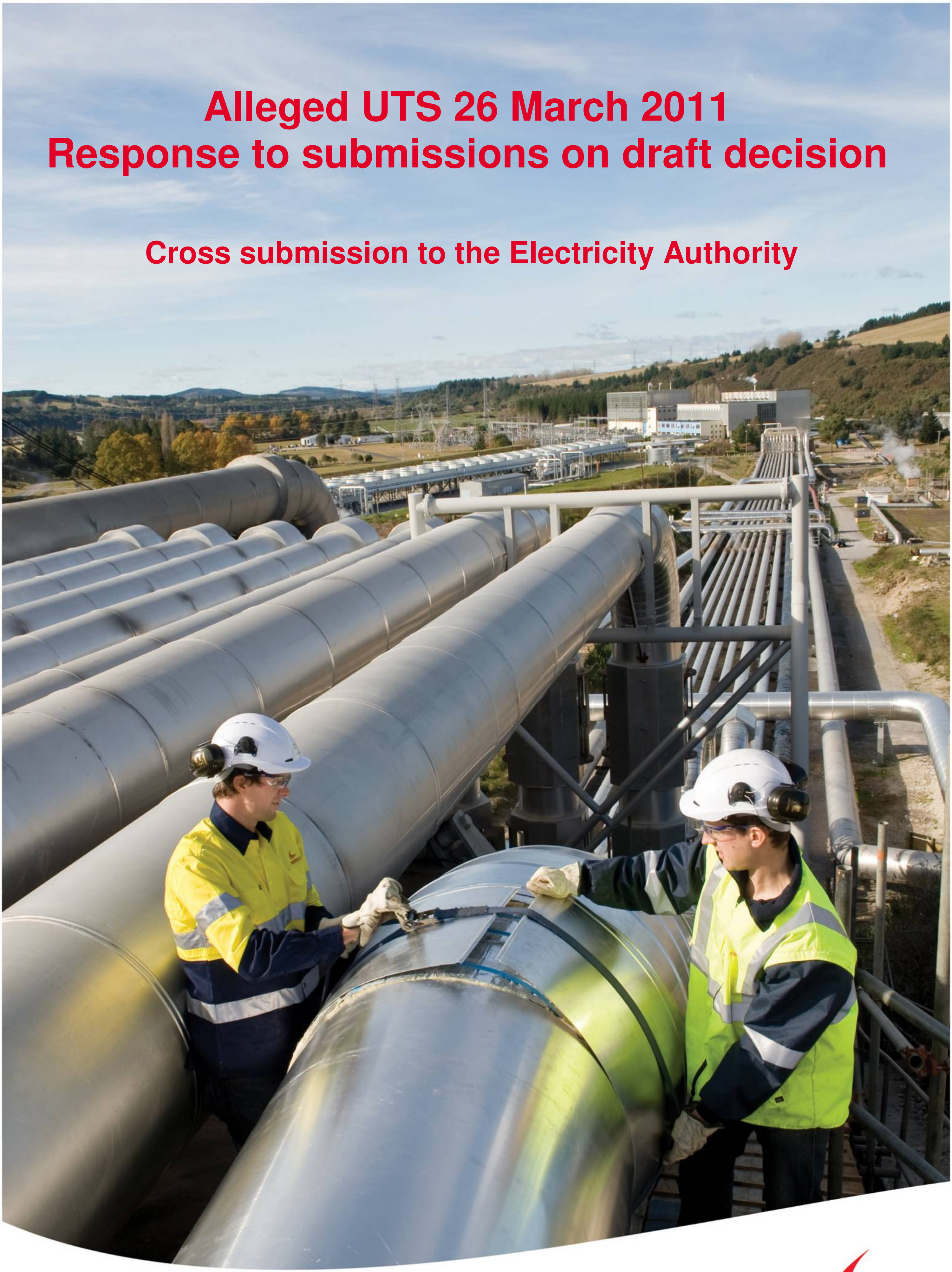
Alleged UTS 26 March 2011
Response to submissions on draft decision

Cross submission to the Electricity Authority



From Contact Energy Limited

This is a cross submission by Contact Energy Limited ("Contact") in response to submissions made on the *Consultation Paper – Draft decision of the Electricity Authority under Part 5 of the Electricity Industry Participation Code regarding an alleged UTS on 26 March 2011* (the "consultation paper") issued by the Electricity Authority ("the Authority") on 6 May 2011. References to the "draft UTS decision" relate to the decisions outlined in the consultation paper.

Where Contact refers to submissions made by other parties, this reference is to submissions as posted on:

http://www.ea.govt.nz/our-work/consultations/uts/26Mar11/submissions-for-draft-decision-regarding-alleged-uts-on-26-march-2011/

Specifically, Contact refers to submissions made by:

- Bryan Leyland
- Genesis Energy
- King Country Energy
- Major Electricity Users Group ("MEUG")
- New Zealand Steel
- Norske Skog Tasman
- Todd Energy

For any questions relating to our submission, please contact:

John Woods | General Manager Wholesale

Contact Energy | DDI: 04 462 1167 | Mobile: 021 409 418

Submissions support Contact's key concerns with draft UTS decision

The concerns raised by Contact in relation to the draft UTS decision are consistent with those identified by a number of participants from across the supply chain, namely that:

- The remedial actions do not prevent another '26 March' from happening – remedial actions relating to price are proposed for a problem about information;
- Some parties who should have been aware of, and responsible for, market risk may not have taken all appropriate steps to do so;
- It will distort the costs of poor risk management decisions, while disincentivising those that did act appropriately, from doing so in the future;
- The sale of market exposed energy products by some participants appears to have been a factor in the outcomes that emerged;
- Serious, and unintended, consequences could potentially arise from the draft UTS decision; particularly in relation to investment signals, the development of the hedge market and other Authority initiatives.

Submissions indicate that the draft UTS decision may be inconsistent with the Authority's statutory objective.

Concerns that draft decision doesn't stop another '26 March' happening

By identifying problems relating to *information*[1], yet addressing an outcome relating to *price*, the draft UTS decision does not prevent the same information led issue occurring again, to the extent it exists.

The Code is the appropriate tool to create the environment within which individual participants operate and manage risk as they see fit, yet no Code changes were proposed in the draft UTS decision.

Other submitters agree that these risks are real, with Trustpower, for example, stating that:

"It is almost certain that such situations will recur without appropriate changes to the Code"

[1] In particular the ability to foresee, or expect, prices to be a certain level.

These concerns[2] raise questions around the sustainability of the draft UTS decision. This will create regulatory uncertainty. The Authority should consider this in making its final UTS decision.

Participants should be aware of, and responsible for, risks they take

All participants should be aware of, and responsible for, the risks they take. This was a common theme in a number of submissions, with Norske Skog Tasman stating that:

"…parties exposed to the spot market should have strategies in place to deal with unexpected spikes."

Some submitters made statements which raise the issue of whether all major generator/retailers had put such strategies in place, with MEUG stating:

"MEUG notes that this event involved the three SOE but neither of the two large listed suppliers. For example Infratil, majority owner of Trustpower, reported "TrustPower closely manages its exposure to volatile electricity prices and has not lodged a complaint.""

Many submitters agreed that the onus should be on participants and parties that consciously take spot market exposure, to be aware of, and manage, market risks; including the risks of volatile prices. In considering its final UTS decision, the Authority must be confident that parties potentially receiving financial relief from the remedial actions have taken all appropriate steps to understand and manage that risk. This will determine the true extent of any information problem.

Sale of market exposed energy products a factor in the outcomes of 26 March 2011

The sale of market exposed energy products by some participants appears to have been a factor in the outcomes that emerged on 26 March 2011. Submissions from other participants support this statement, and the view that some parties did not take appropriate steps to understand and manage risk.

King Country Energy for example states that[3]:

"We are aware that some retailers offer variable spot exposure arrangements. It is apparent from the UTS submissions that these arrangements have been entered into by a number of organisations that might not have good reason to monitor their risks or even an ability to drop much load when prices are high such as 26 March. As a retailer we wouldn't encourage our customers to expose themselves to spot because of the risks and we wonder whether these organisations truly understood their risks. Whatever the answer is we do not see it as the EA's role to bail them out in this case."

[2] Also see Genesis Energy submission, paragraph 16, page 4.
[3] Also see MEUG submission, Q4 response.

Some participants did identify the risks, and manage them, but the draft UTS decision incentivises them not to do so in the future

A number of submissions were from participants who *did* manage risk appropriately on 26 March 2011, expressing concerns about the draft UTS decision. If exposure to normal market risk is mitigated by regulatory intervention, participants will not see a need to manage this risk themselves, and will not be incentivised to seek contracts which improve their ability to respond to certain market outcomes. It may be the case that parties paid high prices for hedges, exacerbating the inequity of the remedial actions to change price.

Norske Skog Tasman supports this, stating that:

"The Authority argues that consumers were not well enough prepared to respond to the high prices of 26th March 2011, and this justifies a UTS. We are quite perplexed about this conclusion – given that we saw the prices coming and took action to avoid them" and "*given that we did respond to the price signals on 26th March and reduced production, the draft decision will penalise us. This seems manifestly unjust."*

Todd Energy and Genesis Energy make similar statements, with Genesis Energy suggesting that the Authority's endorsement of the actions of Genesis Energy and Mighty River Power on 26 March 2011 implies acceptance that parties identified risks and responded appropriately. MEUG's submission suggests that Mighty River Power's choice not to take a hedge was a conscious decision on risk.

These statements[4] indicate that parties could, and did, respond to the signals provided in the market on 26 March 2011 and that there isn't an information problem to the extent implied by the Authority. A number of parties took action in response to the signals provided, and believe that the draft UTS decision effectively penalises them for making informed appropriate risk management decisions.

This raises serious questions about the Authority's conclusion that parties did not have sufficient time to take actions to avoid liability until after it was too late. The submissions from Norske Skog Tasman, King Country Energy (and those inferred in the MEUG submission) would suggest that this conclusion is incorrect.

As a result, because the Authority links an ability to arrange alternative supplies or curtail demand to the decision on appropriate remedial actions, these submissions suggest no remedial actions (in

---

[4] Also see King Country Energy submission, paragraph 11 and MEUG submission, Q3 response.

terms of offer adjustment) are required, as parties **did** secure alternative supplies or curtail demand – or in some cases, chose not to.

Serious, and unintended, consequences could potentially arise from the draft UTS decision if it is confirmed

Serious, and unintended, consequences could potentially arise from the draft UTS decision if it is confirmed where participants are not incentivised to manage risk appropriately. Many submissions reinforce the consequences outlined by Contact.

Realistic risk that people will rely on UTS process for protection from market risk

The level of regulatory intervention contained in the draft UTS decision will lead to more UTS claims, as some participants will be less incentivised to manage risk properly.

Todd Energy identified this, submitting that:

"If the EA confirms its views and acts to set prices at the prices levels indicated in its draft decision, which we believe are too low in any case, this will create incentives for further such claims whenever high price situations occur in the future and create slippery slope risks for the Authority due to the precedent set."

The Authority should be cognisant of these risks[5] in making its final UTS decision, particularly in relation to the durability of such an intervention.

Regulatory uncertainty and the resulting incentives

Contact's concerns of serious, and unintended, consequences resulting from the draft UTS decision are reinforced by concerns from submitters. As Contact did, some submitters also questioned the consistency of the draft decision with the Authority's statutory objective. The concerns are widespread across the industry.

Trustpower notes the potential impact of regulatory uncertainty, submitting that:

"The need for (and use of) intervention creates massive uncertainty for market participants, which only serves to deter long-term commitment to the market and decrease its efficiency. If such events in future lead instead to further UTS claims, settled by further arbitrary price capping, then that in itself is a considerably undesirable situation."

---

[5] Also see Genesis Energy submission, page 2, and Norske Skog Tasman submission, page 2.

The risks[6] are not only to efficient market operation, but to investment[7] and the incentives to operate existing plant efficiently. Contact noted specific risks in relation to investment in peaking plant, supported by Todd Energy. Todd Energy submitted that:

"A decision to reset prices as proposed would create disincentives for…investment in peaking generation"

The Authority should be concerned by these statements, as they are made by participants who will be considering these as genuine investment opportunities. The Authority must be confident that its decision is not likely to lead to outcomes that are inefficient; both in terms of operation of existing plant[8], and investment in new plant.

Risk to hedge market development and other Authority initiatives

The draft UTS decision risks harming the development of the hedge market, and other Authority initiatives resulting from s.42 of the Electricity Industry Act (2010). These concerns are reinforced by comments from other submitters, with Todd Energy suggesting that:

"A decision to reset prices as proposed would create disincentives for participation in future initiatives planned by the EA including demand side management, locational pricing risk and developments in hedge markets."

Because the Authority's initiatives must be consistent with its statutory objective, it must be aware that such comments cast doubt over the proposed benefits of those initiatives. At a minimum, should the draft UTS decision be upheld, the cost-benefit analyses for each initiative must be revisited to ensure they are still appropriate, given the change in incentives.

Comments made in relation to TCC and the Stratford peakers

Comments have been made both by the Authority, and by submitters, in relation to Contact's offering of capacity at Stratford (the Taranaki Combined Cycle plant ("TCC") and the Stratford peakers). Contact repeats again that its decisions to offer plant are based on price signals and an assessment of market conditions. Contact is also able to draw on financial mechanisms to manage risk as opposed to solely relying on physical plant. Contact is under no obligation to run a plant if we do not expect to earn returns sufficient to warrant its operation.

Contact could potentially have offered TCC into the market for 26 March 2011 if parties had provided sufficient fixed returns (via hedges) for some of the plants' capacity. Contact has bought

[6] Also see Norske Skog Tasman submission, page 2.
[7] See King Country Energy submission, paragraph 10(e).
[8] See Genesis Energy submission, page 4.

and sold hedge cover for similar transmission events in the past (and since 26 March 2011). Contact notes again that *no* parties sought hedge cover from the company for 26 March 2011 *prior* to that date.

The Stratford peakers were still commissioning on 26 March 2011, hence were not available for commercial operation.

The draft UTS decision implies that Contact's decisions not to operate plant were a factor in the outcomes of 26 March 2011. Statements made by some submitters[9] indicate that this has been interpreted to suggest a level of significance that was not intended by the Authority's comments. Such an interpretation is incorrect.

[9] See submissions from Bryan Leyland and New Zealand Steel.