New Zealand Steel Limited
Mission Bush Road, Glenbrook
Private Bag 92121, Auckland 1142
P +64 9 375 8963 | M +64 27 839 1107
E gretta.stephens@bluescopesteel.com

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The Chair and Members
Electricity Price Review Committee

EnergyMarkets@mbie.govt.nz

Thank you for the opportunity to comment on the Electricity Price Review Option Paper dated 18 February. We complement the committee on a succinct report covering most of the points relevant to the terms of reference.

NZ Steel is the largest electricity consumer actively engaged in the electricity market. We record our disappointment and concern that we were precluded from attending the discussion forums on the Options Paper.

We commend the submission of the Major Electricity Users Group which covers a wider perspective than the following points we want to emphasis. We also raise some points not included in the Options Paper, in particular concerning operations of the electricity spot market.

We will be pleased to provide further comment or engage with the Committee on any of the points raised.

Yours sincerely

Gretta Stephens
Chief Executive NZ Steel & Pacific Islands

Section D – Reinforcing Wholesale Market Competition.

The period to date since September 2018 has tested the electricity markets. This has included periods where the prices in the spot market have defied logic for even the most experienced analysts and has included a multi-party UTS claim. There is an expectation the EPR process will include in-depth analysis of the Electricity Authority investigation report [1] which was published after release of the Options Paper.

Anecdotally there is wide acceptance that the futures market has failed to operate to an acceptable level during the past six months. Some say it is dysfunctional. We welcome **Options D1 – D4** proffered as steps that if implemented will assist rectify the deficiencies with toughened rules on disclosure of information, but as outlined in this submission more needs to be done.

There is a wider question as to whether the futures market (be this ASX or bilateral arrangements) was fit for purpose in the first place especially in term of liquidity. The EA Hedge Market survey conducted in 2017 [2] revealed a mixed level of confidence in the market. In fact, the confidence level had decreased since the previous survey in 2014.

It should also be noted that a number of the recommendations from the Wholesale Advisory Group Hedge Market Development Report Recommendation Paper of June 2015[3] have not been implemented and/or have not been successful in delivering an efficient market.

The Electricity Authority in its investigation's over time of the Futures Market have used simple volume as the measure of liquidity, in NZ Steel's opinion this is inadequate. Liquidity is a combination of several factors and must embrace a measure of price movement for a given volume traded and the spread of the bid ask stack at that time. If a more comprehensive measure of liquidity had been used by the Authority in the UTS investigation we consider the true level of market failure in the Futures Market would have been abundantly clear.

The International Monetary Fund Recommends market liquidity be measured by:

> "The measures include bid-ask spreads, turnover ratios, and price impact measures. They gauge different aspects of market liquidity, namely tightness (costs), immediacy, depth, breadth, and resiliency. A number of measures must be considered because there is no single theoretically correct and universally accepted measure to determine a market's degree of liquidity and because market-specific factors and peculiarities must be considered." [4]

If options D1 – D4 are to be accepted it is important there is a review mechanism for both the implementation process and effectiveness of outcomes. This needs to go deeper than

[1] https://www.ea.govt.nz/code-and-compliance/uts/undesirable-trading-situations-decisions/15-september-2018/

[2] https://www.ea.govt.nz/development/work-programme/risk-management/hedge-market-development/development/hedge-market-survey-2017/

[3] https://www.ea.govt.nz/dmsdocument/19646-hedge-market-development-recommendations-paper

[4] Measuring Liquidity in Financial Markets
https://www.imf.org/en/Publications/WP/Issues/2016/12/30/Measuring-Liquidity-in-Financial-Markets-16211

the review mechanisms adopted by the Electricity Authority in the past – maybe a process led by MBIE.

Missing are options relating to the spot market

What is happening in the real-time market does flow over to the futures. The forwards market is a reflection of the present spot market outcomes incorporating the supply and investment risks of the future.

The spot market had been maturing over the 20+ years of operation building a degree of confidence regarding its efficient operation *most* of the time. However, for NZ Steel as a large customer this confidence has been sorely dented during the last six months. While the Electricity Authority UTS report[5] concluded no evidence of breach of the code, there are areas of disquiet raised in the report and NZ Steel is not satisfied with the response to the issues raised.

<u>The Options Paper has not made the connection between spot outcomes and forward market outcomes.</u>

Analysis of the spot prices during the two recent Pohokura gas outages has shown that large generator market power is very real and appears to be used whenever there is an excuse that legitimises it. Monitoring of the generator offer changes during the planned February Pohokura outage repeatedly showed ratcheting of the stack by $100s/MWh. Some trading periods those signals were lost as participants priced down to gain volume. For other trading periods the stack just thinned and high prices were locked in. Where is the line between 'testing the market' and 'tacit collusion'?

There is a significant asymmetry of resources and information that is present between the large generators and consumers (irrespective of size). It is not so much about data, but having the system and resources to turn the data into information and the ability to react (see comments below relating to demand side management).

Missing are options relating to demand side management.
Demand side management has been identified by the Electricity Authority and Transpower[6] [7]as important to the future efficient provision of electricity.

Costs associated with transmission and distribution have a large fixed component and pricing signals (direct and indirect) to smooth load during these periods are important to prevent/delay further asset investment. Likewise, for generation required to meet peak demand. These pricing signals have largely been lost at the mass-market level and contribute to the overall increase in prices that have led to the EPR.

As well as the longer-term impact on costs and prices, demand side management also has a place to play in the real-time spot market. Being able to reduce load on a trading period basis provides a mechanism to depress demand and therefore prices during times of high

[5] ibid
[6] https://www.transpower.co.nz/keeping-you-connected/demand-response AND https://www.transpower.co.nz/industry/transmission-pricing-methodology-tpm/role-peak-pricing-transmission

spot prices. For large customers who are direct market participants this can be achieved, *if* there is an efficient fully competitive spot market. The last 6 months have brought this into question. For mass market consumers further consideration is required including renewed encouragement of interruptible load and looking at the role for load aggregators.

A refresh of the current largely unworkable dispatchable demand regime will assist and implementation of the proposed Real Time Pricing regime is important.

In summary the NZ wholesale electricity market is not competitive because there is not the ability for competition on the supply side. The review team need to look further at what regulatory changes are required in the spot market to ensure improved balance to market power. Options need to be advanced to address the information and market power imbalance between the generator and end purchaser. These could include:

1. Review the Code to ensure the demand side can fully participate in all areas of the market including
    a. Implementation of workable dispatchable demand that co-optimises bids to reduce load along with generation and reserves via the dispatch system.
    b. Develop and define the role of a demand aggregator who would offer aggregation services across several GXPs.
2. Require the Electricity Authority to further develop the WITS application to enable consumers access to information to assist in reducing costs.

Specific Points:
D1. "Toughen rules on disclosing wholesale information". The current rule is very narrow requiring publication of information about 'them' i.e. the organisation the information is about. This means information that is not about 'them', but impacts 'their' operation (and likely to impact price), does not need to be disclosed. This issue needs to be addressed.

Option **D3** would require release of information on retail profitability. This should be extended to generation profitability **(D4)** and including the impact from revaluing historic assets. The asset revaluation process is built around expected revenue streams. This is a self-perpetuating justification for ratcheting prices.

Our comments above regarding the spot market and asymmetry of information necessitate the committee develop options additional to the **D4** proposals of further monitoring by the Electricity Authority. If NZ is to have an efficient market that consumers have confidence in, it is essential the Committee recognise the flaws with the current processes and imbalance in market information held by the large generators.

Conceptually NZ Steel does not favour **D5 Prohibit vertically integrated companies**. However, it is important NZ has efficient spot and hedge markets and consumers have confidence in these markets. The recommendations of the EPR committee must be implemented if we are to get the necessary changes in place in an acceptable period of time. As suggested above a review mechanism needs to be put in place, and further steps for internal separation of generation from retail activities may be required.

E1 suggests the Government issue a policy statement on transmission pricing. While this is not ideal we accept many of the reasons the Committee has put forward for favouring such an approach.

Despite many years and millions of dollars, the Electricity Authority has not been able to deliver new Transmission Pricing principles to enable the development of a new methodology. What the Authority releases in June needs to be a pragmatic and broadly accepted proposal. If this does not occur a non-politically influenced GPS may be the best way forward.

Conceptually E9 is not favoured, but again **lower Transpower asset values** may assist in moving forward with a replacement Transmission Pricing Methodology. A related issue is maintaining WACC at the 67th percentile when many consider the 50th percentile to be more appropriate given the low investment risk.