's statutory powers of enquiry and discovery to reveal parties' past choices. The Authority is uncertain this would be a proper use of the Authority's powers of enquiry and discovery and, besides which, it considers the stress test reports provide value to both the Authority and participants that is greater than the costs they impose.
- 4.41 In response to the suggestion from Trustpower and Nova to simplify the stress test parameters (eg, dropping location factors), the Authority reviews the stress tests and parameters every quarter. The Authority will contact those submitters to consider specific ideas for simplifying the parameters as part of the next review.

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<sup>2</sup> <http://www.emi.ea.govt.nz/Reports/Gallery?category=Wholesale>

- 4.42 Finally, the Authority considered Nova's suggestion to allow disclosing participants to either submit a disclosure report or to warrant (annually) they have "systems and procedures in place to monitor and manage its exposures on an ongoing basis and has adequate financial capital to cover the types of risks envisaged by the stress test".
- 4.43 The Authority disagrees with this suggestion as we consider the existing regime provides a better balance between imposing costs on disclosing participants and achieving the objectives of the regime. Disclosing participants might consider they have systems and procedures in place to manage their exposure but have varying degrees of actual exposure. The Authority considers the (anonymised) information published on actual exposure is of sufficient value to the Authority and participants that we should require them to reveal it.