

Summary of submissions on our review of the stress testing regime

Parties that made submissions are listed in the table below.

Generators/Retailers	Demand-side participants
Flick Energy Limited (Flick) Meridian Energy Limited Nova Energy Limited (Nova) Pioneer Energy Limited Trustpower Limited (Trustpower)	Major Electricity Users Group (MEUG) New Zealand Steel Limited (NZ Steel)

All submissions can be found on the Authority's website at <http://www.ea.govt.nz/development/work-programme/risk-management/review-of-stress-testing-regime/consultation/#c16205>.

Summary of responses to question 1:

1. Flick Energy Limited (Flick) suggested changes to the objective/rationale
2. The Major Electricity Users Group (MEUG) questioned whether the concerns that stress testing is designed to address remain valid, as participants realise political lobbying does not work or may result in negative outcomes.

Summary of responses to question 2:

1. Pioneer Energy Limited (Pioneer) noted that those that benefit from simpler reporting could change their exposure at short notice. MEUG suggests other mechanisms (eg unwinding the disclosure requirements to keep only the highest value/lowest cost elements, relying on enquiry and powers of discovery to reveal parties' past choices).
2. Trustpower Limited (Trustpower) believes the tests could be simplified but considers we should retain the existing ones to maintain consistency with past results. Nova Energy Limited (Nova) also suggested the calculation of the spot exposure should be simplified.
3. Trustpower suggested the Authority should reconsider option 1. New Zealand Steel Limited (NZ Steel) accepts the rationale for not proceeding with option 1, but suggests the Authority should provide the base chart to participants each quarter (option 4).
4. MEUG suggested two new options:
 - a. unwind the disclosure requirements, keeping only highest value/lowest cost elements
 - b. rely on enquiry and powers of discovery to reveal parties' past choices.
5. MEUG suggested option 10 should be extended to parties who are 100% hedged or that have a mix of contracts for difference and proven demand response.
6. Nova disagreed with the Authority's dismissal of Option 12 (replacing quantitative answers with qualitative ones). Nova considers that the effectiveness of this option depends on the nature of the declaration required.

Other comments:

1. NZ Steel would like to remove the requirement for participants' Boards to sign off having considered stress test results. It considered that quarterly sign-off of results by the CEO or a Director is sufficient.
2. NZ Steel suggested the underlying tone adopted by the Authority is that not being fully hedged is wrong. It is concerned this tone is misleading participants.

Q1. Do you agree that the rationale for the stress test regime remains valid and that the regime contributes to efficient security of supply?	
Submitter	Comment
Flick	<p>This question has two parts –</p> <p>Part 1. Does the rationale for the stress test regime remain valid?</p> <p>Flick has taken the 'rationale for the stress test regime' to mean the three objectives the Authority identified - that is to:</p> <ol style="list-style-type: none"> a. <i>Reduce the scope for opportunistic lobbying by adversely affected participants to socialise the cost of poor risk management decisions;</i> b. <i>Enhance incentives for participants to appropriately manage their spot price exposure; and</i> c. <i>Enhance access to information</i> <p>Flick appreciates that regulatory refinement is necessarily a continuation of previous work – but read in isolation these are a strange selection of objectives on which to base the rationale for the stress test regime.</p> <p>In particular with respect to objective a: '<i>minimising lobbying</i>' (opportunistic or otherwise) is a peculiar objective for any regulator. Even if the lobbying was by 'participants to socialise the cost of poor risk management decisions'. Regulators should always be open to feedback and contact with industry participants and consumers – not looking to reduce future scope of lobbying.</p> <p>Flick appreciates the Authority's aim to encourage parties to make time consistent choices. However, the way this objective is worded (and the way it would commonly be understood) is not that it is serving the needs of the industry or consumers – but rather that it is serving the needs of the Authority.</p> <p>Objective b. Should be replaced with "<i>Enhance information for participants to appropriately understand and manage their spot price exposure</i>";</p> <p>There should not be reference to 'incentives'. The stress test regime does not 'enhance incentives'.</p> <p>Flick notes that prudential is a mechanism for ensuring risk cover. The market prices prudential accordingly – based on the assessed risk of each participant retailer.</p> <p>Objective c. It is implied, but this objective could be improved by the inclusion of the words: 'accurate and relevant information'. As the inclusion of inaccurate or irrelevant information in the stress test regime is arguably worse than no information at all.</p>

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	<p>The stress test regime scenario both for the energy test and the capacity test should obviously be based on scenarios that have a very low probability of occurring and a very high impact on prices – but they should not be purely theoretical. The current scenarios are too abstract.</p> <p>Flick notes that the Authority considered recent industry developments in deciding to review the stress test regime (in particular the security of supply outlook with planned thermal plant decommissioning).</p> <p>Part 2. Does the stress test regime contribute to efficient security of supply?</p> <p>Like all participants, Flick would encourage the Authority to continue to undertake analysis and activity that promotes efficient supply of electricity.</p> <p>The stress test regime is, of course, one of the activities that contribute to efficient security of supply. In reviewing the regime, consideration should be given to whether the regime could be improved – particularly whether more accurate and relevant risk management information can be provided.</p>
Meridian Energy Limited (Meridian)	<p>Meridian continues to have reservations regarding the likely scale of impact and in particular the degree to which stress testing addresses the specific risk of opportunistic lobbying behaviour.</p> <p>However, we consider the regime is of some value and should be retained.</p>
Nova	<p>Nova accepts that the stress test regime may contribute to greater awareness of spot price risk by some parties, and as a result, contribute to security of supply. Whether or not the expected benefit exceeds the costs incurred by those parties that already have their exposures well managed is less certain.</p>
MEUG	<p>The consultation paper lists three policy objectives that were the reasons for the introduction of the stress test in 2011. Each of those reasons are considered in the next sections.¹</p> <p><u>Reduce opportunistic lobbying</u></p> <p>In 2010-11 there was a legitimate public policy concern about the “scope for opportunistic lobbying by adversely affected participants to socialise the cost of poor risk management decisions.”² The stress test regime as a tool to reduce that risk was a feasible option, albeit controversial and not universally agreed, at that date.</p> <p>MEUG questions whether that risk is still a legitimate concern. Even if it is still a concern whether the magnitude of the risk warrants the relatively heavy handed</p>

¹ Ibid, p2 in section titled “The stress test regime was introduced to achieve three objectives”.

² Ibid, p2, sub-paragraph a.

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intervention of mandatory stress test disclosures.

The paper explains the experience in the extreme dry event of 2012 where “the Authority is not aware of any lobbying for political intervention at all.”³ The paper does not consider what might have changed between the last prolonged dry events in 2008 that might have changed behaviours. MEUG notes there were substantial changes to the governance and structure of the industry between 2008 and 2010 that would, in our view, have had a significant effect on how retailers and generators behaved. To assign all or even a material credit for the change in behaviour to the stress test regime we suggest is unlikely. If we are correct then the purpose of the EA review of the stress test should be to either:

- Progressively unwind the disclosure requirements and only keep the highest value and lowest compliance cost requirements; and or
- Find alternative methods of making transparent parties that could be tempted or that actually do start to commence opportunistic lobbying. The latter is already within the regulatory tool box of the EA in terms of commencing a market enquiry into an event where opportunistic lobbying is suspected including very extensive powers of discovery.⁴

Incentives on parties to manage spot price exposure

The second objective of the stress test introduced in 2011 was to “enhance incentives for participants to appropriately manage their spot price exposure.”⁵

Five years later and with the experience of the dry event in 2012 we think the market participants that indulged in opportunistic lobbying pre-2010, mainly the SOEs, have realised that strategy does not work in the continuous disclosure partially listed environment they now work in. They will also be acutely aware of the downside risk that involving politicians in the sector may open the door to other political interference in the market that will undermine the value to their many shareholders.

All the large market participants have and are all actively using hedge markets, including be-spoke negotiations, to manage events such as the near term future of the Rankine units discussed in section 3 of the paper. We don’t think having to comply with the stress test obligations affects the focus of those companies or any of the companies required to comply with those disclosures to use hedge markets to manage spot price exposure.

Arguably the need to comply with the stress test obligations diverts management time away from more productive work such as managing spot risk exposure.

Enhance access to information

³ Ibid paragraph 4.11, p11.

⁴ Industry participants must provide the EA, as part of the EA’s role to monitor the market, information under s.46 of the Electricity Industry Act 2010.

⁵ Consultation paper p2, sub-paragraph b.

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	<p>MEUG doubts any of the parties required to disclose stress tests view the information they compile for their own company or the aggregated stress test results published by the stress test manager as an essential component of the data they need to better improve management of their spot price exposure. The EA could test the above view of MEUG by surveying parties that must complete stress tests.</p> <p>In the view of MEUG there has been a huge improvement in the quality and timeliness of information that spot exposed consumers can access for free or by subscription to assist them make choices on hedging or not. For example the market arrived at a solution last year for an extension following announcements by Genesis of imminent closure of the Rankine Units. We don't think the market participants involved made those commercial arrangements after waiting for the next quarterly publication of the stress test results.</p>
Trustpower	<p>We agree that the rationale for the stress test regime remains valid and that the regime contributes to efficient security of supply and on this basis should be continued.</p> <p>Trustpower believes that the regime provides the appropriate risk management incentives to disclosing participants, and that the stress test regime adds value both to the industry and, to a lesser extent, to Trustpower.</p>
NZ Steel	<p>We support a regime that "...encourages wholesale market participants to take responsibility for their risk management decisions" and can understand that the EA sees this as contributing to security of supply.</p> <p>However, this consultation paper perpetuates the current narrow focus on where electricity fits into demand-side business operations. Electricity is one of many components that are managed in a dynamic production environment. Risk management as part of international business activities is far wider than contractual arrangements relating to price of electricity as one input to a multi-faceted dynamic equation.</p>

Q2. Do you agree with the proposed improvements we have identified? If you disagree please explain your reasoning in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.	
Submitter	Comment
Flick	<p>Flick notes that the Authority identified a number of options designed to:</p> <ul style="list-style-type: none"> • 'better inform participants of the outcomes of the stress tests' • 'improve coverage of the stress tests' and to • 'improve the efficiency and effectiveness of the regime'. <p>Obviously, providing better information outcomes, improving coverage and improving efficiency and effectiveness are all good design aims for options.</p>

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	<p>However, Flick notes that in weighing up all of the options the Authority assessed all options against the three objectives at set out at question 1, above. As noted above, much better objectives could have been identified.</p> <p>Notwithstanding Flick's comments with respect to the shortcomings of the objectives, Flick is supportive of the Authority improving quarterly stress test report content and format (Option 2).</p> <p>Flick is also supportive of simplified reporting for disclosing participants not exposed to spot pricing.</p>
Meridian	<p>The Authority has proposed only minor adjustments, namely:</p> <ol style="list-style-type: none"> 1. Content and format improvements targeting "more accessible, user-friendly, and informative" stress test reports. 2. Simplifying reporting obligations for participants not exposed to spot prices, e.g. due to a FPVV contract. <p>Meridian is comfortable with the Authority pursuing changes in these areas.</p>
Pioneer	<p>Pioneer supports proceeding with Option 2 to improve the stress test report content and format. We note the Authority would be still not be able to provide any commentary or opinion on the results, given the objective to ensure that accountability for risk management choices remain with participants.</p> <p>We support further investigation and consultation on Option 10 to simplify reporting for reporting participants on fixed price variable volume contracts. However, we note that a participant could change to having an exposure to spot prices within a quarter or at short notice. It is important these participants remain aware of their potential obligations to complete stress test reports.</p> <p>We agree with the Authority's decision not to proceed with any other options identified in the consultation paper.</p> <p>We note that the stress test regime and customer compensation scheme have different approaches to different types of consumers and query whether this means the security of supply framework is comprehensive.</p>
Nova	<p>Nova agrees with the proposed improvements.</p> <p>In addition, the calculation of the spot exposure should be simplified.</p> <p>The amount of effort and complexity involved in completing the stress test needs to be minimal. There is no significant benefit gained by requiring participants to apply spurious accuracy in the calculations. Applying location factors to the prices used in the test scenarios, which are nominal in any case, adds complexity without improving the value of the exercise. Direction and magnitude are the most important factors and the application of location factors does not add any material value to the</p>

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	<p>process.</p> <p>Nova disagrees with the Authority’s assessment of Option 12 as an alternative to submitting quantitative data on a regular basis. The effectiveness of this option depends on the nature of the declaration required. Nova believes parties should be given a choice between completing and submitting the quantitative test, or providing an annual declaration that it has systems and procedures in place to monitor and manage its exposures on an ongoing basis and has adequate financial capital to cover the types of risks envisaged by the stress test.</p> <p>Such an option would allow organisations to focus on their internal reporting and controls rather than having to duplicate that by applying the assumptions specified by the Authority. It also reduces the complexity for those parties that simply cover their risks with a FPVV contract.</p>
MEUG	<p>MEUG agrees with the conclusion in the paper not to pursue options 1, 3 to 9 and 11 to 13 though our reasoning would differ from that in the paper because of the more critical analysis of the rationale for the stress test regime explained in answer to Q.1 above.</p> <p>The rest of this section comments on the proposal to pursue options 2 and 10. We then conclude with noting the paper does not consider the options of winding back the stress test regime and or finding an alternative mechanism as note in response to Q.1 above under the section headed “Reduce opportunistic lobbying”</p> <p><u>Option 2 Improve quarterly stress test report content and format⁶</u></p> <p>As noted in the answer to Q.1 MEUG doubts many stress test obligated parties actually materially rely on stress test reports, their own or the aggregated public report from the stress test manager, to improve management of their spot exposure. Hence this option arguably is just tinkering without any added value to the sector. More appropriate options the review should have considered are discussed in the section headed “options not considered” below.</p> <p>MEUG is also concerned that the EA may be perceived to have a paternalistic almost nanny-state objective with this option where the actual but unstated policy problem is the EA doesn’t consider market participants are capable of making their own risk assessments. If you assume the hedge strategy of opportunistic lobbying is recognised by the industry as no longer available then there are incentives on parties to actively manage their risk. A re-formatted presentation of aggregate stress test results isn’t going to make a difference.</p> <p>Having said that we think the paper does recognise the risk of some participants putting too much reliance on the stress tests whereas they need to improve their own risk management approaches, eg:</p> <p>~ “There is potential that some participants might attach an unrealistically low</p>

⁶ Ibid, pp19-21.

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probability of occurrence to the stress test scenarios and/or fail to realise that changing market conditions have heightened the probability of a stress test scenario coming to fruition. This might result in those participants adopting a greater level of spot price exposure risk than they realised. The converse is also true – some participants may over-estimate the probability and therefore adopt a lower spot price exposure than they realised”⁷

- ~ “As with other options that draw attention to specific risks, there is a potential risk that the Authority is increasingly seen as defining future scenarios for participants’ risk management framework. Although it might be possible to manage this through careful design of the qualitative questions, the Authority remains concerned that drawing attention to specific risks may dilute participants’ responsibility for making their own risk management decisions. This would be inconsistent with one of the key features of the security of supply arrangements: that accountability for risk management decision-making lies entirely with participants.”⁸
- ~ “Ensuring that participants are aware of the dynamic nature of spot price risks is important. However, there are tools other than stress tests that are being used to further this objective. These include futures contract prices and the system operator providing physical security of supply information.”⁹

Should the EA decide to retain the stress test as is then some members of MEUG are making separate submissions suggesting how the content and format could be improved.

Option 10 Simplify reporting for disclosing participants not exposed to spot prices¹⁰

We agree this option should be considered further.

As part of a review of this option 10 consideration should be given to adopting the same approach for parties that have 100% coverage with CfD’s or a mix of CfD’s and proven demand response capability such offered dispatchable demand. Those approaches to hedging are just as effective (and likely lower cost), in terms of having no exposure to spot price fluctuations over the next quarter, as having a FPVV contract for 100% of demand.

Options not considered

As noted in response to Q.1 above under the section headed “Reduce opportunistic lobbying” MEUG suggests the review should have considered the possibility that the need for the stress test as at 2011 is no longer relevant or at least the risk is less and hence other options need to be considered. Those options are not recanvased

⁷ Ibid, paragraphs A.55 and A.56, p24.

⁸ Ibid, paragraph A.77, p26.

⁹ Ibid, paragraph A.113, p30.

¹⁰ Ibid, pp32-33.

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	<p>here other than to note that in response to this Q.2 we think other improvements to the stress test or other ways to achieve the original 2011 objective of the stress test to reduce opportunistic lobbying should have been considered in the review. As commented on in response to Q.1 we do not accept that there is any need to address the other two policy objectives considered in 2011 as requiring the stress test regime.</p>
Trustpower	<p>We believe that it is worthwhile considering what could be done to improve the stress test regime. While we believe that there are opportunities for simplification, given the investments have already been made in the current structure and the value in maintaining a consistent output series over time, we do not believe that these should be pursued.</p> <p>We believe the set of proposed enhancement options that the Authority has developed are reasonable. Furthermore, we agree with the two options (i.e. Options 2 and 10 in Appendix A of the Consultation Paper) that the Authority has decided upon as the ones to be pursued and the reasoning behind not pursuing the remainder of options in the Consultation Paper.</p> <p>However, we do believe one option, the provision of quarterly 'You are here' reports to each disclosing participant (i.e. Option 1 in Appendix A of the Consultation Paper), which the Authority has rejected, should be reconsidered. We consider:</p> <ul style="list-style-type: none"> a) that it would be useful if this was something that the Authority provided, particularly to some of the smaller parties in the industry as it will ensure useful insights are available consistently to all parties, enhancing their exposure risk management and thus contributing to the Authority's statutory objective as it relates to reliability of electricity supply; and b) a process to ensure that the results are not inadvertently sent to an incorrect participant, which was noted as a concern, could be fairly readily implemented.
NZ Steel	<p>We support and will welcome the implementation of Option 2 to Improve quarterly stress test reports.</p> <p>The current reports are not used. When first published, some time was invested to understand what was being presented. Even after explanation was provided, no useful information was considered discernible and they are no longer accessed.</p> <p>The 'You are here' report outline in Figure 1 of Option 1 would seem to be straight forward and contain a worthwhile summary. However, we accept the rationale for not proceeding with this. As a suggestion can the base chart be provided each quarter and participants plot their own numbers?</p> <p>We have no objection to Option 10 being implemented to provide simplified reporting for those not exposed to spot prices (however, note comment 2 below re volume risk).</p> <p>Other comments:</p>

Q2. Do you agree with the proposed improvements we have identified? If you disagree please explain your reasoning in terms consistent with the Authority’s statutory objective in section 15 of the Electricity Industry Act 2010.

	<ol style="list-style-type: none"> 1. We agree with the conclusion to not pursue Option 3 - lifting of anonymity of information. To consider making information disclosed available to third parties is untenable. It would be an intrusion in business affairs of participants, and cannot be justified on the basis of providing “...further discipline on participants’ risk management decisions...”¹¹. The suggestion of “...greater scrutiny from capital providers, customers, and other commercial counterparties”¹² is unconscionable. 2. We do not agree with the conclusion not to proceed with Option 4. To go to all the trouble and cost of collecting the information and preparing improved reports, and then not taking the small, and we would expect very low cost, step to email everyone a link to the report to say it is published, seems to be false economy and cuts across the arguments outlined elsewhere in the consultation paper. 3. Options 5, 6, 7, 8, 9, 11, 12, 13. we agree with the conclusion, but in some case would broaden the rationale for not proceeding.
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Other comments from NZ Steel:

1. Participant entity **Board annual sign-off**. This requirement should be deleted. The world has moved on since the stress test was implemented in 2011. The Market has further matured and the issue of “opportunistic lobbying” seen in a different light. Similarities can be drawn with past lobbying re exchanges rates. In the deregulated environment, commentary is made daily on the exchange rate, but no real suggestion of political intervention.

Electricity prices are just one of many risks managed by business. The Board establishes parameters in which a CEO can work and quarterly sign-off of the Stress Test by the CEO or a Director should be sufficient. A requirement more than this is not justified and is meddling in company affairs. We reject the argument advanced in para A.149.

2. Intended or not, there continues to be a **underlying tone** in the EA approach to the Stress Test regime that to **not being ‘fully covered’ is wrong**. The unstated inference being this should be by way of financial arrangement.¹³

We are concerned the EA may mislead some participants.

The reality is high spot prices can be managed by a range of means, including demand side management. As you identify in Option 10, a FPVV contract takes away price risk. It also takes way volume risk, but you pay the provider accordingly for taking those risks.

¹¹ Para A.33

¹² Para A.33

¹³ Eg A.28(a), A36

For those exposed to spot prices, financial instruments take away price risk, BUT they open up volume risk. Where there are risks regarding reduced operating hours for production activities, being over-committed with financial instruments in a downturn, with a significant swing in the mark-to-market value of the financial instruments, can have severe financial consequences. Fx hedging, with cancelled orders provide clear examples of what can occur. It is why financial reporting requirements make a clear distinction between “effective” hedging and “ineffective” hedging requiring mark-to-market reporting with the inherent impact on EBIT results.

Other comments from Pioneer:

The stress test regime requires particular information at a point in time that may or may not prove to be an accurate indicator of the ability of reporting participants to ride through an energy or capacity shortage event.

We note that New Zealand has only about 10 weeks storage – which is less than the reporting period for the regime. For example, the 1% hydro risk curve went from 61GWh on 1 December 2015 to 1,389GWh on 1 February 2016. Or, in 2012 controlled storage missed breaching the 1% risk curve by 6 weeks. That is, the risk of an energy shortage can change very quickly.

The stress test data depends on a definition of cashflow and shareholders' equity. Cashflow will be significantly different if participants were also asked to take into account the impact of having to pay the customer compensation amount of \$10.50 per week to each per residential customer. The customer compensation payment in effect breaks or makes the stress test regime irrelevant.

Further shareholders' equity for retailers may, in large part, be goodwill – this is only 'callable' to cash if the asset is sold.