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Update of scarcity pricing values will further erode competition

2degrees, Electric Kiwi, Octopus Energy and Pulse Energy (the Independent Electricity Retailers) do not consider that updating scarcity pricing should be prioritised at this time, and do not support the proposed new scarcity values.

The Authority's priority focus should be on resolving problems in the wholesale and hedge markets which are adversely affecting competition in the downstream retail market. The Authority's proposed scarcity pricing changes would exacerbate these issues and do more harm than good. Higher scarcity prices would have a greater impact on independent electricity retailers and, as a result, worsen the barriers to competition in the already 'un-level' playing field.

If the Authority decides to make the changes at this time, it would run counter to the Government Policy Statement focus on competition and delivering more affordable electricity.

Investment in flexible capacity requires a robust and efficient hedge market, including capacity and flexibility products. The stated aim of encouraging industry participants to invest in flexible capacity, such as demand response and batteries, would be best achieved through enabling better hedging products with transparent price discovery. Storage business cases are largely premised on price arbitraging the hedge spread.

The Independent Electricity Retailers recommend that the Electricity Authority: (i) pause the work on scarcity pricing at this time; and (ii) ensure market participants have access to tools to efficiently manage their spot market risk exposure before re-launching the scarcity pricing review.

After these pressing issues have been addressed it may be appropriate to review scarcity pricing. The Authority should then establish, and consult on, robust, up-to-date estimates of scarcity values/VOLL.

Market participants need to be able to protect against scarcity/high prices in a cost-efficient manner

The increases to regulated scarcity pricing values the Authority is proposing would create or increase risk and working capital requirements/costs for market participants which – given current market and regulatory settings – cannot be suitably or efficiently managed with available hedge market products. It would have the knock-on affect of raising hedge prices and the retail prices that would be needed to cover the cost. The impact at this time would be harmful to competition and result in further lowering of affordability and exacerbate wealth transfers from consumers to the gentailers.

Price spikes are a high-risk issue for independent retailers to manage because they are mainly brought about by very high demand.

Having robust and efficient hedge products in place is a key requirement for the Authority to achieve the potential benefits outlined in the consultation; this would put some of the risk on generators and help incentivise the needed investment in capacity. At present, the gentailers benefit from the upside of elevated pricing (be it market or scarcity pricing) when there is insufficient generation capacity to meet demand while independent retailers are caught by inadequate hedging options available to protect against this risk.

Increasing scarcity values could increase gaming incentives

The Authority should be cautious about creating a perverse situation where changes to scarcity value reward generators for scarcity and/or for creating artificial scarcity (where there is sufficient generation to meet demand, but generators withhold supply).

While the Authority undertakes market monitoring this is far from perfect.

The Authority has noted "Monitoring has its limits as a tool for mitigating the exercise of market power. Regulators must work with imperfect information. Traders have very strong incentives to design ever more sophisticated trading strategies and, as noted earlier, even small changes in offers can have a large effect on prices. <u>For example, economic withholding and conserving high opportunity cost water can look the same. Opportunity cost is essentially subjective, as people can take different views on what the future will bring</u> and apply different risk preferences." [footnote removed/emphasis added][1]

If scarcity values are updated it should be on the basis of robust information

The consultation paper makes the twin key points that the scarcity values were set in 2011 and are now out-of-date, while stressing the importance of robust scarcity values sending robust pricing signals for investment etc. The consultation referenced a submission to MDAG that "accurate scarcity prices will be critical to making the business case for flexible capacity like batteries and some demand response".

Given these views, it is not obvious why this is being rushed through with a 'back of the envelop' adjustment ("quick method") to scarcity values, where it essentially takes a Transpower 2018 VOLL study – which is now out-of-date – and then adjusts this for inflation.

The premise of the consultation paper is that scarcity values are out-of-date, but the proposal is to replace one set of out-of-date values with slightly less out-of-date values. The Authority should not assume a 2018 report would be safe to rely on over 6 years later.

Transpower was clear "the results of this study" was "a step towards better understanding of VOLL", the study only addressed "some of the EA's concerns" and that while the VOLL results "may have value for informing other decisions … care should be taken in their use."[2]

If the Authority is going to update scarcity values, it should make sure they are properly up-to-date and have been robustly established.

The Independent Electricity Retailers consider that – if the Authority is going to update scarcity values – then it should commission a report on scarcity values, which draws on international precedent. The Authority should consult on this, before making any decisions about what updated scarcity values should be. The work Transpower has previously commissioned may be a useful input as would the work the Authority has previously done on methods for estimation of VOLL.[3,4]

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[1] Electricity Authority, Promoting competition in the wholesale electricity market in the transition toward 100% renewable electricity Issues Paper.
[2] https://static.transpower.co.nz/public/publications/resources/Transpower%20VoLL%20Study%20June%202018%20-%20FINAL_0.pdf?VersionId=y5HYks4GD8YvXNu_jyRl8d6s7mba7ahf
[3] https://eacorpsitelegacy.z8.web.core.windows.net/assets/dms-assets/15/15385VOLL-technical-report.pdf
[4] Electricity Authority, Investigation into the Value of Lost Load in New Zealand: Guideline for conducting a VOLL survey, 2013.

It might be worth undertaking this work in collaboration with the Commerce Commission given that VOLL values are used for multiple purposes across the two regulators, including as part of the Part 4 Commerce Act grid investment test (GIT).

Concluding remarks

The Independent Electricity Retailers are supportive of wholesale market settings that allow prices to be high when supported by market (supply and demand) fundamentals – i.e. situations where there is genuine scarcity (not enough physical generation capacity to meet supply[5]) – and vice versa, subject to appropriate hedging arrangements being in place/available.

Updating scarcity pricing should not be prioritised at a time when there are major market problems that need to be resolved.

The Independent Electricity Retailers consider that the work should be halted. A change in scarcity values at this time would result in further windfall gains to the benefit of the gentailers and would not be to the long-term benefit of consumers.

Our support for update of scarcity pricing values is contingent on the Authority first: (i) establishing effective trading conduct monitoring and enforcement; (ii) introducing new flexibility hedge contracts (and other risk management contracts); and (iii) establishing a liquid hedge market. The Authority should consider activating new scarcity pricing values AFTER hedge market liquidity has crossed a pre-set threshold following introduction of the new flexibility (hedge) product(s).

Regardless of the above points, the Independent Electricity Retailers would only support updating of scarcity pricing if it is based on a robust up-to-date estimation of scarcity values/VOLL.

Yours sincerely,

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[5] As opposed to situations of commercial scarcity where electricity generators decide to withhold generation from the market.