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By email: submissions@ea.govt.nz

Dear John

Pricing in Pivotal Supplier Situations

Thank you for the opportunity to submit on the Wholesale Advisory Group's (WAG) consultation paper *Pricing in Pivotal Supplier Situations* published 27 May 2013. Our interest in this matter is as grid owner with decision-making for transmission asset availability.

We comment on the WAG consultation paper with reference to the Authority's guidance to the WAG, at paragraph 1.1.3, that for an option to be effective it should provide:

- a) Consumers with more confidence about the efficiency of prices during pivotal supplier situations, and
- b) Investors with more confidence to charge prices they need to get a return on their last resort plant.

We encourage a measured and proportionate regulatory response

Our comments are made in light of the problem definition analysis provided in the WAG consultation paper (we have not undertaken our own analysis to test the scale of the problem). We agree that the 'potential' efficiency impacts could be large and that the impact is greatest where pivotal pricing reduces the intensity of retail market competition as described at paragraph 2.3.13:

"smaller suppliers without any potential to be pivotal may have greater difficulty in managing spot price risk and buying hedge cover on acceptable terms...it could inhibit entry or expansion by smaller or non-integrated suppliers and reduce competitive tension in the generation, hedge and retail markets."

However, the efficiency impact clearly depends on the frequency and location of pivotal pricing events. If the occurrence is infrequent and geographically isolated then the impact of net pivotal pricing on retail market competition is limited to the affected areas. As such, the economic cost is the dead-weight losses associated with higher retail tariffs for a small number of electricity consumers and, potentially, minor excess investment in generation or demand response. These are unlikely to be economically significant costs. In contrast, if occurrences are more frequent and geographically widespread, then they may have an

impact on overall national retail market competition by deterring entry and expansion. This could have an economically significant productive and allocative efficiency cost.

The WAG analysis concludes (at 3.4.1) that there are not currently material efficiency impacts from pivotal pricing but there is the potential for these in future. In light of that conclusion we consider a measured and proportionate approach, at this stage, would be to:

- develop conduct provisions as proposed by the WAG
- use on-going monitoring, analysis and reporting to (a) highlight pivotal pricing (b) inform future decisions on the need for further, 'deeper', intervention
- continue to progress complementary initiatives that may mitigate wholesale market price risk to retailers¹
- continue with current outage scheduling procedures (see below).

If the evidence subsequently suggests that the problem is worsening then the Authority has the option to intervene more firmly. In addition to explicit monitoring, analysis and reporting suggested above, two further options merit consideration.

1. Additional pricing information: an additional schedule that presents a 'reasonable worse case' pricing forecast (e.g. high demand, low wind) may help forewarn participants of the risk of high-pricing periods.
2. Less granular pricing: pulling price discovery back from nodes at the fringes of the grid (for example, pricing at Timaru rather than Tekapo and Albury) would reduce the incidence of net pivotal situations and create a more benign commercial environment for retailers. These benefits may outweigh any costs arising from reduced signalling.

We elaborate on these in Appendix A.

Exposing Transpower to spot market costs is not a sound option

WAG correctly identify that there are significant challenges and risks associated with this option, including that Transpower could not reliably forecast pivotal pricing risks, or measure counterfactual prices. In addition, we consider that this proposal would encourage more pivotal pricing because it would effectively de-risk this pricing strategy for generators. This increased cost, together with the costs associated with Transpower's risk management, would ultimately flow through to higher prices for all end consumers.

We agree with WAG that this option should be set aside as being too costly and as carrying a high risk of unintended consequences. However, should WAG or the Electricity Authority wish to develop this option further then we would gladly provide further context on the broader regulatory framework and operational considerations relevant to this option.

Outage scheduling process has regard to competition effects

The outage protocol already provides the mechanism for interested participants (which includes retailers) to engage in the outage planning process with Transpower. The engagement is collaborative in nature, focussing primarily on the timing and length of outage, and taking into consideration the effect on both parties – including market effects. The

¹ For example: Within Island Basis Risk; Settlement and Prudential Review, Improving Forecast and Settlement Prices, Dispatchable Demand

recent introduction of FTRs has sharpened market impact considerations in outage planning conversations. Our view is that this process works effectively for both Transpower and interested participants.

The net benefit test (the NBT) is the tool for participants to test whether an outage should proceed should there be any dispute. The NBT is rarely used to test whether an outage should occur. Outage scheduling would become unworkable if the NBT were widely applied, and because it is generally clear cut that forgoing outages altogether is not net beneficial. For these reasons, outages are deemed to meet the net benefit test unless challenged (Appendix A of the outage protocol).

We do not, therefore, consider any change to the NBT is appropriate. If there is a desire to elevate the status of competition issues in outage planning, beyond what already occurs through the collaborative process described above, we recommend a technical working group be tasked to work through how this could best be done. It is essential that any change preserves the workability of current practice which schedules approximately 6000 outages each year.

We have responded to the questions at Appendix A. If you wish to clarify any of the points raised in this submission please contact me on 04 590 7544.

Yours sincerely

A handwritten signature in black ink, appearing to be 'JC' followed by a long horizontal stroke.

Jeremy Cain
Chief Regulatory Advisor

Appendix A – Responses to Consultation Questions

Question No.	Question	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?	<p>We have not undertaken our own analysis to test the scale of the problem however consider that the WAG's analysis and conclusions appear reasonable. We note the Authority's focus on investment incentives in its guidance to the WAG.</p> <p>It is important that appropriate consideration is given to ensuring that any analysis recognises the need for generators to recoup investment costs and earn a fair return. Please also refer to our response to question 2.</p>
2	Are there any other high-level options for addressing issues with local pivotal supplier situations that should be considered?	<p><u>Market monitoring</u> Adopt explicit monitoring, analysis and reporting to (a) highlight pivotal pricing (b) inform future decisions on the need for further, 'deeper', intervention. The analysis could investigate the drivers behind the high generation offers (i.e. to determine if the offer structure limits the ability for the generator to make sufficient profits to be able to invest in new generation plant).</p> <p><u>Less Granular Price Discovery</u> The risk of local net pivotal events is a feature of the very granular approach to nodal pricing in the NZEM. It could be useful if the WAG also considered how a less granular pricing approach would alter its analysis. Although the potential efficiency costs associated with pivotal pricing are not material or certain enough on their own to support a widespread change to NZEM spot price discovery, less granular pricing may also have wider benefits relating to intra-island price risk and retail competition.</p> <p>As such, it would be possible to revisit the presumption that every node on the Transpower network should be a pricing node. In many cases, there may be no significant efficiency costs arising from removing pricing at fringe nodes. For example, it would be worth considering removing pricing from Albury and Tekapo A such that prices were discovered at Timaru only. We note that this rationalisation would occur by default if we were to sell the assets downstream of Timaru to Alpine Energy. Also, rationalisation of pricing at the fringes of the grid would not be inconsistent with the approach WAG has proposed to moderating within-island basis risk.</p> <p><u>Extra Pricing Schedule</u> There may be value in developing an additional pricing schedule to provide extra information on the risk of high prices eventuating. For example, publishing a rolling price forecast based on a high (say, P90) demand forecast and pessimistic (say, zero) wind forecast would often provide an effective early warning if there was a risk of high prices being struck. This could complement the richer information already</p>

Question No.	Question	Response
		<p>provided through the implementation of the price-response and non-price-response schedules.</p> <p>Alternatively, the non-price response schedule could be altered to reflect more conservative assumptions regarding demand and supply.</p> <p>Either of these changes would be helpful in forewarning participants of the risk of high prices eventuating from a coincidence of factors. As such, this option would generally be more relevant to wider pivotal supplier events rather than local events.</p>
3	Do you agree with the assessment that the status quo is not sufficient if there are other options available that have low implementation risk and cost, and that could reduce efficiency concerns about pivotal supplier situations?	We think the status quo is always <i>an option</i> - however if there is a better option then it may not be preferred.
4	Do you consider that adding conduct provisions to the Code would be 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? Is it likely to lead to any unintended consequences, and if so, what might these be?	<p>We agree this option should be considered further, noting some of the issues in the details that WAG identified.</p> <p>We agree that appropriate provisions would provide a mechanism for industry parties to allege (ex-post) poor conduct in relation to pricing outcomes and for Code breach processes to be enabled.</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>No.</p> <p>We agree with the risks identified by the WAG with potentially misleading information.</p>

Question No.	Question	Response
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>No.</p> <p>In practice outage planning is a consultative and iterative process designed to provide clarity for Transpower and affected participants, and the NBT is rarely used to test whether an outage should occur. That is because outage scheduling would become unworkable if the NBT were widely applied, and because it is generally clear cut that forgoing outages altogether is not net beneficial. For these reasons, outages are deemed to meet the net benefit test unless challenged (Appendix A of the outage protocol). If there is a desire to elevate the status of competition issues in outage planning, beyond what already occurs through the collaborative process described above, we recommend a technical working group be tasked to work through how this could best be done.</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? Is it likely to lead to any unintended consequences, and if so, what might these be?	<p>No.</p> <p>WAG correctly identify that there are significant challenges and risks associated with this option, including that Transpower could not reliably forecast pivotal pricing risks, or measure counterfactual prices. In addition, we consider that this proposal would encourage more pivotal pricing because it would effectively de-risk this pricing strategy for generators. This increased cost, together with the costs associated with Transpower's risk management, would ultimately flow through to higher prices for all end consumers. We agree with WAG that this option should be set aside as being too costly and as carrying a high risk of unintended consequences. However, should WAG or the Electricity Authority wish to develop this option further then we would gladly provide further context on the broader regulatory framework and operational considerations relevant to this option.</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? Is it likely to lead to any unintended consequences, and if so, what might these be?	<p>Potentially, but it is not clear that a cap would result in more efficient pricing. Generators could be expected to recoup costs elsewhere.</p> <p>If the cap was set too low then security of supply would be expected to deteriorate over time.</p>

Question No.	Question	Response
9	Do you consider that temporary capping mechanisms would be effective at reducing efficiency concerns around pivotal supplier situations, and what is your reasoning? Is it likely to lead to any unintended consequences, and if so, what might these be?	<p>No.</p> <p>There is a material risk of applying that cap at the wrong times, and at a level that is too low (or even too high). In addition, any form of capping creates an allowable pricing target for generators. This even appears to be the case with the \$3,000 figure that was adopted in the 26 March UTS decision.</p>
10	Do you consider that an enforced contract offer obligation should be placed on pivotal suppliers, and what is your reasoning? Is it likely to lead to any unintended consequences, and if so, what might these be?	<p>No.</p> <p>The contract mechanism would act like a capping intervention, and would not support investor confidence in last-resort generation. Hedge prices will also reflect this requirement. Therefore this proposed mechanism would not achieve efficient costs to purchasers.</p>
11	Do you agree with the assessment of the high level options against the criteria in Table 4?	<p>We generally agree, but in relation to outage planning suggest the net benefit test is not the best approach. We agree that competition effects are a relevant consideration when outage planning, but that this already reflected in the process we go through with interested parties to settle on optimal timing for the planned outages.</p> <p>If there is a desire to elevate the status of competition issues in outage planning, beyond what already occurs through the collaborative process outlined earlier, we recommend a technical working group be tasked to work through how this could best be done in a proportionate and manageable way.</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?	<p>It's not clear that any form of temporary capping could be introduced that would have a robust and enduring benefit in terms of restraining prices while maintaining investment incentives.</p>

Question No.	Question	Response
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 suggest this could be better considered at the next stage of the policy process, after all submissions to this paper are in.
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?	If monitoring, analysis and reporting showed that net pivotal pricing was becoming sufficiently frequent and geographically widespread that it was likely to impact on competition in the national retail market, then it would be worth reconsidering 'deeper' interventions.
15	Do you agree that the Authority should consider adding conduct provisions to the Code? If not, why not?	Yes.
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?	We suggest this could be better considered at the next stage of the policy process, after all submissions to this paper are in.
17	Do you consider that an annual compliance certificate requirement would be desirable, and what is your reasoning?	We suggest this could be better considered at the next stage of the policy process, after all submissions to this paper are in.

Question No.	Question	Response
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?	<p>No.</p> <p>We do not consider any change to the NBT is appropriate. Market impact considerations are already a feature of our outage planning conversations, and the introduction of FTRs has sharpened this focus.</p> <p>If there is a desire to elevate the status of competition issues in outage planning, beyond what already occurs through the collaborative process outlined earlier, we recommend a technical working group be tasked to work through how this could best be done in a proportionate and manageable way.</p>
19	Do you agree that the Authority should consider introducing a temporary capping mechanism as the preferred fall back option? If not, why not?	<p>No.</p> <p>As a rule we consider it is not good practice to declare up front what the fall-back option should be if the preferred options are found to be insufficient. It would take some time to decide whether the current preferred options, and the other on-going initiatives likely to improve this situation, were effective or not. If they are found not to be effective, then there will be better information about the problem and options can be considered then.</p> <p>Note that we do consider it valid to declare that further intervention of some sort might be necessary.</p>