



13 May 2011

Carl Hansen
Chief Executive
Electricity Authority
Level 7, 2 Hunter Street
Wellington

By email: submissions@ea.govt.nz

Dear Carl

Draft Decision regarding alleged UTS on 26 March 2011

1. Meridian commends the Authority on its thorough and timely investigation and agrees with the finding that the 26 March 2011 situation constituted a UTS. Meridian considers that this decision will restore confidence in the electricity market.
2. In Meridian's view:
 - (a) as a result of a transmission outage, Genesis was effectively in a position to set the prices north of the constraint at whatever level it offered;
 - (b) Genesis' offer strategy was deliberate in that it was intended to result in prices in the range of \$19,000/MWh to \$20,000/MWh;
 - (c) Genesis' offer prices were so far outside the bounds of efficiency and the public interest (in a situation where there was no shortage of energy or capacity) as to threaten the integrity of, and confidence in, the wholesale market;
 - (d) furthermore, if unremedied, such prices could well become common in similar situations (as illustrated by the conduct of Contact on 2 April 2011);
 - (e) accordingly, the test for a UTS is satisfied; and
 - (f) final prices should be based on what they would have been in normal trading conditions and should approximate SRMC not LRMC.
3. While Meridian agrees with the overall findings and reasoning of the Authority, there are three matters which Meridian believes should be amended in the final decision:
 - (a) the Authority should clarify that concepts such as "net pivotal", "cornering" and "squeezing" are not a necessary part of or a substitute for the application of the UTS test in the Code. That could lead to technical arguments about intention, notice, and the interpretation of net pivotal which are not directly relevant to

determining whether or not a UTS has occurred (that is, it is enough that Genesis was in a position to set the price at whatever level it offered);

- (b) in particular, parts of the draft decision seem to imply that a UTS would not have arisen if Genesis had put participants and end users on sufficient notice -- Meridian would still consider 26 March to have been a UTS if Genesis had given a week, a month or two years' notice; and
 - (c) in terms of resetting the prices, as there was no energy or capacity shortage, the use of "value of lost load" or "long run marginal cost" pricing is unnecessarily punitive to customers and prices should be reset to match what they would have been under normal trading at the relevant nodes.
4. Essentially Meridian is concerned that the Authority should not, in the context of a UTS investigation, attempt to either:
- (a) prescriptively describe the boundary between acceptable and unacceptable offers: it is enough to state that the 26 March situation was clearly across the line; or
 - (b) set prices at what the Authority considers is the "right" level.
5. In a practical sense, unless the amendments outlined above are made to the draft decision, it could be read as inviting participants to:
- (a) put the market on notice that they may charge high, very high or excessive prices whenever they enjoy market power; and
 - (b) regardless of (a), exercise transient market power when it exists by offering in at (say) a \$20,000/MWh level, knowing that the only adverse consequence is that the Authority will find, and set prices at, the highest acceptable level.
6. Meridian's proposed changes to the draft decision are intended to limit the risk of the Authority appearing to endorse behaviours that would threaten confidence in the wholesale market.
7. Meridian would also support the Authority prioritising a consultation process on whether Code amendments are required to provide further standards as to acceptable participant behaviour during times of transient market power.

1. Has the Authority accurately recorded and interpreted all of the salient facts in regard to this matter? If not, please detail the inaccuracies.

8. Meridian broadly agrees with the findings of the Authority. In its view, the key facts are that:
- (a) there was no energy or capacity shortage at the time;
 - (b) as a result of a transmission outage, Genesis was effectively in a position where it could unilaterally set prices north of the transmission constraint;
 - (c) Genesis was aware that its offer strategy would, or could well, result in prices in the range of \$19,000/MWh to \$20,000/MWh;

- (d) such prices are far in excess efficient bounds and the public interest in the context where a transmission outage created transient market power and a lack of competition in the market; and
 - (e) Genesis adjusted its offers during the outage to follow load profile so high tranches continued to clear.
9. Meridian is not in a position to comment on the motivations behind Genesis' offer strategy at Tokaanu nor Contact's withdrawal of generation capacity at Stratford on 25 March.

2. Do you agree with the Authority's draft decision that the situation existing on 26 March 2011 constitutes a UTS? Please give reasons for your answer.

10. Meridian agrees that the situation threatened trading on the wholesale market and, if left unremedied, was likely to preclude the maintenance of orderly trading and the proper settlement of trades. Meridian also agrees that the situation cannot satisfactorily be resolved by any other mechanism available under the Code.
11. The Authority places particular emphasis on the facts that:
- (a) Participants will lose confidence in the integrity of the market if prices are divorced from efficient supply-demand conditions and excessively higher than underlying costs. This could result in both inefficient investment signals and inefficient consumption by individual consumers, as well as reducing the potential level of demand-side management through deterring demand-side participation in the wholesale market.
 - (b) Unless the high interim prices resulting from the squeeze are remedied, the reputation of the market may be damaged to the point where trading is threatened and the adverse financial impact on some parties may preclude the orderly trading and the proper settlement of trades.
12. Meridian agrees with these reasons. As explained by Professor Evans, the UTS rules can be thought of as efficiently filling unavoidable gaps in the Code. That is, by addressing behaviour not codified precisely, a UTS reduces the need for such codes, and enables independent participant decision-making that promotes a workably competitive market in electricity. Unless situations such as occurred on 26 March are remedied through the declaration of a UTS, incentives are created for all participants to take advantage of transient market power, resulting in a reduction of the dynamic efficiency and wider credibility of the New Zealand electricity market.
13. In terms of the legal framework adopted in the draft decision, Meridian:
- (a) agrees broadly with the Authority's approach;
 - (b) agrees that the threshold of an event "that threatens, or may threaten, trading on the wholesale market for electricity and that would, or would be likely to, preclude the maintenance of orderly trading or proper settlement of trades" has been met in this case; and
 - (c) notes that a broad approach (and one that looks at the future consequences which may result if particular market behaviour is not remedied) is appropriate having regard to:
 - (i) the Authority's statutory objective and the purpose of the market;

- (ii) the need for a "gap filler" to protect the integrity of the market; and
 - (iii) the range of situations described in paragraph (c) of the definition of a UTS and which colour the interpretation of paragraph (a).
14. Where Meridian considers that the draft decision should be revised is where the Authority attempts to describe the boundary between acceptable and unacceptable offers. In particular, the decision could imply that if a generator gives adequate notice of the intention to offer at high prices, there can be no UTS.
15. In Meridian's view such an approach is not appropriate as it would encourage generators to make generic statements that they intend to offer at (say) \$19,000/MWh whenever they are net pivotal. This would either lead to exposed parties seeking hedges that would logically be priced at the same \$19,000/MWh level whenever the opportunity arose or spot prices that would threaten confidence in the integrity of the market. That is, it would appear to permit offer behaviour which would give rise to the very same concerns outlined above.
16. Rather, and consistent with the nature of the UTS regime as a "gap filler", in Meridian's view the Authority should not seek to give participants detailed guidance about the circumstances in which prices far in excess of marginal generation costs can be achieved without fear of consequence. The final decision should just focus on the facts before the Authority, and the reasons those facts constitute a UTS. Any further guidance should be provided through amendments to the Code and following consultation.

3. Do you agree with the draft remedial actions that the Authority intends to take to correct the UTS? Please give reasons for your answer.

17. Meridian agrees that the remedial action should focus on setting appropriate final prices for trading periods 22 to 35 inclusive on 26 March 2011.
18. However, Meridian's view is that the Authority's proposed methodology for setting final prices - which essentially involves capping the offer prices of net pivotal generators somewhere between estimates of the LRMC of new entry generation and the cost of demand-side response - is undesirable, for the following reasons:
- (a) The proposed reset prices are still high by any normal measure. As such, the methodology does not address the concerns raised by the Authority and summarised at paragraph 11 above. That is, under the proposed methodology, participants are still likely to lose confidence in the integrity of the market and suffer financial consequences as a result of price squeezes, and the reputation of the market is still likely to be damaged.
 - (b) Furthermore, the reasons for adopting this methodology are not convincing:
 - (i) the Authority can simply declare that Genesis' offer prices were unacceptable, without attempting to define what might have been acceptable;
 - (ii) in the absence of any shortage of energy or capacity, there is no basis for using estimates of the LRMC of new entry generation and the cost of demand-side response, rather the "right" price would be SRMC or something closer to it;

- (iii) in the context of a transmission outage, the prices proposed by the Authority are still punitive to those exposed to them;
 - (iv) while such prices might encourage hedging this is not the purpose of the UTS process, and hedge prices that reflect the exercise of market power by marginal generators in circumstances such as 26 March would be neither efficient nor in the public interest; and
 - (v) the Authority should be concerned to ensure that prices are reset at a level which does not reward or encourage similar behaviour in the future.
- (c) The methodology could be seen as legitimising super-normal prices and is likely to lead to inefficient behaviour by net pivotal generators. That is, once the Authority determines the price cap to apply in its final decision, net pivotal generators will be able to offer in at that level without fear of consequences. Generators could even choose to continue to offer in at \$19-20,000/MWh, knowing that that they may be able to obtain hedges at (or around) this level and that, at worst, their offers may be moderated downwards. None of this behaviour would be consistent with dynamic efficiency or the maintenance of orderly trading.
- (d) In any case, it is artificial to focus on LRMC of new entry generation and the cost of demand-side response when, under the Authority's analysis, the high spot prices experienced were a result of a combination of factors, none of which were (at least until the morning of 26 March) under the control of any one person. In the absence of an energy or capacity shortage, competitive prices should approximate SRMC not LRMC.
- (e) Some may see the methodology as amounting to the introduction of a transient market power mitigation regime. In Meridian's view, such complex issues should be dealt with through detailed analysis and a considered consultation process, rather than in the context of a UTS investigation. As noted in our letter of 5 April 2011, there are a range of potential regime designs, including whether the regime is universal or situation specific regimes (eg limited to localised market power during transmission outages), principle-based or formulaic, or operates ex ante or ex post. There is a wealth of overseas experience to draw on, and examples include good faith requirements, rules against physical and economic withholding, offer price caps, and cumulative price caps. Mechanisms such as directed/vesting contracts for base load and day ahead markets can also mitigate market power issues. If the draft decision is implemented as contemplated, the process for finding which of these candidates (if any) would be best for the New Zealand market may well be short-circuited.
19. In Meridian's view, in its final decision the Authority should recognise that, while there has been abuse of transient market power in this case, the UTS regime is not well suited to a policy debate about the extent to which net pivotal generators should or should not be able to price at their whim. Rather, a pragmatic approach is necessary which:
- (a) recognises that there is a need for a consultation process to consider whether a specific Code amendment in relation to the mitigation of transient market power is necessary; and
 - (b) pending that consultation, and given events on the day, normalises prices for the relevant period in a straightforward way, for example by recalculating final prices assuming that Huntly was offered at its short run marginal cost of generation, as measured by offer prices for the Huntly units during the period

immediately prior to the transmission outage or alternately a short term average.

4. Are there any other remedial actions that the Authority should take to correct the UTS? If so, please detail the other actions and give reasons for your answer.

20. Please see our response to question 3.

21. If you have any questions regarding this submission please contact either myself or Gillian Blythe (gillian.blythe@meridianenergy.co.nz, mobile 021 388 469).

Yours sincerely



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29 April 2011

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By email: carl.hansen@ea.govt.nz

Dear Carl

Implications of 26 March 2011 event for dynamic efficiency in the NZEM

Meridian asked Professor Lew Evans to consider the implications of the 26 March 2011 price spike for the dynamic efficiency of the New Zealand electricity market (NZEM) (see attached memorandum).

Lew is a professor of economics in the School of Economics and Finance at Victoria University of Wellington (VUW), where he lectures in industrial organization, financial economics, and law and economics. Lew is a lay member of the New Zealand High Court for matters of commerce and was a member of the Electricity Market Surveillance Committee for the period of its existence (1996-2004). He has 20 years of experience in consulting in a wide range of industries and in decision-making positions in regulatory institutions.

Meridian would like to draw your attention to his conclusions:

- ...the nature of this event is such that, if it is admitted under the Code, the changes in Participant behaviour that it has induced will continue, and will reduce the dynamic efficiency of the New Zealand electricity market.
- ...the UTS rules can be thought of as efficiently filling unavoidable gaps in the Code. That is, by addressing behaviour not codified precisely, a UTS reduces the need for such codes, and enables independent Participant decision-making that promotes a workably competitive market in electricity.
- ...the Genesis event will continue to spawn Participant actions rendering a reduction in competitiveness, and wider credibility, of the New Zealand electricity market; unless it produces a UTS.

As Meridian has said previously, our main concern is not with who made or lost money on 26 March 2011 but with market viability if the Authority condones participants with transient market power making offers at any level they chose. Lew's memorandum heightens these concerns.

If you would like to discuss this memorandum please do not hesitate to contact me.

Kind regards



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Attachment:

Memorandum prepared by Professor Evans

Brief biography for Professor Evans

Lewis Evans, M.Agr.Sc. (Hons.I) Linc, PhD Wisconsin

Dr. Evans is a professor of economics in the School of Economics and Finance at Victoria University of Wellington (VUW), where he lectures in industrial organization, financial economics, and law and economics. He has 20 years of experience in consulting in a wide range of industries and in decision-making positions in regulatory institutions.

He was the inaugural executive director of the New Zealand Institute for the Study of Competition and Regulation (ISCR), an externally funded research unit of VUW. He is a lay member of the New Zealand High Court for matters of commerce and was a member of the Electricity Market Surveillance Committee for the period of its existence (1996-2004). In 1996, he was awarded the NZIER-Qantas economics award, in 2005 was awarded the position of Distinguished Fellow of the New Zealand Economics Association, and in 2009 was made a Fellow of the Law and Economics Association of New Zealand. He has published more than 40 refereed articles in leading international and local economics journals and has another 50 publications. He is a former member of the editorial board of The Journal of Economic Literature.

Dr. Evans has consulted for a wide range of companies and governmental organisations, including the Asian Development Bank and the RAND Corporation, a private public policy institution in Los Angeles.