MAJOR ELECTRICITY USERS' GROUP

7 December 2009

Kate Hudson
Electricity Commission
By email to submissions@electricitycommission.govt.nz

Dear Kate

Submission on Scarcity Pricing and Compulsory Contracting

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Electricity Commission consultation paper "Scarcity Pricing and Compulsory Contracting: options", published 9th October 2009[1].

2. The behaviour of major suppliers last winter illustrates part of the shortcomings of the current policy for managing the risk of black-outs in extremely dry years, ie:

   a) The largest suppliers agreed to co-ordinate a campaign to elicit voluntary demand savings from consumers rather than paying consumers to reduce demand. This coordinated action lowered the marginal cost of achieving demand reductions to suppliers in aggregate but increased the cost to consumers because they received no compensation whereas in prior dry year events they had been rewarded; and

   b) Some of the largest suppliers lobbied government to enter into a buy-back scheme with major users. Had this arrangement been finalised government would have borne the cost and then levied all consumers. A truly competitive market outcome would have seen spot exposed suppliers contracting bi-laterally with large users to reduce demand.

3. The incentive for spot exposed suppliers to minimise their commercial exposure by using non-market mechanisms to shift risk to consumers has been documented in the Review of Winter 2008, the draft recommendations of the Ministerial Review and this latest Commission consultation paper. The ability for spot exposed suppliers to shift risk was possible because:

   a) Major suppliers were willing and able to act collectively to minimise their net costs to the detriment of consumers; and

   b) Politicians were open to lobbying by spot exposed suppliers and actively intervened thereby undermining confidence for the market to develop solutions[2].

4. Policy solution(s) should minimise the opportunity for major suppliers to act collectively and for political intervention during extreme dry-year events.

5. MEUG submissions on the Review of Winter 2008 and the draft Ministerial Review recommendations supported further work on scarcity pricing and compensation schemes rather than compulsory contracting. That view remains unchanged.

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[1] Refer http://www.electricitycommission.govt.nz/consultation/scarcity-pricing/view
[2] Examples include Whirinaki power station, the gas underwrite for e3p and preferential tax treatment for MRP geothermal power stations.

6. Of the two scarcity pricing options, Option B (phased scarcity pricing for pre-shortage situations) has the risk that there will be political intervention to modify the trigger date for pre-event planned rolling black-outs. As noted in paragraph 3 b) above one of the reasons we have a policy problem is political intervention and discretion in security of supply policy. We should avoid this and therefore Option B is not supported.

7. Having an administered scarcity price when forced black-outs occur due to an extreme dry-year event (option A) should be further considered against a modified status quo option. The status quo has failed because of the ability of spot exposed suppliers to shift risk and this has affected prices. In a modified status quo option suppliers will not act collectively to minimise their risk, there will be no scope for political intervention and therefore market prices will trend to scarcity values because there is no regulated cap. Enforcement of policies to ban retailers not acting collectively and restricting political interference will need careful design; however they will deal to the root cause of the policy problem. A modified status quo option may be a better solution than regulating scarcity values.

8. One reason MEUG supports finding a way for the market to derive scarcity values rather than having regulated values is the inevitable complexity that will be required to make regulations for setting a scarcity price and how that is to be managed for a prolonged event. Markets are not perfect but there is probably a better chance a market will recover quicker from an event and find the right price to achieve that than having days or weeks of administered prices. MEUG members oppose any administered scarcity price that could persist for days or weeks on end.

9. It is not obvious that the same scarcity pricing mechanism should be used for foreseeable dry-year events and real time unforeseeable events. Since the consultation paper was published the System Operator and Commission have initiated a Capacity Adequacy Industry Working Group to consider management of real time events. This submission assumes policies for short-term unforeseeable events are best considered separately as part of that working group.

10. MEUG also supports further consideration of compensation payments. The consultation paper considers regulated compensation payments. MEUG suggests the Commission consider if there is an equivalent contractual incentive on retailers to ensure supply to consumers otherwise risk a damages claim for non-performance of contract, ie affected consumers may seek damages if they can prove the event was foreseeable and the retailer had not taken all reasonable steps to avoid the blackout. A reasonable step would be for a retailer to pay some consumers to save power to avoid others being blacked out.

11. A contractual compensation or incentive mechanism, if one exists, would be preferable to a regulated approach. One way to decide if a market incentive exists would be to seek a Declaratory Judgement from the High Court. This would require the cooperation from a retailer(s) though we don't see that as a barrier because presumably they also would prefer a contractual rather than regulated solution.

12. Responses and comments to the consultation paper questions follow:

<table>
<tr><th>Question</th><th>Response</th><th>Comment</th></tr>
<tr><td>1. What concerns do you have with regard to security of supply under existing arrangements?</td><td>Major suppliers collectively lobbying for interventions and using non-market strategies to minimise their commercial risk in very dry years.</td><td>Refer details in paragraph 2 of this submission.</td></tr>
<tr><td rowspan="2">2. What, if any, other underlying issues lead to the potential for cost shifting among market participants?</td><td>1. The willingness and ability of major suppliers to act collectively to minimise their net costs to the detriment of consumers; and</td><td rowspan="2">Refer comments in paragraph 3 and 4 of this submission</td></tr>
<tr><td>2. Politicians being open to lobbying by spot exposed suppliers and those</td></tr>
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Question	Response	Comment
	interventions undermining confidence for the market to develop solutions.	
3. What is your assessment of pros and cons of scarcity pricing approaches versus compulsory contracting?	Scarcity pricing and compensation approaches are worth further investigation. No further work is justified on compulsory contracting.	
4. What other options should be considered to improve security performance?	• Modified status quo; and • Possible incentives on suppliers to avoid damages claims for non-performance of supply contracts.	Refer comments in paragraph 7, 10 and 11 of this submission.
5. What approach to scarcity pricing should be preferred?	Real time risks should be separately considered by the joint System Operator and Electricity Commission Capacity Adequacy Industry Working Group. Option A is preferred and not Option B. Option A should be compared to a modified status quo option.	Refer comments in paragraph 6 to 9 of this submission.
6. Do you agree with the outlined approach whereby the Commission will progress with a detailed proposal for a scarcity pricing regime and for a default buy-back arrangement? If not, what would be the best approach for moving forward?	Agree more work is needed on Option A and regulated compensation payments. MEUG also recommend the EC consider: • A modified status quo option; and • Any existing contractual incentives to avoid claims for non-performance. This could be advanced by seeking a Declaratory Judgement from the High Court.	

13. MEUG looks forward to participating in the next stage of developing policies to remove the incentive and ability for spot exposed suppliers to minimise their commercial exposure in extreme dry-years by shifting risk to consumers using non-market mechanisms.

Yours sincerely

Ralph Matthes
Executive Director