



MAJOR ELECTRICITY USERS' GROUP

12 May 2011

Anneke Hoek
Electricity Authority
By email to submissions@ea.govt.nz

Dear Anneke

Consultation paper – Managing locational price risk: Proposed amendments to Code

1. This is a submission by the Major Electricity Users' Group on the Electricity Authority consultation paper "Managing locational price risk: Proposed amendments to Code" dated 28th April 2011¹.
2. In our last submission in October 2010 to the Electricity Commission on locational price risk we stated²:

"... we think there will be a benefit in delaying timing and final design pending bedding in of futures and options market and commissioning of Pole 3. There are two aspects to be considered:
 - *A more liquid hedge market coupled with a less constrained grid from as early as 2012 onwards may lead to a different design of FTR than that needed now; and*
 - *MEUG has concerns at the capacity of the market to implement the large number of changes already underway over 2011 and 2012, plus the introduction of an FTR market. It may be that the market decides additional futures and options products (eg cap options) have a higher priority than FTR products."*
3. Since that date the Authority has revised the policy objective to align with the Authority's statutory objective that came into effect 1st November 2010, further developed the details of a proposed inter-island FTR and revised the economic cost-benefit-analysis. In our view the conclusion we reached in October 2010 above still stands, ie deferment and re-consideration of FTR product(s) pending development of futures and options and commissioning of Pole 3 may be a better proposal.

¹ Refer <http://www.ea.govt.nz/our-work/consultations/priority-projects/lpr-proposed-amendments/>

² Refer MEUG to the EC, 22 October 2010, <http://www.meug.co.nz/includes/download.aspx?ID=113270>

4. Our view that introduction of FTR should be deferred has been reinforced by the recent consultation by the Authority on scarcity pricing. The locational price risk consultation paper emphasises the need for FTR to be in advance of scarcity pricing commencing³. In our submission in October 2010 the details of scarcity pricing were not known. The Authority published a paper on scarcity pricing on 28th March and submissions closed 29th April 2011. Submissions from consumers and consumer representatives were unanimously opposed to scarcity pricing⁴. It is difficult to see how scarcity pricing could be viewed as being for the best long-term benefit of consumers when both consumers and new entrant retailers universally oppose mandated price floors. At the least implementation of scarcity pricing must be deferred as the case for it being introduced is reconsidered. In that case there is no longer the need for urgent implementation of an inter-island FTR.
5. Deferment will also allow more time for the Authority to consider the following implementation issues:
 - Finalising the partitioning of AC rentals. MEUG suggest an independent peer review is required (refer response to question 11 below).
 - Management of the FTR account (estimated maximum exposure to be managed of \$145m);
 - Allocation of residual FTR revenue;
 - Concerns by the System Operator that implementation of software changes they are responsible for may not be possible before winter 2012; and
 - Implementation of a market monitoring function.
6. MEUG responses to the questions in the consultation paper follow. We have answered detailed questions on design aspects subject to our overarching conclusion that the early introduction of FTR may not be as optimal as advancing other changes in the market and then reconsidering FTR.

Yours sincerely



Ralph Matthes
Executive Director

³ On page F, and paragraph 3.6.2 and paragraph 3.7.30

⁴ Refer <http://www.ea.govt.nz/our-work/consultations/priority-projects/scarcity-pricing-arrangements-proposed-design/submissions/>

Question		MEUG response
Q1.	Do you agree with the proposal that FTRs would include loss costs (in addition to loss rentals, transmission and reserve constraints and price differences caused by scarcity pricing) so that the FTR payout/MW would be the price difference between Otahuhu and Benmore? If you agree, why, and if not, why not?	Agree.
Q2.	Would you be interested in offering loss and/or reserve support contracts if such products were sought by the FTR service provider?	Not applicable.
Q3.	Do you agree with the proposed variations of obligations and options that could be offered initially? If not, please describe the changes you would propose and an explanation as to why these changes are necessary.	No comment.
Q4.	Do you agree with the proposal that the inter-island FTR would provide coverage for the price difference between the Benmore and Otahuhu grid reference points? If you agree, why, and if not, why not?	Agree. This is consistent with our observation to the EC in October 2010 that most attendees at the ASX briefing in September 2010 preferred nodes over GWAP.
Q5.	Do you agree with the proposal that: (a) by the end of the first year of operation the FTR availability horizon (the period for which FTRs are available in advance at an auction) should be at least 12 months; and (b) by the end of the third year of operation the FTR availability horizon should be at least two years; with details determined by the FTR service provider in the FTR allocation plan (in consultation with persons likely to be substantially affected by the plan)? If you agree, why, and if not, why not?	Long term the horizon should match futures availability. A longer term goal to have a horizon for futures and FTR into the more speculative investment timeframe beyond three years would be preferable.
Q6.	Do you agree with the proposed FTR auction design requirements, and in particular that: (a) the Code will specify the requirements that the FTR service provider must comply with in designing the FTR auction and the FTR service provider will set out the auction design in an FTR allocation plan; (b) that the FTR auction should be designed: (i) so that the number and nature of the FTRs allocated, under the FTR allocation plan, and available for auction must be supported by a reasonable estimate of the capacity of the notional interconnector for the relevant period; (ii) to maximise the value achieved in the auction having regard to bids made in the auction;	Agree.

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<p>(iii) to minimise opportunities for the abuse of weak competitive pressure in the FTR auction; and</p> <p>(iv) to minimise costs of participation in the auction?</p> <p>If you agree, why, and if not, why not?</p>	
<p>Q7. Do you agree with the proposed approach to design of the FTR grid, and in particular, that:</p> <p>(a) the system operator be required to provide information to the FTR service provider (if Option (a) is adopted) on the intended configuration of the transmission grid together with a list of contingencies to be assessed for security purposes for each month for which FTRs will be available for auction;</p> <p>(b) the configuration and capacity of the grid and the contingency list used by the FTR service provider or the system operator to determine the quantity and the allocation of FTRs be based on the grid configuration and capacity and the contingency list provided by the system operator;</p> <p>(c) the FTR service provider or system operator should design the FTR grid according to the following principles:</p> <p>(i) the FTR grid should be based on the forecast baseline dispatch grid for the FTR period; and</p> <p>(ii) the FTR grid should ensure to the extent possible that the quantity of FTRs awarded matches the forecast grid capacity subject to revenue adequacy being maintained in a reasonably foreseeable set of adverse circumstances?</p> <p>If you agree, why, and if not, why not?</p>	Agree.
<p>Q8. Which option for determining the amount of FTRs that can be offered in an FTR auction do you consider should be preferred and why:</p> <p>(a) the system operator providing a provisional FTR grid and relevant model updates and a contingency list to the FTR service provider, who would determine the final FTR grid; or</p> <p>(b) the system operator providing the FTR service provider with the amount of FTRs in MW that can be offered in each direction?</p> <p>Do you have any suggestions for alternative approaches that could be used for determining the amount of FTRs that can be offered in an FTR auction?</p>	<p>Initial least cost option is preferred. If demand for more FTR between different nodes arises, then those parties demanding that product should pay for implementation costs at that date.</p> <p>Whichever option is chosen the model and model inputs must be made public.</p>
<p>Q9. Do you agree with the proposed FTR participation requirements and, in particular, that any party may participate in an FTR auction or hold FTRs provided they meet the</p>	Agree.

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<p>prudential security requirements of Part 14 of the Code? If you agree, why, and if not, why not?</p>	
<p>Q10. Do you agree with the proposed approach to management of FTR revenue adequacy, which it is proposed would be managed through:</p> <ul style="list-style-type: none"> (a) FTR grid and auction design; (b) limiting the quantity of FTRs offered to an amount for which there is a high probability of support; (c) establishment of an FTR account that would be funded by: <ul style="list-style-type: none"> (i) surplus rentals arising between Otahuhu and Benmore; and (ii) auction proceeds; (d) in the event that these measures were insufficient to support revenue adequacy, FTRs would be scaled; and (e) prior to allocation to the FTR account, in the event FTRs were scaled, any surplus rentals or auction revenue in the year following the initial scaling would be applied to attempt to fully fund (retrospectively top-up) these FTRs? <p>If you agree, why, and if not, why not?</p>	<p>Please refer to:</p> <ul style="list-style-type: none"> • Response to Q11 on partitioning the AC grid regarding Q10 (a) on FTR grid design; and • Response to Q12 in relation to Q10 (c) regarding establishment of an FTR account
<p>Q11. Do you agree with the proposed approach, described in Appendix E, to partitioning the transmission rentals between those used for FTR support and those reserved for other purposes? If you agree, why, and if not, why not?</p>	<p>No comment as have no expertise to assess the approach and whether it fits our criteria that:</p> <ul style="list-style-type: none"> • allocation of rentals for this initial FTR does not preclude further FTR being offered; and • rentals to be used involve only transmission of power between Benmore and Otahuhu. <p>MEUG suggests an independent peer review of the partitioning approach to give an assurance to the Authority and consumers that the above two criteria are met.</p>
<p>Q12. Do you agree with the proposed approach to management of the FTR account, which would involve:</p> <ul style="list-style-type: none"> (a) retaining any funds not required to support revenue adequacy in the FTR account for a maximum of six months; (b) after six months remaining funds would be forwarded to recipients of residual revenue; and (c) funds in the FTR account would attract interest, which would be paid to recipients 	<p>This is a lot of working capital to be tied up and the opportunity cost to participants of foregoing those cash flows is significant. The EA needs to be satisfied this is the most efficient means to support revenue adequacy and the maximum exposure is estimated as accurately as possible. An actuarial approach as mentioned in paragraph 3.4.153 should be considered.</p> <p>Note that an independent peer review of how transmission rentals are portioned as noted in response to Q11 above will avert any risk of rentals</p>

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<p>of residual revenue?</p> <p>If you agree, please explain why, and if not, why not?</p>	<p>outside of power flows between Haywards to Otahuhu being used to subsidise the FTR account and capital adequacy of parties that chose to be FTR market participants.</p>
<p>Q13. Do you agree with the proposed approach to management of credit and default risk, which involves:</p> <p>(a) development of specific details for management of credit and default risk by the clearing manager, in consultation with interested parties;</p> <p>(b) high level guidelines in the Code, as follows:</p> <p>(i) the risk of default would be shared proportionately between all parties due FTR payouts in the billing cycle during which the event of default occurred;</p> <p>(ii) the minimum level of security required to be provided by purchasers would be calculated on the basis of the total cost of FTRs purchased less the forecast FTR value with (at least) weekly margin calls for any increases in the level of security; and</p> <p>(iii) a trading limit would apply which would set the maximum total amount an FTR auction participant could bid in an auction (unless the trading limit is adjusted)?</p> <p>If you agree, why, and if not, why not?</p>	<p>No comment.</p>
<p>Q14. Do you agree with the proposed approach to settlement of FTRs, which involves:</p> <p>(a) FTR settlement prices would be final half hourly prices for the Benmore 2201 and Otahuhu 2201 nodes;</p> <p>(b) the amount that the clearing manager would pay per MW for the settlement of FTRs would be:</p> <p>(i) the relevant inter-nodal price difference; less</p> <p>(ii) any scaling in relation to (a); less</p> <p>(iii) the per MW auction price for the FTR; but</p> <p>(c) if this amount is negative, the FTR holder would have to pay that amount to the clearing manager;</p> <p>(d) risks to liquidity in the secondary FTR market from this approach (see paragraphs 3.4.208 to 3.4.210) be addressed by providing that:</p> <p>(i) a party that successfully purchases an FTR in an auction FTR is responsible for paying for that FTR irrespective of whether they hold the FTR at settlement; but</p> <p>(ii) the option of paying for FTRs purchased in an FTR auction at any time prior to</p>	<p>Agree.</p>

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<p>settlement would be available; and</p> <p>(e) settlement of FTRs would be within the same timeframe as that used for energy market settlement?</p> <p>If you agree, why, and if not, why not?</p>	
<p>Q15. Do you agree with the proposed approach to management of weak competitive pressure in relation to FTRs, which would involve:</p> <p>(a) market monitoring;</p> <p>(b) potential limitations on FTR holdings; and</p> <p>(c) a requirement in the Code that the FTR service provider should design FTR auctions to, amongst other objectives, maximise competition?</p> <p>If you agree, why, and if not, why not?</p>	<p>If there is a lack of or continuing weak competition then the ultimate approach is to cease any future FTR auctions and wind the FTR market up.</p> <p>The Authority has suggested that if FTR were in place then change in offer behaviour observed on 26th March 2011 might have been moderated. In a liquid primary energy and FTR market this may be true; but in the transition to such a market we are concerned similar events as those in the energy market on 26th March will occur in the initial FTR market.</p> <p>Implementing FTR when we know primary energy market liquidity and competition is poor and without a comprehensive market monitoring function in place would not be in the interests of the market or consumers.</p>
<p>Q16. Do you agree that options for allocation of residual FTR revenue should be assessed according to the extent to which they contribute to the project objective of promoting competition in the electricity industry for the long-term benefit of consumers?</p> <p>If so, why, and if not, what alternative assessment criteria would you suggest and why?</p>	<p>Efficient operation, particularly efficient operation of the transmission grid, should also be considered.</p> <p>An option to managing any competition concerns is to use the Commerce Act Part 2 provisions rather than amend the Code to change the current allocation.</p>
<p>Q17. Do you have any comments on the options identified for allocation of residual revenue and the preliminary assessment of the advantages and disadvantages of each?</p>	<p>See response to Q18 below.</p>
<p>Q18. What is your preferred option for allocation of residual revenue and why?</p>	<p>No view at this stage. Agree with the proposed approach by the Authority (paragraph 3.4.235) "to undertake work to determine how residual FTR revenue should be allocated." The comparison of alternatives in table 2 (p71) is a good start.</p>
<p>Q19. Do you agree with the proposed approach to funding the costs of FTR provision, which would involve:</p> <p>(a) initial set up and operational costs of the FTR funded through the levy until the outcome of the funding review is implemented;</p> <p>(b) the Authority submitting a request to the Minister for an increase to the Electricity Industry Governance and Market Operations appropriation to fund the set up and</p>	<p>No. Set up costs should be paid for by FTR market participants because that will create the right incentives on those parties to develop an FTR market that meets their needs.</p> <p>MEUG members pay between 20% and 25% of energy related levies. The proposal will result in MEUG members paying increased EA related levies of between ½ million and \$1.2million for FTR development and</p>

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<p>ongoing operating costs for a FTR market in the 2011/12 financial year on onwards subject to funds being available in later years from auction proceeds and potentially user fees;</p> <p>(c) after the first year of operation evaluation of the option of auction proceeds to fund FTR operational and service provider costs to determine whether this would be sufficient;</p> <p>(d) in the event that auction proceeds were insufficient, continuing to fund any shortfall from the levy; and</p> <p>(e) in the longer term, giving consideration to funding FTR operational and service provider costs with user fees?</p> <p>If you agree, why, and if not, why not?</p>	<p>implementation costs⁵. MEUG members find it frustrating that the Authority has decided FTR should be implemented ahead of the following priorities:</p> <ul style="list-style-type: none"> • Improving primary energy market liquidity⁶. We don't think FTR is a necessary precursor to improving primary energy market liquidity. Rather FTR is an add on and partial enabler. The hedge market evaluation and options work announced by the Authority in April 2011 should have been and should from now on be a higher priority than early implementation of FTR. It would be a poor outcome if primary energy market liquidity had not markedly improved by 1st November 2011 because resources had gone into early implementation of FTR. • Improving opportunities for demand side response⁷. The last consultation on a demand side response initiative was by the EC in May 2010 on the proposed Dispatchable Demand Regime. If that proposal had half the resources and consultation that development of FTR has had then it would probably have been implemented this year. • Undertaking market-facilitation measures⁸ and industry and market monitoring⁹. The high price event in December 2010 and events on 26th March 2011 have highlighter gaps in information flows and accuracy of price forecasting. With poor liquidity in the primary energy market and therefore it being prone to strategic behaviour by generators, it should be essential that market-facilitation measures and industry and market monitoring processes are in place ahead of FTR. If implementing FTR is undertaken and we do not have a comprehensive and proven market monitoring function, the consumers will be prone to strategic behaviour in both the primary energy and FTR markets."

⁵ Based on low and high scenario costs in table 3, p88 and estimated MEUG member to total energy consumption of between 20% and 25%.

⁶ Electricity Industry Act, s.42(2)(g)

⁷ Ibid, s.42(2)(d)

⁸ Ibid s.16(1)(f)

⁹ Ibid s.16(1)(g)

Question	MEUG response
Q20. Do you agree with the assessment of the costs and benefits of the proposed inter-island FTR? If you agree, why, and if not why not?	No. We believe the Authority will after considering submissions that closed 29 th April on the scarcity pricing proposals decide not to proceed with those proposals and therefore the need for or any benefit of having an inter-island FTR in place by winter 2012 has been negated. Costs are likely to be overstated as we don't believe between 10 and 15 parties will participate in FTR auctions and therefore participant costs will be lower. An analysis of the benefits and costs of deferment should be considered.
Q21. Do you agree with the assessment of the proposed inter-island FTR against the Authority's statutory objective? If you agree, why, and if not, why not?	No comment.
Q22. Do you agree with the Authority's preferred option and proposal for managing inter-island locational price risk? If you agree, why, and if not, why not?	An inter-island FTR is supported but final design and timing should be considered after the futures market liquidity develops and Pole 3 is commissioned.