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Correct application of market rules is critical to protecting and promoting confidence in the wholesale market

2degrees, Electric Kiwi and Flick Electric (the independent retailers) do not consider the Electricity Authority has demonstrated that correct application of the Code has resulted in an undesirable trading situation (UTS) on 9 August 2021.

The independent retailers also do not consider it is open to the Electricity Authority to revisit whether parts of 9 August 2021 could now be considered a UTS, including a half-hour that was not part of the HAAST ENERGY TRADING LIMITED and ELECTRIC KIWI LIMITED v THE ELECTRICITY AUTHORITY & ORS [2024] High Court decision.¹ Our submission though is limited to the merits of the Authority's reasons for considering that a UTS may have occurred.

Potential precedent risks a decision that there was a UTS may create

We have questions about the potential precedent that may result from a decision by the Authority that 9 August 2021 is now a UTS.

There is a considerable gap (2 ½ years) between the event and the Authority's decision to undertake the 2nd investigation. The Authority notes in the draft decision "By the time the Court decided that scarcity pricing was incorrectly triggered on 9 August 2021 as a result of errors by the system operator in the notices it issued on the day, two and a half years had passed. In addition, prices have now been finalised following the High Court decision." Furthermore, the High Court decision did not impact prices in the trading period 38.

The 10 business day limit for investigating UTSs is intended to avoid revisiting events a significant amount of time after they occurred. This is made clear in the 2013 UTS review decision paper which stated that "a short fixed time limit is important. It limits the Authority to being able to intervene only in those situations that provoke an immediate concern" and that the Authority wanted to avoid "the potential for UTS claims ... for situations in the distant past." [emphasis added]²

The Authority should also consider the potential implications for other instances where the System Operator may request demand reduction, such as the morning of Friday 10 May 2024, which may also be considered to "artificially depress" spot prices.

¹ HAAST ENERGY TRADING LIMITED and ELECTRIC KIWI LIMITED v THE ELECTRICITY AUTHORITY & ORS [2024] NZHC 195 [16 February 2024].

² Electricity Authority, Decision Paper, Review of the Undesirable Trading Situation provisions in the Code, 17 June 2013.

Recommendation

The independent retailers recommend the Electricity Authority: (i) does not determine that a UTS arose following the HAAST ENERGY TRADING LIMITED and ELECTRIC KIWI LIMITED v THE ELECTRICITY AUTHORITY & ORS [2024] High Court decision (allowing the outcomes of the High Court decision to prevail); but, failing that, (ii) adopt a remedy in which spot prices are adjusted to the level they would have been absent curbing of electricity demand following Transpower’s request (as per paragraphs 10.2-10.19 of the preliminary UTS decision).

Summary of the independent retailers' views

The Authority has explained that it considers “Opening a new investigation is the right action for the regulator to take given the circumstances”³ but the exact same justification could have been made for a decision to simply accept the High Court decision, require spot prices to be corrected, and to take no further action. We consider the latter is the most appropriate course of action “given the circumstances”.

The principal conditions the Authority relied on to reach the preliminary decision there was a UTS are unsound

The Authority’s preliminary decision relies on three principal conditions which we do not consider hold given the particular circumstances of 9 August 2021:

<p>(i) “prices being determined by offers and demand management in the circumstances that existed on 9 August 2021 ... is inconsistent with the <u>intent</u> of the scarcity pricing regime ...” [emphasis added]</p>	<p>We do not consider this statement to be correct given the Authority’s articulation of the policy intent at the time it introduced the scarcity pricing regime.</p> <p>The Authority’s policy intent is clear from the summary paper referenced in the consultation: the scarcity pricing regime was designed to address concern about “the tendency for spot prices to fall if demand is <u>forcibly reduced</u> in situations where there is insufficient generation to meet demand” and that “These price floors are <u>intended</u> to stop spot prices falling below minimum levels if demand is <u>required</u> to be reduced during supply emergencies” [emphasis added].⁴</p> <p>There was a request from the System Operator to reduce demand on 9 August, not a requirement, so the threshold in the policy intent was not satisfied.</p>
<p>(ii) “Prices being depressed on 9 August is contrary to prices the market would expect to see in circumstances such as 9 August”; and</p>	<p>While it may be that a minority of market participants expected higher prices to apply – particularly if they weren’t familiar with the market rules/the thresholds for scarcity pricing – other market participants, including the signatories to this submission, did not.</p> <p>We note that Nova was the only party that joined the Electricity Authority in the High Court hearing.</p>

³ <https://www.ea.govt.nz/news/press-release/electricity-authority-will-investigate-possible-undesirable-trading-situation/>

⁴ Electricity Authority, Explanatory Paper: Summary of Scarcity Pricing and Related Measures, 27 July 2011.

(iii) “will also mute the incentives for investment in last resort generation, which will undermine security of supply.”

The prices in the two half-hours on 9 August 2021 have no bearing or relevance to future expected spot and hedge prices and therefore will not impact investment decisions including in last-resort generation and demand management.

Scope of the preliminary UTS decision dictates the potential solution

The Authority’s “preliminary decision on the UTS ... is that prices for trading periods 38 and 39 being artificially depressed by demand management, in circumstances where participants would expect higher prices to apply, threatens or may threaten confidence in the wholesale market” [emphasis added].

The scope of the preliminary decision dictates that the potential solution, if the Authority determines there was a UTS, is to adjust the prices in the two trading periods by removing the impact of the “demand management”.

If loss of confidence in the market was caused by “prices for trading periods 38 and 39 being artificially depressed by demand management” it is tautological that the solution will be to adjust the prices for trading periods 38 and 39 to remove the effect of demand management”. The size of this adjustment is detailed at paragraphs 10.2 – 10.19 as an aggregate \$10.145m price adjustment (if applied to both trading periods 38 and 39).

The Authority has not provided sound or reasonable basis for concluding there was a UTS

The independent retailers consider that normal market operation, and the interaction of supply and demand, results in “prices being determined by offers in conjunction with demand management”.

The same is true in relation to the Authority’s commentary that “Prices [a]re depressed because unpriced demand was competing with high priced thermal generation, causing it to be dispatched down and to receive a lower price.” There are many circumstances under which “Prices [may be] depressed as a result of disconnections” (e.g. outage of a major industrial customer/Tiwa demand reduction under the recently announced new contracts with Meridian et al) just as prices can and are increased as a result of outages at generation plant. We therefore disagree with the Authority’s conclusion that demand management on 9 August was sufficient to trigger a UTS. This would amount to a very low bar for future UTSs.

The scarcity pricing rules, as they stood on 9 August 2021, were specified to provide limited circumstances under which they would apply – reflected in the threshold that the System Operator “require” demand reduction rather than “request” demand reduction.

The Authority’s policy intent is clear from the summary paper referenced in the consultation: the scarcity pricing regime was designed to address concern about “the tendency for spot prices to fall if demand is forcibly reduced in situations where there is insufficient generation to meet demand” and “These price floors are intended to stop spot prices falling below minimum levels if demand is required to be reduced during supply emergencies” [emphasis added].⁵

The independent retailers consider it clear and unambiguous from these statements that the draft decision is incorrect to state “prices being determined by offers and demand management in the circumstances that existed on 9 August 2021 ... is inconsistent with the intent of the scarcity pricing

⁵ Electricity Authority, Explanatory Paper: Summary of Scarcity Pricing and Related Measures, 27 July 2011.

regime ...”. [emphasis added] The intent is that scarcity pricing is only triggered if demand is required to be reduced which did not happen on 9 August 2021.

Market participant expectations are that the Code would be correctly applied

While it may be that a minority of market participants expected higher prices to apply – particularly if they weren’t familiar with the market rules that existed at the time/the thresholds for scarcity pricing – other market participants, including the signatories to this submission, did not.

The independent retailers consider market expectations are that the Electricity Industry Participation Code will be applied.

On 9 August 2021 scarcity pricing was applied in error, contrary to the rules in the Code, so it was reasonable for participants to expect the error to be corrected. This was reflected, for example in the actions taken by Electric Kiwi and Haast Energy Trading to have the error corrected, with 2degrees and Flick Electric both joining the original UTS claim.⁶

It is incorrect for the Authority to now claim “No participants questioned the application of scarcity pricing based on the system operator’s communications following 9 August.” The Authority was also clear in its final original UTS decision in June 2022 that “the Code’s pre-requisites for triggering scarcity pricing were not met during the Event”.⁷

Final pricing outcomes on 9 August will be irrelevant to future investment decisions

We do not consider there is merit in the suggestion that what the Authority has described as “artificial depression” of prices on 9 August “could mute the long-term incentives to invest in last-resort generation or demand”. As the Authority has otherwise pointed out “Generators and electricity retailers make their decisions based on their expectations of future spot prices ...” [emphasis added].⁸ With the adoption of Real Time Pricing (RTP) “The particular circumstances that have led to prices for 9 August 2021 cannot be repeated because the dispatch model responds in real time to scarcity”.

Rules that no longer apply don’t impact “expectations of future prices”.

It is also worth noting that the commentary on incentives to invest the Authority refers to from the Explanatory Paper: Summary of Scarcity Pricing and Related Measures, 27 July 2011, relates to circumstances where future expected spot prices could be suppressed below their true value in a supply emergency. This may be a valid policy issue more generally but is not relevant to the question of whether there was a UTS on 9 August 2021.

The Authority’s own actions risk undermining confidence in the integrity of the wholesale market and in the Authority as industry regulator

We agree there are factors which indicate there is not a UTS on the grounds the Authority has provided. For example, we agree with the Authority:

⁶ This included a pricing error claim (PEC 075), the original UTS claim and appeal under s 64 of the Electricity Industry Act 2010.

⁷ Electricity Authority, The Authority’s final decision on claim of an undesirable trading situation, June 2022.

⁸ Electricity Authority, Explanatory Paper: Summary of Scarcity Pricing and Related Measures, 27 July 2011.

- adoption of RTP is relevant because “The particular circumstances that have led to prices for 9 August 2021 cannot be repeated because the dispatch model responds in real time to scarcity” (see discussion above).
- “By the time the Court decided that scarcity pricing was incorrectly triggered on 9 August 2021 as a result of errors by the system operator in the notices it issued on the day, two and a half years had passed. In addition, prices have now been finalised following the High Court decision.”

We consider that the Authority should be very cautious about opening up historic events to potential UTS investigations given the uncertainty – and the potential impact of that uncertainty – that revisiting spot prices after such a long-time could have on confidence in the market.

This is reinforced by the NZX (8 May) commentary that “The Authority has directed that settlement of trading periods 37-42 for 9 August 2021 is delayed while it considers whether an undesirable trading situation may have developed following the findings of the High Court judgment released 16 February 2024.”⁹ We note that some hedge market contracts have already been resettled based on the High Court decision – this work will have to be repeated if the Authority determines there is a UTS at a cost to a number of parties.

The Authority will also be well aware from the media coverage that there is a material risk the Authority’s own actions could threaten confidence in, or the integrity of, the wholesale market.

The Authority previously considered whether a UTS arose in the 9 August grid emergency, after receiving a claim from Haast Energy and Electric Kiwi in August 2021 for the six trading periods – 37 to 42 – that evening. In June 2022, the Authority decided there had not been a UTS and “There is no situation that the authority needs to correct by using its UTS powers”. The decision to open up the current investigation brings into question whether the market rules that applied at the time will stand. These factors risk creating uncertainty and reduce confidence of investors in the market at a time where investment and innovation in the industry is critical for decarbonisation of the economy.

Concluding remarks

The Electricity Authority is an integral part of the market – putting in place rules (the Code) and monitoring and enforcing compliance with the rules that are publicly available to all participants. Confidence in the market includes confidence the independent Authority will apply and enforce the rules as they stand in its performance of its functions.

For the Authority to hold the view “that prices in trading periods 38 and 39 being artificially depressed as a result of the system operator’s notices to reduce demand, combined with the absence of scarcity pricing, threatens, or may threaten, confidence in, or the integrity of, the wholesale market” could reasonably be interpreted as the Authority stating that problems with the Electricity Industry Participation Code means that correct application of the rules in the Code could undermine confidence in the market.

⁹ The NZX had previously (7 May) indicated “The Authority is working with its service providers and will advise timing and next steps on the settlement process for the six trading periods 37-42 of 9 August 2021 as soon as reasonably practicable.”

Yours sincerely,

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