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Submissions
Electricity Authority
PO Box 10041
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By email to: submissions@ea.govt.nz

21 June 2011

RE: 26 MARCH 2011 EVENT

In response to the recent Consultation Paper regarding the undesirable trading situation (UTS) on 26 March 2011, King Country Energy Ltd (KCE) makes the following submission to the Electricity Authority (EA).

Response to EA Question 1

1. KCE does not agree with the proposed actions. KCE has reviewed the UTS decision and believes it does not address fundamental issues.
2. KCE believes poor risk management decisions by a number of generators and end users, who took spot market exposure, have been endorsed by the EA. Prudent risk management decisions by KCE, and the silent majority of customers who pay fixed price electricity prices, at a premium to spot market have been penalised by the EA decision.
3. KCE has assessed the impact of a base load customer exposed to spot market at Otahuhu (OTA) for the year from 1 April 2010 to 31 March 2011, with no load management response to price signals. The average OTA price the customer would pay for that year is \$58 per MWh (with 26 March price at \$3,000 per MWh), compared with \$73 per MWh if the 26 March interim prices apply. The average hedge price available on ASX in the quarter prior to 1 April 2010 was \$82 per MWh, for the year from 1 April 2010 to 31 March 2011. If the customer chose to hedge they would have expected to pay this amount. Therefore the annual cost to an end user taking spot market exposure is lower than if they had chosen to hedge even if the interim 26 March prices apply. The EA decision has the effect of encouraging and rewarding increased risk taking amongst end users.

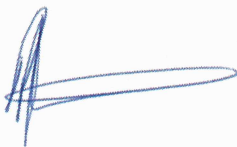
4. In the summary decision the EA correctly points out that “had electricity consumers been aware of the exceptionally high prices in advance, they would have, in many instances, reduced demand or secured other sources of generation, as occurred on Saturday, 2 April 2011, at the prospect of a repeat of the exceptionally high prices of 26 March.” KCE agrees with this statement however disagrees that this should support the UTS being declared. There are a large number of events in the past 10 years where price spikes (and prolonged high prices) have occurred and customers have knowingly taken exposure to that risk. There has been no cap to exposure previously however the EA declared the UTS due to the “exceptionally high prices” eventuating on 26 March 2011. We accept that the EA has declared a UTS but do not accept that the circumstances justify creating the precedent of rerunning the pricing model with offer prices determined by the market regulator.
5. The EA refers to “no indication of the forthcoming exceptionally high prices on 26 March until almost real time”. KCE disagrees with this as there is evidence to suggest prices at or exceeding \$20,000 were credible and signalled several years before, as a consequence of demand side management.
6. In its report to Transpower dated August 2006, Castalia proposed the potential value of unserved energy (for the purposes of the Grid Investment Test) of \$20,000 per MWh with potential for higher in Auckland.
7. The EA is progressing a review of the appropriateness of the current unserved energy values adopted (\$20,000 per MWh, with \$10,000 per MWh and \$30,000 per MWh being applied for sensitivity analysis). The EA states “the appropriate unserved energy values are a critical input into decisions about investments in the New Zealand electricity system, as it is used to estimate the economic impact on customers of planned and unplanned outages.”
8. KCE highlights the EA already contemplates that prices of circa \$20,000 per MWh reflect investment decisions around planned and unplanned outages. This logic equally should apply to supply side investment decisions for the same effect.
9. Under the current market arrangement prices are determined mostly by generator’s offers with little ability for consumer preferences to be reflected in cleared prices. If true scarcity pricing is introduced in to the New Zealand market the pricing mechanisms would be changed to include consumer preference and, we expect, would include the sort of possibilities indicated by the unserved energy values
10. The EA also states that “had the exceptionally high prices resulted from a genuine scarcity of electricity supply, and had the high offer prices been well signalled in advance, it is unlikely the Authority would have found the events of 26 March constituted a UTS, as it is important price is used to signal scarcity to industry participants”
11. KCE is concerned about this statement for two reasons. Firstly we believe that the physical constraints imposed (and not by Genesis) on 26 March did constitute a genuine scarcity of supply, as they eventuated by the combined independent variables of the Transpower constraint, Contact plant withdrawal and a lower than actual demand volume assumption. Secondly had the high prices been well signalled in advance, a demand response would have occurred, however KCE is unaware of any legal or regulatory requirement for Genesis or others to signal prices other than those signals already provided.

12. KCE agrees that it would be ideal for end users who choose to take spot exposure to be informed about price signals and to be provided the ability to react accordingly. However we would expect end users who make that choice, do so with the specific knowledge of their own ability to act upon, or react to, price signals.
13. In reference to the hedge market the EA believes "Hedge markets thrive when participants are confident the underlying physical market is competitive, and they are hampered when this is not the case". KCE suggests that hedge markets also thrive when volatility exists and prudent risk management supports an active hedge market. The EA decision on the UTS does not support an active hedge market, as it removes the risk of extremes in volatility and rewards those who choose to remain exposed. The events of winter 2001 are still recent enough to demonstrate the impact of inappropriate risk management decisions.

Response to EA Question 2

14. To reiterate KCE has an active and effective risk management framework for mitigating its exposure to the wholesale electricity market and has been severely penalised by the UTS decision. KCE is extremely disappointed in the decision, however having declared the UTS we believe the correct course of action for the EA is to reinstate the interim prices. KCE does not accept that the circumstances of 26 March justify creating the precedent of rerunning the pricing model with offer prices determined by the EA.
15. KCE also seeks the EA's clarification on how it intends to respond to large price variations in the future. We believe one of the EA's key responsibilities is to establish market rules which provide certainty to the industry.

Yours sincerely

A handwritten signature in blue ink, consisting of a stylized 'R' followed by a horizontal line.

Rob Foster
CHIEF EXECUTIVE OFFICER