

Electricity Authority
Market Development Advisory Group

By email: MDAG@ea.govt.nz

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Cross Submission on Discussion Paper – High Standard of Trading Conduct Provisions: A Review by the Market Development Advisory Group

Mercury appreciates the opportunity to cross-submit on the Market Development Advisory Group's (MDAG) review of the High Standard of Trading Conduct (HSOTC) provisions within the Electricity Industry Participation Code (the Code). We list below what we see as common themes across the submissions received by MDAG on the discussion paper and further below we elaborate on some more specific issues raised.

Based on the submissions received our views remain unchanged from those expressed in our original submission – we do not support MDAG's proposal proceeding in the current form.

1 Common issues raised in submissions

1.1 Imposing a form of price regulation

The clear view of the generators who have submitted to MDAG is that the proposal will create a form of price regulation despite the lack of a regulatory case for it (Contact, Meridian, Genesis, Trustpower). The Joint Independent Retailer submission (JIR) however suggests this is not the case and that it "...is not a reasonable or accurate representation of the MDAG proposals." The JIR submission also says that an "...onus should be placed on generators to be able to justify and explain their pricing." Mercury's view is that being forced to publicly justify and explain pricing is essentially a form of price regulation.

Contrary to the starting position of market power in the generation market, as the JIR submission seems to assume, and that market power being problematic, we agree with Contact that the wholesale market is fundamentally competitive. Part 4 of the Commerce Act, or a de facto version of it, cannot apply to a fundamentally competitive market.

As noted by Sapere, markets which have little or no competition may be regulated by Part 4 of the Commerce Act provided there had been an extensive investigation into whether the benefits [of Part 4 regulation] would exceed the costs and several other procedural checkpoints fulfilled. MDAG's proposal adds an equivalent regulated price reference into the wholesale electricity market without the analysis of (a) whether market power was a problem; (b) if market power was a problem, whether it was being exercised with negative consequences for other participants; (c) if the benefits of a regulated intervention would outweigh the costs of the intervention; and (d) whether as robust of a process was followed as would be required for a regulated industry.

In Mercury's view, MDAG appears to assert there may be periods in the current market where parties may hold market power, which then justifies regulating offer behaviour. The only material analysis appears to focus on the 2016 Meridian case, but there are no legal decisions or challenges for that case to set any precedent. We would caution MDAG from moving too quickly ahead with its proposal as it may ask the Authority to recommend a Code change outside the Authority's legal remit.

1.2 Legal implementation and development of case law

Genesis, Meridian, Contact and Trustpower all point out the lack of clarity inherent in the proposal. This lack of clarity is particularly concerning for traders who need to operate with the Code in real time under dynamic market conditions. These submitters, along with Mercury, own and/or offer the majority of generation in New Zealand. The submissions also query MDAG's logic of having clarity provided over time through legal challenge and the development of case law. It is not an effective pillar of regulatory design to say clarity for an opaque piece of regulation will come through the legal system. Arguably this same criticism applies to the current HSOTC regime, but there is no reason to carry forward that lack of clarity to a new standard. While the legal challenge process can refine and clarify certain aspects of a regulation, affected parties must have some reasonable understanding of how to comply.



Costly litigation, should it be required to clarify MDAG's proposal, will ultimately come at the expense of end consumers. Mercury does not support adding upward cost pressure to end consumers, particularly given the current economic situation.

1.3 Impact on market offers

Though MDAG reasonably wants to ensure efficient price outcomes, as Contact points out it is the marginal generator which sets the price in each offer period. Mercury suggests this demonstrates the scope of the proposal being too wide – it applies to all offers in all periods rather than specific periods of concern. Meridian also notes this may result in gaming by plant near the margin as traders will attempt to be (or not be) marginal for various reasons. This could have a detrimental impact on market outcomes.

MDAG's proposal may incentivise traders to make 'set and forget' offers, as mentioned for example by Meridian. We also mentioned this in our initial submission and caution again that this may perversely result in outcomes for end consumers which are worse than the status quo, particularly if generators take a view that the efficient cost of water is higher than what typical must-run offers are based on at present.

Electric Kiwi and Haast recommend MDAG look at removing the \$0 price floor for offers. Mercury disagrees with this. Even when a hydro generator has an excess supply of fuel it is constrained by generation capacity and resource consent constraints in the quantity it may offer to the market. Running water through turbines will always have a non-zero marginal cost, if only in the form of short-run labour and a depreciation allocation. MDAG's proposal does not require generators to run plant at an economic loss.

1.4 Problem definition and scope

Contact, Meridian, Genesis and Trustpower all suggest in their submissions that MDAG's solution does not seem to align with the initial problem definition.

Mercury agrees with these views. It is not clear from the paper how MDAG arrived at a solution covering all offers in all periods when it initially set out to analyse the effectiveness of the HSOTC provisions, which only covered pivotal periods. This does not seem like a solution commensurate with the problem originally identified and lends the proposal to risk of regulatory failure due to unforeseen issues. Mercury encourages MDAG to consider if there is a case for refocusing its proposal on pivotal periods only.

1.5 Defining what are economically efficient offers and lobbying

We agree with Contact who points out the EA is likely to struggle enforcing MDAG's proposal due to the potential divergent views in the industry on what constitutes reasonable "economic costs" or efficient outcomes. As soon as the EA issues a decision relating to MDAG's proposed clause, it would be susceptible to legal challenge. At the very least, any regulatory decision made regarding what was or was not economically efficient would effectively lock the market into a new status quo in terms of what was deemed acceptably efficient by the regulator. It is not clear whether that new environment would be an improvement on the current HSOTC provisions for end consumers.

Evans and Meade (XYZ)¹ discuss attempts to model marginal costs of production using "direct analysis". This type of analysis tries to calculate a marginal cost of production of a price-setting generator by building a hypothetical competitive market and comparing outcomes to that hypothetical. MDAG's proposal is likely to require the EA to conduct this type of "bidding analysis" modelling whenever a claim is made that prices are not economically efficient. Evans and Meade also say this type of bidding analysis is not suitable due to "...major difficulties surrounding the measurement of the marginal cost of reservoir generation..." and the reduction of "...the market into a single location – a simplification that could underestimate the simulated competitive price by ignoring inter-nodal constraints and transmission losses."

Mercury welcomes additional analysis on this issue from MDAG and the EA.

1.6 Process must include consultation by Electricity Authority

We agree with the point made by Trustpower in its submission where it says "affected parties have the right to have their views heard directly by the decision-maker" regarding the need for the EA to consult directly with the industry as well as the current consultation being run by MDAG.

In addition to the procedural point made above, parties such as Meridian and the Independent Retailers propose making amendments to the draft Code prepared by MDAG. This suggests the need for further consultation regardless of whether the EA wishes to expedite the overall process so that others can consider any drafting amendments.

¹ Evans and Meade (2005), "Alternating Current or Counter-revolution? Contemporary Electricity Reform in New Zealand", Victoria University Press



1.7 Insufficient cost-benefit analysis and inadequate consideration of alternative options

Genesis, Trustpower and Meridian all submit on the need for a more robust cost benefit analysis. Mercury agrees with these submitters and also refers back to our original submission which stated that, rather than the proposal being costless (as assumed by MDAG), there were likely to be significant costs in terms of dynamic efficiency, retail competition and hedging costs. These other submissions, along with the evidence from Sapere, highlight potential costs which have not been taken into account by MDAG. It would not be advisable for the EA to proceed with a Code change without carrying out a more robust scrutiny of MDAG's proposal as disagreements on cost benefit analyses have caused issues for the EA in the past, for example through the TPM workstream.

2 Other issues raised in submissions

2.1 Monitoring and enforcement are key for compliance of any proposal

While Mercury agrees with those submitters who state monitoring and enforcement² are key for compliance with Code requirements, the EA should not look to recruit "...a much larger, well-resourced and pro-active Compliance Team" as suggested by Haast and Electric Kiwi. The HSOTC provisions are a principles-based requirement, an accounting parallel would be to rely on International Financial Reporting Standards (IFRS) when preparing accounting statements. Our view of MDAG's proposal is to replace a principles-based requirement with a rules-based requirement in the Code. Again, applying the accounting analogy, this is akin to adopting a system such as US Generally Accepted Accounting Principles (US GAAP).

A core aspect of principles-based standards is that observers and participants of the same event may come to entirely different views on whether that event was consistent with the underlying principle. A rules-based standard on the other hand tries to eliminate ambiguity, through stating correct and incorrect ways to operate. While each approach has its benefits and weaknesses the core challenge with a rules-based approach is that it incentivises participants to identify loopholes rather than focus on behaviour. This explains the global convergence in accounting to IFRS. While the desire to create specific black and white rules is apparent, the generality of a principles-based approach provides a better long-term outcome.

Mercury accepts there are aspects of the Code which require a rules-based approach but does not consider this is the most effective way to moderate trading incentives. Clarity on principle-based approaches is provided by regulatory guidance or is developed over time as traders modify their strategies in response to cases being tested through legal channels. These are what has been absent from the existing HSOTC provisions. A large staff of compliance experts is not required to provide this clarity, however this may be the case under a rules-based approach which would add costs to the proposal (and which are not currently modelled by MDAG).

2.2 Independent retailer claims of generators and retailers abusing market power

The JIR submission claims that "...problems of market power in the wholesale electricity market can result in heightened market power problems in the retail market." Leaving aside our disagreement on market power issues in the wholesale market, these are unfounded claims about the retail market in New Zealand. Mercury's view of the retail sector is that it is one of the most competitive markets in New Zealand (if not the world) with dozens of competing retailers, high rates of customer switching and ease of entry and exit.

2.3 Independent retailer claims that generator concentration demonstrates market power

The JIR submission suggests there are issues with concentration in the wholesale market and that this demonstrates the existence of substantial market power. Mercury disagrees with this view and notes there is no basis for this claim. Concentration statistics are not a regulatory requirement under the Code or any other relevant law in New Zealand governing the wholesale market. These measures also do little to assess what an optimal industry structure might be and whether the status quo meets, exceeds or falls short of that ideal state. Even if a measure of concentration did demonstrate some degree of market power, and it could be demonstrated this was having negative long term outcomes for consumers (neither of which is supported on the current analysis), economic literature does not necessarily support intervention. For example, Dupuy (2006)³ says:

"...market power mitigation should not be pursued at all costs. It is unlikely to be practical or feasible to eliminate *all* scope for market power. For example, additional transmission capacity can help promote competition, but this benefit should be balanced against the cost of construction and maintenance."

² Such as the Joint Independent Retailers submission and the Haast/Electric Kiwi submission

³ Max Dupuy (2006), "Electricity generation: Competition, Market Power and Investment", Policy Perspectives Paper for NZ Treasury, <https://treasury.govt.nz/publications/ppp/electricity-generation-competition-market-power-and-investment-pp-06-04-html#section-1>



In addition, it is important to avoid introducing new distortions to incentives for investment, for example by treating all price spikes as undesirable. The international literature suggests that, in some markets, prices do not spike *high enough* to support optimal investment.”

Dupuy also mentions that concentration measures of market power can mislead due to the effect of transmission constraints, which “effectively change the size of the market by limiting the amount of competition at various locations on the network.”

While Mercury accepts concentration statistics can often give an further insight into current market conditions, they are unlikely to be sufficient in isolation to assess impacts of market power.

3 Conclusion

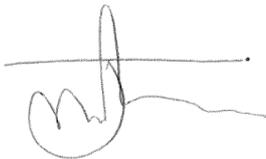
For the reasons outline above, and those mentioned in our original submission, Mercury does not support the implementation of MDAG’s proposal. Mercury does not agree with the implementation of a cost-based economic test as a trading conduct standard and we also do not agree with the MDAG that its proposal would come at negligible cost.

Despite the primarily negative response to MDAG’s paper, should the EA still decide to proceed with the proposal, as a minimum additional analysis is needed for participants so they can understand what would constitute acceptable trading conduct. Relying on costly litigation to provide this clarity is not a satisfactory arrangement for traders operating in real time. This analysis may be carried out by MDAG, but we would also support additional consultation from the EA as the key decision maker in this process, including a more comprehensive cost-benefit analysis

It would be worth seeing if the EA agreed the proposal’s costs would be negligible, particularly as we see a risk for the Authority to be placed in the untenable position of having to assess whether prices reflected economic costs for each trading period. It may become subject of intense lobbying to alter wholesale market outcomes and at minimum require additional staffing cost.

If you have any questions on this submission please direct them to John Bright, Regulatory Strategist at john.bright@mercury.co.nz.

Yours sincerely,



Nick Wilson
Manager Regulatory and Government Affairs



John Bright
Regulatory Strategist

