MAJOR ELECTRICITY USERS' GROUP

8 September 2008

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

Dear Maree

Submission on consultation paper "Issues for Managing Locational Price Risk"

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Commission (EC) consultation paper *Issues for Managing Locational Price Risk*, published 8th July 2008. In this submission the paper is termed the "LRA (Location Rental Allocation) consultation paper." MEUG members with specific knowledge on this issue have been consulted in the preparation of this submission. Some MEUG members will be making individual submissions.

2. LRA are not a sliver bullet to improving the ability of parties to manage constraint risks. Indeed there are significant risks. For example because there is no experience anywhere in the world with LRA, it's likely to be a long and costly path to prove if LRA will add rather than detract to economic efficiency. Ominously the LRA consultation paper notes that in regions where suppliers have market dominance, those parties may be able to game LRA allocations.

3. A full cost-benefit-analysis is needed to assess LRA properly. However until participation factors are available and some experience gained from using those, there would be little benefit in further work on LRA.

4. The best option is to have a perfectly competitive market leading to efficient locational price differences at GXP and GIP along with Financial Transmission Rights (FTR) supported by loss and constraint rentals. MEUG suggest the Commission should not give up on this option. A combination of work to improve competition (ie deal with market power, externality and information asymmetry issues) and some pragmatism using hybrid FTR should still be seen as a feasible option.

5. MEUG comments on the questions in the LRA consultation paper are attached.

Yours sincerely

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MEUG comments on questions in EC consultation paper, *Issues for managing locational price risk*

	Chapter 2: Background and problem definition	MEUG comment
1	Do you agree with the above conceptual approach to defining locational prices?	The discussion in sections 2.1 and 2.2 of the consultation paper is useful background.
2	Do you agree with the above approaches to defining locational price risk?	The discussion in section 2.3 covering short-term and longer-term locational price uncertainty is useful background. We suggest the phrase "locational price uncertainty" has more utility than "locational price risk" because it covers: ▪ Price risks faced by consumers as outlined in the paper; and ▪ Opportunities for efficient investment in generation, transmission and demand-side response. These important opportunities are barely mentioned in the consultation paper.
3	Do you agree with the Commission's problem definition, as outlined above? If not, please explain the source of the problem from your perspective.	The consultation paper has a discussion on "the need for transmission hedges" (Section 2.5), however we think the policy problem could be better defined as follows: *"What options are there to allow parties to better manage constraint risks?"* LRA is one possible solution. Other options include FTR, hybrid FTR and the options listed in paragraph 2.7.8 of the LRA consultation paper. There may be other options also (refer answer to question 4 below).
4	Do you agree with the Commission's decision to exclude hybrid FTRs from the forthcoming cost-benefit analysis? Do you agree hybrid FTRs are not a practicable option to LRAs?	No. Exclusion of considering FTR or hybrid FTR on the basis of a majority view of the HMDSG does not absolve the EC from its statutory requirement to consider all feasible options. As noted in the comment on question 4 above, if the policy problem is restated, then the options listed in paragraph 2.7.8 of the LRA consultation paper should be considered. Another option to allow parties to better manage constraint risks would be to shrink the interconnection assets and increase connection assets. This would increase rentals accruing to connection assets and reduce the residual interconnection rentals.
	Chapter 3: The current allocation methodology	**MEUG comment**
5	Do you agree with the above assessment of the extent to which rentals are passed through to consumers? Is it sufficient to rely on competition, including that arising from LRAs, to promote pass-through of LRAs to consumers?	The overall description is correct. Some more detail as follows should also be published: ▪ Publishing actual payments each month to each of the connection, HVDC and interconnection baskets in figure 6; and ▪ Explaining why notional rentals calculated from SPD do not exactly equal actual rentals (paragraph 3.2.3).

	Chapter 4: The LRA methodology	MEUG comment
6	Do you agree that the simple LRA model provides a reasonable basis for understanding the potential impact of LRAs on the market? Do you agree that further analysis, such as selecting among alternative LRA models and conducting the cost-benefit analysis, is meaningful without the use of participation factors? If participation factors are unavailable for implementing the LRA regime, would that alter your view on whether the LRA approach should be further developed or not?	The simple LRA model without participation factors is sufficient for only for a very high level view. If the EC is serious about LRA, then participation factors need to be calculated and some working knowledge gained. Further development and analysis of LRA without participation factors could easily lead to wasted work. Better to wait until participation factors are available.
	Chapter 5: Numerical analysis of the benchmark model	**MEUG comment**
7	Do you agree with the chosen simulation period, covering 2002-2006 inclusive? If not, please state why not and suggest alternative simulation periods.	Any future work should include 2007 and 2008 if the final data is available as well as estimating the impact of recently approved grid investment (refer comment to question 8 below).
8	Are there other areas or issues of interest that future simulations should examine? If yes, please state why and describe those areas/issues in sufficient detail for the Commission to examine.	There has been significant new grid investment approved and due for commissioning within the next 5 to 8 years. An estimate on how that might affect the results based on 2002 to 2006 data would be interesting. It would also be interesting to study how the new generation projects considered in the SOO might change the frequency and significance of binding constraints. It may be possible for some generators to use their offer strategies to capture a greater proportion of the LRA allocations. For example they may constrain a local transmission line in order to capture a share of the wider LRA allocation. The potential for market power to develop under LRA should be considered if the proposal is to proceed further.
9	Do you agree with the approaches to measuring locational prices? If not, please state alternative locational price measures that should be considered.	This approach leads to the locational price measures discussion covered in question 10 below. No comment is required.
10	Are there other locational price risk measures you think should be used in this analysis?	Measure(s) of locational price opportunities for investors in generation and demand side response over 2002-2006. As well as standard deviation and value-at-risk computed over all trading periods 2002-2006, an estimation of how those measures have trended over time might be useful, eg a rolling average trend line. It may be that the in some areas the measures have begun to decrease over time as a result of the market maturing and or new grid investment and or local generation. In other areas the measures may be worsening. Having an understanding of these effects would be interesting.

11	Do you agree that the analysis of effective marginal prices should be based on the assumption that purchasers never have and/or never exercise market power? If not, please provide a practicable method for estimating effective marginal price for price movers for consideration by the Commission.	For the purpose of this initial analysis of LRA, the assumptions in the consultation paper are appropriate. If more detailed analysis of LRA is proposed, then this may be an area where further work is warranted. However we suspect the materiality of identifying opportunities that consumers' could, have and might exercise market power for these second order effects is probably too small to justify further investigation.
	Chapter 6: Next steps in the analysis of LRAs	**MEUG comment**
12	Do you agree with the above analysis of how the benchmark LRA model could affect incentives for parties to exercise regional market power? In your view, is regional market power a significant issue?	There is less competition in some regions than others. To that extent in some regions some suppliers have a degree of market dominance. MEUG therefore agree that regional market power can be a policy issue. The discussion in section 6.5 indicates that if there is regional market power, LRA may increase the risk of that power being exercised. This observation is a significant concern to MEUG and is a significant detriment of LRA compared to the status quo or hybrid FTR options.
13	Do you agree with the Commission's suggested approach in regard to HVDC and connection rentals? If not, what approach is preferable in your view?	Agree.
14	Do you believe other LRA model options should be considered? If yes, please define those options and explain the rationale for considering them.	We agree that it would be useful to keep open the option of parties contracting to pay for new interconnection services and thereby gaining a property right over rentals attributable to that portion of the grid. If LRA are developed further, the Commission needs to be absolutely sure this option is not foreclosed. MEUG note that FTR associated with new grid investment provides the same benefit.