



Genesis Energy Limited
Level 6
155 Fanshawe Street
PO Box 90477
Victoria St West
Auckland 1142
New Zealand

T. 09 580 2094

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Market Development Advisory Group
C/O:
Electricity Authority
PO Box 10041
WELLINGTON 6143

By email: MDAG@ea.govt.nz

Review of the trading conduct provisions – Supplementary consultation paper

Dear Tony,

Genesis Energy commends MDAG on its work on the rules governing wholesale market trading conduct, and appreciates the complexity of the issues MDAG has had to grapple with. The consultative approach MDAG has taken to date has been most welcome.

As set out in our previous submissions, Genesis agrees that the existing trading provisions – clauses 13.5A and 13.5B in the Electricity Industry Participation Code 2010 – are not fit for purpose and require reform.

MDAG's initial proposal, published in February, represented an improvement on the status quo. While we agreed with the concept of that proposal, we had significant concerns about the details. The revised proposal, published in October, is a material improvement. In particular, removal of references to economic costs reduces the risk of the rules operating as a price control standard, which Genesis understands was not MDAG's intention.

There remains room for improvement in relation to assisting participants with interpreting the bounds of acceptable conduct in practice. Genesis remains of the view set out in our initial submission that it would be useful to provide some concrete examples of conduct that could reasonably be expected to be unacceptable under the new rules. Providing guidance gives participants and the Authority broad "guard rails" to assess whether behaviour is likely to fall below the standard required. This would materially reduce uncertainty and compliance costs

for both participants and the Authority, in contrast to a position where no guidance is provided and the industry is left to find this out through the Rulings Panel and the Courts.

This guidance could be provided in the form of guidelines, or included in the Code as a non-exhaustive list of examples of offer conduct that would be non-compliant. This latter option is consistent with the approach taken in Part 5 of the Code which deals with undesirable trading situations.

We suggest that the case studies that were used for the two panels would be a useful starting point for developing this guidance, and reiterate that it is poor and costly regulatory practice to rely solely on litigation to provide guidance on what acceptable standards mean in practice.

Our detailed feedback follows as appendix A.

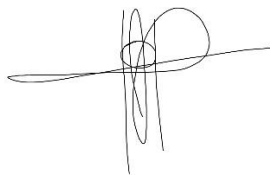
Finally, Genesis is eager to reiterate the view set out in previous submissions that changes to trading conduct provisions are sufficiently significant as to warrant a full Code change process. Our understanding is that a majority of participants who have been involved in the process to date support this view.

The need for a full process, including a detailed and objective analysis of the costs and benefits, is heightened by the late change to the proposal and the limited opportunity for analysis as a result. Although Genesis considers the revised proposal is an improvement, further scrutiny would provide comfort.

Genesis understands that the process of updating trading conduct rules has been long-running and there is a strong appetite to conclude it. However, we consider it is not reasonable to prioritise haste over quality regulation and that full scrutiny by the Electricity Authority is appropriate.

Should you wish to discuss any aspect of our submission further, please contact me by email: matt.ritchie@genesisenergy.co.nz or by phone: 027 204 3864.

Yours faithfully

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke extending to the left.

Matt Ritchie
Senior Advisor, Regulatory Affairs and Government Relations

Appendix A: Consultation responses

Q1. Do you agree that the proposed 'rule' [clause 2] is better than the existing provision requirement for "conduct in relation to offers and reserve offers is consistent with a high standard of trading conduct"?

1. Yes, subject to how the Electricity Authority interprets and applies the new rule in practice.
2. Genesis agrees that the existing HSOTC provision does not clearly identify the scope or nature of prohibited conduct. The proposed rule in clause 2 is a better approach, as it more clearly identifies the situation in which it is intended to apply, and the type of conduct it is meant to prevent (i.e. taking advantage of significant market power).
3. However, the proposed rule does not resolve all ambiguity concerns. An economic efficiency test will always be subject to debate and interpretation, based largely on economic theories that will likely be of limited practical use to those responsible for making offers into the market in real time.
4. An advantage of the existing provision is the practical guidance (by way of safe harbours in clause 13.5B) that help to guide offer conduct, at the time of submitting bids.
5. Although we do not support safe harbours in the Code itself, it would be useful to have additional practical guidance to inform offer conduct under the new clause. We return to this below.

Q2. Do you agree that the economic efficiency framework underpinning the proposed 'rule' is better than the existing HSOTC framework?

6. Yes, subject to Genesis having correctly understood that the economic efficiency framework does not intend to prevent all exercise of market influence by generators. Rather, consistent with the Professor Yarrow and Dr Decker paper referenced by MDAG, its intent is to prevent the exercise of significant market power where it can be shown that the conduct in question has a net harmful impact on efficiency.
7. On that basis, Genesis agrees that the economic efficiency framework is a more tailored approach to dealing with unacceptable offer conduct, and is therefore more suitable than the existing HSOTC framework.
8. Our view is that the revised proposed code change is a better reflection of the intent behind the HSOTC provisions – that is, to deter generators from taking advantage of significant market power to produce inefficient market outcomes.

Q3. Do you agree that the new preamble [clause 1] is effective in conveying succinctly the intended framework and purpose of the 'rule' [clause 2]?

9. Genesis agrees that the new preamble accurately conveys that:

- a. The wholesale electricity market is generally competitive, and designed so that effective rivalry among market participants delivers economic efficiency outcomes for the long-term benefit of consumers. In those circumstances, regulatory control of offer prices and volume is undesirable.
 - b. Instances of market power may exist from time to time, but are transient. It is appropriate for regulation to constrain offer conduct to avoid detriment to the market and consumers in such cases.
10. We agree with MDAG's observations that conduct provisions should not seek to address deep, widespread or enduring problems of market power – if that was to exist. To the extent that problematic market power exists in the wholesale market, it is mostly transient over a small number of trading periods, and can be location specific.¹ We support the specific explanation of this point in clause 1(a) of the revised proposed code change.

Q4. Do you agree with clause 3(a), which states when market power becomes significant?

11. Yes, in principle. As stated above, Genesis understands that the intent is only to prevent conduct where the harm arising from an "inefficient" bid exceeds the benefits.
12. Our concern is that, while the reference to "net adverse impact on economic efficiency" makes sense in theory, it is not clear what it practically means for offer conduct. How would a trader know with any certainty whether his or her conduct is consistent with the provision?
13. The added difficulty is that tests traditionally used by regulators to assess the exercise of substantial or significant market power tend to use relatively long-term measurements of power (e.g. an enduring ability to raise prices), while the HSOTC provisions should only be relevant to cases of transient market power.
14. On its own, the revised proposed code change does not provide sufficient certainty for generators to have confidence that offers comply with the standard. In the context of continuous trading periods where circumstances can quickly change, the provision is not sufficiently clear to allow participants to know what is required of them, in advance of the conduct in question. To the contrary, Genesis anticipates that any investigation of an alleged breach, after the fact, will involve complex economic analysis and economists having differing views on whether an offer was efficient or inefficient (albeit it is far from clear what that analysis will entail).
15. The key complexity will be in determining when the exercise of transient pricing power crosses the line from efficient to inefficient.
16. As stated by Professor Yarrow and Dr Decker, exercise of transient pricing power is generally efficient because it allows generators to recover economic costs.²
17. In providing the test of inefficient exercise of market power that MDAG now proposes to adopt, Professor Yarrow and Dr Decker did not provide practical

¹ *Market Development Advisory Group, Review of the Trading Conduct Provisions: Supplementary Consultation Paper*, at 24.

² *Professor George Yarrow, assisted by Dr Chris Decker, Bidding in Energy-only Wholesale Electricity Markets*, November 2014, at 21.

examples of where the line between efficient and inefficient bids could lie in practice. In fact, they say that it is a matter of degree and the relationship between price influence and inefficiency or harm done is not exact. They also say that use of terms such as 'substantial' or 'significant' only tends to occur when the degree of market power is thought to lie above some "often fuzzy" threshold level.

18. Genesis accepts that it is difficult to translate the intent of the conduct provisions into a workable test under the Code. Whatever further amendments might be made to the Code – it will remain very difficult to define a legal standard that provides complete certainty about offer conduct that crosses a threshold to become unacceptable.
19. Genesis understands that MDAG considers material provided as context over the course of developing the proposal provides sufficient certainty concerning what is permissible. This may be so for the purposes of interpreting the proposed Code change, but is unlikely to be useful to energy traders in real time.
20. It would therefore be better to consult on and publish separate guidance on the types of offer conduct that could be at risk of breaching the rule in clause 2. The guidelines for wholesale information market disclosure requirements under the Code provide a good model.
21. In the HSOTC context, guidelines could include examples of the type of conduct that could risk breaching the provision, depending on the circumstances. This should help to provide generators with more practical certainty as to what is, or is not, acceptable offer conduct.
22. Genesis anticipates that such guidelines would address situations in which generators may be at risk because in circumstances where transient market power exists, they have changed their offer conduct to an extent or in a manner that causes harm to the market.
23. We would expect that an underlying theme would be that an offer is not in breach of the rule in clause 2 unless it can be established that the price does not seek to recover the economic costs of the generator (consistent with the Yarrow and Decker analysis).
24. Guidance could also provide some clarity around 'net adverse impact on economic efficiency', which the proposal suggests as the measure by which it can be judged if market power is significant. In particular, certainty could be provided regarding whether the Authority anticipates there to be materiality thresholds for net adverse impact, and how the costs of intervention may be calculated.
25. We do not expect the guidance to be exhaustive, as (per our comments above) we accept that it will not be possible to identify all types of unacceptable conduct in advance. However, our view is that having some concrete examples will better assist those making offers to comply with what is otherwise an abstract economic test.

Q5. Overall, do you support the revised proposed code change in preference to the existing HSOTC provisions?

26. Overall, Genesis supports the revised proposed code change in preference to the existing HSOTC provisions, but believes it will be necessary to develop separate guidelines that will provide practical assistance to inform offer conduct.
27. Genesis has provided this submission on the basis that MDAG is seeking feedback on the general concepts and approach, and not the detailed drafting. This approach has been taken on the basis that any Code change will be subject to the usual Code change process through the Electricity Authority.
28. We anticipate there will be further opportunities to refine the proposed Code drafting (if necessary) when the Authority undertakes further consultation on a proposed Code amendment. For example, we are not sure that inserting the words "acting rationally" is the best way to incorporate an objective standard, as it could invite further debate on what acting "rationally" means in any given case (typically "reasonable" is used to establish an objective standard).