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Dear Tony,

TRUSTPOWER'S CROSS SUBMISSION ON HIGH STANDARD OF TRADING CONDUCT (HSOTC) CODE CHANGE PROPOSAL

1. Introduction

In our primary submission on the HSOTC code change proposal, we submitted that we think that further work needs to be done before the Market Development Advisory Group (**MDAG**) makes a recommendation to the Electricity Authority (**the Authority**) in response to its terms of reference on the above matter.

This additional work includes:

- the development of case studies to demonstrate how the proposed no significant market power (**NSMP**) offer rules might apply "at the trading desk" to see if, in fact, they will provide a "clearer standard" than the current HSOTC rules;
- a new cost benefit analysis (**CBA**) which addresses the risk that, although well-intentioned, the NSMP offer rules increase regulatory uncertainty and risk and have other unintended consequences; and
- consideration of whether it would be more consistent with the Authority's statutory objective to delete the conduct provisions altogether and rely on the many other methods of managing market power in the current legislative framework.

We have now reviewed the submissions filed by other industry participants and believe that collectively these submissions provide strong evidence of the need for this further work.

2. Development of case studies

Regulatory uncertainty confirmed

Submitters have very different views on what conduct is, or should be, captured by MDAG's NSMP offer rules. This suggests that we are not yet at the point that we can confidently say that the new proposal is a "clearer standard".

For example the non-integrated retailers are of the view that:

...generators should be able to demonstrate their offer pricing is not an attempt to exploit their position in the market or to distort competitive dynamics...¹

...transient market power constitutes significant market power...²

...significant market power is a lower threshold than substantial degree of market power...³

...workably competitive outcomes occur when prices in the half hourly market reflect "normal rates of return" (set by reference to precedents from monopoly regulation)...⁴

In contrast, the integrated generator-retailers have variously submitted that:

Abuse of significant market power is not demonstrated by a short-term ability to raise prices above, or drop prices below, competitive levels. Conversely, this is a necessary feature of workably competitive markets⁵

Prices, which other participants consider high, is not the problem which needs addressing... the market by design allows uncapped prices... periods of limited competition are a feature of a competitive market...workably competitive markets are those which deliver efficient outcomes for the long-term benefit of consumers over time ...whether efficient outcomes are being delivered cannot be measured by a "snapshot" comparison of prices and costs...⁶

The question for regulators is at what point does a firm have 'too much' market power, exercised for 'too long' so that competition is no longer workable. It is this point at which 'acceptable market power' becomes 'too much market power', which is the same as saying the point at which the market becomes 'not workably competitive'⁷

We do not think that these matters can be left to chance or the working out of claims, investigations, Rulings Panel decisions and judicial review hearings. George Yarrow has relevantly commented:

In the UK the notion of outcomes-based regulation became a popular theme for a while, but the meaning of the expression tended to be rather variable and uncertain. And if the concepts that regulators use are variable and uncertain, that will likely transmit itself through into variability (arbitrariness) and uncertainty of decisions...⁸

We agree. We are also concerned that where the rules are not clear, the co-location of rule-making and rule-enforcement function in the Authority creates an opportunity for policy resets to occur through enforcement action rather than the more usual means. For this reason we urge MDAG to develop a proposal which will enable businesses like ourselves to have a reasonable understanding of how the NSMP offer rules will be applied. We are not at this point yet.

Contact has pointed out:

The interpretation and assessment of 'economic costs' is crucial. Participants would need to be confident ex ante as to how the Authority would determine 'economic costs' otherwise the uncertainty of not knowing how the parameters of the new proposal will be applied or developed ... will delay innovation and investment.

Furthermore, calculation of the true economic cost is highly subjective and any analysis will result in different conclusions and different interpretations of opportunity costs, selection bias and choosing particular data to produce a desired result.

Offers made in real time based on the then available information, and while participants are also managing operational complexities may fail to pass a retrospective assessment by the Authority despite the parties legitimate reasons for making an offer at the time the offer was made.⁹

Genesis submitted that:

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

¹ Joint Independent Retailers submission at page 3

² Ibid at page 4

³ Ibid at page 4

⁴ Ibid at page 5

⁵ Contact submission at page 2

⁶ Genesis's submission at page 5-6

⁷ Meridian's submission at page 5

⁸ G Yarrow *Questions relating to the regulation of fibre fixed line access services (FFLAS) in New Zealand* at page 5

https://comcom.govt.nz/data/assets/pdf_file/0022/161941/Yarrow-for-Chorus-submission-Fibre-emerging-views-Questions-relating-to-the-regulation-of-FFLAS-in-NZ-report.pdf

⁹ Contact submission at pages 2-3

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.

The Court arrived at the relatively simple proposition that if rules were set so that monopolies could only set prices to recover efficient costs (including a normal return), then this would produce outcomes consistent with workably competitive markets. However as demonstrated by the multiple years of Commerce Commission consultation, and the 1,000-page High Court judgement, ascertaining "efficient costs" that would be produced in a workably competitive market is a tremendously complex exercise.¹⁰

Case studies are part of the solution

Within this context, we think case studies will be a valuable 'first step' towards the management of these regulatory certainty issues. Other submitters share this view.

Mercury submitted that:

...as a minimum a series of worked examples should be urgently developed which lay out how the proposed Code would be interpreted by the Rulings Panel (and Courts) so that those participants who will be most affected by the proposed Code change can gain a better understanding of the intent of the Code;¹¹

Genesis said:

...it had recent first hand experience of ambiguous regulation which has meant it strongly supports taking the opportunity to ensure any ambiguity is addressed and adequate certainty is provided for the benefit of all concerned¹²:

Contact was of the view that:

For any change to be beneficial, participants will need an increased level of certainty and clear guidelines on what constitutes acceptable market conduct;¹³

And Meridian has said that:

...further guidance on the expected application of the counterfactual test would be beneficial to generators and ancillary service agents. Costly litigation to resolve uncertainty is not helpful and if the MDAG or Authority thinks there are examples of behaviour that would be clearly prohibited then it would be good to know. Meridian suggests that the Authority develop and publish various real-world examples to work through how the behavioural prohibition would be applied and the sorts of things the Rulings Panel or courts would likely consider¹⁴

Case studies will also reveal if the different views amongst industry participants about the trading conduct, which is sought to be prohibited, can be resolved by application of principles to specific facts, or can never be reconciled as the different views are based on preferences for fundamentally different market designs.

Genesis have alluded to this risk in their submission:

MDAG highlights that "smaller or non-integrated parties may have greater difficulty in managing spot price risk and in buying hedge cover on acceptable terms". Genesis considers that this is a disadvantage faced by participants who choose a particular business model, and is balanced by the advantages these models have in other areas. It is therefore not a problem that regulation should seek to solve.¹⁵

If it is the latter, then the need for a clearer standard is magnified if the industry is to avoid costly litigation and disputes.

¹⁰ Genesis submission at page 4

¹¹ Mercury submission at page 1

¹² Genesis submission at page 2

¹³ Contact submission at page 2

¹⁴ Meridian submission at page 7

¹⁵ Genesis submission at page 11

3. New quantitative cost benefit analysis

Trustpower is a strong advocate of the use of robust quantitative CBAs to test and evaluate different reform options.

We think that the process of comparing options by CBA gives a good insight into the core characteristics of the elements of a proposal which drive desirable outcomes and those which either have negligible effect or create a risk of regulatory failure. This in turn can support the refinement of the preferred option or selection of a more tractable option. The discipline of developing a robust CBA also provides a useful safeguard against confirmation bias.

We note the non-integrated retailers, are either broadly satisfied with MDAG's high level CBA or believe it understates the benefits, because they think generator -consumer wealth transfers should be taken into account as the Authority has in its cost benefit analysis for its proposed reform of the transmission pricing methodology (TPM)¹⁶. Trustpower disagrees that transfers should be counted as efficiency benefits. We have made a number of submissions in the TPM process on why transfers are not relevant to efficiency gains and are happy to make our expert reports available to MDAG if that would be helpful.

Putting that issue aside, we note a number of the submitters have not agreed with MDAG's view that the costs of introducing the NSMP offer rules are expected to be negligible. These matters require further investigation.

Cost of compliance understated

Submitters consider MDAG have underestimated the costs of compliance (for both industry and the Authority) associated with this proposal.

Contact said:

Under the current proposal it is likely the number of alleged breaches will increase significantly, which in turn will drive increasing costs incurred by the Authority and participants for compliance, researching the large volume of information that goes into the price discovery process, pursuing and responding to the alleged breaches.¹⁷

Genesis said:

Broadening the scope of the regulations as proposed will, in our view, almost certainly result in an increase in the number of breaches alleged. These allegations will need to be evaluated regardless of their merit, and could potentially proceed to investigations despite resting on tenuous grounds.¹⁸

And Mercury said:

The Authority would come under intense pressure to revise market prices from parties who stood to benefit from any revisions. Mercury observes this type of vexatious behaviour is becoming an increasing feature of the existing market and would only become exacerbated under the MDAG proposal.¹⁹

Other impacts need evaluation

Submitters also referred to wider adverse effects that need to be evaluated including loss of retail competition, higher energy/reliability costs and loss of investment and innovation incentives. For example, Meridian's submission refers to the expert advice from Sapere on the additional work required to assess the costs and benefits of the proposal and comments that MDAG:

...does not assess how its proposals might distort price discovery (distortion is unavoidable if a regulator is to alter market prices). Such an assessment is necessary so that the economic cost of these distortions can be compared against the benefits expected.

also does not assess whether significant market power has been exercised, or is a problem, in the wholesale electricity market and therefore the potential benefits of its proposal are

¹⁶ Haast & Electric Kiwi at page 13

¹⁷ Contact submission at page 4

¹⁸ Genesis submission at page 10-11

¹⁹ Mercury submission at page 3

*unknown. Attempts by the MDAG to quantify costs and benefits are based on theoretical assumptions about pricing in pivotal situations with an assumed frequency of pivotal supplier situations, not based on real evidence that significant market power has been exercised and has cost consumers in the long term.*²⁰

Likewise, Mercury said that the costs of the proposal (assuming its effect is to prohibit generators from using physical assets close to transmission constraints to manage downside risks) include:

Loss of retail competition as the market does not provide sufficient risk management products to manage these high impact low probability risks;

Higher costs associated with both high hedge prices for this type of event and from the over signalling the need for new generation and transmission investment;

Reduction in dynamic efficiency as parties adopt “set and forget” offer strategies rather than engage in the price discovery process to avoid the uncertainty and risk of having to justify every trading offer; and

*Risks relating to uncertainty about how the new offer rules affect the hydraulic management of integrated river systems.*²¹;

Genesis also query if it will promote long term affordability if the rules restrict a generator’s ability to take a portfolio-wide view of its economic cost of generation.

Taking a portfolio-wide view of generation cost ‘smooths’ offers over time, and lessens the likelihood of extreme high prices at given locations. Indeed, a generator’s view of the future value of a unit of fuel/generation will naturally be informed by the alternatives available within its portfolio, in a similar way to how judgements are made on whether to generate oneself or buy from the market.

*MDAG’s proposal, as drafted, could have the perverse outcome of extremely high prices during a smaller number of trading periods as generators attempt to recover costs on a plant-by-plant basis.*²²

Genesis went on to note that the proposed Code change:

...has potentially significant implications for market participants, well beyond the intention of preventing the exercise of unfettered market power where this exists. Therefore we consider it is right for a proper CBA to be conducted that attempts to quantify the impacts of the proposal.

The proposal underestimates the countervailing (potentially greater) cost of generators offering at inefficiently low prices, due to the uncertainty associated with falling foul of the too much, too long standard as set out earlier.

These costs are two-fold. There is the immediate cost of foregone revenue as a result of offering at below an efficient level, and the longer-term cost of inefficiently delayed generation investment because the market is not sending the appropriate price signals. The cost of the associated increase in risks to security is impossible to quantify, but could reasonably be expected to be significant.

These submissions reinforce our view that a new CBA needs to be completed to establish, not just that the proposal is better than the status quo, but also that it is better than the other options to promote effective wholesale market competition (should there be a finding that this does not presently occur).

4. Removal of HSOTC provisions

Trustpower’s views

MDAG’s terms of reference require it to review the HSOTC provisions in the Code and advise if they are adequate to promote the Authority’s statutory objective, or whether changes are required to better promote outcomes consistent with workable competition. Our primary submission noted that one obvious preliminary question was whether any trading conduct rules were required in the light of the infrequent occurrence of problematic behaviour and the range of other remedies available.

²⁰ Meridian submission at page 12

²¹ Mercury submission at page 3

²² Genesis submission at page 9

It is clearly not consistent with the efficient operation of the industry if there is a regulatory overreach beyond what is required for the identified problem or a pancaking of outcome focussed obligations which are difficult to interpret and apply in real time.

We think there is a strong argument that the Authority's:

- expanded Undesirable Trading Situation (**UTS**) jurisdiction;
- acceptance of UTS claims which cover extended trading periods and reflect a combination of market conditions; and
- willingness to amend the Code at any time it finds a risk of a problematic outcome (as evidenced by its changes to the UTS definition and the current process),

already provide a significant constraint on market power.

Thus unless a way can be found to create a proportionate, targeted, sufficiently certain solution with clear headroom between benefits and costs then we think the better solution may be to remove the HSOTC provisions from the Code.

Views of other generator-retailers

Other integrated generator-retailers also:

- queried whether the NSMP offer rules were a proportionate and appropriately targeted solution to the identified problems; and/or
- raised concerns about the potential significant unintended consequences of this proposal.

For example, Mercury pointed out that:

New Zealand's electricity market is internationally recognised world leading, with efficient investment and retirement decisions made in response to clear wholesale market signals.

No evidence is provided in the MDAG discussion paper that the six identified instances of local pivotal situations have led to significant long term consumer detriment.

Much of the analysis of gross pivotal situations appear to be concerned with the theoretical potential incentive to raise prices rather than actual observable impacts.

There is no analysis of the extent to which it is appropriate for parties to use their physical assets to manage price separation risks and thereby reduce the long term costs to consumers.

*The premise on which the proposed NSMP offer rules are formulated is contrary to the Authority's views in its seminal paper *The Economics of Electricity*.²³*

Mercury went on to note that in its view:

Given the potential for inefficiencies from distorted price discovery, the Authority has rightly been focussed on ensuring that barriers to entry into the market remain low such that any attempt to exploit market power to raise prices get competed away and that sufficient hedging products are available to reduce a participant's exposure to wholesale market temporary price fluctuations.

In terms of the former, we are currently observing significant generation investment occurring suggesting there are few barriers to generation investment in New Zealand. In terms of the latter, the EA continues to work on a review and potential enhancements to the FTR regime and on long term sustainable arrangements for the market making in the futures market. This suggests there are other market and policy solutions that will reduce the potential for market power over time.²⁴

Genesis commented:

There are currently narrow circumstances in which generators are not constrained by competitive forces. In 2012, WAG did not identify any specific efficiency losses relating to pivotal supplier situations, but indicated that there was "potential for material efficiency losses to arise in some scenarios".

²³ Mercury submission at page 2

²⁴ Mercury submission at page 4

The Authority's analysis suggests net pivotal situations are very rare at an Island and national level, occurring in between 0 and 1% of trading periods in recent years. As such, an approach to addressing this problem that applies to 100% of trading periods at all locations is difficult to justify in practice.

In Genesis' case, local pivotal situations typically arise at Waikaremoana 0.2% of the time, and at Tekapo A 2% of the time. We consider that rules aimed at addressing these situations should be appropriately targeted, rather than attempting to prevent market power from being exercised in net pivotal situations with a catch-all approach that applies at all times and at every location.

Since the introduction of the HSOTC provisions, there have been two compliance investigations, both of which related to alleged misuse of a pivotal position. It is clear that the problem only exists in a small proportion of the already rare trading periods when generators have market power. The solution should therefore not apply to all offers into the electricity spot market at all times.²⁵:

In terms of unintended consequences, Meridian said:

In a world where generators must be able to justify their offers by reference to their economic costs (regardless of how that is defined), investment incentives would become a product of the precedents set by the Rulings Panel and court indicating how to calculate the economic costs of generation and construct offers. This would be something like the regulatory regime that applies to monopoly businesses except rather than detailed input methodologies and price paths with defined rates of return, generators would learn after the fact what was acceptable, via a process of reading between the lines of decided cases and application to their own circumstances in an iterative process as cases are tested by the Rulings Panel and courts. In this context, there would be a very real risk of weaker investment signals and reduced security of supply in the longer term.

There is a risk that trading would cease to be an active process of rivalry and price discovery. Instead generators and ancillary service agents would be required to construct offers based on some measure of economic costs and would likely set-and-forget those offers, with the only adjustments over time being for variation in fuel costs. The offers made in forward schedules could be ignored as generators would not be allowed to respond to offers from others and there would be no process of rivalry ahead of gate closure. It is far from clear that this way of operating would deliver more efficient outcomes for consumers in the long term.²⁶:

Views of non-integrated retailers

In marked contrast to these views, the non-integrated retailers believe the NSMP offer rules have merit in themselves but also **need to be strengthened** to reflect their view²⁷ that any form of “observable market power” for any period of time in any market is an undesirable market outcome which requires both:

- an *ex ante* remedy [expanded HSOTC and NSMP provisions]; and
- an *ex post* remedy [the current UTS provisions].

This leads them to suggest that a package of further reform is required including:

...increased monitoring and reporting by the Authority of all forms of market power,²⁸

...consideration of the impact of power in parallel markets as well as the primary market,²⁹

...the retention of the existing clause 13.5A (1), the HSOTC rules, to act as a catch-all requirement for generally undesirable behaviour such as market manipulation and insider trading as well as the NSMP offer rules³⁰;

...new definitions of significant market power which would make it clear that transient market power constitutes significant market power and that significant market power is a lower threshold than substantial degree of market power³¹;

...amendments to the proposed explanatory purpose clause to clarify that the outcome which is sought by the two 13.5A(1) obligations is the attainment of outcomes consistent with workably

²⁵ Genesis submission at page 8

²⁶ Meridian submission pages 8-9

²⁷ Joint independent retailer submission at page1; Haast &Electric Kiwi submission page 1

²⁸ Joint independent retailer submission page 1

²⁹ Joint independent retailer submission page 2

³⁰ Joint independent retailer submission p2, Haast &Electric Kiwi submission page 1

³¹ Joint independent retailer submission p2 Haast &Electric Kiwi submission page1

competitive outcomes as applied in the WIA case and/or various telecommunications precedents³².

The non-integrated retailers also submitted that no changes to the existing UTS provisions are needed as they consider there are events, such as those referred to in their current HSOTC and UTS breach claim, that warrant consideration under *both* parts of the Code.

5. Way forward

We think the next steps for MDAG are relatively clear:

- develop worked examples of how the NSMP offer rules should operate; and
- further evaluate the NSMP offer rules against the status quo, more modest reform and having no conduct provisions.

As noted earlier, this may bring the parties together or it may highlight irreconcilable differences on market design. If this occurs we think the best option for the group is to develop a paper for the Authority setting out clearly the points of agreement and difference.

This will then enable the Authority to make the final decision on a way forward which aligns with its interpretation of its statutory objective, the application of existing rules such as the UTS and its other policy work to lower barriers, and promote competition in the wholesale markets.

We look forward to continuing to engage with the MDAG on these important matters.

If you have any questions in relation to this cross-submission please contact me directly on 027 549 9330.

Kind regards



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³² Joint independent retailer submission p2 Haast & Electric Kiwi submission page1