

TRANSPower NEW ZEALAND LIMITED

# Submission to the Electricity Commission on Managing Locational Price Risk Proposal

*22 October 2010*



**TRANSPower**



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## **1. Introduction**

### **1.1 Purpose of this document**

Transpower thanks the Electricity Commission for the opportunity to make a submission on its consultation document “Managing locational price risk proposal”, 13 September 2010. This report is Transpower’s response to the consultation document.

This submission should be read in conjunction with Transpower’s submission to the Electricity Commission (“the Commission”) on “Market Development Programme: Overview, December 2009” and “Managing Locational Price Risk: options, December 2009”.

## **2. Executive summary**

The Commission is undertaking an important market development programme that requires careful co-ordination of all elements to deliver good consumption, investment and divestment signals, liquid hedge and contract markets, increased competition and reduced barriers to entry for new retailers, generators and intermediaries in the financial derivatives markets.

The management of locational price risk is an important foundation for the outcomes desired by the Commission and the Electricity Authority. Transpower is pleased with the progress to date and feels the current proposal to implement a simple Financial Transmission Right (FTR) addresses many of the recommendations made by Transpower in its December 2009 submission. However, it is only a first step in the journey to establishing liquid hedge markets and increased competition in the New Zealand electricity market. Continued evolution of the FTR design must be planned to ensure that FTRs are developed to fully support energy trading in the electricity market.

Transpower supports the introduction of an FTR market, and supports the Commission’s concept of a contracted FTR Provider with FTR settlement through the Clearing Manager.

The Commission has proposed a simplified FTR on the basis of assumptions derived from the analysis of historical locational price risk patterns. Transpower cautions that congestion patterns in the transmission network may change significantly once FTRs are implemented, as energy hedge markets increase in liquidity and market behaviour changes in response to the ability to compete across transmission constraints with reduced risk. In recognition of this risk, careful attention must be paid to the initial and evolving design of the FTR market to ensure it provides the level of locational price risk cover required, initially and into the future. In particular, increased intra-island risk would introduce locational price risk that is not accommodated by

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the proposed FTR design. Transpower believes that this is an important factor that should be considered by the FTR Provider in consultation with the industry as part of finalising the initial FTR design to be implemented.

To enable the FTR market to evolve in tandem with the energy market it will be important that the Code encourages, rather than inhibits, the evolution of FTRs. Transpower's preference is therefore to have high level principles and objectives set in the Code, not detailed FTR design such as precise hub definitions. The design should be left to the FTR Provider and the industry to develop in response to need. The Electricity Authority's role should be to assess the FTR design against the requirements of the Code.

Transpower continues to advocate the evolution of an FTR solution and agrees that, with minor amendments, the proposed FTR solution is heading in the right direction. To create certainty in the energy hedge market Transpower advocates that the Commission and the Electricity Authority resist the temptation to introduce Locational Rental Allocations (LRA) within an island. Our view continues to be that an LRA solution is not a possible next step in the design, but should be abandoned altogether.

The Commission has taken a particular academic viewpoint in FTR design, resulting in a complicated payment formula for FTRs and a dynamic (continually changing) hub definition. Transpower considers this to be a flawed approach. The approach could be improved by considering what might work best for traders, offering them the product they need, and putting any complexity required to achieve revenue adequacy into the internals of the FTR design, not into the product itself.

Transpower is not a trader, but believes that traders would value:

- fixed hubs/nodes closely aligned with current (and future) energy trading nodes, and
- a simple payment formula based directly on locational price differences.

This would create a much more efficient and liquid market and would also be consistent with best practice overseas.

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We therefore **recommend** that the Commission consider building on its proposal by considering the following:

- Enable the FTR Provider to:
  - align the FTR hubs with the ASX trading nodes;
  - introduce additional hubs and/or key node FTRs, if and when agreed with participants, both with the initial design and over time.
- Ensure that the FTR product is a simple payment formula based on price differences, with the underlying complexity regarding losses and revenue adequacy resolved in the design, not in payment uncertainty to FTR holders.
- Devolve, as far as possible, FTR and auction design to the FTR Provider and the industry.
- Ensure that the Code is limited to high level principles and objectives and means of achieving the objectives, not detailed FTR design such as precise hub definitions.
- Create certainty by abandoning LRAs as an option for addressing intra-island locational price risk and signalling that limited FTRs will be developed by the FTR Provider in consultation with the market participants.

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### **3. Defining the problem**

#### **3.1 The objective**

The consultation paper has the stated objective to introduce a risk management instrument that:

- enables participants to manage basis price risk caused by transmission constraints;
- assists with competition in the wholesale market;
- reduces barriers to retail entry, such as vertical integration and regionalisation of generation and retail.

We agree with these objectives and suggest they could be enhanced by adding the following:

- ability to evolve and align with developments in the energy hedge/contract market and with other market developments such as scarcity pricing;
- minimal disruption to existing commercial framework by avoiding unnecessary value transfers and distortion to marginal production and consumption signals;
- simplicity, transparency and predictability. The predictability should not necessarily be in price itself, as it is a market, but in the performance of hedging instruments relative to the price.

#### **3.2 The proposed solution**

The consultation paper proposes to introduce a locational hedge that consists of:

- FTRs for locational price risk between a North Island and a South Island hub;
- option and obligation FTRs;
- FTR hub prices set at generator weighted average price for the island;
- revenue inadequacy risk initially borne by the FTR market participants but over time a proportion funded by Transpower;
- a staged approach to addressing locational price risk that first implements inter-island FTRs and then determines whether another instrument is warranted once inter-island FTRs are in place;
- no clear indication of what instrument might be used to manage intra-Island locational price risk should the need arise in the future;
- an allocation of residual rentals and auction income using the current methodology.

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The consultation paper proposes that an FTR Provider be contracted to deliver FTR market services. The role of the FTR Provider would be to:

- design and implement an FTR market which is consistent with design details specified in the Electricity Code, including auction design;
- consult with FTR market participants on the development and evolution of the FTR design;
- report on market performance, assisting the Electricity Authority to meet its market monitoring obligations;
- comply with service requirements set by the contract with the Electricity Authority;
- propose new products and alterations to the FTR design for approval by the Electricity Authority.

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## 4. Analysis of proposed solution

Transpower is pleased that the Commission has proposed to implement a simplified FTR, which is to some extent consistent with the recommendations made by Transpower in its submission to the Commission's consultation paper "Managing Locational Price Risk: Options".

Transpower has concerns about the following areas of the proposal:

- **LRAs have not been abandoned:** The Commission has not abandoned the option of using an alternative allocation of rentals to address intra-island locational price risk at a later date. This leaves open the option of implementing an LRA to address intra-island locational price risk.
- **Incomplete hedging at best:** The use of island hubs with prices set at GWAP (Generation Weighted Average Price) is inconsistent with the energy hedge market nodes set at Benmore and Otahuhu, leaving open the possibility for residual basis risk because energy market participants will not be able to match their energy hedges with a back-to-back FTRs. The use of complex payment adjustments on issued FTRs would further reduce their hedging value.
- **Historical analysis:** The simplified FTR proposed by the Commission is supported by analysis of historical locational price risk. These patterns should not be assumed to be a good predictor of future locational price risk.

### 4.1 LRAs have not been abandoned

For the reasons outlined in section 4 of our submission dated 7 December 2009, LRAs do not meet the objectives for locational price risk management set by the Commission.

Congestion in the grid can be expected to change as participants gain the ability to mitigate locational price risk by purchasing FTRs. Even with increased transmission investment congestion may increase because participants will be able to tolerate congestion if they can hedge against it – this may be more efficient than offering generation to avoid congestion. Congestion should not be seen as inefficient; rather it should be viewed as efficient when supported by efficient dispatch in the presence of a full suite of hedging instruments. (What is inefficient is generators withholding or over-pricing capacity to prevent constraints, a behaviour that FTR ownership removes the incentive for.)

It is therefore important that the locational hedge market be initially designed to preserve the option to evolve to accommodate increased intra-regional locational price risk.

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Transpower does not support LRAs as a credible locational price risk hedge but does support the evolution of the FTR market to include more than two hubs and maybe key nodes.

Transpower **recommends** that the Commission:

1. Explicitly abandon LRAs as an option for managing locational price risk, including intra-regional locational price risk.
2. Send a strong signal to the market that FTRs are the preferred instrument for managing both inter- and intra-island locational price risk provided they are appropriately designed and evolved to support the energy hedge market.
3. Include FTRs as the required option for managing locational price risk in the Electricity Code.

#### **4.2 Incomplete hedging at best**

In our 7 December 2009 submission to the Commission we built the case for an FTR design to support the energy hedge market:

*“To fully hedge locational risk a party must be able to purchase an FTR that matches the capacity, duration and end locations of an energy hedge. Without this it is likely that liquidity and competition in the energy hedge market will not evolve. Liquidity and competition in the energy market are key outcomes sought by the Ministerial Review and the Electricity Commission’s Market Development Programme.”*

The proposed FTR design, based on GWAP hubs in each island, is a good start as it goes some way to reducing inter-island basis risk but it is not a full hedge because:

- it is not aligned to the energy hedge nodes;
- it does not resolve intra-island locational risk; and
- issued FTRs do not have simple, predictable payouts relative to nodal prices observed.

Because there is inconsistency between the locational hedge market and the energy hedge market one could expect conservative behaviour in the energy hedge market, leading to sub-optimal liquidity and reduced competition in the energy market: Why would an energy trader or third party derivatives provider enter into an energy hedge (contract for differences) between two nodes, in the presence of congestion, when it has no control over the price separation between the energy purchase nodes and the FTR hubs, which are not the same? The proposed FTR design assumes that this difference will be small, and without volatility, and supports these assumptions with analysis of historical price differences between GWAP hubs and nodal prices within an island. We do not agree with this assessment and recommend that it would be prudent to align the energy and FTR trading points.

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Figures 16 and Figure 17 (of the Commission's consultation paper) support this argument because they clearly demonstrate volatility in the historical price difference between the South Island GWAP and Benmore and the North Island GWAP and Otahuhu and Benmore. With two Island GWAPS and energy trading between ASX nodes there is no way of adequately hedging the locational price volatility displayed in these two figures.

Transpower has the following comments on the proposed design:

- It would be unwise to assume that historical market behaviour will continue into the future: increased congestion within an island could quickly erode confidence in the proposed FTR design.
- It would be unwise to assume that FTRs between dynamic island GWAPs will, in the longer term, provide adequate confidence to underpin energy hedge purchases between current and future ASX trading nodes. This assumption undermines the objective to develop liquid hedge markets and increased competition: Why would participants seeking long term energy contracts have confidence in an FTR that originates and ends at a different (and constantly changing) point to the energy hedge?
- The implicit assumption that the energy hedge market will align itself with the FTR hubs is speculative. The energy hedge market is facilitated by the ASX, which will cater for the needs of the energy market participants. The FTR market should align itself to support the energy market, not vice versa.

The Commission has taken a particular academic viewpoint in FTR design, resulting in a complicated payment formula for FTRs and a dynamic (continually changing) hub definition. Transpower considers this to be a flawed approach. The approach could be improved by considering what might work best for traders, offering them the product they need, and putting any complexity required to achieve revenue adequacy into the internals of the FTR design, not into the product itself. Transpower is not a trader, but believes that:

- fixed hubs/nodes should be closely aligned with current (and future) energy trading nodes, and
- a simple payment formula should be based directly on locational price differences.

Applying these principles would create a much more efficient and liquid market that would be consistent with best practice overseas.

In FTR design, there is nothing to prevent overlapping hubs. A simple test of whether GWAPs or some other hubs are better would be to allow both, and let the market decide which it preferred to use. It would be much better, in Transpower's view, to allow the market to decide this in the first place.

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There are some important FTR auction design considerations involved in choosing hubs, nodes and the treatment of losses. For example:

- Hubs are weighted collections of nodes. Issues arise when a hub cannot clear against a certain auction grid because, for example, there is a disparity between generation assumptions in the hub definition and reduced grid capacity for the generation.
- Nodes are typically buses. Buses will only clear to their capacity, which might be only a proportion of the region that they nominally represent. A small “hub” of electrically close high voltage busses may be required.
- The treatment of losses in FTRs can adversely affect obtaining an efficient clearing price in the FTR auction.

All these issues are resolvable. The point is that the design of hubs (or nodes) and of losses representation must be done in concert with the auction design. If they preceded it (as in the Commission’s current proposal) the FTR Provider may be constrained in design details, and a sub-optimal product would result. It is important that the FTR Provider, with the industry, define the hubs and loss treatment with other design aspects from an FTR design point of view, as well as from the point of view of trader’s requirements.

Transpower **recommends** that the Commission consider the following:

Enabling the FTR Provider to:

- align the FTR hubs with the ASX trading nodes;
- introduce additional hubs and/or key node FTRs, if and when agreed with participants, both with the initial design and over time.

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### 4.3 Historical analysis

The Electricity Commission can be commended for its thorough analysis of past locational price differences between island GWAP and nodes within the same island and between an island GWAP and the nodal prices in the other island.

The analysis clearly shows that intra-island locational risk has been significant and intra island risk has been small. This is illustrated by the Commission's innovative "heat maps". On the basis of its analysis the Commission concludes that "a large portion" of locational price risk can be managed with a simple 2 hub FTR model. The hubs being in each island with a hub price set at the GWAP for that island. However, Transpower does not agree that historical locational price risk is necessarily an adequate predictor of future locational price risk. We base our view on the fact that market behavior in the current regime is incentivised to minimise locational price risk through vertical integration of generation and retail within unconstrained regions. When FTRs are introduced it is likely that market behaviour will change to maximise the benefits of trading across constraints and hence one could reasonably expect the constraint patterns in the grid to change. The risk is therefore that the Commission's proposal may not be adequate for the needs of the market because additional locational price risk could be introduced through changed market behaviour.

Even if market behaviour does not change, the proposed 2 island GWAP FTR does not remove the volatility of the price difference between the ASX node and the island GWAP (see Figures 16 and 17 of the Commission's consultation paper). It is this volatility that will continue to be of concern to participants and could inhibit the development of liquidity in the energy hedge market.

While Transpower accepts the introduction of a simplified FTR it **recommends** that:

1. it is critical that the initial design recognise and accommodate the potential for a change in market behaviour rather than assume that future behaviour will be consistent with past behaviour;
2. systems and process are put in place to monitor the effectiveness of the FTR regime and to ensure the regime can proactively evolve to meet the changing needs of the market place;
3. the contract with the FTR Provider and the Electricity Code explicitly require evolution of the FTR design as needs justify it.

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## 5. Conclusions

The Commission's proposal undertakes thorough historical analysis to demonstrate that inter-island locational risk has been high and that intra-island locational price risk has been low. Further, analysis shows that in many remote areas price differences are due to predictable losses.

Based on its analysis, the Commission has concluded that a two island hub FTR, priced at island GWAP, will provide the means for eliminating the main source of locational price risk in the electricity market.

Transpower supports the introduction of FTRs and welcomes the Commission's proposal as a good basis for finalising a sound FTR design. We have some reservations that the proposal will not deliver the benefits of increased liquidity in the energy market, increased competition and reduction of barriers for new entry without some refinement.

Our reservations are based on the following:

- the FTR hubs do not align with the ASX energy trading nodes of Benmore and Otahuhu;
- the proposal is not clear about how intra-island locational price risk will be dealt with in the future, leaving open the possibility that LRAs could be introduced at a future date;
- the proposed FTR model is constructed on the assumption that transmission augmentation and unchanging market behaviour will result in reduced transmission congestion.

Transpower concludes that the Commission's proposal is a solid base from which to develop an FTR market for New Zealand and believes that the proposal can be significantly improved with some minor but significant amendments to insure that the proposal is robust to the potential for changing market behaviour and the possibility of incorrect initial assumptions.

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We therefore **recommend** that the Commission consider building on its proposal by considering the following:

- enable the FTR Provider to:
  - align the FTR hubs with the ASX trading nodes;
  - introduce additional hubs and/or key node FTRs, if and when agreed with participants, both with the initial design and over time;
- ensure that the FTR product is a simple payment formula based on price differences, with the underlying complexity regarding losses and revenue adequacy resolved in the design, not in payment uncertainty to FTR holders;
- devolve, as far as possible, FTR and auction design to the FTR Provider and the industry;
- ensure that the Code is limited to high level principles and objectives and means of achieving the objectives, not detailed FTR design such as precise hub definitions or loss representation;
- create certainty by abandoning LRAs as an option for addressing intra-island locational price risk and signalling that limited FTRs will be developed by the FTR Provider in consultation with the market participants.

## Appendix 1. Response to Commission Questions

Question	Answer	General comment
<p>Q 1. <i>Are there any other issues relating to the background, previous analysis and consultations that are relevant to consideration of the Commissions locational price risk management proposal?</i></p>		
<p>Q 2. <i>Do you agree with the apportionment of contributing factors (losses, line constraints &amp; reserve constraints) to locational price risk set out within the paper?</i></p>	<p>Technically yes, but disagree that they are the main issue.</p>	<p>It is true that that nodal prices are affected by loss, thermal and reserve constraints. They are also affected by others, e.g. ramp rate constraints and security constraints, and most importantly participants' bids and offers. The important issue from a trading perspective is that the resultant prices are volatile.</p> <p>The FTR product should have a simple price-difference based payment formula and measures to minimise the risk of revenue inadequacy.</p>
<p>Q 3. <i>Do you agree with the analysis of future locational price risk, and in particular that:</i></p>	<p>No</p>	<p>The basis for our response is that we do not agree with the Commission's assumption that market behaviour will remain constant after energy hedges, FTRs, scarcity prices and other MDP initiatives are implemented.</p> <p>It is our view that, with the introduction of all the initiatives in train, risk in the energy market will change and there is therefore every chance that future locational risk will be different to that which has been</p>

		historically experienced:
<i>a. the predominant source of locational price risk will continue to be inter-island price differences?</i>		We agree that inter-island risk is likely to remain the predominant source of locational price risk but do not agree that intra-island locational risk will not change over time.
<i>b. the volatility of losses has a material effect on inter-island locational price risk? and</i>		Agree.
<i>c. that grid investment should minimise intra-island price risk?</i>		Whilst it could be easy to assume that increased capacity will reduce constraints and therefore locational price risk between islands this does not take into account modified behaviour in the presence of FTRs, scarcity pricing and a superior energy hedge market. Transpower also cautions against the assumption that locational price risk will reduce with increased investment. It is possible that constraints could increase as a result of the introduction of location price risk instruments and this should be acknowledged and accounted for in the design and development of FTRs.
<i>Q 4. Do you agree that locational price risk is, and will continue to be, a serious impediment to retail competition?</i>	Yes	Without the ability to hedge locational price risk associated with an energy hedge, third parties are likely to consider it risky to enter the energy derivatives market. Hedge liquidity may therefore develop more slowly and vertical integration of generation and retail, with constrained regions may continue. Competition may not increase in the New Zealand electricity market as a result of simply introducing the ability to hedge locational price risk only.

<p><i>Q 5. What other issues do you consider are materially impeding retail electricity competition and what priority should be attached to addressing them?</i></p>		<p>In Transpower's view, the major inhibitor to retail competition is the inability to hedge locational price risk. Locational price risk is volatile and unpredictable and hence assumed to be a significant source of uncertainty for investors in generation and retail, particularly new entrants.</p> <p>Management of locational price risk with FTRs is a necessary step but is only one component required to increase competition. Attention must also be given to developing liquidity in the energy hedge market as it is this liquidity that will drive competition and new entry in the future. As the energy hedge market gains liquidity and market needs become more sophisticated the FTR market must evolve. Transpower believes that the Commission and the Electricity Authority must signal a strong commitment to FTRs, both inter- and intra-island, as this will build confidence in the energy market, hence fuelling liquidity.</p>
<p><i>Q 6. Do you agree that locational price risk is a problem that requires a specific locational hedge solution introduced through the Electricity Authority Participation Code?</i></p>	<p>Yes</p>	<p>Given that the locational risk is exactly equivalent to the market settlement surplus (or rental) it is unreasonable to expect that market participants will voluntarily implement a locational hedge market as they have no jurisdiction over rentals. It is imperative that the Commission and the Electricity Authority require a specific locational hedge to be funded by rentals and that the general nature of the hedge is specified in the Code. Transpower supports the introduction of FTRs in the Code.</p>
<p><i>Q 7. Do you agree with the proposal to minimise the amount of detailed specification of the</i></p>	<p>Yes</p>	<p>The key role of the Code should be to specify how rentals should be used in the interests of market efficiency. Transpower believes this should be FTRs. The Code should be based on economic principle rather than be operational in nature.</p>

<p><i>FTR in the Code, and using the FTR service provider contract to manage future development of the product? If not why not?</i></p>		<p>Market participants should be allowed to work with the FTR Service Provider to determine the details of the design, implementation and evolution of the FTR market. should be to assess the FTR design against the requirements of the Code. The role of the Electricity Authority should be to assess the FTR design against the requirements of the Code.</p>
<p><i>Q 8. Do you agree with the locational risk coverage proposed for the inter-island FTR?; and in particular that proposed exclusion of loss costs from coverage will not significantly limit the use of the FTR? If not why not?</i></p>	<p>No</p>	<p>We believe that the proposed design could approach this problem in a much better way. Transpowers suggestion is as follows:</p> <ul style="list-style-type: none"> <li>• the complexity of losses should be treated through good auction design, not via a complex and uncertain payment formula for FTR holders;</li> <li>• the formula should be a simple MW multiplied by price difference payment, with low risk of downwards adjustments;</li> <li>• losses should be allowed for in the auction design.</li> </ul> <p>From an FTR design perspective, how losses are treated can have significant impact on auction clearing prices, and so on the price of FTRs. The precise treatment of losses is best developed in parallel with detailed auction design. Loss treatment should therefore not be prescribed by the Code but rather left to the FTR Provider and Industry to develop.</p> <p>The treatment of losses in the design and the resultant complex and unpredictable payment against FTRs is unnecessary and will detract from the utility of the product as an effective hedge. A much simpler product design based directly on unadjusted locational price differences is preferable and possible (and the international norm). The detailed design could affect auction clearing prices. For all these reasons, the design should not be prescribed in the Code (or the</p>

		contract) beyond broad guidelines but left to the FTR Provider to develop with the industry.
<p><i>Q 9. Do you agree that the proposal for an Inter-island FTR only locational hedge does not limit the design options of a scarcity pricing regime for the electricity market? If not why not?</i></p>		<p>It has not yet been determined whether scarcity pricing will apply at a national, island, regional, or nodal level, or once established whether and how the level of application might evolve over time.</p> <p>Clearly there is a high-level match between an FTR hub in each island and island (or national) scarcity pricing. This is not so for regional or nodal levels of scarcity pricing. The solution to this is to ensure that the FTR hubs and/or nodes can be evolved over time by the FTR Provider and the industry.</p>
<p><i>Q 10. Do you agree or disagree or have any comments on the FTR design details, and in particular on: (a) the proposed use of virtual GWAP hubs rather than nodes?</i></p>		<p>a) Transpower is concerned that the Commission has chosen to propose a pricing basis (island hubs with prices set at GWAP) for FTRs, which is different to that used by the energy hedge market (Haywards and Otahuhu as set by the ASX). In principle, this introduces unnecessary basis risk between energy purchase endpoints and the endpoints of an FTR, creating the potential to undermine the FTR market. Further, Transpower does not agree with the Commission's suggestion to dynamic GWAPs for the hub prices when it is specific nodal prices that energy is traded against. Transpower's proposal to resolve this issue is to allow the FTR provider to:</p> <ul style="list-style-type: none"> <li>• align the FTR hubs with the ASX trading nodes;</li> <li>• Introduce additional hubs and/or key node FTRs, if and when agreed with participants, both with the initial design and over time.</li> </ul>

<p><i>(b) the proposed approach to management of revenue adequacy? and</i></p>		<p>b) While Transpower can understand the temptation to allocate revenue adequacy risk to Transpower as an incentive to offer maximum grid capacity into the FTR market it is not the FTR market that determines Transpower’s revenue requirements and associated service levels.</p> <p>Transpower therefore opposes the Commission’s proposal that, over time, Transpower should fund a proportion of FTR revenue inadequacy attributable to its actions<sup>1</sup>. This is not a cost that the Commerce Commission has contemplated when developing the input methodologies and individual price-quality path determinations that will apply to Transpower under Part 4 of the Commerce Act 1986. Further, Transpower believes it would be inappropriate for the Code to impose this kind of liability of Transpower because:</p> <ul style="list-style-type: none"> <li>i. the liability would effectively be an unlimited civil penalty and it is inappropriate for a liability of that sort to be imposed by super-delegated legislation such as the Code. By comparison, the ancillary service cost allocation provisions required ministerial consent;</li> <li>ii. the basis for Transpower’s liability is described in the consultation paper in vague and potentially subjective terms (i.e. “attributed to its actions”) – attributed by whom and against what criteria? If Transpower could potentially be liable to this penalty when it was otherwise acting in accordance with the Code, this would be inappropriate;</li> <li>iii. if the idea is to base Transpower’s liability on whether or not it has breached the Code then that needs to be dealt with</li> </ul>
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<sup>1</sup> Allocating revenue adequacy risk to the transmission provider has been considered and rejected in overseas jurisdictions.

		through the Rulings Panel process (ref s55(1) of the Electricity Industry Act 2010) and be subject to the limitations and exclusions of liability in the Enforcement Regulations.
<i>(c) the proposal to allocate residual revenue to Transmission customers, based on the TPM?</i>		c) Transpower supports the allocation of residual rentals and auction income using the current loss and constraints excess payments allocation methodology, which is to transmission customers. This limits value transfers. The discussion paper proposes that the apportionment of rentals be performed by the Clearing Manager. In our view, the most efficient approach would be for this function to continue to be performed by Transpower for its customers. The allocation is heavily based on grid topology, which Transpower is most familiar with. The Clearing Manager should pass the FTR auction income and residual rentals to Transpower for onward allocation in accordance with Transpower's prevailing methodology for the distribution of losses and constraint excess payments as specified in clause 45.1 of the default transmission agreement, i.e. in effect maintain the current practice.
<i>Q 11. Do you agree with the view that the inter-island FTR sufficiently concentrates competition for FTRs to limit the ability of Participants to abuse market power? If not why not?</i>	Yes, extremely so.	Transpower believes that there could be a significantly larger number of FTRs hubs and/or nodes without increasing the ability of participants to abuse market power, noting that: <ul style="list-style-type: none"> <li>• The ultimate counter to market power is increased competition, which FTRs are designed to achieve;</li> <li>• FTRs provide an ability for participants to hedge themselves against the abuse of market power by others;</li> <li>• Full transparency on FTR contract information will increase visibility of abuse of market power by FTR holders in the much larger energy market.</li> </ul>

<p>Q 12. Do you agree with the proposal's other means of dealing with the issue of potential abuse of market power? If not why not?</p>	<p>Yes</p>	
<p>Q 13. Do you agree that the market monitoring regime should include full transparency of the FTR contract information? If not why not?</p>	<p>Yes</p>	
<p>Q 14. Do you agree with the proposed role of the FTR service provider in developing the locational hedge over time? If not why not?</p>	<p>Yes, but the role should be expanded</p>	<p>The role of the FTR service provider should be expanded to include the initial and future hub design and how losses are treated in FTR design. The regulator should not prescribe these operational details.</p>
<p>Q 15. Do you agree with the proposal to not charge a fee for provision of FTR services, but to fund those cost through the Electricity Industry Levy? If not why not?</p>		
<p>Q 16. Do you agree with the results of the cost-benefit and qualitative analyses undertaken by the Commission? And if</p>		

<i>not why not?</i>		
<p><i>Q 17. Do you agree with the content of the risk analysis undertaken by the Commission and the conclusion that the proposal includes sufficient strategies to manage the risks involved? If not why not?</i></p>		
<p><i>Q 18. Do you agree that the proposed Inter-island FTR is the best immediate solution for the New Zealand market, and in particular that it:</i></p>	<p>With refinements as recommended, yes.</p>	<p>Transpower supports FTRs as a solution and compliments the Commission on its efforts to simplify the FTR model as much as possible. However, we feel the solution is oversimplified and some big assumptions with regard to future market behaviour have been made. As an insurance policy, Transpower suggests that the Electricity Authority consider the possibility that future market behaviour may not be reflected by past behaviour and that basis risk is more likely to increase rather than decrease in the future. To mitigate the risk of increased rather than decreased future basis risk Transpower suggests that the Authority seriously consider enhancing its proposal by allowing the FTR Provider to:</p> <ul style="list-style-type: none"> <li>• align the FTR hubs with the ASX trading nodes;</li> <li>• introduce additional hubs and/or key node FTRs, if and when agreed with participants, both with the initial design and over time.</li> </ul>

<p><i>(a) will significantly contribute to improved retail electricity competition?</i></p>		<p>Transpower is confident that the proposal is likely to go a long way to resolving inter-island location price risk. However, for the reasons outlined above, Transpower is concerned that the Commission's proposal will not have the impact on retail competition that is anticipated because the FTR design is not aligned with the energy hedge market. Further, Transpower remains concerned that intra-island locational price risk may become an issue and would like to see the Commission send a strong signal that it will be resolved with FTRs if necessary.</p>
<p><i>(b) fits well with energy hedge market developments? and</i></p>		<p>We disagree that the proposal fits well with energy hedge market developments for the simple reason that FTR hub prices (GWAP) are not aligned with ASX nodes. Transpower recommends allowing the FTR Provider to align the FTR hubs with the ASX nodes as outlined in the response to Q10 above.</p>
<p><i>(c) could be readily adapted to future possible needs of the market?</i></p>		<p>Transpower agrees that the proposal could be readily modified for future market needs but strongly recommends that the initial FTR design aligns with the ASX nodes or signals the intention to allow multiple hubs or key nodes so that market participants can align their FTR purchases with the energy hedges.</p>