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Dear Jenny

Hedge Market Development – Issues and Options

Meridian Energy ("Meridian") appreciates the opportunity to provide the Electricity Commission (the "Commission") with its submission on the Hedge Market Development Steering Group (HMDSG) consultation papers.

Meridian commends the HMDSG for the significant amount of work it has put into this project. Meridian supports the overall goals and objectives of the HMDSG and, furthermore, is supportive of the broad range of measures that the HMDSG has proposed in its paper. Meridian is encouraged by the level of consensus reached by the group and supports the permissive nature of its preferred package of initiatives.

In this submission Meridian makes some general comments relating to the issues raised in the paper before specifically addressing the questions asked by the Commission.

General Comments

Meridian is supportive of the objective developed by the HMDSG to give priority to a package initiatives that will, together, provide a voluntary foundation for efficient and effective price risk management among participants in the electricity market.

Meridian is also supportive of the objective set out in the Government Policy Statement on Electricity Governance (the "GPS") and suggests that the GPS objective can be used to test whether the HMDSG initiatives deliver.

Meridian submits that the Commission does not need to use its regulation making powers, as proposed in the GPS, as the package of initiatives appear to be consistent with the GPS objectives to promote voluntary and co-operative arrangements before enacting regulation. Having said this, the Commission may need to add rules to give particular initiatives effect (for example the publication of contract details initiative).

The proposal relating to the publication of contract details and the transmission risk management initiatives require further detailed consideration before adoption. Meridian submits that the Commission must seek to further educate the industry on the transmission risk management initiative and consult with the industry as it determines its approach to and proposal for these initiatives.

Meridian's Answers to the Commissions Specific Questions

The Commission has requested that submitters address specific questions in their response to the HMDSG consultation papers. Below are Meridian's answers to those questions.

1) Do submitters agree with the HMDSG's view on the policy objective?

The HMDSG was initially set up to "provide advice to the Commission on the development and implementation of a transparent and liquid electricity hedge market"¹.

The basis for the HMDSG terms of reference was paragraph 76 of the GPS which is set out below:

76. A transparent and liquid hedge market is a critical component of an efficient wholesale market. It enables market participants to manage their risks and facilitates retail competition. Concerns are regularly expressed that the current hedge market does not operate particularly well.

The HMDSG came to the view that it may be unrealistic in the current circumstances for the relatively small New Zealand electricity market to sustain a highly liquid market for hedging electricity price risks. Therefore the HMDSG decided that its objective should be amended and restated as to "recommend to the Commission a package of initiatives that would collectively provide the foundation for efficient and effective price risk management among participants in the electricity market".

Meridian agrees that the objective of the HMDSG should be to provide the Commission with a voluntary package of initiatives that support development of efficient and effective price risk management.

Meridian considers that the job of the Commission should then be to determine whether this package is likely to deliver 'a transparent and liquid' hedge market as set out in paragraph 76 of the GPS or whether the Commission needs to recommend regulations as suggested in paragraphs 71 and 77 of the GPS, (set out below), to realise this goal.

71. The Commission is also expected to be active in monitoring developments, using the powers available to it, and, if necessary, making recommendations to the Minister on any further powers it believes to be necessary to ensure the market operates efficiently. This may involve:

- *Undertaking co-ordination tenders to incentivise (via payments) a combination of hydro storage and thermal fuel that is sufficient to achieve the security of supply standard over a short term timeframe (e.g. one year)*

¹ HMDSG terms of reference.

- *Using the proposed additional powers in the Electricity Act 1992 to recommend regulation or rules, which should be applied in non-discriminatory manner, to:*
 - *set minimum requirements on generators to hold or provide for reserve fuels (including water)*
 - *set requirements on generators to offer by tender a minimum volume of contracts that enable the price associated with the spot market to be managed, including requirements relating to the terms and conditions of those contracts (excluding prices and reserve prices). This would incentivise generators, if those contracts were taken up, to hold sufficient capacity and fuel to meet those contracts or to cross insure with other generators for that purpose*
 - *set requirements on retailers and other direct buyers of electricity from the wholesale market to maintain minimum levels of hedge and contract cover with generators and/or minimum levels of hedge and contract cover with generators and/or minimum levels of demand-side management programmes and contracted demand response.*

77. *The Government has amended the Electricity Act 1992 to provide regulation making power to establish and promote hedge markets. As with other regulation making powers, the Commission may only recommend regulations if it has first established that there are significant problems that are not resolvable through voluntary arrangements and co-operation. The regulation making power cover:*

- *Disclosure of information on hedge and contract volumes and prices;*
- *Requiring generators to offer by tender a minimum volume of contracts that enable the price risks associate with the spot market to be managed, including the terms and conditions of those contracts (excluding prices and reserve prices);*
- *Requiring generators to post buy and sell prices for hedge (including futures) contracts; and*
- *Requiring buyers of electricity from the wholesale market to maintain minimum levels of hedge and contract cover with electricity generators.*

If the Commission is satisfied that these voluntary initiatives, with modifications based on submissions received, are likely to resolve any problems then it should develop specific rules (where necessary), consult with industry on those proposed rules and implement the initiative as and when practical.

Meridian suggests that a transparent and liquid hedge market can and must be developed in New Zealand and that it should continue to be the objective of the Commission². The Commission should not seek to make amendments to the GPS in this regard. The degree of liquidity and transparency is by definition subjective and should and will continue to be debated.

2) Has the HMDSG correctly identified the key problems relating to the hedge market?

Meridian has no specific comment on the problems that were identified in the survey of hedge market participants. However, it does recommend that the survey should be repeated annually to assist determine whether the objectives of the GPS are being delivered upon (assuming the preferred package of initiatives proposed by the HMDSG are implemented).

Meridian does agree that forward price risk management and hedging is important to the economy and that the process of entering into forward contracts must continually be refined and improved. So rather than focus on problems, Meridian has focussed on the proposed package of initiatives to determine whether they are likely to materially improve price risk management activities among participants in the electricity market.

Meridian submits that the package generally achieves this objective (with modification as suggested in this submission).

3) Do you agree that the evaluation criteria are appropriate for assessing the various potential initiatives?

The HMDSG used three general criteria to evaluate the competing initiatives:

- Did the initiative contribute towards addressing the electricity price risk management problems it had identified?
- Do the likely economic benefits from each initiative, or linked initiatives, exceed the costs of implementation (it did not conduct a formal quantitative assessment of these but did assess them qualitatively and tried to gauge the likely net benefits of each)?
- How long will each initiative, or linked initiatives, take to implement (the HMDSG considered that, other things being equal, it would prefer the initiative which would take the shorter time to implement)?

Meridian broadly supports the criteria adopted by the group as providing an appropriate assessment of the proposed initiatives. In particular, Meridian suggests that significant weight should be placed on the economic cost and benefit criteria as it is an objective measure.

² Meridian has read the 2004 "Hedge Markets and Vertical Integration in the New Zealand Electricity Sector" paper prepared by NERA and while that paper is well founded, the conclusion that New Zealand derivatives market may be unable to reach a high level of liquidity must be tested rather than simply accepted. Meridian for one, suggests that a liquid and transparent forward market can develop in New Zealand.

Given this, Meridian submits that either the HMDSG, the Commission or a subsequent advisory group further develop the cost and benefit criteria from a quantitative perspective. Meridian understands that the Commission intends to undertake additional consultation before adopting any specific proposal. Meridian suggests that the Commission could include more robust and quantitative analysis at that point. Meridian also suggests that the Commission review and update any quantitative analysis a year following the implementation of any proposals in order to accurately assess their effectiveness.

4) Do you consider that the HMDSG has correctly identified and described an appropriate range of potential initiatives?

Meridian submits that the HMDSG has identified and described a range of potential initiatives that are both substantial and wide ranging.

Meridian further considers that the preferred HMDSG initiatives represent a reasonable package that should promote efficient and effective price risk management among participants in the electricity market.

5) Do you agree with the preferred package?

Meridian generally supports the preferred package, subject to further refinement, and consideration of the points raised below.

- *Publication of Contract Details*

The HMDSG proposes that parties who enter into risk management contracts exceeding 10GWh per annum publish details of their agreements.

It is proposed that contract sellers would have the obligation to post their contract details on a website specified by the Commission and purchasers would have an opportunity to dispute the accuracy of the details. The details published would include contract quantities, prices, reference nodes, duration, start and end dates, and other key terms and conditions. Contract counterparties would not be required to be identified.

This initiative would require the Commission to implement rules specifying the details to be disclosed, when they have to be disclosed, who is required to disclose those details, where the details are to be published, and processes for monitoring and enforcing compliance with these requirements.

Meridian generally supports the intent behind the initiative to publish contract details as that it should improve the amount of information disclosed to the marketplace and therefore improve participant's ability to manage risk. However, Meridian suggests that further detail is required to ensure that the benefits of the initiative are realised (and outweigh the potential costs). In particular Meridian would like to see further detail on compliance and additional consideration of competition and contract law as part of any Commission process referred to in Meridian's answer to question three above (the HMDSG notes these issues but is not expansive on the detail). Meridian comments on each of these issues below.

Compliance Cost

Meridian considers that compliance costs may arise in two general areas:

1. The registering of the contract by the seller (and confirmation by the buyer); and
2. Commission enforcement of any rules requiring publication.

The process and timeframe for contract registration is likely to be relatively straightforward for standardised contracts but could be more complex for tailored arrangements. Likewise enforcement should be straightforward for standard contracts. Both compliance and enforcement could be complex for tailored arrangements for a number of reasons including: differing interpretation by buyer and seller, the large quantities of energy expected to be sold, the term of the deals, confidentiality provisions, the materiality of the commercial and competitive positions of the counterparties and the likelihood that counterparties could be determined even if names are not published.

While Meridian suggests that there are answers to the above problems, it raises the issues so that they are effectively managed in any proposed implementation and the costs and benefits of compliance are taken into account.

Competition Law

In relation to competition law principles, the HMDSG notes that *"the main risk is in regard to the disclosed information facilitating collusive behaviour among market participants. This risk is considered negligible, as the competition regulators will also have more information with which to monitor participant behaviour."* Meridian is unsure that the Commission can deal with the collusive issue so lightly.

The Commerce Commission has recently considered a similar issue, the release of wholesale market offer and bid information. It is similar to release of contract information in that it improves the timeliness of information getting into the marketplace. It raises different issues in that release of offer and bid information occurs after it has been used for commercial purposes whereas if contract information is released, it is likely that details will be available to the wider market before the contract comes into effect.

In the case of wholesale market bid/offer information release, the Commerce Commission's key concerns were the potential for increased tacit collusion versus the pro competitive effects of disclosure. As noted by the HMDSG, the same or similar issues exist here. Again this is likely to be a larger concern for tailored arrangements but Meridian recommends that any proposal is developed with the Commerce Commission and that emphasis is placed on the competing outcomes of tacit collusion versus improving competition.

Contract Law

Meridian notes that any proposal will also need to give consideration to contract law. The Commission needs to consider how it will treat the number of historical and future long-term contracts that have confidentiality clauses in place. The parties to these existing contracts are very unlikely to want this information disclosed and it would be a

large step for the Commission to force the release of information for existing arrangements. . Therefore, Meridian believes that consideration should be given to excluding historical contracts from the disclosure rules.

Finally, in recognition of the above issues Meridian submits that the Commission enter into additional consultation on the publication of contract information before it is implemented

- *Further Development of energyHedge Services*

Meridian generally supports development of *energyHedge* as proposed by the HMDSG.

Meridian also suggests that the HMDSG should have considered increasing the minimum *energyHedge* volumetric requirements above and beyond the existing minimum of a ¼ MW, quarter year contract for the following three years. By way of example only Meridian suggests that the minimum volume requirement should increase to at least four ¼ MW, quarter year contracts for the following three years.

The rationale for this proposal is that the *energyHedge* style of market is similar in concept to the rationale that supports interbank forex markets. Those markets have minimum dollar commitments, in the order of millions or tens of millions, made by each of the participants presumably to assist position management. *EnergyHedge* does not have these types of commitment

Obviously this is an issue that must be considered by the owners of *energyHedge* (of which Meridian is one). Meridian will be making this suggestion formally to the other owners of *energyHedge* and would appreciate feedback from the HMDSG, other industry participants and the Commission on the benefits or otherwise of this proposal.

- *Model Master Agreement*

Meridian supports the development of the model master agreement. Meridian notes that the industry is already moving towards this on its own accord. Meridian considers that this will facilitate increased standardisation and transparency across the industry.

- *Centralised web-based publication of planned outage and fuel stock information by the Commission*

Meridian supports the web based publication of planned outages and the levels of fuel stock. Meridian notes that this already takes place on a limited and voluntary basis as part of the Published Outage and Co-ordination Process (POCP).

For this to be effective the Commission will need to implement rules specifying the details to be disclosed, when they have to be disclosed, who is required to disclose those details, where the details are to be published, and processes for monitoring and enforcing compliance with these requirements. Meridian submits that these issues are similar to those discussed above relating to Disclosure of Contract Information bullet above and should likewise be developed further by the Commission.

- *Greater purchaser understanding of electricity price risk management*

Meridian believes that these proposals will promote greater purchaser understanding of electricity price management. Meridian believes that the explicit hedging of electricity price risk should lead to a more efficient market over time.

6) Please provide your views on the practicality of the two initiatives (disclosure of contract information and change the allocation of loss and constraint rentals) that, in the Commission's opinion, would make the biggest difference in moving existing market arrangements.

Meridian submits that there are practical challenges to be overcome to implement the proposed initiative. These challenges are set out in Meridian's answer to question five above but to summarise they are the development of compliance and enforcement mechanisms, and further work to demonstrate that the benefits of the initiative can be realised particularly for tailored arrangements (above and beyond the costs). Meridian also submits that the Commission must take competition and contract law issues into account in its deliberations. Meridian is committed to improving current levels of information disclosure and to practically resolving these issues through the Commission process.

Meridian does not have enough information to realistically form a view on the proposed allocation of loss and constraint rental proposals. At this time we are only able to make the following general points:

- Mechanisms that allocate loss and constraint rentals to those that are exposed to those risks are an improvement on existing arrangements;
- Parties that have physical and financial exposures need to be treated consistently. The financial transmission right (FTR) proposal allows parties to manage exposures by selecting and purchasing instruments that are consistent with expected exposures. However, there are complex issues that must be overcome before it could be put into effect;
- It is not clear whether the locational rental allocation (LRA) proposal would allocate rentals to those exposed to the risks.

Meridian suggests that the Commission continue to refine both the FTR and LRA proposals and enter into further industry seminars and consultation as a next step to moving forward particularly as the HMDSG suggests that any proposal would take three to four years to implement.

In conclusion, Meridian agrees the preferred package of initiatives developed by that group should together, provide a foundation for efficient and effective price risk management among participants in the electricity market. However, Meridian suggests that voluntary implementation of the package is preferable to proposing regulation at this time and that the Commission should further refine and consult on the contract disclosure and allocation of loss and constraint rental initiatives.

Yours sincerely

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