

27 May 2020

Submissions
Electricity Authority
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By email: MDAG@ea.govt.nz

High Standard of Trading Conduct provisions: Cross-Submission

Contact appreciates the opportunity to make this cross-submission on the Market Development Advisory Group (MDAG)'s proposed option for the High Standard of Trading Conduct (HSoTC) provisions in the Electricity Industry Participation Code (Code). The cross-submission process will assist the MDAG to make clear recommendations to the Electricity Authority (the Authority) in order to achieve an optimal outcome.

After consideration of the submissions, we propose that the MDAG should seek solutions beyond the current proposed approach and believe more consultation is required on the options analysis.

Our cross-submission focuses on six key issues which were raised in submissions:

1. Is market power a problem?
2. Should the Code provisions be based on "efficient costs"?
3. Should the Code provisions focus on pivotal supplier situations?
4. Clarity from the Authority, not from the Courts
5. Likely increase in alleged breaches
6. Further consultation

1. Is market power a problem?

Numerous submissions express concern that the proposed Code change would mark a significant departure from the current wholesale electricity market design in New Zealand. The wholesale electricity market has been established with structures and incentives to protect against the exercise of market power¹ and it is fundamentally competitive. Economically efficient outcomes for the long term benefit of consumers should continue to be delivered by the effective competition which occurs among market participants.

There has been significant feedback that the proposed solution imports a price control type standard² and follows a legal and economic approach that has been developed for monopolies and is not

¹ Genesis submission, page 2

² Genesis submission, page 1; Trustpower submission, Appendix 1; Meridian submission, page 2

applicable to workably competitive markets.³ Requiring offers at each node for each half hour to be based on a generators economic costs would destroy the dynamic price-discovery role of the market and would be akin to Part 4 regulation under the Commerce Act.⁴

We agree that efficient pricing relies on promoting competition, not economic costs. Generators may offer energy at whatever level they wish, but if this is above a competitive benchmark they will neither be dispatched nor earn revenue.⁵ Where generators submit offers in a workably competitive market (i.e. where they are not pivotal), the process of rivalry will drive efficient offer conduct and pricing outcomes.⁶

As part of an ongoing consultation, we also welcome further consideration of the concern raised by Trustpower as to whether it is consistent with the efficient operation of the industry for a single event to be subject to (1) a UTS investigation; (2) a HSOTC breach investigation; (3) a market review; and (4) potential review under the Commerce Act.⁷ It is important to maintain a distinction between the domain of the Authority and the domain of the Commerce Commission. The Commission has the core skill set appropriate to dealing with anti-competitive market behaviour.

Contrary to the independent retailer submission⁸, we do not consider that insider trading needs to be specifically captured by any new trading conduct rules. Part 5 of the Financial Markets Conducts Act 2013 contains prohibitions and controls preventing insider trading.

2. Should the Code provisions be based on “efficient costs”?

Contact notes the consensus from the majority of submitters that the “purpose statement” proposed by MDAG for Part 13.5A(3) will increase uncertainly, misapply the Authority’s statutory objective and risks significant unintended consequences. In this regard, we support the analysis undertaken by the Sapere Research Group for Meridian on the unintended consequences that might result from the MDAG proposal.⁹

A review of the expert analysis and the submissions by the other generators confirms our view that comparing offers to cost in any given period is an unreliable indicator of whether market power has been exercised in the wholesale electricity generation market and/or whether efficient outcomes are being delivered for the long term benefit of consumers.¹⁰ In this respect, it is important to note that trading on the wholesale spot market is only one part of wholesale trading – i.e. hedging is an important determinant of overall costs recovered by generators.¹¹

³ Genesis submission, cover letter, page 2

⁴ Meridian submission, page 6, taken from Sapere Research Group “Misread theory and underweighting harm to price discovery” 27 April 2020

⁵ Mercury submission, page 4

⁶ Genesis submission, paragraph 2

⁷ Trustpower submission, Appendix 1

⁸ Independent retailer submission, page 5

⁹ Sapere Research Group “Misread theory and underweighting harm to price discovery” 27 April 2020

¹⁰ Genesis submission, paragraph 18

¹¹ Genesis submission, paragraph 11; taken from Professor Stephen Littlechild, “Electricity: Regulatory Developments Around the World”, The Beesley Lectures, 12 November 2001 at page 10.

A shift toward an economic cost-based market power test could undermine the efficient price discovery process, which was the foundation of the shift toward the competitive market from government control.¹²

The Authority's June 2013 paper entitled "Economics of Electricity", which was attached to Mercury's submission demonstrates that the Authority has previously rejected implementing Code changes in response to calls for a single buyer to deal with perceived market power due to the challenges of undertaking a similar type of economic cost-based analysis to that proposed by the MDAG. The Authority provided a highly cogent and well-reasoned economic critique of the challenges of undertaking assessments of reasonable economic costs and noted that it would not be progressing such Code changes as it does not believe they are consistent with its statutory objective¹³.

Contact's view is consistent with Mercury's, that in order to evaluate whether generator's offers were reasonable, the Authority would require a detailed understanding of commercially sensitive information such as an integrated entity's sales positions in the retail market and hedging positions. Even with such inform, there would be substantial room for misinterpretation, error and bias.¹⁴ As demonstrated by the multiple years of Commerce Commission consultation, and the 1,000-page High Court judgement in the Wellington Airport case, ascertaining "efficient costs" that would be produced in a workably competitive market is a tremendously complex exercise.¹⁵

3. Should the Code provisions focus on pivotal supplier situations?

The scope of the MDAG's analysis has expanded beyond providing clarity to the existing undefined concept of a high standard of trading conduct and upholding the Authority's statutory objective "to promote competition in ... and the efficient operation of, the electricity industry for the long term benefit of consumers" to formulating a proposal that generators should have to justify positions taken in all trading periods with reference to economic costs.¹⁶

It is important to reflect on the Authority's original request of the Wholesale Advisory Group, which was to advise on measures to improve confidence in the efficiency of prices when competitive pressures in the wholesale market are weak.¹⁷

There are very limited occasions when competitive pressure may not exist among generators, yet the proposed wording for part 13.5A(1) empowers the Authority to scrutinize all offers at all points of connection, whether or not competitive pressures were weak. The breadth of the proposal to capture every offer does not seem necessary for a market that is fundamentally competitive.

Contact agrees with both Mercury and Genesis that the focus should instead return to measures to address the original problem definition of net pivotal situations where generators may have scope to manipulate market power situations to extract excessive economic rents.

¹² Mercury submission, page 3

¹³ Mercury submission, page 2; and Electricity Authority (4 June 2013) "The Economics of Electricity", pages 2-3

¹⁴ Mercury submission, page 3

¹⁵ Genesis submission, paragraph 10

¹⁶ Mercury submission, page 4

¹⁷ Wholesale Advisory Group Discussion Paper, 27 May 2013

For this reason, we would support the further development of Genesis' proposal¹⁸ to:

- (a) remove the high standard of trading conduct requirement and safe harbour provisions; and
- (b) require offers from generators (and ancillary service agents) in trading periods where those generators are net pivotal, to be consistent with offers that would have been made if market power could not have been exercised; and
- (c) like the UTS provisions in the Code, set out non-exhaustive examples of offer conduct that is non-compliant.

While generators may not know that they are pivotal at the time of placing an offer, this should just reduce any ability to take advantage of market power, as generators would price according to a competitive market that they (at the time of placing the offer) thought that they were operating within.¹⁹

However, we are not convinced that gross pivotal is the right threshold. The analysis of the risk from using gross pivotal situations appears to be concerned with the *theoretical* potential incentive to raise prices²⁰, even if parties have no short term incentive to do so, rather than actual observable consumer impacts. Net pivotal situations are the most likely to cause loss of confidence in the market in the short term and the conduct provisions should be introduced to address the original identified problem definition.

Alternatively, the Code provisions should focus on when pivotal supplier situations exist but monitoring and enforcement should be greatest when net pivotal situations exist.

Furthermore, if the pivotal test is to remain, it should be further developed so that we have a clear definition of pivotal and net pivotal in the Code to ensure compliance. Meridian provides a good commentary as to why further clarification is required as to when a generator will be pivotal²¹ - estimates of net pivotal situations have varied significantly despite using the same data.

Also, a distinction needs to be made between exercising market power to extract excessive economic rents and generators prudently using physical assets to manage constraint and price separation risks and reduce long run costs to consumers.²²

We do not support the view²³ that the existing clause 13.5A(1) should be retained. One of the primary reasons for the Code change is to provide clarity to the existing undefined concept of a high standard of trading conduct.

From a trading perspective, Contact has found the safe harbour provisions to be useful and straightforward. Therefore, the replacement of the safe harbour provisions with some non-exhaustive

¹⁸ Genesis submission, paragraph 65

¹⁹ Genesis submission, paragraph 38

²⁰ Mercury submission, page 2

²¹ Meridian submission, page 11

²² Mercury submission, page 2

²³ Independent retailers submission, page 5

examples of offer conduct that are non-compliant would be valuable. We note that Meridian also welcomes real-world examples to work through how the behavioural prohibition would be applied.²⁴

We also support further analysis on whether any counterfactual test should be by reference to node or a wider defined “market”.²⁵

4. Clarity from the Authority, not from the Courts

As noted in our submission, an increased level of certainty and clear guidelines on what constitutes acceptable market conduct needs to be provided by the Authority. Leaving the Courts to provide clarity will result in unnecessary and expensive litigation and clogging of our judicial systems and could produce unintended consequences counter to the Authority’s objectives.

Our view is shared by Genesis who also consider 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. Contact agrees with Genesis that the Courts will exhibit strong deference to the expert regulator’s decisions.²⁶

Furthermore, the Treasury has published the Government’s expectations for the design of regulatory systems, which includes (among other things), the need for a regulatory system which:

- (a) has processes that produce predictable and consistent outcomes for regulated parties;
- (b) sets out legal obligations and regulator expectations and practices in ways that are easy to find, easy to navigate, and clear and easy to understand.²⁷

5. Likely increase in alleged breaches

We take this opportunity to reiterate that the number of alleged breaches will likely increase significantly under the current proposal, which in turn will drive increasing costs for the Authority and for participants to comply with information requests and investigations.

The Authority will come under intense pressure to revise market prices from parties who stand to benefit from any revisions. This is becoming an increasing feature of the existing market and would only become exacerbated under the current proposal²⁸, which opens the flood gates by introducing an ability to challenge all offers.

²⁴ Meridian submission, page 7

²⁵ Meridian submission, page 6

²⁶ Genesis submission, paragraph 27

²⁷ Genesis submission, paragraph 28

²⁸ Mercury submission, page 3

6. Further consultation

We share the concerns of the other generator submitters that this proposal could proceed to a Code change without the usual consultation process. Consultation by an advisory group should not be used as a substitute for direct consultation by the decision-maker.

We agree with Meridian that the Authority should be encouraged to take a cautious approach and read section 39(3) of the Electricity Industry Act 2010 narrowly.²⁹ The MDAG's proposed option for the HSoTC provisions in the Code would mark a significant departure from the current wholesale electricity market design in New Zealand, has created controversy amongst respondents to the MDAG's discussion paper, and is unlikely to be backed by widespread support from those participants likely to be affected by it.

Like Trustpower, we support advisory groups providing advice to the Authority on the viable options to achieve its regulatory objective, and undertaking consultation during the design and development process is likely to result in better quality regulatory proposals that are more likely to achieve their objectives.³⁰ However, a proper consultation process should then be implemented by the Authority to allow stakeholders the opportunity to fully assess all options and consequences.

We are happy to discuss any aspects of our cross-submission. Please do not hesitate to contact me if you have any queries.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris Abbott', with a stylized flourish at the end.

Chris Abbott

GM Regulatory Affairs and Government Relations

²⁹ Meridian submission, page 13

³⁰ Trustpower submission, Appendix 1