

MAJOR ELECTRICITY USERS' GROUP

14 March 2011

Mr Albert Brantley
Chief Executive
Genesis Energy

By email to albert.brantley@genesisenergy.co.nz

Dear Albert

Immature approach by electricity industry to hedge products

It has been reported that at the Commerce Committee annual review of the performance of Genesis Energy last Thursday you said:

the electricity industry has an "immature" approach to hedge products and that may not improve until the company puts the first of its four Huntly coal units into storage in 2012.

MEUG is astounded at this view for three reasons:

- Putting the blame on consumers for problems with the wholesale market is incorrect. It's the incumbent dominant suppliers who create problems with the spot, futures and CfD markets and the solution to the problem is largely in the hands of those suppliers, including Genesis Energy;
- Time-of-use consumers may have many varied risk management strategies, but we think it a gross exaggeration to class them as "immature"; and
- In competitive markets suppliers usually don't blame their customers for failed product offerings.

The balance of this letter expands on the above three points.

Copies of this letter have also been sent to the Chair of the Commerce Committee, the Electricity Authority and Commerce Commission. A copy will be posted on the MEUG web site.

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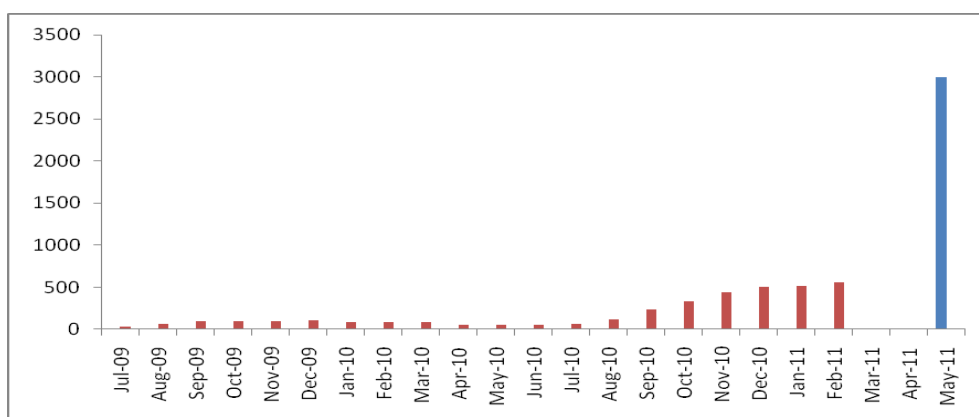
Suppliers not consumers are the source of the problems in the wholesale market

One of the objectives of the decisions by Government in December 2009 following the Ministerial Inquiry and subsequent implementation of those decisions including passage of the Electricity Industry Act in 2010 was to unravel the market power of incumbent suppliers.

Good progress is being made with many initiatives part way through implementation. The results though have yet to be realised. We don't think any informed commentators would say the spot, futures and CfD markets today are significantly more competitive and give time-of-use consumers more choice compared to 2009.

One metric the Government is using to measure competitiveness in the wholesale market is the level of unmatched open interest in the futures market. In the announcements of December 2009 a threshold against which progress was to be assessed was set at 3,000 GWh of unmatched open interest contracts by 1st June 2011. Accountability for achieving this target rests with the five largest suppliers. The graph below shows progress to date is poor. With less than three months to go the level of open interest contracts is a sixth of the Government set threshold.

Estimated ASX electricity futures Open Interest (GWh) at month end since July 2009 compared to 1st June 2011 threshold of 3,000 GWh (blue column)



Any reference to immaturity in the electricity industry is more appropriately labelled on the five largest suppliers who have, to date, collectively failed to support the development of a competitive futures market. Without a competitive futures market the CfD market will continue to languish.

Consumers' management of risk reflects a market where prices are not set competitively

Risk management practices by end consumers vary widely. There is one common feature though. That is standard risk management strategies that businesses employ for other commodities cannot be used for the wholesale electricity market because spot, futures and CfD prices are not set competitively. Solve that problem and standard risk management practises will follow.

That might also be the reason why the recent tender by Genesis Energy may not have attracted the interest you expected. If Genesis Energy helps improve the overall market and particularly the underlying futures market then we think that will give you more scope for product innovation and demand for CfD products you offer in the future. A vibrant futures market will probably lead to development of futures options and futures cap products and hence better align with how you can offer products to match your generation portfolio.

Suppliers usually don't blame their customers for failed product offerings

It would be irresponsible in competitive markets for a supplier to call their customers risk management strategies "immature". In competitive markets customers needs and perceptions command respect. Not so in the New Zealand electricity industry it seems. The difference, in our view, is that the New Zealand electricity industry is far from competitive and the five dominant suppliers continue to have a take-it-or-leave-it approach.

We would expect Genesis Energy to have carefully analysed why a product offering may not have been taken up by the market. If the results of the analysis are simply that the market is "immature" and that physical withdrawal of Huntly units is the only response then we don't think Genesis Energy understands its customers nor has the commercial drivers to think innovatively.

Yours sincerely



Ralph Matthes
Executive Director

cc Hon Lianne Dalziel, Chair, Commerce Committee
cc Dr Brent Layton, Electricity Authority
cc Dr Mark Berry, Commerce Commission