



# MAJOR ELECTRICITY USERS' GROUP

29 November 2016

Dr John Rampton  
General Manager Market Design  
Electricity Authority  
By email to [submissions@ea.govt.nz](mailto:submissions@ea.govt.nz)

Dear John

## Consultation paper – Review of stress test regime

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Authority (EA) consultation paper "Review of the stress test regime" dated 18 October 2016.<sup>1</sup> A useful companion paper titled "The security of supply framework" was also published. MEUG is also today submitting on the review of the customer compensation scheme that is part of the security of supply framework.
2. MEUG members have been consulted in the preparation of this submission. This submission is not confidential. Some members may make separate submissions.
3. Responses to questions in the consultation paper follow:

Question	MEUG response
1. Do you agree that the rationale for the stress test regime remains valid and that the regime contributes to efficient security of supply?	<p>The consultation paper lists three policy objectives that were the reasons for the introduction of the stress test in 2011. Each of those reasons are considered in the next sections.<sup>2</sup></p> <p><b><u>Reduce opportunistic lobbying</u></b></p> <p>In 2010-11 there was a legitimate public policy concern about the "scope for opportunistic lobbying by adversely affected participants to socialise the cost of poor risk management decisions."<sup>3</sup> The stress test regime as a tool to reduce that risk was a feasible option, albeit controversial and not universally agreed, at that date.</p>

<sup>1</sup> URL <http://www.ea.govt.nz/dmsdocument/21365> at <http://www.ea.govt.nz/development/work-programme/risk-management/review-of-stress-testing-regime/consultation/#c16205>.

<sup>2</sup> Ibid, p2 in section titled "The stress test regime was introduced to achieve three objectives".

<sup>3</sup> Ibid, p2, sub-paragraph a.

Question	MEUG response
	<p>MEUG questions whether that risk is still a legitimate concern. Even if it is still a concern whether the magnitude of the risk warrants the relatively heavy handed intervention of mandatory stress test disclosures.</p> <p>The paper explains the experience in the extreme dry event of 2012 where “the Authority is not aware of any lobbying for political intervention at all.”<sup>4</sup> The paper does not consider what might have changed between the last prolonged dry events in 2008 that might have changed behaviours. MEUG notes there were substantial changes to the governance and structure of the industry between 2008 and 2010 that would, in our view, have had a significant effect on how retailers and generators behaved. To assign all or even a material credit for the change in behaviour to the stress test regime we suggest is unlikely. If we are correct then the purpose of the EA review of the stress test should be to either:</p> <ul style="list-style-type: none"> <li>• Progressively unwind the disclosure requirements and only keep the highest value and lowest compliance cost requirements; and or</li> <li>• Find alternative methods of making transparent parties that could be tempted or that actually do start to commence opportunistic lobbying. The latter is already within the regulatory tool box of the EA in terms of commencing a market enquiry into an event where opportunistic lobbying is suspected including very extensive powers of discovery.<sup>5</sup></li> </ul> <p><b><u>Incentives on parties to manage spot price exposure</u></b></p> <p>The second objective of the stress test introduced in 2011 was to “enhance incentives for participants to appropriately manage their spot price exposure.”<sup>6</sup></p> <p>Five years later and with the experience of the dry event in 2012 we think the market participants that indulged in opportunistic lobbying pre-2010, mainly the SOEs, have realised that strategy does not work in the continuous disclosure partially listed environment they now work in. They will also be acutely aware of the downside risk that involving politicians in the sector may open the door to other political interference in the market that will undermine the value to their many shareholders.</p> <p>All the large market participants have and are all actively using hedge markets, including be-spoke negotiations, to manage events such as the near term future of the Rankine units discussed in section 3 of the paper. We don’t think having to comply with the stress test</p>

<sup>4</sup> Ibid paragraph 4.11, p11.

<sup>5</sup> Industry participants must provide the EA, as part of the EA’s role to monitor the market, information under s.46 of the Electricity Industry Act 2010.

<sup>6</sup> Consultation paper p2, sub-paragraph b.

Question	MEUG response
	<p>obligations affects the focus of those companies or any of the companies required to comply with those disclosures to use hedge markets to manage spot price exposure.</p> <p>Arguably the need to comply with the stress test obligations diverts management time away from more productive work such as managing spot risk exposure.</p> <p><b><u>Enhance access to information</u></b></p> <p>MEUG doubts any of the parties required to disclose stress tests view the information they compile for their own company or the aggregated stress test results published by the stress test manager as an essential component of the data they need to better improve management of their spot price exposure. The EA could test the above view of MEUG by surveying parties that must complete stress tests.</p> <p>In the view of MEUG there has been a huge improvement in the quality and timeliness of information that spot exposed consumers can access for free or by subscription to assist them make choices on hedging or not. For example the market arrived at a solution last year for an extension following announcements by Genesis of imminent closure of the Rankine Units. We don't think the market participants involved made those commercial arrangements after waiting for the next quarterly publication of the stress test results.</p>
<p>2. Do you agree with the proposed improvements we have identified? If you disagree, please explain your reasoning in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.</p>	<p>MEUG agrees with the conclusion in the paper not to pursue options 1, 3 to 9 and 11 to 13 though our reasoning would differ from that in the paper because of the more critical analysis of the rationale for the stress test regime explained in answer to Q.1 above.</p> <p>The rest of this section comments on the proposal to pursue options 2 and 10. We then conclude with noting the paper does not consider the options of winding back the stress test regime and or finding an alternative mechanism as note in response to Q.1 above under the section headed "Reduce opportunistic lobbying"</p> <p><b><u>Option 2 Improve quarterly stress test report content and format<sup>7</sup></u></b></p> <p>As noted in the answer to Q.1 MEUG doubts many stress test obligated parties actually materially rely on stress test reports, their own or the aggregated public report from the stress test manager, to improve management of their spot exposure. Hence this option arguably is just tinkering without any added value to the sector. More appropriate options the review should have considered are discussed in the section headed "options not considered" below.</p>

<sup>7</sup> Ibid, pp19-21.

Question	MEUG response
	<p>MEUG is also concerned that the EA may be perceived to have a paternalistic almost nanny-state objective with this option where the actual but unstated policy problem is the EA doesn't consider market participants are capable of making their own risk assessments. If you assume the hedge strategy of opportunistic lobbying is recognised by the industry as no longer available then there are incentives on parties to actively manage their risk. A re-formatted presentation of aggregate stress test results isn't going to make a difference.</p> <p>Having said that we think the paper does recognise the risk of some participants putting too much reliance on the stress tests whereas they need to improve their own risk management approaches, eg:</p> <ul style="list-style-type: none"> <li>~ "There is potential that some participants might attach an unrealistically low probability of occurrence to the stress test scenarios and/or fail to realise that changing market conditions have heightened the probability of a stress test scenario coming to fruition. This might result in those participants adopting a greater level of spot price exposure risk than they realised. The converse is also true – some participants may over-estimate the probability and therefore adopt a lower spot price exposure than they realised"<sup>8</sup></li> <li>~ "As with other options that draw attention to specific risks, there is a potential risk that the Authority is increasingly seen as defining future scenarios for participants' risk management framework. Although it might be possible to manage this through careful design of the qualitative questions, the Authority remains concerned that drawing attention to specific risks may dilute participants' responsibility for making their own risk management decisions. This would be inconsistent with one of the key features of the security of supply arrangements: that accountability for risk management decision-making lies entirely with participants."<sup>9</sup></li> <li>~ "Ensuring that participants are aware of the dynamic nature of spot price risks is important. However, there are tools other than stress tests that are being used to further this objective. These include futures contract prices and the system operator providing physical security of supply information."<sup>10</sup></li> </ul>

<sup>8</sup> Ibid, paragraphs A.55 and A.56, p24.

<sup>9</sup> Ibid, paragraph A.77, p26.

<sup>10</sup> Ibid, paragraph A.113, p30.

Question	MEUG response
	<p>Should the EA decide to retain the stress test as is then some members of MEUG are making separate submissions suggesting how the content and format could be improved.</p> <p><b><u>Option 10 Simplify reporting for disclosing participants not exposed to spot prices<sup>11</sup></u></b></p> <p>We agree this option should be considered further.</p> <p>As part of a review of this option 10 consideration should be given to adopting the same approach for parties that have 100% coverage with CfD's or a mix of CfD's and proven demand response capability such offered dispatchable demand. Those approaches to hedging are just as effective (and likely lower cost), in terms of having no exposure to spot price fluctuations over the next quarter, as having a FPV contract for 100% of demand.</p> <p><b><u>Options not considered</u></b></p> <p>As noted in response to Q.1 above under the section headed "Reduce opportunistic lobbying" MEUG suggests the review should have considered the possibility that the need for the stress test as at 2011 is no longer relevant or at least the risk is less and hence other options need to be considered. Those options are not recanvassed here other than to note that in response to this Q.2 we think other improvements to the stress test or other ways to achieve the original 2011 objective of the stress test to reduce opportunistic lobbying should have been considered in the review. As commented on in response to Q.1 we do not accept that there is any need to address the other two policy objectives considered in 2011 as requiring the stress test regime.</p>

4. We look forward to the EA considering this submission.

Yours sincerely



Ralph Matthes  
Executive Director

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<sup>11</sup> Ibid, pp32-33.