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| Report |
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| Prepared For: |
| Trustpower |

GTAC Comments

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The TLG team and network of affiliates provide expert economic and commercial consulting services to businesses and governments throughout the Asia Pacific region. We have deep expertise in the energy and infrastructure sectors, in regulatory economics and competition, and in commercial opportunity assessment.

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# REview of Draft GTAC[[1]](#footnote-1)

## Overview

I have been asked to comment on aspects of the Revised Draft Gas Transmission Access Code (GTAC), particularly those pertaining to Priority Rights and how the proposed GTAC provisions affect competition and sit with the overall Gas Act and Government Policy Statement objectives.

Recognising that I come a bit late into a discussion already quite advanced, it seems best to turn that into an advantage by offering a fresh look at what clearly has involved a lot of close-in work under a tight timetable.

Usually, when complexity meets brevity (even the sort of “relative brevity” that involves prolonged effort over more than 18 months), the main risk is that of unintended consequences or overlooked detail. In my review, therefore, I’ve focussed mainly on areas where unintended consequences seem both likely and material.

Most notably, this orientation has led me to focus on the Priority Rights scheme.

## General Context

The concept of a priority right is not without merit. At some point on virtually any network there can be a need to ration network capacity, and it is helpful to have a basis with which to implement that rationing most efficiently. Also, the idea that some might value firm access more than others is well established. Furthermore, the idea these preferences and likelihoods may vary over time as development occurs or stuff happens is not unreasonable.

Yet, the details of the proposed Priority Rights regime are insufficiently clear and, being idiosyncratic to New Zealand, without obvious precedent on which to draw comforting inferences or insights. Consequently, it will (and should) take time to evaluate. It may also mean that a different mechanism is needed or that material changes are advised. At least some are suggested below. But, most importantly, more time is needed than current schedules anticipate, as there is no way in a few short months to close the gap between good intention and robust solution while also avoiding unintended consequences.

## Bespoke, Unique, and Unfinished

The proposed Priority Rights (PR) regime takes a different approach to that found in most other gas markets that provide some form of firm access. Firstly, the proposed PR regime does not provide firm access to anyone, anywhere, at any time. PRs only provide some vague quality of priority. PRs are more of a commitment-free promise to try harder, rather than the sort of commercially enforceable contract for firm service that comes with penalties should the service be non-firm, in fact. Is the NZ regulatory environment so remiss, the associated technical challenges so daunting, or First Gas’ business acumen so poor that anything better than such a commitment-less promise to try hard is simply out of the question?

This alone makes it difficult to put the PR regime into context, internationally, or to draw on experience elsewhere as to what exactly to expect.

The inability or unwillingness to offer firm access implies an unwillingness or inability to provide the information necessary with which users make the most efficient decisions concerning usage and investment. Without risk of penalties, First Gas holds all the cards and has an incomplete set of incentives. First Gas surely has all the same information that other high-pressure gas transmission companies have, and that, from which, those other companies manage to be offer a *firm* service. Hence the dilemma. Is the proposed PR regime a novel solution to some crucially challenging or costly problem, or is it just half a loaf? I don’t think I’m alone in reaching this view at this stage. Users will find it challenging to value PRs or to make decisions about future gas usage or investments that might modify that usage or possibly about locations in which to invest.

Why, exactly, can a firm service not be offered?

Is the problem the risk that compensation would need to be paid? If so, then is this a regulatory design failure or a market design failure that should be resolved in a different forum or with different arguments before a PR regime is, in fact, launched into the wild? Or is it that First Gas has no confidence that, having provided firm capacity, it can actually manage the resulting outcomes – potentially through mechanisms or offers to “buyback capacity” in the event it sold too much of it? Or is it that First Gas is so risk averse or, as yet, relatively inexperienced in dealing with congestion (not a criticism) that it does not yet know how much firm capacity it really can or should offer – or how it would be to manage around any such offering – so better to offer something that is merely just, sort of, firm-like, but not really firm in fact?

These questions are important – and apologies if some have been answered – because if First Gas is not (or cannot be) confident that mechanisms exist by which capacity previously sold as “firm” can be bought back at some price, then is this not suggesting that a “priority” rights auctions or associated “trading” may not work effectively either? The whole rubric would appear to depend critically on no one being able to know or value precisely what rights they actually have. As long as rights are mere suggestions, then complex commercial issues of value and responsibility can be set aside if and as necessary, on any day that they would otherwise have been expected to be important.

So, it is fair to ask the question: To what extent can it be (or has it been) determined that the PR regime is the solution that best fits (whatever is) the problem?

## Contextual Information is Lacking

One area that merits more attention is the nature of information that will be made available about PRs, why they exist, how their numbers were determined, and what future developments will influence them. The GTAC has scant details. There appears limited information about the PR regime itself, except the ambiguous definition of PRs and the lack of transparency as to how they are (to be) determined, that suggests that First Gas has any incentive to provide the sort of information that gas users need to optimise the value of gas use in New Zealand.

For example, suppose First Gas changes the allocation rights available at a location or imposing them in a new location. Will it be sufficiently clear what has changed (or how much)? Or for what purpose and for whose benefit? And within First Gas’ regulated revenue cap, will there be sufficient incentive to propose and justify the necessary capital investment steps truly as fast as possible? And will the PR regime itself truly provide the type of better information that could assist in expediting approvals based on value to users? As far as I can tell, all or most of these questions are not easily answered. At least with the public information available to date.

And if the number of PRs for a location is kept lower out of concern for “hoarding”, does this not also raise the prospect that the price for the now potentially “scarcer” actual PRs could be higher? And if eventually additional PRs are released, do we not just have a situation where PRs have a more volatile value? At minimum, it seems some analysis of the nature of PR “exposure” in each identified zone would be important to settling whether any competition concerns exist. And, because the PR regime would be “new”, one might consider borrowing from experience in markets that introduce new competitive mechanisms during periods of relative tightness and start with a set of grandfathered or transitional PRs so that the wealth-transfer and potential competitiveness issues that can arise when replacing prior ambiguity with crystallised scarcity are more clearly managed until everyone gains experience with the arrangements and, in fact, sees some nexus between congestion and some combination of demand or investment response.

## Can my firmness be firmer than your firmness?

The PR regime appears to make no use of *preferences* for firmness. For example, does someone willing to pay *more* for their PRs have any way to assure a *higher* priority than the default PR priority? Or is it simply assumed that all PRs are equal and that it’s all or nothing, not shades of grey? The problem with an all or nothing approach in which firm service is nevertheless not assured, is that it provides only the most limited information with which to actually satisfy user preferences for degrees of firmness. It neither provides firmness nor makes use of differentiation. If I can’t have absolute firmness, can I at least have the sort of firmness that means I get cut off only just before the hospitals do? (Just to exaggerate for the sake of the point).

The whole PR regime would seem to be better designed more in the spirit of an operational merit order guide, in which it is the value of firmness preferred by each tranche that is the most useful information that could be made available to First Gas. The key is surely to ensure operational consistency with the underlying contingency management regulations (as I discuss further below).

Alternatively, if the issue is one of managing congestion – and assuming sufficient advance knowledge – a buy-back bulletin board in which First Gas posts a dynamic price to buy back firm capacity and escalates the offered price (or starting at a maximum price and de-escalating the price in a reverse auction) it until it has secured enough reduction would seem to be more likely to be pro-competitive. The competition to provide reduction at least can come from almost anyone, in contrast to a single-price clearing auction for sell PRs where the clearing price can be dramatically influenced if competition is limited, and especially if hoarding turns out to be a profitable strategy for raising rivals’ costs or otherwise discouraging entry.

If the concern is that congestion events can happen faster than they can be dynamically managed, then the same buyback schema can be kept updated as evolving call-off orders. In any event, it is not clear why there would be any operational difference between maintaining such a “dial-down” arrangement and implementing a priority rights scheme which, by intention, provides an analogous priority not-dial-down list but without the same rich information content.

To look at this issue a bit more specifically, the price of a PRs in a zone would be set by the lowest offered bid that clears the level of PRs that are available in the zone. But, does this mean that **all** PRs are then “equally” prioritised? What if the problem itself is the *number* of PRs awarded?

What if First Gas gets it wrong?

First, suppose First Gas issues too many PRs. This should not be too far-fetched a scenario if there is a fair bit of diversity affecting gas flows in a location. There is clearly a probabilistic aspect to determining the firm capacity of a pipeline given a set of customers with various characteristics. At least with a “firm” product one can take an economic stance about how certain one needs to be that a given level of firm rights can be issued and that the probability of not being able to serve them is less than some acceptable level.

But with a “priority” right, there is not similar rigorous definition. Is there? What approach and level of Type 1 and Type 2 error would be inherent in First Gas’ assessment of the need for Priority Rights? Isn’t it more likely that First Gas is incentivised to be too conservative in determining the number of PRs available? Only a conservatively set number of PRs can reasonably comfortably be assumed to have the “same” Priority without need for any pecking order.

Or perhaps the more likely scenario in which First Gas issues too few PRs. Does First Gas have an appropriate incentive to issue the *optimal* number of PRs, or does First Gas only see downside risk for itself if it gets the number of PRs too high, but not if it gets the number too low? Or are there other reasons for conservatism that need to be understood and probed further, such as whether some PRs should be held back, or distributed differently, just in case, or to assure more competitive access by somehow managing to limit hoarding. I understand these issues are being given some attention, which is good. But limiting the number of PRs below what could actually be accommodated on the system does not enhance competition, but merely creates artificial scarcity. In any event, as I noted above, if there really is concern about competitive impacts of PRs allocations or access at a location, then we have a bigger problem, and the PR regime, as currently configured, does not solve it.

Ultimately the adopted approach should ensure that First Gas has the incentive or obligation to optimise the value of the pipeline *to its users.* Might this require a different regulatory treatment? There is necessarily a nexus between regulation, incentives, and the intensity of various behaviours, including, what can reasonably be expected of First Gas. It may be that this is an area where there is misalignment (or could be) in respect of what is sought to be achieved through the PR regime and what First Gas is most incentivised to provide.

To optimise the pipeline to users requires that any access regime clearly define capacity and all that goes with it (recognising that “capacity” has a fixed technical meaning, but the allocation of capacity access rights has a probabilistic implementation). And that, the most likely optimal approach would be to concentrate mechanisms or buying back capacity if in fact too much capacity has been issued. And finally, that to avoid or mitigate any anticompetitive aspects when introducing such a change as being contemplated, that any critical locations be clearly identified and some form of grandfathering or transitional mechanism be put in place for such time as is required for (a) everyone to understand how the system actually works; and (b) for everyone to see the nexus between congestion and eventual demand-side or supply-side (investment) response.

## Why Do the Proposed Priority Rights Contravene *Priority RIGHTS?*

The above discussion is really at a relatively high level of abstraction and focusses on the entire gas system and all of the users. But there is a further set of issues that concern the relatively small amount of gas that is transported on behalf of “Band 6” and “Band 7” users. These issues are independent of the above discussion, as even if a transitional or grandfathering approach were adopted, the inelastic and special characteristics of mass market and critical care users and would continue to be the most challenging (and most exposed to any gaming of PR pricing or access) in terms of making the PR regime work efficiently.

A Contingency Management regime already exists, but the proposed Priority Rights (PR) regime ignores it, a situation that is odd on its face, unnecessary in fact, and not aligned with economic efficiency in any obvious way. The result is that there is a risk that Band 6 or 7 customers could be curtailed under a PR regime and face excess costs, but not under a Contingency Management regime.

Customers in Band 6 and 7 under the Contingency Management regulations are deemed to have maximum priority. Indeed, there’s not much else to say other than the proposed PR regime forces some customers (or their retailers) to figure out how to ensure they keep when they are already supposed to have.

It’s not clear what valid purpose is served in this case whereby PRs run potentially counter to the contingency management regulations, as one would expect (want) there to be a consistent relationship between expectations and outcomes under the PR regime (soft landing) and under the contingency management regime (hard landing). It’s not hard to anticipate the politicised consequences of any error in determining PR allocations that leave Band 6 or 7 customers exposed. Humans and complex systems make errors. Why tempt fate? Is a situation in which a retailer failed (or was unable) to secure enough PRs for Band 6 or 7 customers thus putting First Gas into a decidedly awkward position something that First Gas really wants to experience? “It’s not my fault” may be cheeky, it might even be true, but it can be terrible business and political management.

Besides that, it’s not even good economics. One presumes the reason for Band 6 and 7 customers having *de jure* priority is that they vote, have limited ability to respond and their disaggregated diverse nature make it difficult and excessively expensive to coordinate and control. Lower volume use makes it more challenging (and probably uneconomic) to invest in automated controls at each location, and so in reality, for congestion management, there seems little, technical, commercial, economic, or institutional that can be done.

Besides that, Band 6 and 7 usage is very, very small, in the context of system transported volumes.

Elsewhere it is not at all uncommon that domestic customers have priority rights. Power generation in New England (USA) switches to imported LNG if needed in the winter time as residential gas use has absolute priority on the pipeline system. India, which used to prioritise fertilizer, linked to food supply, has switched to prioritising domestic gas use as well as its economy has developed. Just to give some sense of the commonality of prioritisation of domestic gas access. In all cases the presumption and reality to date is that domestic consumption is not responsive to price in the short-term. The main drivers for domestic customers are electricity to gas switching (or vice versa) for cooking and heating, and these decisions involve time frames that are much longer than the proposed 6 monthly PR regime.

A simple solution is almost certainly the best solution: assign PRs by default to Band 6 and 7 volumes (or at the very minimum assign PRs based on an assessment of legacy Band 6 and 7 volumes that can reasonably constitute a baseline). A default PR position is consistent with the points made previously of focussing the value of mechanisms and signals on managing increments and decrements, rather than putting the whole demand in play each period.

Put differently, what matters in economics is how best to elucidate the relative value placed on firmness *by users in the other Bands*.

## Why Can’t (at least some) PRs be Longer Term (at least Initially)?

The whole PR regime is quite short-term in nature, but it is difficult to imagine that the sort of situations that might give rise to emerging scarcity value are equally short-term. Reliance on 6 monthly PRs seems to favour increased transactions and risk management costs without corresponding gain. It may also be easier to try a strategy of periodically disrupting PR pricing or availability knowing that the cost of doing so is just for a 6-month time frame. A new entrant might be discouraged if it is unable to secure long-term rights and believes that PR pricing is or could be volatile for reasons unrelated to fundamental supply and demand conditions.

The determination and reliance for some period of time on legacy rights may also reduce risk of gaming (or at least the financial consequences) as users only have to procure their incremental requirements, and not be exposed for their entire preferred priority rights volumes. If it is determined to move over time to some clean sheet of paper status whereby there are no “legacy” users, then one can just as easily transition to such a status by starting with, say, 100% legacy rights, which decline 5% each period until they hit some threshold whereby they either stay or go completely. Such an approach would initiate with competition only for increments and decrements and end with (eventually) competition for full tranches of capacity.

Most likely a concern is that there may not be sufficient competition for PRs or that there may be strategies to hoard PRs. But if so, then doing this every six months does not achieve a whole lot more than doing it every year. There is a cost to administering the auction and participating in it (a cost that First Gas would charge back to users). Such costs should be optimised, and it is not clear this has been done. It is more likely that a 6-monthly design is the product of concerns over competition and other aspects but that these may be better resolved through other changes or approaches.

## How do PRs work with Planning and Investment and Regulation?

Money is paid to access PRs. Where does it go? What does it signal? This money constitutes a vote of sorts for the quality of firmness, which at some point, becomes a scarce resource about which investment decisions must be made. So presumably PRs are to assist in signalling value. But this has not been vetted or explained or given any particular or useful context as to how it interacts or influences or justified capacity expansion planning or associated cost-recovery. If PRs are to be tied to firmness, and ultimately to prioritisation of firming investments, then the connection should be clear, practical, and robust. The regime must be more than recycling the money collected and offering an effective discount to those who take a lower level of priority.

Consider that the conditions under which PRs can become valuable are not necessarily fully within the control or influence of those who pay for them. Expansion of distribution systems will naturally lead to increasing demand in different parts of the transmission network which can then can create or accelerated the eventual appearance of congestion. In that sense, First Gas as a distributor (as well as other distributors) can take actions that ultimately create the need for PRs (or raise the value of PRs) to be sold.

But this also means that the cost of congestion *caused* by expansion of distribution networks is expressly socialised across all customers in the zone. Is this the acknowledged and accepted regulatory deal? Or is the deal more in the nature that causers are supposed to pay? In this case I can merely acknowledge pros and cons to both bookend approaches, as socialisation shifts the maximum to “innocent” customers and the pure causer-pays approach can undermine socially optimal investment if the distribution companies are not properly incentivised to take growth-related risks.[[2]](#footnote-2) But at least it should be very clear and accepted (and it is entirely fine if it already is) that the PR regime is a full-blooded socialisation-of-congestion costs scheme. In some ways, it is an incentive for distribution expansion, which will increase the frequency, depth, and duration of congestion in the transmission system by location over time.

By the same token, should congestion due to distribution network expansion occur for which PRs become valuable, the presumption is that such events could have been projected through simulations – in the same way that the zones for PR relevance are designated. *So at least some articulation between distribution expansion and transmission congestion is merited, if only to signal and perhaps trigger approval of, the cross-over impacts before they actually occur or rise above some materiality threshold.* A clearer understanding of what investment would be required to restore or increase firmness would also be useful in such contexts.

## A potentially useful alternative perspective

Any problem that First Gas might perceive should it have to use an auction to determine what it (as First Gas) should pay for “less firmness” is the flip side of a problem that could arise using an auction to determine how much users would pay for PRs. So, it is a useful lens through which to evaluate the auction design, the extent of competition within the auction process, and the possible issues that can arise.

Personally, though, I’m leaning towards an auction to decrement firmness, as I think the competitiveness issues are much easier to resolve. I suspect First Gas’ concerns would mainly be about the potential cost to be paid out and then collected. These are all relatively straightforward issues for further investigation and design, however, provided time is available to do a prudent job.

## Auction Process is Not Clear

From the GTAC draft it appears that the auction for PRs is to clear at the lowest price of a tranche of PRs the clears the PRs available at a location. That can introduce some interesting dynamics depending on the level of competition in each location and possibly on the characteristics of the participants.

### Dynamics Uncertain

It would surely be prudent to advance the design to the stage of some meaningful simulations or trials ahead of committing formally to what is currently described using a very few words. How susceptible would pricing be to small changes in the number of PRs offered by First Gas (such as a situation where First Gas holds some PRs back or where First Gas does not willingly test the limits of what capacity could be offered)? How costly would it be for some parties to hoard PRs at a location even if only for 6 months, and thereby influence the cost of competitors?

The use of more frequent auctions may assist in more efficient price discovery / risk management, or it may assist in easier gaming. At this point it seems too early to say.

### Auction Success Factors

The essential success factors for an auction to be efficient (and not merely to conclude with a “sold” declaration) include the following:

* The “thing” being auctioned is well defined and fit for purpose.
* With respect to PRs, it is clear that there is still some ways to go to clearly define what a PR is and how it is to work and how it is to be applied in the event of a problem for which a PR is a solution;
* It is further clear that there is a line between a PR and a contingency that is not well defined, as surely a PR should allow modification of priorities for curtailment during a contingency, as that would both enhance value of PRs and give more meaning to “firmness” as an attribute
* Why not auction decrements to Firm Capacity, rather than total numbers of Priority Rights?
* The auction approach is fit for context
* Design best to achieve efficient price discovery
* Assurance of adequate competition
* Definition of zones and whether and how these might change over time
* Auction to buy unallocated PRs or auction to retain PRs?
* Staggering auctions or use of PR strips to avoid value bunching?
* Why only six-month PRs?
* What is the role or need of a reservation price?[[3]](#footnote-3)
* Integration of auction with trading regime
* Do all PRs expire at same time, in which case trading is just within a 6-month period?
* Or is there staggering which might allow some trading to occur across an auction, which might enhance competition and price discovery?
* How is the PR regime integrated with decisions about congestion relief?
* Is the auction the best way to identify a curtailment merit order?
* And is a non-firm six-monthly PR the best instrument on which to guide potential prioritisation of investment decisions?

## Will the Information Necessary to Make Efficient Decisions Be Made Available?

Presumably when determining that PRs are appropriate for a zone, there is some modelling of some scenarios using some assumptions that result in some projected degree of congestion necessitating some likelihood that PRs will have value. All of this should be made available.

## Summary

The PR regime is some combination of unfinished, unclear, and unusual. It needs more time to resolve the many questions it raises. Even if some have been answered, it is not clear the answers are widely known or understood. Most, however, I suspect have not been answered yet.

The idea of a PR regime is not without merit. As noted, some basis for operational management of congestion is needed. So too is some basis for more efficient long-term capacity investment decision-making.

The most problematic aspects of the PR regime concern why exactly it needs to be as it has been proposed. At least three key enhancements merit attention:

* Band 6 and 7 users should have default PRs as there is no reason to expose them to risks that cannot be managed, particularly in a regime that is novel, new, and potentially prone to teething issues or competition risks;
* In fact, the question could be turned on its head and start with the presumption of firm access and then design the PR regime as a Priority Reduction regime to surrender firm rights for a period. As the price paid to gain flexibility increases, it provides both clear operational and investment signalling – much more clearly than can be inferred from the PR regime at this point;
* The linkage between distribution expansion and transmission network congestion should be as clear as possible as there are embedded assumptions that may not have been fully vetted or considered in terms of who pays.

Furthermore, more information should be provided in terms of the definition of “firmness”, the basis for the determination of numbers of PRs in each location, and the implications for competition and competitive dynamics within whatever auction framework is adopted (whether for Priority Rights or Priority Reductions).

A few other summary observations:

* Risk mitigation would plausibly force small-customer serving retailers to secure PRs in competition with others. Of course, there is nothing necessarily wrong with competition, but given the diversity of customers and retailers, and the possibility, even if small, that PRs could be hoarded, gamed, or otherwise competitively weaponised, then it compromises what could otherwise be a simple platform for competition.
* It is not clear how smaller customers can manage risk associated with not having PRs, as this segment is notoriously insensitive to the need to curtail without a major communications effort or government involvement, so for a retailer to just ignore the PR arrangements and hope that everything turns out to be a critical contingency seems imprudent, if not foolhardy. Consequently, PRs will have to be secured.
* PRs are not long-term instruments and so represent a continuing business risk and cost to manage, introducing an uncertainty that would be more easily catered for via default PRs and a clear cost allocation (tariff) regime.
* It remains unclear how exactly PRs work in practice, which means that if anything does go wrong with their pricing or implementation or market dynamics, the most inelastic demander of firm service will bear the brunt of an “learning process”.

The workings of a PR mechanism are like a capacity auction, but without a variable underlying “energy” price or congestion price to go with it. So, the idea of a PR is that it establishes a preference, but not any protection against a price increase (so it is more difficult to value) and no clear protection against congestion beyond what can be inferred from the number of PRs transacted. There’s no integration of “energy” and “capacity” pricing and no similar firm contract mechanism. The PR proposal is indeed something unusual and bespoke, which makes it especially difficult to assess in a limited time frame.

No doubt some stakeholders will like an ambiguous PR mechanism. Those that are already most exposed to critical contingency can only improve their lot in life with PRs. And larger retailers with highly diverse customer bases may have some advantage in securing and managing PRs, especially if they have some customers that they can work with to manage demand and thus have better knowledge of how likely congestion could, in fact, ripple through to affect Band 6 or 7 customers. But that just means that PRs can be better for those who are larger or can cross-subsidise their exposure from time to time. That’s hardly a basis for claiming competition is enhanced.

And it is likely that these same advantages at least for truly flexible customers can be more robustly achieved with fewer competition or complexity issues with the changes to the PR regime as discussed above.

Trustpower’s admonition: “More Haste, Less Speed” seems spot on.

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2. All customers may benefit from expansion if it means better utilization of the network. Consequently, a *beneficiary* pays approach can result in much better overall outcomes that differ from both pure socialization and a pure causer pays approach, though it is more nuanced and can be quantitatively more challenging. [↑](#footnote-ref-2)
3. Not clear why there would need to be a reservation price. If the auction does not clear all PRs then that does not mean that bids for PRs can’t still be valid as a basis for differentiating curtailment risk exposure. It does not seem to be a situation where somehow it is “bad” to sell a PR, in fact, for a low price if that is the value placed by users at a location. [↑](#footnote-ref-3)