



MAJOR ELECTRICITY USERS' GROUP

1 September 2008

Maree McGregor
Electricity Commission
By email to info@electricitycommission.govt.nz

Dear Maree

Submission on Market Design Review – Options Paper

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Commission (EC) *Market Design Review – Options Paper, July 2008* (the "Options Paper"). MEUG members have been consulted in the preparation of this submission. Some MEUG members will be making individual submissions.
2. On 20th July 2007 MEUG made submissions¹ on the *Market Design review – Survey of Market Performance*, published 21 May 2007. After considering submissions on that paper from MEUG and others, the EC announced on 4th October 2007 five key areas for detailed consideration:
 - a) Pricing and competition especially in ten retail market;
 - b) Energy affordability issues;
 - c) The effectiveness of the energy-only spot market design;
 - d) Demand participation; and
 - e) Availability of market information.
3. Although four of the top priority areas have some relevance to the wholesale market, MEUG is gravely concerned that improving competition in the wholesale market and improving the performance of the wholesale market has been glossed over. We think the decision not to include a comprehensive review of the wholesale market and instead to adopt a piece meal approach by considering only certain aspects is a poor outcome.
4. Analysis undertaken as part of the review led the Commission to conclude²:

“Wholesale energy charges have increased substantially over the period. However analysis of the available data indicates that this increase has been broadly inline with the rising cost of new supply- i.e. there is no evidence that contract electricity prices to date have persistently overshot new supply costs “
5. We find this conclusion somewhat simplistic and point to the uneven performance of the wholesale market when it is subjected to any form of stress. The pricing or supply crises which occurred in 2001, 2003, 2006 and most of 2008 have created such uncertainty (i.e. both price and supply along with the market power of suppliers) within large industrial consumers that many have been forced into adopting risk adverse positions whereby they have had to pay a premium for contracts than underlying LRMC would indicate.

¹ Refer <http://www.meug.co.nz/includes/download.aspx?ID=26259>

² Refer EC Options Paper, Chapter 1, p9, paragraph 5, bullet point 2

6. The Mercury Energy weekly report as at 25th August 2008 reports the 2008 year to date wholesale spot price for Haywards as \$166/MWh, i.e. the average price for the last 237 days was 16.64 c/kWh – spot. The average spot price for the last 365 days was over 12.36 c/kWh. Generation costs for geothermal power stations have recently been reported as low as 6 c/kWh³. MEUG acknowledges that spot prices do not necessarily reflect “contract prices” but any detailed analysis of spot and forward prices will confirm that the conclusion reached in the market review paper (refer paragraph 4 above) appears somewhat superficial.
7. It is also simplistic to conclude that whenever spot prices increase dramatically large industrial consumers will reduce their consumption of electricity. Where an industrial customer has room to move their production schedules this may occur (to a limited extent) but where it involves cancelling or delaying export orders that have been obtained against off shore competition most exporters will press on. The issue of being exposed to spot or having hedge cover is relevant but will not necessarily be the final determinant. Arguably the percentage of customers that maintain some exposure to the spot electricity price has progressively reduced as confidence in the performance of the market has declined.
8. MEUG suggests that the review process to date has devoted insufficient attention to wholesale market flaws and deficiencies and that unless the fundamental issues are addressed the outcome will be sub-optimal. A peripheral approach of looking at capacity payments or other mechanisms to incentivise generators to invest in additional generation will not solve either the short term or long term market and structural issues.
9. The disastrous outcomes in the wholesale market observed in autumn and winter 2008 have proven how important a comprehensive and independent review of the wholesale market is needed. Therefore before any further work is undertaken on the Market Design Options Paper a review of 2008 is essential. MEUG believe this will be far more important than the proposed analysis in the Options Paper.
10. MEUG strongly believes that a fully independent and comprehensive review of outcomes, drivers and behaviour over spring and winter 2008 is critical. The review must also cover why the wholesale market has performed so poorly in 2001, 2003 and 2006. Analysis undertaken by the MED post 2003 should therefore be revisited. Other aspects that require attention include the location of dry year reserve generators, the pros and cons of changing from diesel to natural gas, the behaviour of a market where demand may decline by 100% whereas prices may change by only 10%, transmission constraints in the lower North Island, the HVDC south ward flow capacity and the impacts of intermittent generation on a stressed non-performing wholesale market. It will be appropriate for the review to analyse what contribution Whirinaki made to alleviate the 2008 crisis and how the existing wind generators performed.
11. MEUG recognises that the EC may manage part of that review. However part of the policy problems observed, such as capping Whirinaki spot prices, seeking additional appropriation for security of supply and attempts to influence the behaviour of generators, were controversial decisions made by the EC itself. We do not think it reasonable to expect the Commission to review its own performance. Recent public comments by the Commission appear to indicate a high level of satisfaction with its own performance during the crisis. It is therefore of vital importance that the review of the EC's performance and other relevant aspects of the review be conducted by independent parties. Anecdotal evidence that at critical stages of the supply crisis South Island generators were “advised that they were not valuing their water high enough” must be thoroughly investigated to restore confidence in the integrity of the bid and offer process.
12. Answers to the questions in the Options Paper are attached.

Yours sincerely



Ralph Matthes
Executive Director

³ Dominion Post, 30th August 2008, reported “Contact sees geothermal generation, costing about \$60 a megawatt hour, as much cheaper than gas-fired generation or wind, at between \$80 and \$110, depending on C pricing under an ETS.”

MEUG comments on questions in EC consultation paper, *Market Design Review – Options Paper*

	Chapter 2: Background	MEUG comment
1	<p>Are there other key performance issues that should be considered in the context of the review of retail and wholesale markets – if so, what are they?</p>	<p>MEUG is surprised the EC:</p> <ul style="list-style-type: none"> ▪ Did not consider competition in the wholesale market was one of the top five areas requiring closer review; and ▪ Chose energy affordability issues ahead of the wholesale market as one of the top five areas requiring closer review. We can understand Energy affordability being a primary issue for the Ministry of Social Development, but do not understand why it would be a primary area of work for the EC ahead of improving competition in the wholesale market. <p>In reaching its decision that wholesale market competition was not a top five issue, the EC analysis comprised unbundling end prices into component parts to derive a wholesale component and then comparing that wholesale component with forecasts of LRMC. As observed wholesale prices do not vary much from predictions of LRMC, the EC therefore decided competition in the wholesale market was not a problem.</p> <p>MEUG believe the EC should be more circumspect about wholesale market competition. In addition to the lessons of winter 2008, the EC should have considered:</p> <ul style="list-style-type: none"> ▪ The Commerce Commission commenced an investigation into the behaviour of suppliers in terms of Part 2 of the Commerce Act some years ago. That fact this investigation is underway is a strong indicator that the market may not be competitive; irrespective of whether the Commerce Commission finally decides to pursue a breach of the Act. The EC should have recognized this precedent and made improving wholesale market competition a priority accordingly. ▪ The EC has failed to analyse concerns of excessive profits having been earned to date. MEUG note that MEL revalued their assets by \$1.8 billion on 30 June 2006 and then added another \$1.435 billion revaluation on 30 June 2007. The detailed analysis supporting both revaluations has not been published. MEUG suggest there is high risk of price making rather than price taking behaviour if such unilateral revaluations are coupled by shareholders revising SCI target rates of return. The EC should at least have considered this risk to prices. ▪ As noted in the cover letter to this submission, using the latest rolling average spot prices, the year to date (since 1st January 2008) spot price at Haywards has been 16.641 c/kWh and the 12 month rolling price 12.36 c/kWh. These prices are well above LRMC. <p>A review of ten performance of the market over 2008 should consider how alternative arrangements might have worked. This should re-open the options considered by MED following the 2003 event. Other options raised by parties since then should also be considered, eg MEUG is aware of an option whereby generators have incentives to have their own back-up generation or failing that to pay levies for a pooled back-up.</p>

	Chapter 3: Competition and pricing issues	MEUG comment
2	What steps, if any, should be taken at this time to improve the hedge market?	Standardizing financial quarterly reports of large electricity suppliers to allow improved transparency and comparability would assist. As a first step this may be considered as a change to the mandatory reporting of SOE suppliers supplemented by a voluntary approach by the two other large suppliers.
3	What steps, if any, should be taken to address nodal price risk?	As well as investigating the locational rental allocation approach, MEUG note that Financial Transmission Rights should also be considered because they are a feasible alternative and have been introduced in other similar markets (eg PJM). MEUG sees little value in publishing guidelines on the application of the GIT because sufficient experience is already being gained from successive GUP applications and EC decisions. A guidelines paper would have no status in terms of the decision making criteria set out in the rules.
4	What steps, if any, should be taken to reduce variation in network pricing structures/terms?	MEUG agrees with monitoring uptake of the voluntary model system agreement and then deciding next actions if any. MEUG believes the Commerce Commission is better placed to develop pricing guidelines for line businesses.
5	What steps, if any, should be taken to reduce customer search and switching costs?	CC93 have made a separate submission on this point noting that as part of a CC93 submission to the EC in June 2008 the coalition strongly recommended retailers be required to publish on invoices a breakdown of major costs. MEUG is a member of CC93 and fully supports that submission.
6	What other issues, if any, are impediments to retail competition?	-
7	What steps, if any, should be taken to address these other retail competition impediments?	-
	Chapter 4: Energy affordability issues	MEUG comment
8	From a conceptual viewpoint, what are the relative merits of considering energy affordability in its own right – ie as an issue which is distinct from general (income) poverty?	Income poverty can lead to households having such limited resources that they cannot afford an optimal level of heating and that can have effects on the health of individuals in the household. The solution is to provide income and budgeting support. Healthy levels of heating may involve electricity, gas, solid fuel or a mix of various sources and technologies. Why the EC should have a role when for example the GIC doesn't shows that the EC involvement is arbitrary and ad hoc. The lead agency on these issues should be the Ministry of Social Development and to the extent the EC expertise are needed; those should be funded from Vote: Social Development.
9	What factors should be taken into account in assessing the level of affordability of household energy?	Refer answer to question 8 above.
10	What information should be collated and analysed to obtain a better understanding of the extent, and underlying causes, of energy affordability problems?	Refer answer to question 8 above.
11	What steps, if any, should be taken in the interim to	Refer answer to question 8 above.

	address energy affordability problems?	
	Chapter 5: Effectiveness of energy-only price signal	MEUG comment
12	How effective is the current market design in ensuring appropriate capacity adequacy and resource commitment outcomes?	<p>The answer to this question will be clearer after the review of events over winter 2008.⁴</p> <p>The Options paper discussion could be improved by:</p> <ul style="list-style-type: none"> ▪ Noting regulatory intervention as a barrier to spot prices reflecting resource costs (refer paragraph 329 of the Options Paper); ▪ Having a more balanced discussion on managing transmission hedging that included the relative benefits and costs of Financial Transmission Rights as well as LRAs (paragraphs 412 to 417); and ▪ As well as considering 5 minute ex ante pricing, also discussing the option that final prices being determined on a 5 minute ex post basis.
13	What options should be pursued to improve information for capacity investment and resource commitment decisions?	<p>Experience gained over winter 2008 shows several new information streams were useful, eg:</p> <ul style="list-style-type: none"> ▪ The Special Winter Schedule; and ▪ The daily and weekly reports by Transpower. <p>MEUG will be submitting to the winter 2008 review and the National Winter Group review of 2008 that both these pieces of information (and possibly others) should be retained.</p>
14	Which options are most attractive within an 'energy-only design' to improve incentives for capacity investment and resource commitment decisions?	A cost-benefit analysis should be undertaken to determine the best option(s) to improve the existing energy-only market design. The options should also include those suggested in the answer to question 12 above.
15	Which new payment/market mechanism options are most attractive to improve incentives for capacity investment and resource commitment decisions?	It's premature to consider these until a policy failure is identified from as yet implemented improvements to the energy-only market.
16	Which options, if any, should be reassigned between Tiers?	The Tier 2 and 3 options to improve information and improve energy-only signals should be more formally assessed in a cost-benefit analysis.
17	What ranking should apply within each Tier?	Refer answer to question 16 above.
	Chapter 6: Demand-side participation	MEUG comment
18	What actions, if any, should be taken to improve shorter term demand-side participation?	<p>MEUG support the various work streams the EC already has underway that cover most of the actions proposed in paragraph 566 of the Options Paper.</p> <p>One additional to consider is monitoring the outcome of Transpower's Upper SI demand response pilot project. While this is aimed at substituting for transmission services at peak demand periods, there may be lessons that can be used for the energy market.</p>

⁴ Refer EC Options Paper, paragraph 301 notes the EC intends to review experience of 2008.

		MEUG believe the role of demand side participation in the energy market will be relatively small; though of more value for peak loping than as a sustained dry-year back-up option.
19	What actions, if any, should be taken to improve medium term demand-side participation?	Improve ability for the demand side to forecast, respond and benefit by short-term responses and this will help medium term responses; although MEUG believe medium term responses will be relatively limited.
20	What actions, if any, should be taken to improve longer term demand-side participation?	Improvements in the longer term will arise with new technologies and new investment. Improve short-term pricing signals and efficient types and levels of investment in end user plant that is capable of demand-side response will flow.
	Chapter 7: Availability of market information	MEUG comment
21	What role and objectives should the Commission have in relation to information provision?	To facilitate the market or other means to provide missing information. This is different from the proposal in the Options Paper that the EC should fulfill ⁵ "its role as a core provider of information to the electricity market." For example we don't think the EC should be expanding its role to publish forward prices because that is already adequately provided by energyhedge. Another example where it would be inappropriate for the EC to be the core provider of information would be if a more standardised and timely reporting of financial results were required of SOE suppliers. That option would be best considered as amendment to the SOE Act and a generic improvement in reporting of all SOE.
22	What approach should the Commission take to ensure it can gather core market information in the event that voluntary or contractual means prove unsatisfactory?	Any consideration by the EC that voluntary measures to provide information had failed and therefore backstop regulation was required should be subject to the current requirement to be justified by a cost-benefit analysis.
23	What actions should the Commission take to secure access to primary data?	Refer answer to question 22 above.
24	What specific information enhancements should the Commission seek to make?	MEUG suggest the EC consider: <ul style="list-style-type: none"> ▪ Asking Transpower to continue publishing the daily and weekly information sheets started during the winter 2008 event; ▪ Asking Transpower to continue publishing on COMIT the Special Winter Schedule; ▪ Asking Transpower to add to publish SCADA data from GIP (or grouped GIP) in the same way regionally collated GXP SDADA data is published; ▪ Expanding the Daily Pricing Report (circulated by M-co on behalf of the EC) to separate the "other" generation category into wind, geothermal, other hydro and other thermal.

⁵ Refer EC Options Paper, bullet point 4, paragraph 650.