



# MAJOR ELECTRICITY USERS' GROUP

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John Hancock  
Wholesale Advisory Group Chair  
c/- Electricity Authority

By email to [wag@ea.govt.nz](mailto:wag@ea.govt.nz)

Dear John

## Pricing in Pivotal Supplier Situations

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Wholesale Advisory Group Electricity (WAG) discussion paper<sup>1</sup> "Pricing in Pivotal Supplier Situations" dated 27<sup>th</sup> May 2013. Members of MEUG have been consulted in the preparation of this submission. This submission is not confidential.
2. Responses to questions in the consultation paper follow:

Question	MEUG response
1. Do you agree with the assessment of the potential efficiency losses of pivotal supplier situations for both localised situations and wider area situations? If not, why not?	<p>The NPV range for potential future localised pivotal events is so wide that it is likely to cover all scenarios. We agree with the observation in the paper<sup>2</sup>, "... offer behaviour can evolve rapidly, meaning that history may not provide a reliable guide to the future"; hence the wide NPV estimates for future potential local net pivotal effects is reasonable.</p> <p>The discussion paper focuses on the task set by the Board of the Electricity Authority on local net pivotal risks. Of second order were wider area effects, eg<sup>3</sup> "... the WAG has given <u>some consideration</u> to pivotal supplier situations that affect wider areas". Note that only "some"</p>

<sup>1</sup> <http://www.ea.govt.nz/dmsdocument/15049> found at <http://www.ea.govt.nz/our-work/consultations/advisory-group/pivotal-supplier-situations/>

<sup>2</sup> Discussion paper, Executive Summary, paragraph 5, pi

<sup>3</sup> Ibid, paragraph 2

Question	MEUG response
	<p>consideration was made rather than a comprehensive investigation. Accordingly the analysis of wider area net pivotal effects is only partial in order to identify effects that might spill over from local situations.</p> <p>Given the caveat that the analysis of wider area issues was only a partial analysis, we suggest the range of NPV effects for a wider area analysis may have a lower bound than the \$10m for productive efficiency and \$60m for dynamic efficiency effects in table 1 on pages 14 and 15. A feasible scenario would have an NPV lower bound of close to zero compared to the status quo because:</p> <ul style="list-style-type: none"> <li>• Under a “best case” scenario a combination of new technologies would facilitate lower cost demand and generation alternatives, and more effective public scrutiny and potential countervailing force to mitigate the exercise of market power (refer response to Q2 below).</li> <li>• The lower bound dynamic efficiency effect for localised situations is not significant and we think that less exercise of market power will be possible in wider area situations because there are more nationwide or island wide pro-competitive market improvements such as FTRs still being implemented.</li> </ul> <p>Note MEUG’s comments above on the potential lower bound estimate for future wider area effects should not be taken as refuting the analysis of historic frequency and value of pivotal situations by Professor Wolak and Professor Philpott in Appendix B, section B.5<sup>4</sup>. Those analyses are based on historic market performance whereas the NPV analysis in the discussion paper is forwarding looking. In any case the higher upper bounds in the discussion paper for potential efficiency losses would support those scenarios that assume there have been excessive profits and or inefficient behaviour of the past and the ability and exercise of that market power is carried forward into the future.</p>

<sup>4</sup> As an aside MEUG notes the discussion paper analysis of historic excessive rents is a useful introduction to that issue. Further work on the question of historic rents and whether those are a good guide for future likely excessive rents following implementation of the various policy decisions of 2009/10 is a separate issue to the localised net pivotal issue that was the subject of this WAG discussion paper.

Question	MEUG response
<p>2. Are there any other high level options for addressing issues with local pivotal supplier situations that should be considered?</p>	<p>More ex post information disclosure by net pivotal suppliers and analysis by the Authority to facilitate scrutiny by customers could be considered.</p> <p>Suppliers in a net pivotal situation may be wary of exercising transient market power if post event they risk credible analysis demonstrating their behaviour was cynically designed to obstruct competition. The risk of public odium and consequential damage to the retail brand for those suppliers should not be under-estimated.</p> <p>For example it would be useful for consumers in the Cobb area to know:</p> <ul style="list-style-type: none"> <li>• The specific Hirschman Herfindahl Index (HHI) for GXP in their area compared to HHI for GXP in adjacent areas and trends over time<sup>5</sup>;</li> <li>• If prices for all classes of consumer in the Cobb area differed from adjacent areas. And where there was a difference if that was sufficient to deter competition; and</li> <li>• A cost to serve analysis comparing the net margin for the net pivotal supplier assuming the net pivotal supplier had to purchase on spot on an arms-length basis at the same spot price as other suppliers<sup>6</sup>.</li> </ul>
<p>3. Do you agree with the assessment that the status quo is <u>not sufficient</u> if there are other options available that have low implementation risk and cost, and that could reduce efficiency concerns about pivotal supplier situations?</p>	<p>The status quo can only be described as being <u>not sufficient</u> if a proposed change is NPV positive. The discussion paper suggests options that might be NPV positive but more work is needed on those.</p> <p>We agree that an expansion of FTR nodes as mentioned in paragraph 4.4.1 will not assist reduce localised net pivotal risks; however dispatchable demand will. The status quo as at July 2013 will look quite different this time next year even for localised areas if the Modified Option Dispatchable Demand (MODD)<sup>7</sup> is implemented.</p>

<sup>5</sup> Page 71 of the discussion paper mentions HHI for Tasman/Motueka and Cobb areas. MEUG's suggestion is that HHI trends over time per GXP for the area of concern and adjacent areas be published. Along with the HHI analysis the EA could publish the market share for each customer class for each retailer at each GXP.

<sup>6</sup> For example assume in areas without net pivotal situations retailers earn a margin of \$5-10/MWh on sales (paragraph B.2.19). In the Cobb area Trustpower can eliminate retail competition by increasing spot price during net pivotal events. If Trustpower offers cleared at \$3,000/MWh and this occurs approximately 30 hours per year in the Cobb area (paragraph 3 b) then using the analysis in table 9 gives an increase in excess of \$7/MWh in mean spot price in the Cobb region, ie just sufficient to eliminate retail competition by eliminating margins competing retailers need to justify entry.

<sup>7</sup> MODD is the dispatchable demand option approved by the Electricity Authority Board as opposed to that in the Code. MODD will allow dispatchable demand to be implemented at both conforming and non-conforming nodes and therefore will include all GXP in localised areas subject to recurring net pivotal risk.

Question	MEUG response
<p>4. Do you consider that adding conduct provisions to the Code <u>would be</u> effective at reducing efficiency concerns around pivotal supplier situations, and if so what is your reasoning and which type of conduct provisions do you advocate and why?</p>	<p>Adding conduct provisions <u>might be</u>, rather than <u>would be</u>, effective. The WAG analysis is a good starting point. However given experience to date with supplier's behaviour we do not view adding conduct provisions will necessarily be clearly beneficial. More work is needed to ensure the code changes would be unambiguous and a material change in behaviour to justify the change was likely. We do not want code changes for conduct provisions that at their first test will be subject to legal proceedings on interpretation and therefore rather than improve confidence, will undermine confidence by reinforcing views that suppliers are becoming increasingly litigious.</p> <p>There is a risk that adding conduct provisions to the Code will give the appearance of progress when in fact nothing will really change. Indeed welfare may deteriorate as the legal interpretation wrangles unprofitably use resources (from the national perspective) and or lead to further Code amendments to plug gaps exploited by suppliers.</p> <p>MEUG would be interested in:</p> <ul style="list-style-type: none"> <li>• How effective were the code of conduct provisions of NZEM and MARIA? Examination of events when net pivotal situations occurred and how events unfolded including the effectiveness of the code of conduct rules and role of the Market Surveillance Committee would be useful.</li> <li>• How many allegations of market manipulation have been made in overseas jurisdictions and what has been the outcome? This will assist determine the effectiveness and specific drafting that could be used in NZ.</li> <li>• We assume Boards of Directors of suppliers would have very strong governance oversight of potential net pivotal situations because of the risk of adverse publicity affecting their retail brand. Therefore we do not necessarily agree with the argument in paragraph 4.5.32 that oversight by those Boards of Directors may be less now than when suppliers were subject to the conduct rules in NZEM. It would be useful to know from the large suppliers if Board oversight of such incidences has declined or not.</li> </ul>

Question	MEUG response
<p>5. Do you consider that the net pivotal declaration mechanism would be effective at reducing efficiency concerns around pivotal supplier situations, and if so what is your reasoning? Is it likely to lead to any unintended consequences, and if so, what might these be?</p>	<p>This option appears to have less merit for further investigation than other options.</p>
<p>6. Do you consider that amending the Outage Protocol to include competition effects in the net benefit test would be effective at reducing efficiency concerns around pivotal supplier situations, and if so what is your reasoning?</p>	<p>This option is worth further consideration. The outcome of the current review of POCP due to Transpower by 31<sup>st</sup> October 2013 is likely to be useful<sup>8</sup>.</p>
<p>7. Do you consider that making the grid owner accountable for increased spot market costs caused by pivotal generators during outages would be effective at reducing efficiency concerns around pivotal supplier situations, and if so what is your reasoning?</p>	<p>This option appears to have less merit for further investigation than other options.</p>
<p>8. Do you consider that a general cap on offers or prices would be effective at reducing efficiency concerns around pivotal supplier situations, and what is your reasoning?</p>	<p>MEUG is averse to using price caps in general because of the risk prices will be artificially depressed below levels to support efficient longer term investment. This will lead to either longer term shortfalls and or a sudden increase in catch-up investment that is not well planned or efficiently implemented had there been no price cap.</p> <p>That general view also applies to this specific option of using price caps to manage potential future local net pivotal risk. We are always open to exceptions to the rule however and therefore work on a temporary capping mechanism may be useful.</p>
<p>9. Do you consider that temporary capping mechanisms would be effective at reducing efficiency concerns around pivotal supplier situations, and what is your reasoning?</p>	<p>The complexity and continuous regulatory intrusion to implement a temporary capping mechanism is daunting. Nevertheless we are open to this being explored further as improvement to the long-term benefit of consumers at risk of localised net pivotal situations may justify the complexity and cost of a temporary capping mechanism.</p>

<sup>8</sup> <http://www.systemoperator.co.nz/n1709.html>

Question	MEUG response
10. Do you consider that an enforced contract offer obligation should be placed on pivotal suppliers, and what is your reasoning?	This option would be unworkable as ever increasing layers of regulation and bureaucracy would be needed to plug regulatory gaps and unintended consequences as they emerged.
11. Do you agree with the assessment of the high level options against the criteria in Table 4? If not, why not?	<p>Table 4 on pages 52 and 53 is useful to explain figure 1 on page 56 and how figure 1 is a guide to identify options worth further investigation and those unlikely to be feasible.</p> <p>The index ratings in table 4 and figure 1 are qualitative. It would be useful to have a quantitative scale rather than the relative index rating; nevertheless the approach is helpful for a high level comparison.</p> <p>Using quantitative values would assist distinguish between potential local net pivotal risks in energy, IR and frequency keeping markets. It's important to distinguish different offer behaviour and local net pivotal effects in each of these markets so that interventions tailored to each are developed. The discussion paper does not consider this detail.</p>
12. What, if any, modifications could be made to a temporary capping mechanism to reduce the risk of adverse effects on investor confidence in last resort resources, without significantly eroding the beneficial impact on consumer confidence in pricing outcomes?	We are open to any suggestions from other parties but at this stage would not support further work on this option.
13. What, if any, modifications could be made to conduct provisions to improve its impact on consumer confidence in pricing outcomes, without significantly eroding the beneficial impact for investor confidence in last resort resources?	We are not as confident as WAG that conduct provisions will be beneficial, refer response to Q4 above. Therefore it is premature to consider design details when the option in general still needs to be shown to have merit to justify significant more work including detailed design.
14. What circumstances or conditions should trigger a reassessment of the options for addressing concerns relating to pricing outcomes in pivotal supplier situations? Should the effectiveness of measures be reviewed after a defined period?	See response to Q13 above.

Question	MEUG response
15. Do you agree that the Authority should consider adding conduct provisions to the Code? If not, why not?	No. More work is needed as discussed in response to Q4 above) to ensure more detailed design and implementation costs are worth it.
16. Do you agree that the Authority should consider adding a provision relating to formation of offers similar to that in the NZEM rules? If not, why not?	Same response as Q15 above.
17. Do you consider that an annual compliance certificate requirement would be desirable, and what is your reasoning?	<p>See answers to Q15 and Q16 above.</p> <p>Also relevant to the suggestion that all participants submitting offers would have to furnish annually director signed compliance certificates is the comment in response to Q11 repeated below:</p> <p>“Using quantitative values would assist distinguish between potential local net pivotal risks in energy, IR and frequency keeping markets. It’s important to distinguish different offer behaviour and local net pivotal effects in each of these markets so that interventions tailored to each are developed. The discussion paper does not consider this detail.”</p> <p>MEUG also notes that subjecting parties that are unlikely to ever be net pivotal to provide annual director signed compliance certificates will be an unnecessary barrier to entry for existing and new small energy, IR and frequency keeping suppliers.</p>
18. Do you agree that the Authority should consider a Code change to broaden the net benefit test in the Outage Protocol to include competition effects? If not, why not?	This should be considered under the concurrent POCP review being undertaken by the system operator <sup>9</sup> .
19. Do you agree that the Authority should consider introducing a temporary capping mechanism as the preferred fall back option? If not, why not?	MEUG would not support further work on this option as a fall-back at this time. Resources would be better employed monitoring behaviour in future actual local net pivotal events to determine if the mix of ongoing changes to the market and greater public scrutiny is effective. If problems persist than further interventions based on observed issues can be developed; those might or might not include a temporary capping mechanism.

<sup>9</sup> <http://www.systemoperator.co.nz/n1709.html>

3. Given the complexity of the net pivotal issue we suggest the Authority ask the WAG to consider a cross-submission phase to allow further testing of ideas by the industry as a whole.
4. Finally we reiterate the point in footnote 4 of this submission that while the focus of this consultation is on localised net pivotal situations, the greater potential effect<sup>10</sup> on the long-term benefit of consumers is on nationwide or island wide or larger regional effects termed wider area issues in the discussion paper. That issue has gained more public currency with the NZ Power proposal announcements of 17<sup>th</sup> April 2013 and an estimate of excess profits using the counterfactual of US style regulation on suppliers assuming, inter alia, certain rates of return, opening asset values in mid 1990's and treatment of revaluations<sup>11</sup>. That historic accounting treatment needs to be reconciled with the ex post optimisation models of Professors Wolak and Philpott and forward looking estimation techniques alongside other approaches such as the current Authority work on historic margin trends by customer class.

Yours sincerely



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Executive Director

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<sup>10</sup> The greater potential effect refers to the upper bound scenario NPV's

<sup>11</sup> As an aside note we believe the treatment of revaluations in the analysis supporting the NZ Power proposal is flawed.