MAJOR ELECTRICITY USERS' GROUP

25 October 2006

Jenny Walton
Electricity Commission
By email to info@electricitycommission.govt.nz

Dear Jenny

Submission on Hedge Market Development – Issues and Options

1. This is a submission by the Major Electricity Users' Group (MEUG) on two Electricity Commission (the "Commission") papers. Both papers are titled "Hedge Market Development – Issues and Options." One paper is subtitled "Overview Paper" and the other "Technical Paper." Both papers are dated 18 July and were publicly released for comment on 25 August 2006. The papers summarise the work and recommendations of the Hedge Market Development Steering Group ("HMDSG" or the "Group").

2. Overall MEUG are supportive of the recommendations of the HMDSG. The table attached provides comments on matters of detail in response to the six questions in the papers. To assist MEUG form a view on the development of Locational Rental Allocation (LRA) as a mechanism to hedge locational risks, MEUG commissioned Dr Brent Layton, Director of the NZ Institute of Economic Research (NZIER) to analyse LRA as proposed by the HMDSG. A copy of the NZIER report, *Locational Rental Allocation and Financial Transmission Rights*, dated October 2006 is separately attached.

3. There is no silver bullet to improve competition and choice for all consumers. The HMDSG proposals are a useful step, however MEUG recommend the Commission and government continue to assess and where beneficial to implement a range of other strategies. Some of these other strategies are within the control of the Commission. For example improved information disclosures to assist consumers make more informed choices and publication of key indices to track whether competition and product innovation is improving.

4. Other strategies are, or should be, on the agenda of the government such as an independent review of the overall market design compared to alternative market designs. A comprehensive review of market design should also include an assessment of the regulatory structures such as whether changes to the governance of the Commission are desirable. Market distortions created by political incentives and weaker governance of SOE suppliers compared to privately owned and listed companies is another key problem that government needs to address.

5. Some MEUG members will be making separate submissions. This submission reflects a consensus, but not necessarily unanimous view, of MEUG members.

Yours sincerely

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Discussion questions	MEUG comment
1. The Group defined its policy objective as promoting a well-functioning hedge market. By contrast, the GPS policy objective for the hedge market is to improve transparency and liquidity. The Group questions whether liquidity is a goal in itself, and the extent to which it can be achieved in the NZ context. Do submitters agree with the Group's policy objective? If not, please outline what you consider the policy objective should be.	The GPS focus on liquidity is too narrow although the suggestion that transparency needs to be improved is agreed. MEUG agree with the HMDSG focus on improving the risk management market for TOU consumers, suppliers, intermediaries and potential new entrants.
2. Has the Group correctly identified the key problems relating to risk management in Section 6 of this Overview Paper and Section 3.3 of the Technical Paper? If not, please outline what you consider to be the problems.	The problems identified by the HMDSG reasonably reflect the experience of MEUG members and the issues identified by the UMR survey.
3. Do you agree that the evaluation criteria outlined in Section 7 of this Overview Paper and Section 4.2 of the Technical Paper are appropriate for assessing the initiatives? If not, please outline any additional initiatives you believe the Group should have considered.	The evaluation criteria and largely qualitative approach used by the HMDSG were relevant for this study as a means of identifying and prioritising the mix of options that the Commission should develop further. As options are firmed up and specific interventions by way of rules or regulations are proposed, the evaluation criteria should be standardised into an economic cost-benefit analysis framework comparing the detailed proposal(s) with a counterfactual. The latter is the most likely case that will occur should the option not proceed. The counterfactual need not be the status quo[1]. The advantage of standardising and having to quantify all possible benefits and costs is that some factors that on the surface appear to have merit, can be exposed as having a shallow political motive such as wealth re-distribution without any economic efficiency gains.
4. Do you consider the Group has correctly identified and described an appropriate range of potential initiatives in Sections 6 and 7 of the Technical Paper? If not, please outline any additional initiatives you believe the Group should have considered.	Yes. It was beyond the scope of the HMDSG to consider structural changes to the existing market. The possible alternative market designs that might be more advantageous to NZ and the need to have an independent review to assess those options has been raised directly by MEUG with both the government and EC.

[1] Refer The Treasury Cost benefit Analysis Primer, Dec-05, http://www.treasury.govt.nz/costbenefitanalysis/default.asp

5. Do you agree with the preferred package described in Section 8 of this Overview Paper and Section 8 of the Technical Paper? If not, please outline the initiatives you consider are more appropriate and describe the benefits they deliver, with particular reference to the policy objectives.	MEUG agree with the preferred package as listed in the seven bullet points in paragraph 8.4 of the Overview Paper and repeated below in bold text. Any supplementary comments MEUG have to each of the proposals are also listed: ▪ **The compulsory web-based publication of the key terms and conditions of all contracts entered into by parties that consume above a minimum level of electricity per year**. MEUG supplementary comments: Designing a table to capture summary information on shorter term financial derivatives is likely to be easier than for very long duration contracts. The difference is because shorter duration contracts are likely to be more standardised whereas very long duration contracts are likely to be more be-spoke. For example in summarising price terms shorter duration contracts may be as simple as specifying a single price per trading period for the term of the contract. That contract price formula can be summarised as the time weighted average price. Regulations to accommodate that formula are relatively easy to draft. If the price varies over time with an escalation factor then the summary information might only cover the opening (time weighted) price for the period until the first escalation and then flag a "yes" to the question "is there escalation in the contract?" For very long duration contracts escalation formula can be very complex, the contract might have pause and review provisions and the contract is likely to be in a form that cannot be traded out of or sold to a third party. Typically these types of contracts are for the most electricity intensive industries in NZ producing goods for export markets. The issue of commercial confidentiality then becomes a factor because if international competitors or international customers of those export industries have access to electricity cost information they can use that against the interests of the NZ business and hence affect the welfare of NZ. Therefore there may be merit in considering for very long duration contracts some commercial sensitive information such as certain pricing terms, should be excluded from the mandatory disclosure provisions. The EC could consider various generic definitions to separate those end consumers whose contracts would be summarised as proposed by the HMDSG and those end consumers whose contracts would not be fully disclosed. For example the EC could set a 15-year maximum time frame and any contracts longer than that would have less information disclosed. An end user that had contracts longer than 15 years would therefore publish some information on those long duration contracts but not the same as that required for contracts of less than 15 years. If that same company also had some shorter duration contracts, then those contracts would be disclosed in the full summary format. In summary mandatory disclosure requirements should aim to maximise the public benefit and minimise private costs. Most transactions are relatively short and will fit the example of the disclosure format in paragraph 85 of the Overview Paper. The cost of those parties complying with the mandatory disclosure requirements will be modest but the

	public benefit to promote understanding of the market and foster competition and innovation is high. With very long duration be-spoke contracts the nature of the contract is more a very long-term partnership. There are few such long-term partnerships to date and few are likely in the future. Having to require those types of arrangements to disclose key information may be costly to those companies because of the value of that information to their international competitors and customers. However, their disclosure may have little public benefit due to the highly tailored nature of the contracts. ▪ **The Commission inviting the current owners of the web-based electricity contracts trading platform, EnergyHedge, to further develop its services**. MEUG supplementary comments: MEUG suggest the emphasis should be on the EC facilitating the owners of energyhedge to develop that trading platform. Facilitation could take the form of helping to advertise to the industry the platform exists through to understanding and helping to remove any barriers to the platform owners extending the services provided. The EC should also keep an open mind about facilitating other service providers that might be considering starting other open and transparent trading platforms[2]. ▪ **Development of a mechanism to hedge AC transmission costs by changing the allocation of loss and constraint rentals**. MEUG supplementary comments: The LRA option is a very high level conceptual idea. On the basis of the LRA concept it appears to have some merits and some downsides compared to the hybrid FTR option. MEUG support further work to improve our knowledge of the LRA concept so that a more detailed comparison with alternatives can be made. While the HMDSG papers use the FTR hybrid as the counterfactual, MEUG suggest that for the purpose of the Commission assessing and proposing any regulations or rules to implement LRA, a much wider suite of alternatives will have to be considered. These would include the hybrid FTR (per the GPS) and a range of other FTR variants. One alternative that should also be considered is the status quo. MEUG note that there is no point in simply changing from the status quo if there is no efficiency gain. The HMDSG papers are a useful first step in assessing what factors need to be considered. However a more robust cost-benefit analysis methodology will be needed if specific rules or regulations are proposed. The issue of a robust cost-benefit analysis approach and the need to quantify perceived benefits and costs was noted in reply to question 3 above.

[2] For example EMS has recently announced they were considering using their very successful future and options product in Australia in NZ. This specific proposal might not fit the NZ environment, but the EC should keep an open view of facilitating platforms that will help promote competition.

	▪ **Support from the Commission for the development jointly by consumers and retailers of a model master agreement for the purchase and sale of financial contracts relating to electricity**. ▪ **Centralised web-based publication of planned outage and fuel stock information by the Commission**. MEUG supplementary comments: There is a wealth of data on planned outages (ie Red Spider and proposed Outage Protocol as part of proposed change to regulate Interconnection services). The problem for most TOU consumers is it isn't worthwhile having dedicated resources to monitor this data to anticipate problems whereas suppliers can and do have dedicated resources to analyse the data. What would help is if some of the data on key outages were converted to graphical form to provide a high level view of near and long term outages – this would provide an early warning for interested parties who could then interrogate the data in detail if needed. MEUG accept automating this to provide a high level view isn't straight forward and there would have to be the usual caveats about the graphs not necessarily being comprehensive. However even given those limitations it would be a much better outcome for the majority of TOU consumers who do not have the time and systems to analyse outage data. The Commission already publishes some fuel stock information on the security of supply web pages. The only major omission that could be included is useable snow pack. ▪ **The Commission promoting greater purchaser understanding of electricity price risk management**. MEUG supplementary comments: All possible means to facilitate the market developing industry training protocols should be explored, ie the Commission should be wary of becoming the funder of training that the market would otherwise have developed itself. ▪ **A regular survey of electricity market participants to ensure improvements in hedging are on track**. MEUG supplementary comments: A survey say 6 months after publication of contract details would be most useful because the reaction to the market to the value of that change could be compared to the UMR survey in 2005. This is different from the Overview Paper proposal that a survey be conducted in September 2006 (paragraph 191).
6. The HMDSG identified two initiatives in the preferred package that, in its views, would make the biggest difference in improving existing market arrangements: disclosure of contract information and changing the allocation of loss and constraint rentals. Please describe your views on the practicality and acceptability of these initiatives.	These two initiatives are important but MEUG would see the development of the forward curve (energyhedge) and voluntary standard ISDA as necessary components of a minimum package. The proposals on improving outage and fuel information flows, improving risk management expertise within the industry and further Commission surveys appear to have value but are not necessary. Refer answer to question 5. above for comments on these two proposals.