

Consultation on within-island basis risk: proposed approach



6 August 2013
From Contact Energy Limited



This submission by Contact Energy Limited (**Contact**) responds to the *Consultation on within-island basis risk* paper (**the consultation paper**) released by the FTR Manager on 25 June 2013.

Our submission offers general comments on the consultation paper, as well as responses to the specific questions raised.

For any questions relating to our submission, please contact:

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The comments below are in response to the Electricity Authority's (**Authority's**) preferred option of a multi-hub FTR market.

The cost to implement the Authority's recommendations outweighs the benefits

Contact believes the Authority's estimate of the cost to implement a multi-hub FTR market underestimates the true cost to industry. Contact believes the productive and allocative efficiency gains recognised by the Authority would be easily displaced if the true cost were to be accounted for.

The Authority's cost benefit analysis estimates the cost to industry as 0.5 FTE of additional resource for each of the eight participants. Contact believes this represents only a fraction of the true cost to implement the processes, systems, training and personnel to trade in a multi-hub FTR market.

Our estimate of the cost to implement the recent two-hub FTR market is set out below in order to assist the Authority's cost benefit analysis.

| | Cost |
|---|----------------------|
| Data capture and settlement system | \$380,000 |
| Integration into existing trading systems | \$200,000 |
| Additional trading resource | 0.5 FTE at \$120,000 |
| Ongoing IT support | \$100,000 p.a. |

Contact's forecast of the additional costs arising from the implementation of a multi-hub FTR solution is set out below.

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|---|-----------------------|
| Initial cost | |
| System design and business analysis | \$300,000 |
| IT development | \$200,000 |
| Training | \$20,000 |
| Total initial cost | \$520,000 |
| | |
| Ongoing costs | |
| Additional risk and compliance monitoring | \$12,000 p.a. |
| Additional audit resource | \$6,000 p.a. |
| Additional trading resources | \$120,000 p.a. |
| Additional settlement resources | \$12,000 p.a. |
| Additional system support | \$50,000 p.a. |
| Total ongoing costs | \$200,000 p.a. |

Assuming that the cost to four participants is as per the tables above, and that four other participants can implement a solution at 50 per cent of this cost, the additional efficiency gains required to break even are \$12m. This is four times higher than the gains required under the Authority's analysis. We do not believe the analysis supports that this level of efficiency gain can be

achieved under a multi-hub FTR model, and as such do not believe that the proposal is NPV positive.

The complexity of a multi-hub FTR market cannot be assessed in isolation

A multi-hub FTR market, when viewed in isolation, can be traded and managed with moderate analysis and system support. However the complexity increases exponentially when up to 168¹ new FTR products a month are incorporated into an existing energy portfolio where reserve and energy offers are co-optimised, ASX futures and OTC hedge products are incorporated, and frequency keeping and MRDA are managed. Contact believes the Authority's evaluation does not suitably acknowledge the increased complexity that the incorporation of FTRs into a portfolio creates.

Trading FTRs is not optional

Although there is no requirement to trade FTRs, Appendix D of the consultation paper raises a number of important points around locally dominant suppliers. It is in this environment that participating in FTR auctions becomes less about hedging existing risk and more about ensuring new risks are not created by participants obtaining large FTR positions. Participants with any exposure to locally dominant suppliers will need to have the systems and processes in place to participate in FTR auctions whether or not they plan on being active market participants. Therefore the costs associated with multi-hub FTR markets cannot be avoided.

Reduced complexity will offer the most value

Noting the increased complexity each additional hub adds to the New Zealand electricity market, Contact believes that if any new hubs are added, they should only be those that clearly demonstrate significant value. Based on the Authority's analysis, the only hubs that should be considered are HAY and INV.

¹ $N(N-1)$ where $N = 7$ FTR hubs as per the Authority's recommendation, and each point to point can consist of up to four products

Responses to specific questions

| Number | Question | Response |
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| Q1 | Do you agree that the Authority has characterised the problem of WIBR correctly? If not, how could the problem be better described? | Contact agrees that WIBR is a commercial risk, albeit one that has significantly reduced during a period of increased investment in transmission. However, the Authority has provided little supporting evidence that WIBR is negatively impacting competition to the long-term dis-benefit of consumers. In the absence of such analysis, Contact believes it is difficult to see where the value of introducing more complexity to the market is derived from. |
| Q2 | Do you agree that these four options are an appropriate shortlist? If not, are there other options that should be considered? | Yes. |
| Q3 | Do you agree that the four options in Table 2 need not be considered at this stage? If not, which of them should be considered and why and what other options should be considered and why? | Zonal pricing should have been considered. |
| Q4 | Do you agree that the two-node hybrid option has been characterised correctly? If not, how could it be better described? | Yes – adequately described |
| Q5 | Do you agree that the three-node FTR option has been characterised correctly? If not, how could it be better described? | Yes – adequately described |
| Q6 | Do you agree that the three-node hybrid option has been characterised correctly? If not, how could it be better described? | Yes – adequately described |
| Q7 | Do you agree that the multi-node FTR option has been characterised correctly? If not, how could it be better described? | Yes. We also note that, although the implementation date of mid-2014 may be achievable for the FTR Manager to introduce new products, the policies need to be finalised well before go-live date to give participants time to prepare for the market. Mid-2014 therefore seems to be too rushed. |
| Q8 | Do you agree that all four high-level options are feasible? If not, why not | Yes |

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| Q9 | Do you agree that all four options would avoid distortion to price signals? If not, why not? | Contact does not agree all four options would avoid distortion to price signals. In the absence of any decision around pivotal pricing behaviour, we do not know what impact the Authority's market monitoring will have on pivotal pricing. Contact does believe that the introduction of multiple new FTR nodes could increase pivotal pricing incentives. |
| Q10 | Do you agree that the criteria in Table 7 are reasonable and roughly equal in priority? If not, why not? Should other criteria relating to competition, reliability or efficiency be considered? | <p>Criterion 1 makes the mistake of assessing the complexity of the product in isolation rather than when the product is incorporated into an existing portfolio.</p> <p>The Authority should also consider participants' ability to be ready to trade FTRs rather than just the FTR Manager's ability to launch new products. The FTR Manager should have time to put in place finalised consultation on policies that participants can rely on to establish trading systems. Developing systems in parallel with policy creates significant unnecessary cost when changes are made.</p> |
| Q11 | Do you agree that the multi-point FTR would promote the Authority's statutory objective most effectively? If not, why not, and which option do you think would most support the statutory objective? | <p>The consultation paper provides little supporting evidence that WIBR is negatively impacting competition to the long-term dis-benefit of consumers. As such we cannot comment on how the options presented meet the Authority's statutory objective.</p> <p>We do not believe the consultation paper adequately demonstrates that multi-hub FTRs would promote enough competitive and efficient outcomes to justify the cost.</p> <p>If a multi-hub FTR is implemented, we believe the additional hubs should be limited to HAY and INV.</p> |
| Q12 | Do you agree that the multi-point FTR would produce a greater net benefit than any of the other options? If not, why not, and which option do you consider would produce the greatest net benefit? | Contact believes the inclusion of HAY and INV to the FTR market would reduce the most WIBR as demonstrated in the Authority's analysis; however we are concerned that the net benefit is still less than the cost to industry. |
| Q13 | If the decision is to proceed with the multi-point FTR, which FTR points do you consider should be added at this point, and why? | HAY and INV. As discussed above, the inclusion of each additional FTR hub increases the complexity across a portfolio. The statistical analysis presented by the Authority shows the HAY and INV nodes offer the greatest ability to manage WIBR whilst all other hubs provide only marginal benefit at increased cost. |
| Q14 | Do you agree that, if the decision is to proceed with the multi-point FTR, the new FTR points should generally be nodes rather than hubs? If not, why not? | Yes, we agree they should be nodes. |

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| Q15 | Do you agree that, if the decision is to proceed with the multi-point FTR, the new FTRs should be point-to-point rather than radial? If not, why not? | If one or two new nodes are included, they should be point to point. |
| Q16 | Do you agree that, if the decision is to proceed with the multi-point FTR, the new FTR products should include a full selection of options and obligations? If not, why not? | Yes |
| Q17 | Do you agree that, if the decision is to proceed with the multi-point FTR, the Authority should proceed according to the roadmap set out in Figure 7? If not, how should the Authority proceed? | |
| Q18 | Do you agree that, if the decision is to proceed with the multi-point FTR, the Authority should develop objective criteria for adding and removing FTR nodes in future years? What should be taken into account in developing these criteria? | <p>Contact notes that, of the four factors outlined in 6.2.4, only one (locational price variability) has been considered in this consultation.</p> <p>Contact agrees with the four factors outlined but believes that ultimately a net benefit must be shown if new FTRs are to be added.</p> |