23 March 2021

Submissions
Electricity Authority

By email: tradingconduct@ea.govt.nz

Wholesale markets – Trading conduct

Meridian appreciates the opportunity to provide feedback on the Electricity Authority's (**Authority**) proposal to replace the high standard of trading conduct (**HSOTC**) provisions in Part 13 of the Electricity Industry Participation Code 2010 (**Code**) with a new rule.

This submission should be read together with Meridian's three submissions to the Market Development Advisory Group (**MDAG**) dated 4 May 2020, 27 May 2020, and 5 November 2020.

Several of the points made in this submission have been made previously to MDAG. Appendix F of the Authority's consultation paper briefly addresses and dismisses these points. In restating these points we have suggested how each issue might be resolved in a way that preserves the intention of the Authority's proposal while mitigating the risks identified by Meridian. We think there are simple ways to resolve these points of difference and that doing so will improve the proposal and increase the benefits to consumers from reform of the HSOTC provisions. We ask the Authority to seriously consider these improvements and not merely rubber stamp the MDAG proposal and their dismissal of previous feedback.

Meridian Energy Limited

Level 2, 55 Lady Elizabeth Lane
PO Box 10-840
Wellington 6143
New Zealand

Phone +64-4 381 1200
Fax +64-4 381 1272
www.meridianenergy.co.nz

The Authority's proposed drafting:

> (1) In the spot market –
>
> (a) it is expected that **offers** and **reserve offers** will generally be subject to competitive disciplines such that no party has significant market power;
>
> (b) however, there may be locations where, or periods when, one or more generators, or ancillary service agents, as the case may be, has significant market power.
>
> (2) Accordingly –
>
> (a) where a **generator** submits or revises an **offer**, that offer must be consistent with the **offer** that the **generator,** acting rationally, would have made if no **generator** could exercise significant market power at the **point of connection** to the **grid** and in the **trading period** to which the **offer** relates;
>
> (b) where an **ancillary service agent** submits or revises a **reserve offer**, that **offer** must be consistent with the **reserve offer** that the **ancillary service agent**, acting rationally, would have made if no **ancillary service agent** could exercise significant market power at the **point of connection** to the **grid** and in the **trading period** to which the **reserve offer** relates;
>
> (3) For the purposes of this clause –
>
> (a) market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency;
>
> (b) "spot market" has the same meaning as **wholesale market** except that it excludes the hedge market for **electricity** (including the market for **FTRs**).

As stated previously, Meridian tentatively supports the counterfactual test proposed in subclause (2). However, Meridian still has concerns with aspects of the drafting and the potential for unintended consequences. This submission is structured under the following headings:

- Clause (1) is awkwardly framed
- Clause (2) has the basis of a workable test but needs refinement
- Clause (3) introduces a novel and unworkable definition of significant market power
- There is a significant risk of unintended consequences that has not been accounted for in the cost benefit analysis

Meridian's drafting suggestions are included in aggregate in Appendix A.

Meridian's responses to the consultation questions are included in Appendix B, however, Meridian's key comments are in the body of this submission.

Clause (1) is awkwardly framed

> (1) In the spot market –
>
> (a) it is expected that **offers** and **reserve offers** will generally be subject to competitive disciplines such that no party has significant market power;
>
> (b) however, there may be locations where, or periods when, one or more generators, or ancillary service agents, as the case may be, has significant market power.

The newly proposed clause (1) contains two observations about the market. Meridian generally agrees with these observations and, while it is unusual for a rule book to simply make observations, Meridian agrees they are useful context for the rule that follows. However, the framing of these observations is awkward because of the use of the words "it is expected". It is not clear who has the expectation and it does not seem appropriate for the Code itself to have expectations – it is a rule book not an animate entity.

Meridian therefore suggests that the words "it is expected" simply be deleted. This is a minor change and not of great importance to Meridian, however, the change would improve the drafting and avoid imbuing the Code with sentiments, without losing or changing any meaning. The clause would then read as follows:

> (1) In the **spot market** –
>
> a) ~~it is expected that~~ **offers** and **reserve offers** will generally be subject to competitive disciplines such that no party has significant market power;
>
> b) however, there may be locations where, or periods when, one or more **generators**, or **ancillary service agents**, as the case may be, has significant market power.

Clause (2) has the basis of a workable test but needs refinement

> (2) Accordingly –
>
> (a) where a **generator** submits or revises an **offer**, that offer must be consistent with the **offer** that the **generator,** acting rationally, would have made if no **generator** could exercise significant market power at the **point of connection** to the **grid** and in the **trading period** to which the **offer** relates;
>
> (b) where an **ancillary service agent** submits or revises a **reserve offer**, that **offer** must be consistent with the **reserve offer** that the **ancillary service agent**, acting rationally, would have made if no **ancillary service agent** could exercise significant market power at the **point of connection** to the **grid** and in the **trading period** to which the **reserve offer** relates;

As noted in Meridian's earlier submissions, the standalone behavioural standard or test, now proposed in clause (2) is broadly workable and capable of being read consistently with the Authority's statutory objective. A counterfactual test as proposed in clause (2) could be considered ex-ante by traders and draws on established competition law jurisprudence. Meridian would not oppose this formulation per se, provided the important caveats below are addressed:

- allowing for appropriate market definition; and
- ensuring generators and ancillary service agents are only responsible for their own offers and do not have to assume anything other than observed behaviour from competitors.

Allowing for appropriate market definition

By definition, market power exists and can only coherently be assessed in a properly defined market. The economic benefits of regulating market power are completely undermined if the conduct sought to be regulated does not arise in or affect a properly defined economic market[1]. Deeming something other than a properly defined market to be a market for the purposes of regulating misuse of market power turns an economically robust approach into an inquiry unsupported by sound economic policy. The counterfactual test needs to allow for the proper definition of the market by the Rulings Panel or courts. This would be done on a case-by-case basis both geographically and in terms of the relevant time scale over which market power is to be assessed. Meridian believes that the proposed behavioural standard could therefore be improved by removing the words "at the point of connection to the grid and in the trading period to which the offer relates". The Authority presumably does not intend for market power to be always assessed in relation to a market defined as a single point of connection or trading period; such an assessment would not encompass the factors that directly shape and constrain rivalry.

[1] As discussed by Mason C.J. and Wilson J. in the Australian High Court in *Queensland Wire v Broken Hill* (1989) 167 C.L.R. "Defining the market and evaluating the degree of power in that market are part of the same process, and it is for the sake of simplicity of analysis that the two are separated." Indeed, as noted by the US Supreme Court in *Spectrum Sports v. McQuillan*, 506 U.S. 447 (1993) "The purpose of the [Sherman] Act is not to protect businesses from the working of the market; it is to protect the public from the failure of the market.". Market failure rarely arises in a narrowly defined market for a short period of time, see for instance *Universal Music v ACCC* (2003) 131 FCA 193 at [158], where the Federal Court of Australia noted that "Market power is judged by reference to persistent rather than temporary conditions: see Queensland Wire at CLR 200; ALR 591–2 per Dawson J, Boral at [287] and [293] per McHugh J and at [379] per Kirby J."

Previously Meridian suggested (and MDAG and the Authority rejected) an alternative reference to "the spot market" in the drafting of this clause. In rejecting this submission, the Authority states that: "Widening the definition of 'market' to the entire geographic extent of the spot market would have the effect of watering down the proposed rule. This approach could potentially exclude breaches that occur at the local or regional level, which constitute the more common instances where parties abuse their market power." Meridian and the Authority appear to be in agreement in principle – we do not want market definition to be prescribed in any way – whether too broad (as the Authority suggests would be the effect of referring to "the spot market"), or too narrow (as Meridian suggests would be the effect of referring to "the point of connection to the grid and in the trading period to which the offer relates"). A simple solution would be to instead refer to the "relevant market". The Rulings Panel or courts would then be left to decide the relevant market definition over which a generator or ancillary agent's conduct is to be considered, whether that is a single trading period and point of connection or a more extended period and geographic area. Proposed clause (2) would then read:

> Where a **generator** submits or revises an **offer**, that **offer** must be consistent with **offers** that the **generator**, acting rationally, would have made if no **generator** could exercise significant market power in the relevant market ~~at the **point of connection** to the **grid** and in the **trading period** to which the **offer** relates~~.

Generators and ancillary service agents are only responsible for their own offers and should not have to assume anything other than observed behaviour from competitors

The test should be about the generator in question and should not require offers to be constructed based on speculation about the exercise of market power by *all* generators. A requirement for generators to look beyond their own offers and construct offers in a hypothetical world where "no generator could exercise market power" would be extremely challenging and a high burden for all generators. Each generator can observe market conditions and construct offers accordingly to be consistent with the proposed Code. However, each generator can never know whether or to what extent any market power is exercised by its competitors in their offers. In submitting or revising offers a generator should only be responsible for its own offers and the text should therefore be revised to read:

Where a **generator** submits or revises an **offer**, that **offer** must be consistent with **offers** that the **generator**, acting rationally, would have made if it ~~no~~ ~~**generator**~~ could not exercise significant market power...

Clause (3) introduces a novel and unworkable definition of significant market power

> (3) For the purposes of this clause –
>
> (a) market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency;
>
> (b) "spot market" has the same meaning as **wholesale market** except that it excludes the hedge market for **electricity** (including the market for **FTRs**).

Proposed clause (3) is awkwardly drafted in that it seeks to define significant market power by reference to (non-significant) market power, in a manner that is inconsistent with the case law relating to the definition of a market, or identification of a position of market power in that market. It also does not define significant market power for the purposes of the counterfactual test, but rather defines significant market power by reference to the *exercise* of market power. This definition quickly leads to a circular inquiry in a rule that is designed to identify and prohibit the exercise of market power. Neither MDAG, nor the Authority addressed this issue in Appendix F of the consultation paper or in earlier papers.

Of even greater importance is that the proposed new clause (3) misapplies the economic texts upon which MDAG and the Authority claim it to be based. The test proposed by Yarrow and Decker for when market power becomes 'significant' is when the potential for inefficiency or harm is sufficiently high to warrant incurring the costs of intervening measuring both potential harm/inefficiency and the costs of intervention in net present value terms. This is a public policy type test of the costs and benefits of regulatory intervention. Yarrow and Decker suggest that in many cases there will be inefficiency or harm from the exercise of market power but that it will not be 'significant' unless that harm or inefficiency is sufficiently high to overcome the costs of intervention.

In contrast, the Authority's proposal is silent on the costs of intervention and simply suggests that *any* adverse impact on economic efficiency will mean market power is 'significant'. No weight is given to the countervailing costs of intervention to prevent that exercise of market power, including the administrative costs of intervening and, most importantly, the harm that would be done to the price discovery function of the market and price signals for investors in the market.

The attempt to define significant market power is therefore overly broad as it has no countervailing costs of intervention threshold to overcome. As Yarrow and Decker note, market power is the ability to affect the market price even a little and even for a few minutes and market power is almost ubiquitous. Each time market prices are affected by market power there will be some impact on economic efficiency in the sense that there will be a deviation from the theoretical ideal of perfect competition. Therefore, in effect the definition of significant market power proposed by the Authority means that *all* market power is significant because exercising market power even a little would have a net adverse impact on economic efficiency, i.e. it would be a deviation from perfect competition.

The use of the word "net" in the proposal does not allay our concerns. The definition of significant market power is about whether the *exercise* of market power would have a net impact on economic efficiency – it therefore has no regard to the costs of intervention. This disregard for the cost of intervention is also a core problem with the Authority's cost benefit analysis and is discussed further in the following section.

Overall, Meridian considers that clause (3) as currently drafted amounts to a novel and likely unworkable definition of significant market power that risks significant unintended consequences. The concept of significant market power is something that the courts have considered in detail in a range of contexts and which they have been unable to reduce to a bite sized definition. It is a complex concept that must be understood in the context in which it is applied. It seems unlikely that any simple definition suggested by the Authority or anyone else would be able to succinctly summarise what is involved without oversimplification, errors, and unintended consequences. As stated in Meridian's earlier submissions to MDAG, there is absolutely no need for the Code to abbreviate the detailed economic concepts and jurisprudence that will inform the counterfactual test and meaning of significant market power – all of which are better to be inferred by decision-makers in the Rulings Panel and courts based on their own consideration of the relevant authorities and circumstances.

There is a significant risk of unintended consequences that has not been accounted for in the cost benefit analysis

We continue to see significant potential for unintended consequences for the same reasons set out by Sapere in their paper of 1 May 2020 *Misread theory and underweighting harm to price discovery* as attached to Meridian's initial submission to MDAG.

We restate the following extract from the Sapere report by way of summary:

> "MDAG says that the costs of its proposal would be negligible; it believes that no efficient behaviour would be deterred. In practice, achieving that degree of precision in regulatory intervention is an impossible task; it is important to recognise that impossibility so the expected costs can properly be weighed against expected benefits.
>
> The reason it is safe to say that the [Rulings Panel] would make significant mistakes in assessing efficient offer prices, is because discovering the competitive, or efficient, price has to do with information. Fundamentally, the information a central decision-maker needs to promote social welfare (such as individual preference functions and supplier production functions) is hidden from it. Efficient economic costs—scarcity rents, opportunity costs, premiums for risk, etc—are revealed in the process of price discovery. They cannot be accurately determined ex ante nor known when a generator prepares its offers.
>
> As the estimates by the [Rulings Panel] of efficient offer prices will almost certainly be wrong, the proposal will distort some efficient behaviour. Over time, these errors are likely to be biased toward under-estimating efficient costs. This is because, if the [Rulings Panel] were to have the power to influence prices, there would be demands by interested parties for those powers to be used for their benefit. The rule as drafted by MDAG would provide the [Rulings Panel] with few handholds to resist that pressure.
>
> Under-pricing tends to restrict the supply-side of the markets: certainly in the longer-term by discouraging investment and innovation, and possibly also in the short-term by reducing reliability and security of supply. A poorly conceived intervention, that errs toward unduly low prices over time, would lead to the electricity sector becoming a very major policy problem."

The Authority's cost benefit analysis, like that of MDAG, is not adequate. The Authority appears to have copied the MDAG analysis and added little of its own. Critically, the Authority makes the same unfounded assumption that the proposal will not deter any efficient behaviour. For that claim to be true, investigations by the Authority and decisions by the Rulings Panel would need to always result in and incentivise more efficient market prices than would result from price discovery in the market, and all generators would need to be confident ex ante how the rules would be applied in any given situation so that they could act accordingly. Such a claim assumes perfect decision making by enforcement bodies and perfect foresight from generators. If the Authority were able to always calculate

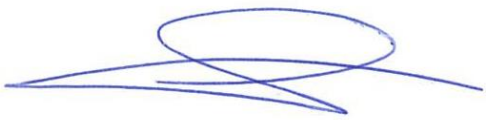
the efficient offer price for each generator and to set those prices without fear or favour, competition in the wholesale market would be largely redundant.

The only quantification of costs and benefits by the Authority is an estimate of the hypothetical costs of over investment in generation were any sustained exercise of market power found to drive up prices (with no evidence any such situation exists) and assuming that the proposed Code identified and corrected those inefficiently high prices. One could equally estimate the costs of under investment in generation and risks to security of supply (i.e. based on the value of lost load) if the proposed Code and enforcement decisions (based on imperfect information) incentivised or required offer prices that were less than efficient and did not allow for a return on investment in new generation.

Meridian would prefer the Authority turn its attention to this risk now rather than leave it for enforcement decisions once the proposed Code is already in place.

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

Yours sincerely



Sam Fleming
Manager Regulatory and Government Relations

Appendix A: Meridian's proposed drafting changes

(1) In the spot market –
   a) ~~it is expected that~~ offers and reserve offers will generally be subject to competitive disciplines such that no party has significant market power;
   b) however, there may be locations where, or periods when, one or more generators, or ancillary service agents, as the case may be, has significant market power.

(2) Accordingly –
   a) where a generator submits or revises an offer, that offer must be consistent with the offer that the generator, acting rationally, would have made if it ~~no generator~~ could not exercise significant market power in the relevant market ~~at the point of connection to the grid and in the trading period to which the offer relates~~;

      [same for reserve offers by ancillary service agents]

(3) For the purposes of this clause –
   a) ~~market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency~~;
   b) "spot market" has the same meaning as wholesale market except that it excludes the hedge market for electricity (including the market for FTRs).

Appendix B: Responses to consultation questions

	Question	Response
1.	Do you agree with the issues identified with the current trading conduct provisions (clauses 13.5A and 13.5B) in the Code? Please provide the reasons for your answer.	Yes.
2.	Do you agree the proposed trading conduct rule is preferable to the other options? If you disagree, please explain your preferred option in terms consistent with the Authority's statutory objective in section 15 of the Electricity Industry Act 2010.	Yes. However, as noted in the body of this submission, the proposal needs some minor changes to mitigate the potentially significant risks it creates.
3.	Do you agree that the Authority has appropriately considered viable alternatives to the proposed rule? Please provide the reasons for your answer.	While a spectrum of options has been considered by MDAG, it is not clear whether alternative behavioural rules have been adequately considered by the Authority and assessed relative to the status quo and the proposal. It appears that the Authority intends to move quickly to endorse the MDAG recommendations without much further analysis of options.
4.	Do you have any comments on the Authority's view on submitters' issues and concerns? Please provide the reasons for your answer.	The body of this submission addresses instances where Meridian's previous submissions have been dismissed by the Authority and seeks to reconcile the different views and improve the proposal.
5.	Do you agree with the Authority's decision for not providing specific examples or hypothetical scenarios in guidelines on how the proposed rule should be applied? Please provide the reasons for your answer.	We understand the reasoning and appreciate the limitations faced by any guidance from the Authority. However, Meridian continues to see some value in the Authority itself turning its thoughts towards the application of the rule in practice rather than deliberately making a rule the boundaries of which will only become clear when it is tested – in the process potentially causing significant reputational harm to the participants involved. This is not a good way to make policy decisions.
6.	Should the Authority provide access to anonymized	In general, the Authority should be more transparent about the allocation of its limited compliance

	information on the findings of cases that have been considered but not progressed and the content of 'please explain' notifications, where appropriate? Please provide the reasons for your answer.	resources and the basis for decisions to investigate or not investigate allegations. The Authority should also be clearer on why some allegations are investigated more quickly than others.
7.	Do you agree that the proposal is a material improvement on the status quo? Please provide the reasons for your answer.	Yes. Meridian has said for several years now that the status quo is unworkable. However, the proposal can be further improved as noted in the body of this submission.
8.	Do you agree with the objectives of the proposed amendment? Please provide the reasons for your answer.	Yes.
9.	Do you agree that the relative assessment approach used in the CBA is sufficient to determine whether the proposal has net benefits relative to the status quo? Please provide the reasons for your answer.	No. The CBA is not a sufficient basis to determine whether the proposal has net benefits relative to the status quo. Some significant potential costs are ignored completely.
10.	Do you agree the proposed amendment will result in net benefits? Please provide the reasons for you answer.	No. The CBA does not account for the costs of unintended consequences, namely the deterrence of efficient behaviour by the proposal.
11.	Do you agree the Authority's proposed amendment complies with section 32(1) of the Act?	Yes, provided the amendments suggested in this submission are made. As currently drafted, we are concerned that the proposal does not comply with section 32(1)(b). In particular, the proposal has the potential to deter efficient behaviour and that in turn would affect reliability of supply in the long term.