27 April 2021

Submissions
Electricity Authority
P O Box 10041
Wellington 6143
By email: uts@ea.govt.nz

Dear team,

Re: Proposed Actions to Correct 2019 UTS—Submission

Pulse Energy Alliance (Pulse) welcomes the opportunity to submit on the Electricity Authority's (Authority's) proposed actions to correct the 2019 UTS.

Pulse commends the Authority on the work it has done to investigate, confirm an undesirable trading situation (including undesirable behaviour) and now develop actions to correct the situation.

Pulse submits on two key points:

1. the proposed cap of $13.70/MWh is too high and should be more reflective of an opportunity cost of zero when spilling water; and
2. the actions to correct should apply to financial derivatives market as well as the spot market.

These points are discussed below. The Appendix has answers to the questions asked in the consultation paper.

1. The proposed cap should be more reflective of SRMC when spilling is occurring

Pulse agrees that placing a cap on offer prices is the appropriate mechanism for resetting prices. We agree with the Authority that *"A cap on offer prices directly addresses the concern that offer behaviour led to high nodal prices that were inconsistent with the supply and demand conditions that prevailed during the UTS period."* (para 5.26)

The Authority notes the reset is intended to mimic the market "operating normally" – described below:

> *"The scale of the proposed price reset is guided by the offer behaviour in the spot electricity market that would have occurred if there had been no UTS and the market was operating normally. The proposed actions correct the UTS by setting certain South Island hydro generation offers to levels that reflect normal competitive pressures, in the context of an abundance of water to generate electricity."* (Executive Summary) [emphasis added]

Pulse's view is that "normal competitive pressures" means a workably competitive market.

Our view is consistent with Genesis submission *"Genesis considered that "any proposed remedy should focus on attempting to arrive at what a workably competitive outcome would have been, rather than resetting prices to reflect the Authority's view of economic costs.""* (quotes by the Authority on page 37 of actions paper) [emphasis added]

Pulse submits that an offer cap of $13.70/MWh is well above the level that could be expected in a workably competitive market given the supply and demand conditions at that time.

Comments by the Authority in this consultation paper as well as previous papers confirm or imply a lower cap price than $13.70/MWh should be used:

> *"Water was abundant, cheap and available for generation"* (Exec Summary of actions consultation paper)
>
> *"For a hydro generator without storage, or with storage that is at or above capacity, water's value is derived only from its value from immediate generation—the opportunity cost is zero."* (page iii of Preliminary Decision document)

We agree with the Authority that *"the opportunity cost of water is zero for a spilling generator—this does not imply a zero offer price because of other costs of generating"*[1]. However, a cap of $13.70/MWh implies an excessive amount of 'other cots of generating'.

The Authority states: *"The Authority currently considers that a $13.70/MWh cap during the UTS period would appropriately calibrate the expected degree of competitive pressure, given the abundance of water, driving offer behaviour towards rather than to short-run marginal cost."* (para 5.44)

Pulse queries why SRMC is not the benchmark for a workably competitive market? The Authority's offer price cap should be at and not towards SRMC.

The Authority should be guided by the actual offer prices at Manapouri (and Tekapo A and B) in setting the cap. There is plenty of evidence about the level of these offers, including in the Authority's actions paper:

> *"Offer prices at Manapōuri and Tekapo A and Tekapo B were predominantly low during the UTS period, consistent with the abundance of hydro storage, and the Authority proposes to leave those original offers unchanged."* (Executive Summary)
>
> *"As noted in figure 19 of the preliminary decision paper, the mean quantity-weighted offer prices (QWOPs) for Manapōuri were very low, below $2.50/MWh for the UTS period, though there were occasional spikes in QWOPs for several hours at a time."* (para 5.21)

Further, Figures 37 - 39 in the Authority's Preliminary Decision paper[2] show a high proportion of Genesis' offers for the Tekapo stations were less than $0.01/MWh during December 2019 and January 2020.

We also note that Meridian submitted prices closer to $6/MWh would have been necessary to reduce South Island spill.[3]

The Authority states: *"It is worth noting that the analysis used to derive that offer price [$13.70/MWh] was conservative, in that it only focused on absorbing spill at Benmore, and a lower offer price, closer to a measure of*

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[1] Para 8.3(a) of the Authority's Preliminary Decision document

[2] Page 69-70 https://www.ea.govt.nz/assets/dms-assets/27/27018Preliminary-decision-paper-10-November-2019-UTS-claim.pdf

[3] Page 42 https://www.ea.govt.nz/assets/dms-assets/27/Meridian-2019-UTS-Preliminary-Decision-Supplementary-Consultation-Submission-v2.pdf

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marginal cost, could be argued for given that spill was occurring much more broadly across the Waitaki and Clutha/Mata-Au river systems." (para 5.43) [emphasis added]

Pulse submits that relying on analysis that derives a "conservative" offer price is insufficient. We query whether this conservatism creates a workably competitive outcome. Being conservative does not ensure Pulse is confident in these outcomes – derived by the Authority – nor that the market has integrity.

Pulse can support an offer price cap of $7.42/MWh as derived by the Authority:

> *"reflecting the South Island Mean Injection (SIMI) rate of $6.42/MWh from Transpower that applied in 2019/20 with an additional $1/MWh for other operating and maintenance costs."* (para 5.41(e))

While this offer price cap is well above the offer prices hydro plant owners were prepared to make / take in the market at the time (see above), the derivation of $7.42/MWh is more robust than undertaking "conservative" analysis to reach a $13.70/MWh offer price cap.

2. Actions to correct should also apply to the financial derivatives market

Pulse believes the approach to actions to correct the UTS should be principles based. A principles-based approach would require actions to correct the derivatives market as well as the spot market, to ensure confidence in and the integrity of the entire wholesale market.

The wholesale market is spot and derivatives trading. Pulse supports the Authority correcting the UTS by revising final prices in the spot market. The Authority outlines the benefits of resetting prices in the derivatives markets as well to ensure confidence in and the integrity of the wholesale market:

"If the wholesale market were operating normally, the derivatives market would also embody the prices that reflect normal competitive pressure." … *"Arguably a return to 'normal' market operation would require derivatives to incorporate the correction to the UTS, at least to the extent that derivatives contracts provide for this possibility."* (para 5.6)

> *"If the wholesale electricity market were operating normally, markets for financial derivatives, including bilateral 'over the counter' (OTC) forwards, financial transmission rights, and futures and options would adjust to reflect final prices in the spot electricity market. These financial derivatives are used by participants to manage their risk positions. Ideally, the settlement of derivative contracts should reflect the prices that would have prevailed if the UTS had not occurred."* (para 5.63)

Financial derivatives are settled against spot prices.

Under clause 5.2(1) the Authority should require:

- financial derivatives settled using the high prices created by the UTS to be resettled using the reset final spot prices; and
- margin calls paid using the high prices created by the UTS to be resettled using the reset final spot prices.

Resetting only one part of the market leaves an imbalanced impact on participants. For example, reset spot prices could leave a generator with lower income from spot market sales but benefiting from settlement of derivatives at the escalated prices that have been proven to be inefficient, consistent with reduced competition in generation and confirmed to have created an Undesirable Trading Situation.

The Authority noted in its Preliminary Decision document *“prices in the forward and financial transmission rights (FTR) markets are formed on expectations of the spot price. Spot prices that are inconsistent with underlying supply and demand conditions may have caused confidence or integrity of the forward market to be threatened over the long term.”* (page v)

We note that Genesis commented in its submission on the Preliminary Decision consultation paper that “*there was a material change in the futures market that may indicate a loss of confidence in the forward market*”.

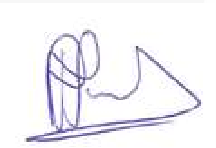
The Authority is proposing to ‘reset’ the FTR market[4]. The FTR market is a risk management market. It is inconsistent that the Authority would require resettlement of the FTR market and not the derivatives market.

With financial derivatives being a reasonably large part of the market, the Authority’s proposed approach to exclude derivatives has the potential to dramatically reduce the impact of the actions to correct the UTS on individual participants. Does this ensure confidence in and the integrity of the (spot and derivatives) wholesale market?

The Authority has the opportunity with its actions to correct the UTS to restore confidence in the forward markets for the long term benefit of consumers by including derivative market transactions in its price reset.

We would welcome the opportunity to discuss this submission with you in more detail.

Yours truly



Fraser Jonker

Chief Executive

[4] By requiring customers to pay back any over-payments to Transpower and require Transpower to reallocate residual LCE in accordance with the resettlement implied by the actions to correct the UTS.

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Appendix: Pulse response to the Authorities specific questions

Q1. What, if any, actions should the Authority undertake to address excess spill, system security, and any other consequent effects? How would such actions address the objectives of Part 5 of the Code?

Pulse supports the Authority's proposed actions to correct the UTS (the excess spill). We acknowledge that it is difficult to address the consequences of other impacts from the behaviour during the UTS period (namely the impact on security of supply which resulted in additional North Island generation and environmental impacts of burning coal).

Q2. Do you agree that the Authority should seek to correct the UTS period by resetting the payments made/received by spot market purchasers and generators? (If not, please explain your reasoning.)

While Pulse agrees that the Authority should seek to correct the UTS period by resetting the payments made/received by spot market purchasers and generators, this is insufficient to instil confidence in and the integrity of the entire wholesale market. The Authority must also reset prices in the derivatives market (discussed in more detail in our cover letter).

Q3. Do you agree that the Authority should attempt to correct settlement during the UTS period by resetting prices in the electricity market?

Pulse agrees with the Authority's proposed approach to resettle using volumes originally dispatched with revised final prices (para 5.3 and 5.4)

Q4. Do you agree that injection and off-take volumes should remain unchanged in any resettlement?

Yes (also discussed in answer to Q3)

Q5. Do you agree that the Authority should attempt to correct the UTS by revising final prices in the electricity market, rather than by an 'off-market' wash-up of spot electricity payments to and from the clearing manager?

Pulse agrees with the Authority's proposed approach to formally reset final prices (and does not support an off-market wash-up)

Q6. If offer prices and offer volumes are reset, which hydro generating stations should have offers reset? (Please answer yes/no, with any additional supporting commentary.)

a. Aviemore? Yes, support Authority's conclusions
b. Benmore? Yes, support Authority's conclusions
c. Clyde? Yes, support Authority's conclusions
d. Manapōuri? Yes – the proposed cap must also apply to Manapouri as it as integral part of the South Island hydro system and subject to the same decision-making processes (Ie owned by Meridian) as other the other hydro stations the Authority has proposed to rest offers for
e. Ōhau A, B, C? Yes, support Authority's conclusions
f. Roxburgh? Yes, support Authority's conclusions
g. Tekapo A, B? No, as proposed by the Authority
h. Waitaki? Yes, support Authority's conclusions
i. Other stations? No

Q7. If offer prices and volumes are reset, do you agree that North Island offer prices and offer volumes should remain the same as originally submitted? (If not, please identify any alternative actions.)

Pulse agrees with the Authority's approach to North Island offer prices and volumes.

Q8. Do you agree that resetting offer prices and volumes by imposing a cap is the preferred action to correct the UTS? If not, please identify preferred alternatives.

Pulse agrees with the Authority's proposed approach to impose a cap on offer prices to calibrate a final price correction.

Q9. If revisions to offer prices are to vary through time or across generating stations, how should the offer prices be determined?

Not relevant because Pulse supports imposing a cap.

Q10. Do you consider that final prices should be reset directly? If so, how should they be calibrated?

Not relevant because Pulse supports imposing a cap.

Q11. Do you agree that the aggregate offer volumes of each generating station should equal the aggregate amount offered by that station during the UTS period? Please describe any preferred alternatives.

Pulse agrees with the Authority's proposed approach.

Q12. Which of these mechanisms in paragraph 5.41(a) – (e), if any, should be used to calibrate 'corrected' electricity offer prices? (Please identify any other preferred alternatives.)

Pulse supports option (e) – a cap of $7.42/MWh. Our reasons for supporting this cap price are detailed in our cover letter.

Q13. Do you agree that generators, other than those with 'reset offers', that were dispatched to generate electricity at offer prices above the reset final prices should be treated as constrained on? (If not, please identify preferred alternatives.)

Pulse agrees with the Authority's proposed approach.

Q14. Do you agree with the Authority's proposal not to revise constrained off payments, associated with frequency keeping? (If not, please explain and identify any preferred alternatives.)

Pulse agrees with the Authority's proposed approach.

Q15. Should offers to the instantaneous reserves market during the UTS period be corrected? If so, how should instantaneous reserve offers be corrected?

Pulse agrees with the Authority's proposed approach.

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Q16. Do you agree with the proposed approach to treatment of derivatives for the purposes of correcting the UTS? Please explain your answer.

Pulse does not agree with the Authority's proposed approach to treatment of derivatives. Our reasons are provided in our cover letter.

Q17. Are there any additional, feasible and lawful actions that the Authority should or could undertake in relation to derivatives markets?

See answer to Q16.

Q18. How should the Authority use its powers under Part 5 in relation to LCE payments?

Pulse agrees with the Authority's proposed approach to require customers to pay back any over-payments to Transpower and require Transpower to reallocate residual LCE in accordance with the resettlement implied by the actions to correct the UTS.

The FTR market is a risk management market. It is inconsistent that the Authority would require resettlement of the FTR market and not the derivatives market.

Q19. Should the Authority use its powers under Part 5 of the Code to direct retailers to reimburse consumers that had contracts on variable price terms? What, if any, action should the Authority take in relation to variable price contracts?

Pulse suggests retailers own the relationship with their customers and any reputational impact from how they decide to apply any correction due to the UTS to customers exposed to spot prices.

Q20. How should any resettlement arising from the actions to correct the UTS be implemented?

Pulse notes the Authority's assessment of implementing the actions to correct the UTS in paragraphs 5.85 to 5.87 of the actions paper.

Q21. If there is a resettlement, what window of time after invoicing should be allowed for traders to meet their obligations?

Sufficient time should be allowed for this one-off adjustment taking into account allowing for the ongoing demands of day-to-day trading. The reconciliation wash-up process might provide a guide to an appropriate timeframe.

Q22. Please provide feedback on the operational implementation of the proposed actions to correct the UTS, including the interest rate that should be used to scale payments.

Pulse notes the implementation steps outlined by the Authority in paragraph 5.88. An appropriate interest rate could be the Default Interest Rate used in the Default Distribution Agreements between distributors and retailers.

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