



27 May 2020

Cross-submissions  
Market Development Advisory Group  
Electricity Authority

By email: [MDAG@ea.govt.nz](mailto:MDAG@ea.govt.nz)

**MDAG review of the high standard of trading conduct provisions:  
Cross-submission**

Meridian appreciates the opportunity to provide a cross-submission following the first round of consultation on the Market Development Advisory Group (**MDAG**) review of the high standard of trading conduct (**HSOTC**) provisions in Part 13 of the Electricity Industry Participation Code 2010 (**Code**). This cross-submission should be read together with Meridian's primary submission to MDAG dated 4 May 2020.

Meridian's position remains unchanged from that expressed in the first round of submissions. As a reminder, Meridian considers the current HSOTC provisions to be unworkable and agrees that there is a need for change. We are pleased to see that many submitters are aligned in this respect. Meridian also tentatively supports MDAG's proposed option of a counterfactual test so that offers must be consistent with offers that the generator or ancillary service agent would have made where no generator or ancillary service agent could exercise significant market power. That tentative support is conditional on:

- Several changes being made to the drafting. Most importantly, Meridian does not support the "purpose statement" that is proposed to accompany the test. We think the "purpose statement" increases uncertainty, misapplies the Authority's statutory objective, contains several errors or omissions, and risks significant unintended consequences.

- A full cost benefit analysis of the proposal as part of consultation by the Authority. We believe the cost benefit analysis prepared by MDAG is inadequate and that regulatory change of this potential significance should be assessed and consulted on by the Authority, rather than the work of MDAG simply being rubber stamped.

We have treated this cross-submission as an opportunity to summarise areas of common ground with other submitters and to address a few key areas of disagreement. This cross-submission is structured under the following headings:

- Submitters agree workable competition should be the basis of any rule
- Submitters are unsure how the proposed rule would be interpreted
- Submissions confirm the risk of price regulation
- There is widespread concern about potential unintended consequences
- Submissions on the 26 March 2011 UTS are not relevant in this context
- Further analysis and consultation by the Authority is required.

### **Submitters agree workable competition should be the basis of any rule**

All submitters broadly agree that the concept of workable competition should be the basis for any new trading conduct provisions. For example, Electric Kiwi and Haast support trading conduct rules which promote the long-term benefit of consumers in the electricity industry by promoting outcomes consistent with outcomes produced in workably competitive markets.<sup>1</sup> The joint independent retailers' submission similarly seeks to align the drafting of the rule more tightly to the concept of workable competition.<sup>2</sup>

Meridian agrees with the Trustpower and Genesis submissions in that “we strongly caution MDAG against moving away from the concept of workable competition”<sup>3</sup> and that by rejecting workable competition as the underlying basis, “MDAG's current proposal is inconsistent with the statutory objective of the Authority under the Electricity Industry Act, and therefore will be open to legal challenge if it is included in the Code. In particular, MDAG's proposed standard compares a party's offers to a hypothetical counterfactual that assumes a strongly competitive market where there is sufficient rivalry between sellers to push offer prices close to their associated efficient costs.”<sup>4</sup>

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<sup>1</sup> Haast and Electric Kiwi *MDAG Submission* 30 April 2020, page 3.

<sup>2</sup> For example: Joint Independent Retailers *MDAG Submission* 30 April 2020, pages 2 and 3.

<sup>3</sup> Trustpower *MDAG Submission* 4 May 2020, Appendix 1.

<sup>4</sup> Genesis *MDAG Submission* 4 May 2020, paragraph 14.

As a reminder, the Authority's own interpretation of its statutory objective states:<sup>5</sup>

"The Authority interprets *competition* to mean *workable or effective competition* ..."

"The Authority interprets *promoting competition* to mean exercising its functions to facilitate or encourage stronger competition. The Authority is not focussed on the conduct of individual participants with respect to competition in the electricity industry as this is the responsibility of the Commerce Commission. Rather the Authority is focussed on improving the arrangements in the electricity industry to promote competition. Promoting competition does not mean achieving a certain level of competition."

"In regard to *long-term benefit*, the Authority considers that its primary focus is to promote dynamic efficiency in the electricity industry, which includes taking into account long-term opportunities and incentives for efficient entry, exit, investment and innovation in the electricity industry, by both suppliers and consumers..."

Any trading conduct rule that was based on a measure of costs rather than workable competition would not *promote* competition as is required by the Authority's statutory objective but would seek to impose a specific state of competition (strong competition in MDAG's opinion and assessed by a static snapshot in time rather than as a dynamic process), meaning that regulation would become a substitute for the competitive process.

Like many other submitters, Meridian encourages the MDAG and Authority to consider the consistency of the proposal with the Authority's statutory objective and what improvements might better align the proposal with the concept of workable competition.

### **Submitters are unsure how the proposed rule would be interpreted**

Most submitters are unsure how the MDAG proposal would be interpreted and operate in practice. While it will always be the role of the Rulings Panel and Courts to enforce the Code, as a general principle of public policy it is not good practice to implement a rule which no one understands. We agree with Genesis that "it is poor regulatory practice to draft amendments that will produce material industry uncertainty on the basis that they can subsequently be clarified by the courts."<sup>6</sup>

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<sup>5</sup> <https://www.ea.govt.nz/dmsdocument/9494-interpretation-of-the-authoritys-statutory-objective-february-2011>.

<sup>6</sup> Genesis *MDAG Submission* 4 May 2020, paragraph 28.

Trustpower and Contact similarly note that:

“As it stands, we think MDAG is optimistic about the prospects that the new test is clearer.”<sup>7</sup>

“For any change to be beneficial, the Authority must provide participants with an increased level of certainty and clear guidelines on what constitutes acceptable market conduct.”<sup>8</sup>

Like Genesis, Meridian considers the source of much uncertainty to be the proposed “purpose statement” and we agree that despite being presented as a purpose statement there is considerable uncertainty and risk that rather than a counterfactual test, the proposed rule is interpreted as requiring:<sup>9</sup>

“..that offers not exceed (for too much or too long) the associated "economic costs" of generation ... A standard that allows the regulator to determine an allowable offer price based on its assessment of associated economic costs effectively imports a price control type standard on a competitive market.”

### **Submissions confirm the risk of price regulation**

The joint independent retailers’ submission and the submission from Haast and Electric Kiwi confirm that some parties want the trading conduct rules to deliver price control regulation for the wholesale spot market. Both submissions seek to build into the proposed rule a focus on outcomes (rather than the process of rivalry), specifically the “earning by firms of normal rates of return, and the existence of prices that reflect such normal rates of return.”<sup>10</sup> These submissions appear to suggest the imposition of regulated or normalised rates of return for generators, like the requirements of Part 4 of the Commerce Act in respect of natural monopolies.

Independent retailers dispute that the MDAG proposal would be a form of price regulation. Their submissions instead suggest that the rule is similar to the Human Rights Act and that

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<sup>7</sup> Trustpower *MDAG Submission* 4 May 2020, Appendix 1.

<sup>8</sup> Contact *MDAG Submission* 4 May 2020, page 2.

<sup>9</sup> Genesis, *MDAG Submission* 4 May 2020, paragraph 7.

<sup>10</sup> See: Joint Independent Retailers *MDAG Submission* 30 April 2020, page 8; Haast and Electric Kiwi *MDAG Submission* 30 April 2020, page 2.

it should require generators to “provide an ‘objective justification’ for their offer pricing to demonstrate what they are doing is not an attempt to exploit their position in the market or to distort competitive dynamics.”<sup>11</sup> Rather than clarify anything this submission adds to the uncertainty of the proposed rule, which according to independent retailers could seemingly be read as either:

- a counterfactual test – as in proposed subclauses 13.5A(1) and (2); or
- a test of whether offers exceed economic costs by too much or for too long – as in the “purpose statement” of proposed subclauses 13.5A(3); or
- a test requiring generators to provide an objective justification for offers – as suggested by independent retailers.<sup>12</sup>

Each of the above tests would have different implications for the wholesale market and Meridian considers it critical that MDAG and the Authority decide what form the test takes and state that unequivocally in proposed Code. As it stands, with the inclusion of the “purpose statement” there is considerable risk that the test might evolve to effectively be price regulation requiring all offers to be compared to economic costs. It is not only Meridian that has identified this risk. Contact has stated that:<sup>13</sup>

“The proposed 13.5A(3) Code provisions mandate specific market outcomes which are usually a feature of regulated markets. Regulation in this way can impact the ability of a market to function properly over time.”

Trustpower has also noted:<sup>14</sup>

“The paper says that the test it has formulated derives from the *Wellington International Airport (WIA)* case. This context is very different, however. In the WIA case, a decision had already been made that regulated suppliers were to receive a return of their efficient costs. The exercise was merely to work out the level of those costs.”

Genesis has stated that:<sup>15</sup>

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<sup>11</sup> Joint Independent Retailers *MDAG Submission* 30 April 2020, page 3.

<sup>12</sup> Independent retailers would also layer on top of this confusion all the problems identified by MDAG with the current HSOTC provision, which they would retain in addition to the MDAG proposal.

<sup>13</sup> Contact *MDAG Submission* 4 May 2020, page 1.

<sup>14</sup> Trustpower *MDAG Submission* 4 May 2020, Appendix 1.

<sup>15</sup> Genesis *MDAG Submission* 4 May 2020, paragraphs 9 to 11.

“...the discussion of workably competitive markets in the *Wellington Airport* case must be considered in its proper context. It does not provide a sound (if any) basis to inform the regulation of offer conduct in the wholesale electricity market. Part 4 of the Commerce Act regulates monopolies, and requires the regulator to promote outcomes consistent with outcomes in workably competitive markets. The High Court was therefore grappling with the task of assessing whether the applicable regulatory rules, as applied to monopolies, would generate outcomes consistent with workably competitive markets.”

“As the proposal is currently formulated, we do not see that ascertaining "economic costs" in a workably competitive market would be any easier than the task under Part 4.”

Finally, Mercury too has stated that:<sup>16</sup>

“If implemented, the Authority would potentially be placed in the untenable position of having to assess for each trading period whether prices reflected economic costs with a sufficient margin to ensure new capacity is built and security of supply is maintained.”

“...a shift toward economic cost-based market power test would have similar effects of undermining the efficient price discovery process which was the foundation of the shift toward the competitive market from government control. The net effect of the MDAG proposal would therefore be to introduce de facto price regulation on the wholesale market and could have a chilling effect on capital flows into generation investment over the long term. The EA would also come under intense pressure to revise market prices from parties who stood to benefit from any revisions.”

We consider there a very real risk that the proposal as currently formulated, particularly with the inclusion of the “purpose statement” will over time become a form of price regulation and result in a range of unintended consequences as noted below. MDAG and the Authority need to be alive to this risk in drafting the proposed Code. There is clearly broad support amongst all major generator-retailers for abandoning a cost-based test, or at least the perception created by the “purpose statement” that a cost-based test might be required.

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<sup>16</sup> Mercury *MDAG Submission* 4 May 2020, pages 1 and 3.

## **There is widespread concern about potential unintended consequences**

As was noted in Meridian's initial submission, if the proposed "purpose statement" is retained and colours the interpretation of subclauses (1) and (2) by the Rulings Panel and courts, there is a high risk of adverse and unintended consequences. Many of these unintended consequences are discussed in the report by Sapere Research Group appended to Meridian's initial submission.

Other submitters are similarly concerned about the potential for unintended consequences. For example, Contact notes the potential for "pressure on the Authority to assess lower economic costs, with the consequential negative impact on dynamic market efficiency and further investment".<sup>17</sup> Contact also states they are concerned the "amount of (often commercially sensitive) information that goes into the price discovery process would make it impossible for any regulator to calculate 'economic cost' accurately."<sup>18</sup>

In a similar vein, Genesis expresses concern that an economic cost basis for all offers would prevent generators from taking a portfolio wide view, drive higher locational price differences, and cause some generator retailers to cease competing in regions without generation.<sup>19</sup> Mercury notes that this would run contrary to the Authority's statutory objective to promote competition and is also concerned that the economic cost basis of the MDAG proposal may not allow for the hydraulic management of integrated river chains where frequent shifts in offers are often required to adjust generation levels to avoid spill and to ensure adherence to consented flow requirements.<sup>20</sup> Many submitters also note that the proposal threatens the dynamic price discovery function of the market, for example:

"...when faced with the uncertainty and risk of having to justify every trading offer, the most likely outcome will be that wholesale market traders will tend toward "set-and-forget" offer strategies which may under or over price electricity during peak and off-peak periods. This would reduce dynamic price signals to both supply and demand side participants over time."<sup>21</sup>

The risk of unintended consequences would also be far greater if the suggestions of independent retailers are given credence. Independent retailers propose that the existing

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<sup>17</sup> Contact *MDAG Submission* 4 May 2020, page 1.

<sup>18</sup> Contact *MDAG Submission* 4 May 2020, page 2.

<sup>19</sup> Genesis *MDAG Submission* 4 May 2020, paragraphs 43 – 46.

<sup>20</sup> Mercury *MDAG Submission* 4 May 2020, page 3.

<sup>21</sup> Mercury *MDAG Submission* 4 May 2020, page 3.

HSOTC provision be retained, meaning all the problems with the status quo identified by MDAG would be perpetuated while adding to those problems the uncertainty and risks introduced by the proposed rule. Independent retailers also seek to draft the new rule so that it would be applied as strictly as possible, for example so that “significant” market power is effectively “any” market power no matter how insignificant or short term. The position of independent retailers seems to be that wholesale spot prices should be driven as low as possible by whatever means possible. Meridian encourages independent retailers, MDAG, and the Authority to also consider the longer-term impact on consumers if a trading conduct rule creates significant market distortions that affect:

- the efficient operation of generators;
- the price discovery function of the market; and
- generation investment decisions; and
- security of supply over the long-term.

The Electricity Price Review found that “wholesale prices have moved broadly in line with the cost of adding more capacity”.<sup>22</sup> Regulation that upsets this market equilibrium by lowering wholesale prices below the costs of new entry in the long-term would eventually have to be repealed or other steps taken to prop up investment in generation if security of supply concerns are to be avoided.

### **Submissions on the 26 March 2011 UTS are not relevant in this context**

Meridian and Powershop comments from the 26 March 2011 UTS investigation have been selectively quoted in the submission from Haast and Electric Kiwi, in an attempt to make the Meridian position appear inconsistent over time. More recent submissions have been ignored by Haast and Electric Kiwi and they have gone all the way back to 2011 to try and find statements that fit their narrative.

It is worth reminding MDAG and submitters of the different contexts for the 2011 UTS investigation and the current MDAG proposal. In 2011 the Authority found that a UTS developed on 26 March 2011 because the events on that day threatened, or may have threatened, trading on the wholesale market for electricity and would be likely to have precluded the maintenance of orderly trading or proper settlement of trades. The event could not satisfactorily be resolved by any other mechanism available under the Code and at the time there were no trading conduct provisions in the Code. The Authority gave as

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<sup>22</sup> Electricity Price Review Hikohiko Te Uira *First Report* 30 August 2018, page 32.

reasons for the decision that Genesis offers set the market prices for Hamilton and regions north of Hamilton at around \$20,000 during trading periods 22 to 35, during a transmission outage. As a remedy for the UTS the Authority reset offers at Huntly to \$3,000/MWh and recalculated final prices.

In the context of the 2011 UTS, it was abundantly clear from a number of market indicators that confidence in the market had been shaken and that the Authority should recalculate final prices. The question then for submitters like Meridian was how, following the finding of a UTS, prices should be recalculated over the relevant fourteen trading periods. The Authority was considering adjusting Huntly offers to reflect the cost of new entrant diesel generation or demand response at around \$3,000/MWh. Meridian considered this too high and that resetting of offers to \$3,000/MWh would still reward Genesis' behaviour.

In 2011 Meridian was not commenting on the dividing line between acceptable and unacceptable offers in general (it was clear in 2011 that confidence in the market had been shaken), nor was Meridian commenting generally on if or how offers should be regulated – only fourteen trading periods were in question. In fact, several key lines from Meridian's submissions in 2011 are deliberately overlooked by Haast and Electric Kiwi. For example:<sup>23</sup>

“Meridian is concerned that the Authority should not, in the context of a UTS investigation, attempt to either:

- (a) prescriptively describe the boundary between acceptable and unacceptable offers: it is enough to state that the 26 March situation was clearly across the line; or
- (b) set prices at what the Authority considers the “right” level.”

Meridian's submissions from 2011 clearly stated that a UTS investigation is not the best place to have a policy debate about how generators should offer, rather Meridian sought a pragmatic approach in the 2011 UTS, for example stating that:<sup>24</sup>

“Some may see the methodology [proposed by the Authority for setting final prices] as amounting to the introduction of a transient market power mitigation regime. In Meridian's view, such complex issues should be dealt with through detailed analysis

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<sup>23</sup> Meridian *Submission on draft decisions regarding alleged UTS on 26 March 2011* 13 May 2011, paragraph 4.

<sup>24</sup> Meridian *Submission on draft decisions regarding alleged UTS on 26 March 2011* 13 May 2011, paragraphs 18 and 19.

and a considered consultation process, rather than in the context of a UTS investigation.”

In 2011 Meridian stressed the need for a full policy process and consultation on whether Code reform was necessary to introduce new trading conduct rules, but in the meantime Meridian advocated for a pragmatic normalisation of prices in a way that did not set a price cap or otherwise regulate offer prices.<sup>25</sup> This is consistent with Meridian’s submission on the current MDAG proposal.

### **Further analysis and consultation by the Authority is required**

Given the lack of any agreement on the MDAG proposal and the considerable risks identified with the proposal, it is vital that the Authority undertake its own analysis and consultation rather than merely rubber stamp the work of the MDAG.

We agree with the sentiments of Trustpower that:<sup>26</sup>

“Affected parties have the right to have their views heard directly by the decision-maker. We strongly suggest a full consultation process by the EA should be undertaken ...”

We also agree that the relatively high-level cost benefit analysis “might be satisfactory for a minor, insignificant Code change, however, ... it is not adequate in this instance as the proposed change is far from inconsequential. It will potentially impact a number of generators and could be interpreted as a significant change to the underlying wholesale market design in New Zealand, particularly if arrangements akin to price controls are introduced.”<sup>27</sup>

Other submitters like Genesis share the same concerns with the suggestion that this proposal could proceed to a Code change without the usual consultation process<sup>28</sup> and that a full cost benefit analysis must be undertaken to quantify the potentially significant costs to market participants and consumers.<sup>29</sup> Meridian strongly agrees.

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<sup>25</sup> See for example Meridian *Submission on proposed actions regarding 26 March 2011 UTS* 21 June 2011, paragraph 5.

<sup>26</sup> Trustpower *MDAG Submission* 4 May 2020, Appendix 1.

<sup>27</sup> Trustpower *MDAG Submission* 4 May 2020, Appendix 1.

<sup>28</sup> Genesis *MDAG Submission* 4 May 2020, page 2.

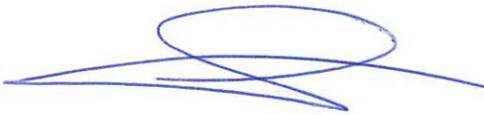
<sup>29</sup> Genesis *MDAG Submission* 4 May 2020, paragraphs 54 to 56.

The idea that the Authority could jump from an MDAG discussion paper to final Code changes without further consultation is troubling in the case of fundamental wholesale market changes that could have a significant impact on the operation of the market and long-term costs to consumers. Surely the Authority has a responsibility to articulate, publish and consult on its own views regarding the issues with the HSOTC provisions and a preferred way forward rather than effectively delegate decision making functions to an advisory group.

Meridian again urges the Authority to follow due process and carry out its own consultation and analysis in respect of this potential change to the Code. Not doing so would contradict the intent of the Electricity Industry Act as well as the Authority's own foundation document – the Consultation Charter. It would also risk over-inflating the importance of advisory group membership and drive the industry participants that are fortunate enough to be represented on advisory groups towards more partisan participation. This would be a poor outcome.

Please contact me if you have any queries regarding this cross-submission.

Yours sincerely



Sam Fleming  
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