



# MAJOR ELECTRICITY USERS' GROUP

20 August 2013

Dr John Rampton  
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By email to [submissions@ea.govt.nz](mailto:submissions@ea.govt.nz)

Dear John

## Consultation Paper – Settlement and Prudential Security Review

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Authority consultation paper<sup>1</sup> "Settlement and Prudential Security Review" dated 18<sup>th</sup> June 2013. Attached to this submission is a report by the New Zealand Institute of Economic Research (NZIER) titled "Electricity market – settlements and prudential security review – advice to MEUG on aspects of the EA consultation paper" dated 16<sup>th</sup> August 2013.
2. The policy issues considered and proposed solutions are material issues for MEUG members. An example of the materiality follows. Assuming MEUG members use 25% of total annual national demand (39 TWh) and an adder of between \$10 and \$20/MWh for 8 days applies, then MEUG members will have an additional working capital requirement of between<sup>2</sup> up to \$2.1m and \$4.3m per annum. For non-household consumers in total<sup>3</sup> the proposed adder will require dedicated working capital of between up to \$9m and \$18m per annum. These are material costs to businesses in New Zealand.
3. The Authority workshop of 18<sup>th</sup> July, attendance of Authority staff and advisors at the MEUG monthly meeting on 24<sup>th</sup> July and subsequent response for further information have been very helpful. Members of MEUG have been consulted in the preparation of this submission. This submission is not confidential. Several MEUG members will also be making individual submissions.

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<sup>1</sup> <http://www.ea.govt.nz/dmsdocument/15149> found at <http://www.ea.govt.nz/our-work/consultations/wholesale/settlement-prudential-security-review-code-amendment/>

<sup>2</sup> Calculated as 39 TWh/y \* (8 days/365 days) \* a range of between \$10/MWh and \$20/MWh

<sup>3</sup> Assumes non-MEUG non-household consumers use 36% of total demand, households 39% and MEUG members 25%. Non-MEUG non-household adder working capital requirements calculated the same as MEUG members except an 18 day rather than 8 day exit period. These are both upper bound estimate because some suppliers may be net retailers and therefore the full exit period margins may not apply.

4. MEUG has also submitted on the Authority "Consultation Paper – Arrangements to manage retailer default situation" dated 18<sup>th</sup> June 2013. This is important because the proposals in that paper will significantly reduce the ongoing exposure of wholesale spot market sellers to defaulting payers. MEUG supports the proposals in the retailer default paper. The key policy question is therefore what is the value and cost to further reduce the exposure of sellers as proposed in the settlement and prudential review paper?
5. In relation to the settlement and prudential security review paper MEUG supports proposals that address the policy issue<sup>4</sup> "wholesale purchasers face unnecessary costs". Those proposals include options to use pre-payments, an opt in for an earlier post-default exit period, more flexibility on Hedge Settlement Agreements (HSAs) and rolling static estimate of exit period prudential margins. MEUG is very disappointed that implementing these proposals was not commenced immediately after consultation on the Wholesale Advisory Group (WAG) paper<sup>5</sup> "Settlement and Prudential Security Review" dated 14<sup>th</sup> May 2012.
6. Instead of making progress on the above quick wins, work by WAG over the last 14 months has been stalled by work on the unproven view by WAG in May 2012 that the "overall level of prudential security appears low". None of the agenda papers considered by WAG since May 2012 have demonstrated that the benefits and costs of shifting from the status quo level of prudential security are net beneficial in the short and long term for consumers. The latest consultation paper also fails to prove the case for change.
7. MEUG recommend the Authority proceed with Code amendments that address the policy issue "wholesale purchasers face unnecessary costs" and defer for later consideration an adder once robust evidence is available to justify that option. Note that this conclusion by MEUG is unchanged from our view on 29<sup>th</sup> June 2012 in response to the WAG paper of May 2012 when we submitted<sup>6</sup>:

"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."
8. In addition to getting on with the quick wins identified over a year ago and putting on hold until the evidence is clear to make any changes to the aggregate level of prudential levels, MEUG recommends the Authority consider the advice of NZIER that a more fundamental review of the structure of the whole prudential system may yield more benefits. Those structural changes include<sup>7</sup> "setting qualifying criteria for market participants" and "setting maximum trading limits for participants".

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<sup>4</sup> Consultation paper, paragraph 2.3.1

<sup>5</sup> <http://www.ea.govt.nz/dmsdocument/13033> found at <http://www.ea.govt.nz/our-work/consultations/advisory-group/settlement-prudential-security-review/>

<sup>6</sup> <http://www.meug.co.nz/includes/download.aspx?ID=123168>, p4

<sup>7</sup> NZIER report, pii

## 9. Responses to questions in the consultation paper follow:

Question	MEUG response
<p>1. Do you agree the problems identified by the Authority are worthy of attention?</p>	<p>MEUG agrees the problem summarised in paragraph 2.3.1 “Wholesale purchasers face unnecessary costs” is a material problem<sup>8</sup>. As discussed in paragraphs 6 to 8 above MEUG supports the quick win proposals to remove these unnecessary costs and we are disappointed WAG did not advance those quickly.</p> <p>The second problem stated in the paper “Wholesale purchasers face heightened payment risk” is in our view debateable. The text in the Executive Summary (p A) we think better summarises that issue:</p> <p>“Wholesale sellers face heightened payment risk because the overall level of prudential security in New Zealand <u>appears</u> low relative to that observed in other broadly comparable electricity markets.”</p> <p>The word “appears” is highlighted because we think it supports the view that the question of an optimal level of prudential security is not adequately considered.</p> <p>As discussed in paragraph 6 to 8 above MEUG recommends the Authority defer any code changes to change the overall prudential levels until a case for such can be proven and also consider NZIER’s advice that a more fundamental review of the settlement system be considered.</p>
<p>2. If you support weekly settlement over monthly settlement, would you also support that approach if generators paid for the additional NZX costs of moving to weekly settlement (estimated at \$0.15 million capital costs plus \$0.225 million per annum ongoing costs)?</p>	<p>MEUG members have varied views on the benefits and costs of monthly versus weekly settlement. There does not appear to be any generic analysis to clearly identify a preference from a national view point. It may be that the differences between the two options are small and the impact on each participant dependent on their own individual circumstances and those in turn may change year by year.</p> <p>In the absence of any clear evidence that shifting to weekly will be in the short or long-term benefit of consumers then sellers to the Clearing Manager should pay.</p>

<sup>8</sup> This is identical to the WAG paper of 14<sup>th</sup> May 2012, p8 that from a policy perspective more accurately described the issue as “inefficient prudential methodology and mechanisms.”

Question	MEUG response
3. If you support weekly settlement over monthly settlement, would you be willing to support monthly settlement if it was accompanied by a higher 'adder' so that the required prudential exit period margin was sufficient to cover the clearing manager's exposure more than 75 percent of the time (the target that is currently being proposed)?	Same response as Q2.
4. Do you agree with the proposed timetable for weekly settlement?	Timetable is reasonable.
5. Is the provision for prepayment appropriate and useful?	Approach is reasonable on the presumption of a potential risk of claw back of prudential payments by a receiver or liquidator. MEUG is not convinced that risk exists. Refer NZIER advice in section 2.2 of their report.
6. Is the provision for payment from prudential cash appropriate and useful?	Yes.
7. Do you agree with the proposed priorities for notional flows from the general account?	Approach is reasonable.
8. Do you agree with the Code provisions and the intentions described in this paper for the determination of SRAs and amounts payable?	Approach is reasonable and clear.
9. Do you agree with the proposed provisions relating to registered post-default exit periods and the prudential exit period for a participant?	Approach is reasonable subject to seeing how this will work in practice. If there is too much ambiguity in how decisions are made then we may have to revisit the criteria and remove regulatory discretion in order to give certainty to purchasers.
10. Do you agree with the order in which the clearing manager must exercise various powers following a settlement default?	Approach for managing default described in paragraphs 4.3.1 to 4.3.14 seems reasonable.
11. Do you agree with the provision requiring the Authority to publicise information about a default, including the defaulting party's identity, when the settlement default causes the need to scale back amounts owing to participants?	Same response as Q10.

Question	MEUG response
12. Do you agree with the provisions requiring the clearing manager to use cash prudentials before other forms of prudential security?	Same response as Q10.
13. Do you agree with the provisions allowing the clearing manager to draw on other forms of security without having to achieve any kind of pro-rata allocation between different prudential securities?	Same response as Q10.
14. Do you agree with the proposed requirement on direct purchasers, and on the connecting distributor or grid owner, to include provision in the connection contract for disconnection of the direct purchaser at the end of the post-default exit period following an instruction from the clearing manager?	Agree.
15. Do you agree with the overall proposal for allocating available funds when there is a settlement shortfall?	Agree with overall approach subject to considering any new information that generators may submit because we are conscious generators buy-in to how shortfalls are treated is important.
16. Do you consider that there should be a limit to the amount of unsecured credit provided to a party on the basis of their credit rating? At present no limit is proposed.	Do not consider a change should be made to remove the unlimited unsecured credit for parties with A- or better credit ratings.  If a change were to be made there may be more value in considering lowering the acceptable credit rating in whole or part for a purchaser's exposure
17. Do you agree with the proposed broad approach to prudential requirements?	Proposed approach agreed except the adder (see response to Q23).
18. Do you agree with the proposal to set the general prudential requirement equal to outstandings, which will increase each day and fall on settlement day, plus a general exit period prudential margin which will cover a fixed number of days and be reasonably constant over time for a participant?	Proposed approach agreed except the adder (see response to Q23).

Question	MEUG response
19. Do you agree with the proposed approach to calculating general outstandings?	Agree.
20. How, if at all, do you think that quantities and prices should be "profiled" during the prudential exit period for the purpose of calculating the general exit period prudential margin? It is envisaged, although this is not set out in the proposed Code, that profiling will be by trading period of the day, by weekday and weekend day, and by node.	"Profiling" by every trading period during a day, where days are treated as either week day or weekend and node specific is essential.
21. Do you agree that the Code should not mention the ASX products specifically? Do you agree with the Authority's intention to use the existing ASX NZ electricity futures quarterly products, and that it would be appropriate for the clearing manager's methodology to specify this?	Agree the Code should be generic and not mention ASX products though the methodology used by the Clearing Manager should state ASX products will be used.
22. Do you agree that the quarterly estimated prices (the ASX-based estimates of future quarter average prices) should be published 2 months in advance of the quarter?	Having prices published 1 month in advance would be better for some but 2 months in advance for other participants. Two months is satisfactory but it's unclear if the downside in forgoing better information from 1 month in advance outweighs the disbenefit to some participants.
23. Do you agree with the proposed approach to determining the price adder?	<p>No we do not agree with the proposed approach to determine the price adder because we do not agree with the need for an adder at all.</p> <p>The policy rationale for including an adder to shift the estimated current PLGD from 57% to a regime where an adder is set to meet a defined PLGD of 26% has not, in our view, been justified. The adder is the mechanism to lift aggregate market prudential levels to overcome the perceived problem that "wholesale sellers face heightened payment risk because the overall level of prudential security in New Zealand <u>appears</u> low relative to that observed in other broadly comparable electricity markets." As we noted in response to Q1 the use of the word "appears" is telling because the Authority have provided no evidence that the status quo level of aggregate prudential levels is not optimal apart from vague references to Australian practice.</p>

Question	MEUG response
	<p>NZIER's advice (section 3.1 including table 1 at start of section 3) discusses the proposed use of PLGD. Table 1 of NZIER's advice is important because it shows that, apart from Australia, no other regulator relies on a predefined PLGD in the design of a prudential system.</p> <p>The materiality of the proposed adder is discussed in paragraph 2 of this submission where we conclude "For non-household consumers in total the proposed adder will require dedicated working capital of between \$9m and \$18m per annum. This is a material cost to businesses in New Zealand."</p> <p>In NPV terms<sup>9</sup> the above working capital requirements equal between \$61m and \$122m. This is an upper bound range (see caveats and assumptions in footnote 3); nevertheless even if the NPV values were only a 10<sup>th</sup> of these values, that is still material. The fact that no generator has provided any evidence that the assessed current level of PLGD was crucial to decisions not to proceed with a generation investment or to obtain funding from a bank, makes us sceptical that a problem exists or that it is sufficiently material to justify imposing higher working capital requirements on purchasers.</p> <p>An important detriment arising from the proposed adder is the relative effect on a new entrant net retailer competing with an established supplier that can net off generation and retail. As an approximation we estimate an adder of between \$10/MWh and \$20/MWh would add between \$0.49/MWh and \$0.99/MWh to a net retailer's costs to supply households relative to a balanced supplier costs. This equates to between 0.2% and 0.4% of total sales revenue assuming an average tariff to households of say 24 c/kWh. That higher cost to net retailers may be sufficient to deter entry into the retail market. This calculation is an estimate only because the costs to a balanced supplier are complex and the difference compared to a net retailer may be less; nevertheless balanced suppliers will always have a cost advantage compared to a net retailer because of the adder. The key point is that the consultation paper has not calculated the relative impact and risk of deterring new entrant retailers because of the new adder.</p>

<sup>9</sup> 8% discount rate over 10 years.

Question	MEUG response
24. Do you agree with the proposed approach for valuing the contribution of HSAs to the general exit period prudential margin?	Agree.
25. Do you agree that the Code provides sufficient guidance for the determination of forward estimate minimum prudential security levels, and that further details belong in the clearing manager's methodology?	Agree.
26. Do you agree with the proposed approach to require participants to provide sufficient prudential security by 1600 hours on a business day to cover the lesser of (a) the minimum prudential security level applying for that day, and (b) the projected minimum prudential security level applying to that day, determined on each of the previous 3 business days?	Agree.
27. Do you agree with the proposed restriction on the parties who can enter HSAs?	Agree with the approached proposed for HSA's in paragraphs 4.6.4 to 4.6.29
28. Do you agree with the proposed legal structure for HSAs?	Appears reasonable.
29. Do you agree with the proposal that HSAs should share in the general account prudential risk? This means that a party receiving funds under an HSA will support a shortfall into the general account caused by a third party default, and that the general account will support a shortfall into the general account caused by the default of a party who owes funds under an HSA.	Same response as Q27.
30. Do you agree with the proposal that parties should be able to cancel an HSA by giving 90 days' notice to the clearing manager, or by obtaining the clearing manager's agreement to the cancellation?	Same response as Q27.



Question	MEUG response
31. Do you agree with the proposal that the clearing manager must cancel an HSA at the expiry of the defaulting participant's post-default exit period?	Same response as Q27.
32. What other forms of bilateral financial contract that should be able to be recognised by having a related HSA form included in Schedule 14.4 of the proposed Code? This would mean those contracts could be settled by the clearing manager and could contribute to the determination of a participant's required prudential level.	. No view on other forms.
33. Do you agree that the Authority's aim should be to make HSAs a useful product for participants, to educate participants in their use, and to remove any unnecessary barriers to their uptake? An alternative would be to pursue an explicit aim of increasing the use of HSAs. Possibly HSA arrangements could provide financial incentives to lodge bilateral financial contracts as HSAs, but if you prefer that approach please explain why.	Same response as Q27.
34. Are arrangements for HSAs effective and efficient? If not, how should the arrangements be altered and why?	Same response as Q27.
35. If you are a participant with existing long term bilateral electricity derivative contracts, would you envisage renegotiating those contracts to match the weekly settlement in the physical market, if the proposal based on weekly settlement proceeded?	Individual MEUG members will respond.
36. If you are a net generator, would you move all future bilateral electricity derivative contracts to a weekly settlement basis? Would you expect to lodge those contracts as HSAs?	Not applicable.
37. Do you agree that the proposed static (as opposed to dynamic) approach to the determination of the general exit period prudential margin addresses the Authority's objectives for prudential security arrangements?	Agree static approach is helpful. Unsure if the quarterly estimated prices (the ASX-based estimates of future quarter average prices) should be published 1 or 2 months prior to the quarter; refer response to Q22

Question	MEUG response
38. Do you agree with the objectives of the proposed amendment? If not, why not?	<p>There is a lot of repetition in the objectives listed in paragraph 6.1.1. A more concise statement of the objectives for policies to address the policy question "Wholesale purchasers face heightened payment risk" would be to use only paragraph 6.1.1 (a):</p> <p>"Minimise the cost to purchasers of providing a given level of prudential security to the market."</p>
39. Do you agree the benefits of the monthly settlement proposal outweigh its costs?	Not clear that one approach is better than the other. Refer response to Q2.
40. Do you agree the benefits of the weekly settlement proposal outweigh its costs?	Same response as Q39.
41. Do you consider there is any additional benefit of the weekly settlement proposal over the monthly settlement proposal? If so, do you consider this benefit will be larger than the additional costs of the weekly settlement proposal over the monthly settlement proposal? Please explain why.	Same response as Q39.
42. Do you agree the Authority's proposed amendments comply with section 32(1) of the Act?	<p>Partly.</p> <p>We agree those parts of the proposal designed to<sup>10</sup> "reduce costs to purchasers of meeting their settlement and prudential obligations" are welfare enhancing and will contribute to the Competition, Reliability and Efficiency (CRE) objectives of the Authority.</p> <p>We do not agree those parts of the proposal designed to<sup>11</sup> "reduce the residual credit risk borne by generators" have been proven to be welfare enhancing and neither has it been proven they will positively contribute to the Competition, Reliability and Efficiency (CRE) objectives in a material way to offset short and long term higher costs to consumers. In particular the proposed increase in aggregate prudential levels for the market through an adder will definitely add costs but there is no evidence of offsetting benefits. For more details see response to Q23.</p>

<sup>10</sup> Consultation paper, table 7, p108

<sup>11</sup> Consultation paper, table 7, p108

Question	MEUG response
43. Do you have any comments on the drafting of the proposed amendment for the proposal based on weekly settlement?	No comments.
44. Do you have any comments on the drafting of the proposed Part 14A covering prudential requirements?	No comments.
45. Do you have any comments on the drafting of the proposed amendment for the proposal based on monthly settlement?	No comments.

10. We look forward to considering the submissions of other parties on this proposal and the response of the Authority to submissions.

Yours sincerely



Ralph Matthes  
Executive Director