



MAJOR ELECTRICITY USERS' GROUP

29 June 2012

James Moulder
Chair
Wholesale Advisory Group

By email to wag@ea.govt

Dear James

WAG Settlement discussion paper

1. This is a submission by the Major Electricity Users' Group on the Wholesale Advisory Group discussion paper "Settlement and Prudential Security Review" dated 14th May 2012¹.
2. This submission is not confidential. MEUG members assisted prepare this submission. Several members will also be making separate submissions. This topic is in our top priority category of work. We expect to have ongoing involvement with WAG and the EA on unresolved issues. MEUG appreciates the effort WAG and Authority staff members have taken to discuss the paper ahead of close of submissions. We look forward to continued dialogue.
3. At the workshop on 20th June it was welcome to have an acknowledgment that the paper was retailer-centric. Large single end user dedicated GXP connected customers consume between 25% and 30% of power. Innovative settlement and prudential solutions for those grid connected customers can be quite different from options for mass market retailers default risk. The paper focuses on the latter perhaps because that is the real risk to suppliers; with options to manage grid connected customer default listed but not expanded on in the discussion.
4. Working capital requirements for grid connected customers under the current regime are excessive when spot prices plateau for weeks or months at high levels compared to alternatives such as flexibility regarding exit arrangements. Excessive working capital requirements affect the profitability of those consumers and are therefore a detriment when those businesses need to source capital for innovation and expansion. MEUG urges the Authority to commence work on designing those options as soon as possible. We see no reason why work cannot commence on those ahead of the final WAG recommendations to the Authority in September.

¹ <http://www.ea.govt.nz/our-work/consultations/advisory-group/settlement-prudential-security-review/>

5. Responses to the questions in the consultation paper follow:

Question	MEUG response
<p>Q1. To what extent have we defined the regulatory failures appropriately, and what other problems are there, if any?</p>	<p>Agree the existing settlement and prudential security arrangements have inefficiencies².</p> <p>Aggregate level of prudential security is low compared to AEMO and PJM using PLGD though we are not sure the level of security measured by PLGD in those markets is appropriate for New Zealand. Our position is best summarised as stated in the Executive Summary of the paper that³</p> <p><i>“Overall level of prudential security <u>appears low</u>”</i></p> <p>The underlined text is our emphasis. This leads MEUG to be cautious about increasing overall levels while very supportive of steps to improve efficiency.</p>
<p>Q2. What, if any, material issues have been missed from the description of current arrangements?</p>	<p>No additional issues suggested.</p>
<p>Q3. To what extent is this an accurate description of the failures around current arrangements? If not, what have we missed, how would you describe it and why is the issue material?</p>	<p>Looks reasonable.</p>
<p>Q4. Have we identified the right measures of risk? If not, what would you use?</p>	<p>As the paper notes there is no internationally recognised single standard and there are pros and cons of alternative metrics. MUEG has no suggestions for better metrics.</p>
<p>Q5. Do you agree with the assessment of the appropriate level of security? If not, what information do you have to support an alternative level of security?</p>	<p>See answer to Q1 above. We also agree with the statement in the paper⁴</p> <p><i>“This (referring to the comparison of PLGD in NEM and PJM with New Zealand) suggests that there is a reasonable case for increasing the level of security, although there is less clarity about the magnitude of the increase that should be applied”.</i></p>
<p>Q6. Do you agree we have described the right set of solutions? Have we outlined the right mechanisms that highlight the different options? Are there other mechanisms?</p>	<p>This seems to be a reasonable assessment of feasible options that needed to be considered.</p>

² Paragraph 3.2.3

³ Paragraph 1.1.2 b)

⁴ Paragraph 7.3.1, bullet point 2

Question	MEUG response
<p>Q7. To what extent do you agree with the proposed path for moving forward? Should other options be explored, and if so, why?</p>	<p>Agree with the paper that⁵</p> <p><i>"... there is a clear case for moving away from the Status Quo and adopting a variant of Option 3 or 4".</i></p> <p>Weekly settlement, use of an initial margin and flexibility regarding exit arrangements are likely to be definite mechanisms⁶ in any final package. MEUG suggests the EA could commence detailed design work on these immediately ahead of the WAG reporting a final package in September.</p> <p>More flexible HSAs⁷ might be possible for some CfDs though we expect application to futures or more complex hedges might be better considered in a later second stage. MEUG would not wish to see a delay to implementing the above three efficiency improvement mechanisms to try and solve implementing more flexible HSAs.</p> <p>Similarly MEUG has no view on net settlement and the other possible efficiency improving mechanisms in paragraph 7.5.2 apart from endorsing the approach of undertaking further analysis as appropriate. As with more flexible HSAs we would not want that analysis to delay implementation of weekly settlement, use of an initial margin and flexibility regarding exit arrangements.</p> <p>Implementing a mechanism for a quick exit of a defaulting retailer is essential. That may be a bespoke ROLR mechanism⁸ or existing general receivership processes. RAG should tidy their work up and make a recommendation to the EA expeditiously.</p> <p>We do not support implementing a higher initial margin⁹ until all of the mechanisms listed above in this answer to question 7 have either been implemented or considered and dismissed. After some experience with that set of mechanisms a further assessment should then be made as to whether a higher initial margin is needed.</p>

⁵ Paragraph 8.7.2 that follows on from the logic in paragraph 8.7.1

⁶ These three mechanisms are discussed in paragraphs 7.5.1 a), b) and c)

⁷ Paragraph 7.5.2

⁸ Paragraph 7.6.1 b)

⁹ Paragraph 7.6.1 a)

6. In conclusion MEUG considers it unlikely the WAG will reach a definitive view on metrics for setting a deterministic security level that can be used to better define the optimal level of security. We can though improve the efficiency of determining and procuring security. We should take those gains and continue to assess if and how to improve aggregate levels. As efficiency improvements are made that may give some insights into aggregate level requirements. On this basis a summary of MEUG's submissions on each of the mechanisms discussed in the paper follow:

Mechanism	MEUG recommended action
Design work can start immediately: <ul style="list-style-type: none"> Weekly settlement Use of an initial margin Flexibility on exit arrangements (for single end user dedicated GXP) 	EA should commence detailed design and draft Code ahead of WAG reporting to EA in September. In September the EA will then have to only start work on balance of mechanisms WAG recommend have merit.
WAG to decide merit of each by September: <ul style="list-style-type: none"> More flexible HSAs stage 1, ie easy wins Net settlement Settlement from prudential cash Recognition of investment grade credit ratings Limiting unsecured credit Expanding range of assets that can be used as prudential security 	WAG to consider submissions and as appropriate discuss with parties to reach a decision on ranked priority of those that have merit, those that can be shifted into a second stage round in future years or those that work should cease.
Possible later round of Code changes: <ul style="list-style-type: none"> More flexible HSAs stage 2, ie more complex options. This includes¹⁰ "further recognition of futures positions" 	Set aside for future year work programme to ensure resources focussed on immediate Code change work.
Change in level of security: <ul style="list-style-type: none"> Higher initial margin 	Continue to assess how Code changes affect security and if a change in level is needed. Critical to making decisions on level of security will also be reaching a conclusion on ROLR or equivalent mechanism to manage retailer default.

7. We look forward to ongoing dialogue with WAG and the Authority on this important topic.

Yours sincerely



Ralph Matthes
Executive Director

¹⁰ Paragraph 7.5.2 e)