Electricity Authority
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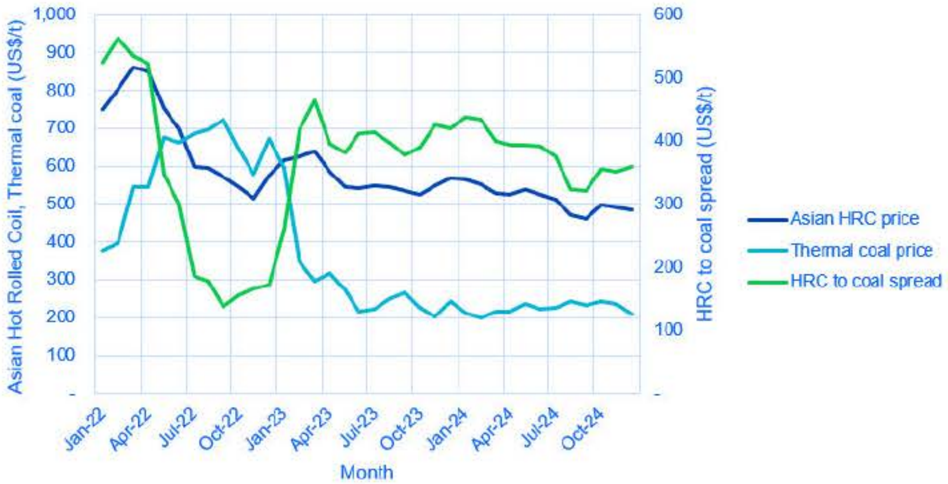
Re: Omnibus #5 consultation

Thank you for the opportunity to submit on this discussion paper.

This submission is restricted to the stress test regime.

Before answering the specific questions, here are some overview points:

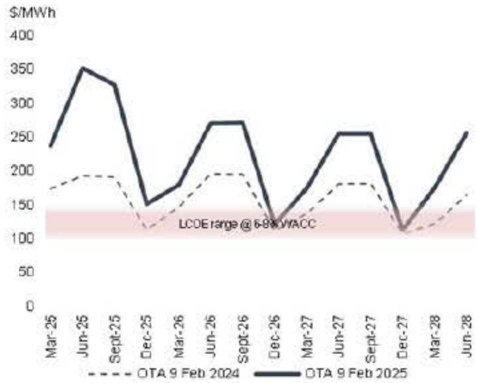
1. The stress test may be well intended in ensuring market participants are adequately informed as to risk relating to electricity spot prices. However, it is narrowly focused and can have a counter-outcome drawing attention away from other business risks.
2. The test scenarios do exposure specific electricity related pricing risk and the appendices being consulted on go into some detail as to electricity related factors (eg own generation) that can influence supply and pricing. However, for demand side participants like NZ Steel operating a dynamic business impacted by world events and commodity markets over which we have no influence, the risks are much wider.



3. Extending the stress test out to 36 months from the current next-quarter reporting, increases the undue focus on electricity prices, and away from other business factors including production volumes. Longer term stress testing just factors one limited set of risks when reality is a much wider sets of risks.
4. Hedge volume risk is a key consideration. The higher the percentage of hedging, the higher the risk. Variation of load profile to hedge profiles is a subset of this risk.
5. We note an important distinction between end-consumers such as industrials, and those that may have contractual obligation to supply consumers (eg retailers). Stress testing for the latter group does have greater relevance.
6. **We urge the Authority to re-think the one-size fits all approach to stress testing.**

7. Hedges and similar contracts are financial instruments and raise as many issues as they attempt to solve, particularly longer term contracts.
8. The complexity of the International Financial Accounting Standards are a reminder of the complexity of these instruments and potential impact on businesses.
9. Hedges (and PPAs) do not guarantee delivery of energy (unless a through-the-fence supply is involved). Albeit they do support maintaining/building generation and Transmission.
10. MDAG likens being under hedged to being under-insured[1]. This misconstrues the purpose of insurance. An electricity option or price cap instrument[2] is an insurance – if the price reaches a specified level, the holder of the option or cap is protected. However, an electricity hedge premium only buys certainty of price (subject to credit risk), but in so doing introduces other risks for the purchaser. It is fallacy to liken this to insurance[3].
11. We observe underlying sentiment within the Industry has changed since the MDAG report was published 15 months ago. We now see wide acceptance that the Markets are not delivering what is needed for consumers and therefore NZ Inc and this reflects in inefficient futures market pricing.

Baseload OTA ASX futures
9 Feb 2024 vs 9 Feb 2025



Source: ASX, Enerlytica

12. Market design and tighter supply builds in risk premiums that favour the provider. The pricing of futures instruments does not make sense for many on the demand side and other risk management tools such as increased demand side management, or just taking the risk it will rain (as seen mid-August 2024), are understandable, but not optimum risk management tools. This is particularly the situation for those who cannot pass on the costs of hedging ie price takers.
13. It is important the non-supervisory nature of the stress test is clearly stated and understood. Yet words such as "moral hazard"[4] used by MDAG give a different message – either be fully hedged or you are a "sinner'. This boarders on financial advice and the hazards involved especially given electricity price variation is only one risk of a complex business operating in a dynamic environment. Extending the current three month assessment to 36 months increases risk to the Authority of been seen to be providing financial advice.
14. We support the Authority stepping back from the recommendations of MDAG in C.15 to C.21 relating to spot risk management policies and a myopic view of the risks[5].
15. Participants reducing production or closing facilities has become a reality of recent years and this got particular attention during Winter 2024 and the unfortunate social consequences. The mantra from some that those entities should have been hedged is not the answer. Tension re lack of adequate supply has put upward pressure on prices. Futures prices that are outside the range that make business sense for

[1] Price discovery in a renewables-based electricity system: Final Recommendations PAPER 2023, MDAG report, Appendix C. C.6(b), page 152
[2] Not being able to purchase an option or cap product at a price that makes sense is topic in itself for consideration.
[3] MDAG. And the life insurance cover example quoted by MDAG in footnote 239 is invalid.
[4] MDAG page 152
[5] MDAG page 155

customers resulted for some in physical means becoming the remaining risk management tool ie turn down or turn off. Sadly, some have decided to not start-up again.

16. A turn-down/turn-off strategy is particularly valid for some industrial demand participants for the Capacity shortage stress test (C 1).
17. In support of points made above relating to broader risks we draw attention to specific situations:
    a. During Covid, system demand dropped significantly resulting in low spot prices. Businesses were forced to close. There was reduced need for electricity. Their revenue base was eroded, yet the financial commitments including hedges remained. Fortunately, Government funding and a return to a degree of economic normality quicker that may well have been the case, assisted in alleviating the financial outcomes for many.
    b. Cyclone Gabriel. The Hawkes Bay was hit hard with a Transpower substation taken out of action and businesses that were inoperative for more than 12 months in some cases. Yet hedge contracts continued. Again, with much of New Zealand being back to normal fairly quickly, the financial impact of unwanted hedges was somewhat offset, but things could have ended quite differently.
18. MDAG para C.27[6] is a good reminder that each participant is responsible for determining the range of adverse spot market scenarios relevant to their risk management. However, **we suggest the Authority include a further scenario of collapsed demand and collapsed spot price market.**
19. **In conclusion, participants have a right to expect a workably competitive market. New Zealand does not currently have this. It is inappropriate for the Authority to expand the stress testing regime at this time.**

Our response to the specific questions below should be read within the context of the points above:

Q2.1. Do you support the Authority's proposal to insert the purpose of subpart 5A before existing clause 13.236A? Please explain your answer.

Yes, we support the Authority making the purpose crystal clear that there is no minimum requirement for hedging. As has been pointed out in our opening comments, the inference often conveyed by the Authority and the MDAG paper is to not be hedged is a sin. The reality is a much more complex set of equations.

Q2.2. Do you support the Authority's description of the proposed purpose of subpart 5A in a new clause 13.236AB (as detailed in Appendix A)?

We suggest deleting the last part of (2)(c) ie stop the sentence at "…drive forward wholesale market prices."

The last part of the sentence should be deleted "…which in turn strongly influences investment decisions in relation to new supply, which in aggregate determines reliability of supply over the short, medium and longer terms". In the 15 months since the MDAG report was finalised we conclude that by far the majority view within the Industry is the current market settings are not working as intended and the fact we have now had 6+ years of elevated prices with minimal investment in generation.

Q2.3. Do you support the Authority's proposal to amend clause 13.236A of the Code to extend the horizon of the stress test regime from 1 quarter to 12 quarters? Please explain your answer.

No. There is a logic to extending the time horizon to the extent of contractual or other commitments requiring electricity eg for retailers with extended supply contracts, essential services such as health facilities, and Council pumping stations. However, for the manufacturing sector the scale of ongoing operations is determined by a number of business factors. Modelling just electricity is only part of a complex set of equations. Perceived 'encouragement' by the Authority to hedge for spot price risk may actually be detrimental drawing attention away from other business risk.

[6] MDAG page 156

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Q2.4. Do you support the Authority's proposal to introduce a simplified and separate methodology for quarters beyond the next quarter? Please explain your answer.

This will be sensible if the 36 month proposed report is to be required.

Q2.5. Do you support the Authority's proposal to require the registrar to send disclosing participants 'you are here' reports? Please explain your answer.

If the information exists it may as well be shared with participants. We are sceptical of the information that will be collected, but given it is collated it should be shared for reflection by participants.

Q2.6. Do you support the Authority's proposal to change the EMI reporting to provide additional information? Please explain your answer.

No. Each participants situation is different and published information may infer a benchmark that is invalid.

Q2.7. Do you support the Authority's proposal to amend clause 13.236F(1) of the Code to require the board of the disclosing participant to certify that the disclosing participant has complied with clause 13.236E(1)? Please explain your answer.

NZ Steel takes compliance with the Code as a serious matter. We understand why the Authority may require compliance on these matters to be signed off by senior management of a market participant. However, we suggest the Authority relook at the prescriptive nature of the current and proposed sign-off process and how this reflects on both participants and the Authority.

Q2.8. Do you support the Authority's proposal to amend clause 13.236F(1) to require a disclosing participant to certify that it has complied with the requirement to submit spot price risk disclosure statements in clauses 13.236A and 13.236E as part of the Certificate of spot price risk disclosure statement? Please explain your answer.

As per 2.7 above.

Q2.9. Do you support the Authority's proposed changes to the stress test methodologies? Please explain your answer.

These generally provide good guidance for the detail to be applied in making the calculations. The point that stands out is 2.57 suggesting controllable batteries should be assumed to be fully charged at the start of the stress test. This is a questionable, and perhaps material, assumption for the capacity shortage stress test (C1).

Q2.10. Do you support the Authority's proposal to require disclosing participants to provide target and actual cover ratios and for the Authority to publish this information anonymously? Please explain your answer.

No. As outlined elsewhere in this submission, target ratios for industrial operations extending out 36 months have greater complexity than electricity price projections.

We question if there is any real value in reporting actual cover ratios. Reporting of historic actuals provides a reference point, but does little for large consumers in terms of advising what the position would have been had one of the scenarios or similar occurred ie load management would likely have been implemented. Again, we submit a one-size fits all stress test is not appropriate.

Q2.11. Do you agree with the transition plan and a quarter-long transition period? Please explain your answer.

If this is to proceed, we have no issue with the timing.

Q2.12. Do you agree the proposed amendment is preferable to the alternative options? If you disagree, please explain your preferred option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.

No alternative has been presented. The Authority has not presented any evidence in support of how these changes would be consistent with the statutory objective.

Q2.13. Do you agree with the analysis presented in this Regulatory Statement? If not, why not?

The rationale outlined has merit for those operating within the bounds of the NZ electricity system ie generators and retailers. However, as outlined elsewhere in this submission the inward electricity-industry looking approach of this consultation is questionable for market participants exposed to world commodity markets. Unless managed carefully what is being proposed with changes to the stress test may actually run counter to the intention with an undue focus on electricity pricing over even greater business risks.

We will be pleased of an opportunity to discuss our submission.

Yours sincerely

New Zealand Steel

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