

2 November 2020

Tony Baldwin
Chair
MDAG
Electricity Authority
Wellington

By e-mail: mdag@ea.govt.nz

Dear Tony

Independent retailers support MDAG's revised HSOTC proposal

Ecotricity, Electric Kiwi, Flick Electric, Pulse and Vocus (the independents) appreciate the opportunity to submit in relation to MDAG's revised High Standard of Trading Conduct (HSOTC) proposal.¹ The additional consultation step accords with our recommendation to consult on any revisions to the original MDAG proposal before the group submits its recommendations to the Electricity Authority.

The independents consider the revised HSOTC proposal could be further improved by amending the definition of when "market power becomes significant". We recommend tweaking the proposed definition to align with the Yarrow and Decker definition, and to ensure it captures all three of the limbs of the section 15 statutory objective:

"market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency, or otherwise cause harm to consumers".

While we consider that the MDAG revised proposals clearly capture transient market power, inclusion of a 'for the avoidance of doubt' clause could avoid unnecessary debate on how significant market power should be interpreted.

However, we support the revised HSOTC proposal regardless of whether our recommendations are adopted.

MDAG has run a sound process

MDAG has run a very good process over the last year,² which is reflected in the quality of the revised HSOTC proposal, and the high standard of the two HSOTC consultation papers.

We agree with Genesis that "MDAG is to be commended for its good work on wholesale market trading conduct rules".³

We would like to acknowledge the availability of the MDAG chair and staff to answer queries, the helpful way our enquires have been answered and discussed, the use of cross-submissions and

¹ We respond to some misinterpretations of our submissions in the Appendix; in particular, claims that we want price control and for prices to be as low as possible "by whatever means" have no foundation. We have included this appendix because it is relevant to the potential benefits and (overstatement of) the risks of the HSOTC proposals.

² There had been little sign of progress under the previous incarnation of MDAG.

³ Genesis, Re: High standard of trading conduct provisions – cross submission, 27 May 2020.

workshops, and the innovation of using independent Evaluation Panels acting as proxies for the Rulings Panel and Courts to test how the proposed and existing HSOTC rules might be interpreted.

The use of Panels has ensured the MDAG proposals are ‘evidence-based’ and has proven to be more useful than reliance on traditional quantified CBA would have been. We agree with MDAG’s conclusion “The quality of the learning and insight gained in the evaluation panel process was considerable, which included a set of independent expert views on the comparative costs and benefits of the proposed and existing provisions from an applied perspective, which has strongly informed our revised proposal” [emphasis added].

MDAG articulated well the limitations of reliance on quantified CBA on this matter. As we noted in cross-submission, no stakeholder challenged MDAG’s reasoning for not undertaking a CBA.

The quality and nature of MDAG’s consultation and engagement on the HSOTC review means we are comfortable if the Electricity Authority doesn’t undertake duplicate consultation before amending the Code to introduce the revised HSOTC rules, if the Authority adopts MDAG’s Code amendment proposal in full. We note though that the Authority’s intention to make a decision by mid-2021 indicates additional consultation is likely.⁴ We can understand if the Authority feels it should or needs to consult again, given the submissions of other stakeholders.

We support the changes made to the proposals

For the avoidance of doubt, we agree with:

- the addition of “, acting rationally,”;
- replacement of “where” with “if”, and that ““If” better conveys that the clause requires a comparison of an ‘actual’ to a ‘what if’”;
- the “tweaks to improve the plain English flow without changing the meaning”; and
- MDAG’s proposal to replace the purpose provision entirely with a simplified preamble. This accords with our earlier submission which raised relatively material concerns about its drafting.

The independent retailers propose a minor amendment to the definition of significant market power

The MDAG proposed definition of significant market power attempts to do two things concurrently: (i) define significant market power; and (ii) capture the undesirable market outcomes the HSOTC rules are intended to address.

The orthodox approach to the definition of the various forms of market power is, as the MDAG consultation paper articulates, to determine “the degree to which prices can be influenced by one party or group of co-ordinating parties, or the degree to which prices can be set above some relevant measure of economic costs”.⁵

⁴ <https://www.ea.govt.nz/assets/dms-assets/27/October-2020-UTS-HSOTC-compliance-and-market-review-summary.pdf?ct=t%28Market+Brief+-+29+October+2020%29>

⁵ Whether or not there is significant market power is entirely independent of the Authority’s statutory objective, or how it is interpreted.

It is not clear the definition of significant market power needs to do anything more than define when “market power becomes significant”.⁶

The undesirable market outcomes the HSOTC rules are intended to address are captured by the proposed clause: “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”.

The reference to “net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency” in MDAG’s definition of significant market power articulates this in an overlapping but different way, which may result in potential conflicts, and legal arguments about the correct interpretation and which takes prominence.

The reference to “net adverse impact on economic efficiency” is also an incomplete facsimile of the Authority’s statutory objective in section 15 of the Electricity Industry Act and the harm that misuse of significant market power can cause.

The long-term benefit of consumers includes “promot[ing] competition in, reliable supply by, and the efficient operation of, the electricity industry for the long-term benefit of consumers”. The proposed definition only includes one of the three elements of the long-term benefit of consumers. The three elements may overlap, but are distinct and important in their own right, which is reflected in the statutory objective separately including efficiency, reliability and competition.

Misuse of significant market power in the spot market can cause harm to reliability of supply and to competition. For example, the Authority’s preliminary UTS decision raised concern about the impact of trading conduct on competition and found unnecessary spilling of water in the South Island resulted in higher use of North Island hydro storage and adversely impacted security of supply in the North Island:⁷

We estimate about 17MW of the extra generation would have displaced North Island generation and resulted in increased North Island storage during December. It was known at the time there were planned HVDC and Pohokura outages during the first quarter of 2020. A large focus of the planning for that outage was security of supply, and North Island storage was critical to that. The foregone North Island storage likely meant the system was less resilient during the outage than it otherwise would have been, and that North Island prices were higher.

Similarly, in our original submission to MDAG we commented on how misuse of significant market power/breaches of the HSOTC rules can adversely impact competition in downstream or related markets:

We are at the frontline of abuses of market power in the wholesale electricity market. If or when Meridian (ab)uses its market power to raise wholesale electricity prices (including what it euphemistically describes as ‘efficiently managing locational risk’) it also results in windfall gains (higher spot prices) for Contact, Genesis, Mercury and Trustpower’s wholesale businesses. There is no countervailing benefit, only detriments, for independent retailers and, more importantly, consumers. Abuses of market power erode our margins and ability to offer lower and efficient (genuinely cost-reflective) retail prices for consumers.

...

⁶ This would correspond to a definition of significant market power such as: “market power becomes significant when prices can be influenced to a significant degree by one party or group of co-ordinating parties, or when prices can be set significantly in excess of economic costs”.

⁷ Electricity Authority, The Authority’s preliminary decision on claim of an undesirable trading situation: Claim submitted 12 December 2019 by Haast Energy Trading, Ecotricity, Electric Kiwi, Flick Electric, Oji Fibre, Pulse Energy Alliance, and Vocus, 30 June 2020, page iv.

Consistent with the circumstances we face, the European Union recognises that “Where [a supplier] has significant market power on a specific market, it may also be deemed to have significant market power on a closely related market, where the links between the two markets are such as to allow the market power held in one market to be leveraged into the other market, thereby strengthening the market power of the [supplier]”.⁸ In short, what this says is that problems of market power in the wholesale electricity market can result in heightened market power problems in the retail market. This is consistent with our observations and experience.

In order to ensure the definition of significant market power encapsulates all forms of harm, in relation to the section 15 objective, the definition should follow the Yarrow and Decker definition, cited in the MDAG consultation paper, and capture “the potential for inefficiency or harm”. The inclusion of the term “harm” would be a useful catch-all to ensure all elements of the long-term benefit of consumers is reflected in the definition.

The independent retailers **recommend** MDAG amend the proposed definition of significant market power to ensure it encapsulates all potential harm caused by the exercise of significant market power, including to reliability of supply and competition, with the addition of “, or otherwise cause harm to consumers”:⁹

“market power becomes significant when its exercise would have a net adverse impact on economic efficiency, which includes productive, allocative and dynamic efficiency, or otherwise cause harm to consumers”.

The independent retailers propose confirmation that significant market power includes transient market power

We consider that transient market power is a subset of significant market power, and clearly implicit in the MDAG proposed definitions. We note, however, questions were raised about this in submissions which MDAG does not appear to have explicitly addressed. From our submission:

“**MDAG should ensure its proposals capture transient market power:** We note Russell McVeigh’s commentary that the Courts may interpret significant and substantial market power in a similar way. This reinforces our recommendation that the scope for any ambiguity about the interpretation of significant market power be removed, either by clarifying “For the avoidance of doubt, significant market power includes transient market power” or otherwise defining what significant market power means in the Code.”⁷

From Meridian’s submission (circa 2011):

“It is odd to suggest that generators with transient market power should have unconstrained ability to take advantage of that power, or that the resulting price outcomes are an essential feature of an efficient spot market ...”¹⁰

While we consider that the MDAG revised proposals clearly capture transient market power, inclusion of a ‘for the avoidance of doubt’ clause could avoid the type of unnecessary debate reflected in the Meridian/Russell McVeigh submissions to MDAG, and Contact’s claim:

“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 markets.”¹¹

⁸ Article 14(3) of Directive 2002/21/EC: <https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32002L0021>

⁹ We are also comfortable with the adoption of a pure definition of significant market power, which does not add reference to the detriment the proposed HSOTC rules are trying to mitigate. See footnote 6.

¹⁰ Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.

¹¹ Contact, High Standard of Trading Conduct provisions: Discussion paper, 4 May 2020.

Potential guidance/examples of trading conduct that may breach the HSOTC rules

A number of the incumbent generators have suggested it would be desirable to provide examples or some form of guidance about how the HSOTC rules should operate. From the Trustpower cross-submission:¹²

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

We do not have a particular objection to this proposal, though it should not be allowed to hold up introduction of the new HSOTC rules. We consider behavioural or conduct issues, the market and environmental outcomes, and whether there are any extenuating (and, by inference, mitigating) factors should be taken into account.

We detail below a (non-comprehensive) checklist of examples/considerations which should be taken into account when considering potential HSOTC breaches, under the existing and proposed new HSOTC rules:

Behavioural issues	• Did price offers exceed SRMC by too much or for too long?
	• Were there attempts to avoid nodal price separation?
	• Was there unnecessary spill of water?
	• What was the intent of the trading conduct?
Adverse market and environmental outcomes	• Did the outcomes reflect supply and demand conditions?
	• What was the magnitude of the outcome compared to previous HSOTC breaches?
	• Did spot prices rise by too much or for too long?
	• Was there inefficient dispatch of electricity generation?
	• Were there any secondary impacts on reliability or security of supply?
	• Did the conduct have any adverse impacts on competition in the spot market or adjoining markets e.g. the electricity hedge and retail markets?
	• Were there any adverse environmental costs or waste of scarce resources?

¹² Trustpower, TRUSTPOWER'S CROSS SUBMISSION ON HIGH STANDARD OF TRADING CONDUCT (HSOTC) CODE CHANGE PROPOSAL , 27 May 2020.

Extenuating factors	<ul style="list-style-type: none"> • Is there an ongoing pattern of behaviour that needs to be addressed?
	<ul style="list-style-type: none"> • Have previous warnings by the Authority been ignored?
	<ul style="list-style-type: none"> • Were there any potentially misleading and unsubstantiated representations¹³ about the trading conduct?
	<ul style="list-style-type: none"> • Has there been an admission of harmful conduct and remedial actions to ensure no future breaches?

The integrity of the market must be protected

We agree with Sapere: “a fundamental function of market rules is to deter opportunistic behaviour and obviate costly self-protective measures” and “If the Code is to protect the integrity of the price discovery process, then it should, in line with all organised markets, require Market Participants to observe high standards of trading conduct”.¹⁴

We similarly agree with Mercury that “The integrity of the wholesale electricity market ... is the paramount consideration”¹⁵ and a “fundamental issue is that the regulatory system for the electricity market is seen to be effective, and has boundaries of acceptable behaviour that will give confidence to participants, consumers and investors”.¹⁶

Similarly, Tusk Legal Services acting for Mercury has commented:

There are certain prerequisites for a successful organised market (often referred to as an ‘exchange’). These markets, including NZEM, survive and develop when the participants in them are governed by a series of rules designed to protect the integrity of the market itself with particular regard to:

- (a) the flow and parity of information;
- (b) a robust settlements system;
- (c) avoidance of ‘artificial’ pricing; and
- (d) efficiency of the price discovery process.

Another feature of a successful exchange is one where not only are the rules (described above) in place but where there is also a mechanism for and a determination to enforcement of the rules and the provision of sanction for breaches.¹⁷

... public interest is a vital ingredient in the success or otherwise and the ongoing viability of the market. If the public has no confidence in the ability of the market to clear prices at what are reasonable levels, given the circumstances of the period in question, not only do participants face potential loss but the market as a whole faces a loss of confidence. This loss of confidence in NZEM would have serious public interest repercussions, including, but not necessarily limited to;

- (i) possible intervention by relevant authorities including, central Government, in the pricing of electricity in the wholesale market;
- (ii) lessening of the efficacy of price discovery leading to a rise in wholesale prices and the resulting rise in retail prices ...¹⁸

These comments all reinforce and support the efficacy of MDAG’s proposals to improve the HSOTC rules, to better ensure they protect against abuses of significant market power in the spot market.

¹³ Under the Fair Trading Act “A representation is unsubstantiated if the person making the representation does not, when the representation is made, have reasonable grounds for the representation, irrespective of whether the representation is false or misleading”.

¹⁴ Sapere, Kieran Murray, Claimed undesirable trading situation, 26 March 2011, 6 April 2011.

¹⁵ Mercury, Undesirable Trading Situation on 26 March 2011 - Submission on Proposed Actions in Response to the Final Decision, 21 June 2011 (and elsewhere).

¹⁶ Mercury, UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011, 19 May 2011.

¹⁷ Tusk Legal Services, Claimed Undesirable Trading Situation on 26 March 2011, 7 April 2011.

¹⁸ Tusk Legal Services, Claimed Undesirable Trading Situation on 26 March 2011, 7 April 2011.

Meridian submissions provide additional evidence there is a problem that needs to be resolved

Meridian has provided evidence, which based on our reading, indicates it considers it can take advantage of its significant market power, and this is part of normal, economically rational behaviour:¹⁹

- “Meridian considers its offer strategy to be economically rational behaviour ... there are no requirements to offer based on costs ... Meridian and other generators have implemented these tactics for many years.”
- “Spilling and making non-zero price offers is consistent with the normal operation of the wholesale market”.
- “generation is highly concentrated regionally ... short-term demand responses are very inelastic at low-to-moderately-high spot prices ... When these features of the spot market are taken into account, it is very predictable that there are times when offer prices will not fall to the low levels that might be “expected” despite spill occurring”.
- “... hydro generators do not offer their generation based on a bottom up assessment of their costs, they ... are economically rational in seeking to generate high volumes at prices the market will support ... Commonplace strategies in this regard include ... non-clearing tranches at high prices during periods of spill ... and ... offering some volumes at a price just below that of the next available source of generation from a competitor (this is economically rational behaviour and is to be expected in the New Zealand electricity market ...” [emphasis added].

We consider these types of statements reinforce the need for reform of the HSOTC rules, and for compliance monitoring and enforcement, particularly as they come from the largest New Zealand generator which has 55-60% of hydro generation capacity and 35% of generation supply.

Increase resourcing of the Authority’s monitoring and compliance function

To ensure the potential benefits from the HSOTC rule changes are realised it is critical the penalty provisions are reviewed and substantially increased. It is also critical the Authority has the resources and capacity to vigorously monitor and enforce compliance, and to do so in a timely manner.

This goes directly to the Authority’s strategic intent “to build trust and confidence in the industry for all stakeholders” and that: “As regulator, we need to continue using markets and our compliance function to create the right incentives for progress. We want participants to have regulatory confidence, stakeholders to trust in the system’s performance, to see better practice across industry and for consumers to feel empowered to act”.²⁰

In order to achieve the Authority’s strategic intent, it needs to substantially increase its resourcing and prioritisation of compliance monitoring and enforcement. We agree with the BHR Panel that “The Authority should beef up the current level of monitoring, and when it observes behaviour that may not be consistent with clause 13.5A it should issue the generator (or ancillary service agent) with a ‘please explain’ notice”.

¹⁹ Meridian Submission, Preliminary decision on claim of an undesirable trading situation, 18 August 2020.

²⁰ <https://www.ea.govt.nz/about-us/strategic-planning-and-reporting/strategy-reset-2020/>

The current penalty and compliance arrangements are not sufficient to protect against breaches of the HSOTC rules or misuse of significant market power, regardless of how clear or well written the rules are.





Concluding remarks

We agree with MDAG that its “... revised proposed code change is considerably better than the existing high standard of trading conduct provisions and should be put in place as an improved mechanism for mitigating the risks of significant market power”.

The Authority decided that the trading reviews should be reviewed in November 2017. We would like to see the changes MDAG is proposing introduced by the Authority as soon as practicable. While the Authority has set mid-2021 as its target, we are confident the Authority could complete any consultation it considers necessary and make a decision in the first quarter of 2021. The review of the HSOTC rules shouldn't take more than 4 ½ years to complete.

The MDAG proposals will help resolve the legitimate concerns Meridian (circa 2011) previously articulated that “It is odd to suggest that generators with transient market power should have unconstrained ability to take advantage of that power, or that the resulting price outcomes are an essential feature of an efficient spot market ...”.²¹

Yours sincerely,

<p>Al Yates Chief Executive alyates@ecotricity.co.nz</p> 	<p>Luke Blincoe Chief Executive luke.blincoe@electrickiwi.co.nz</p> 	<p>Steve O'Connor Chief Executive Officer steve.oconnor@flickelectric.co.nz</p> 
<p>Fraser Jonker Acting Chief Executive Officer fraser.jonker@pioneerenergy.co.nz</p> 	<p>Quentin Reade Head of Communications quentin.reade@vocusgroup.co.nz</p> 	

²¹ Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.

Appendix: Clarifications in response to the depictions of the independent retailers' positions

For the avoidance of doubt, Meridian's claim that "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"²² misinterprets our submissions. This is little more than a variation on the incumbent generators collective (incorrect) claim that the original version of the MDAG proposal is price control.

We have been very clear "It is disingenuous to suggest the MDAG proposal is price control" and "It is important that there is a clear understanding of what the proposal is and is not ... At the workshops there were attempts to liken the proposed trading conduct rules to price control. This is not a reasonable or accurate representation of the MDAG proposals (including our proposed variations and enhancements)".

The incumbents' submissions coalesced on the claim MDAG is proposing price control.²³ These claims are little more than scaremongering.

Mercury's claim that "being forced to publicly justify and explain pricing is essentially a form of price regulation",²⁴ if valid would mean that insurance and superannuation products in New Zealand that differentiate price on the basis of either age or gender is also amount to price control.²⁵

The MDAG proposals to restrict misuse of market power is not price control.

There is nothing in the MDAG proposal that would prevent prices from rising and falling in response to market changes in supply or demand, or from reflecting the short-run opportunity cost of supply (including changes in water value). The MDAG proposals would provide confidence to market participants that the market will operate in this way, even when individual suppliers have market power.

The MDAG proposals apply restrictions on offers that take advantage of market power in ways that deviate from the normal operation of supply and demand and are analogous to the restrictions in Part 2 of the Commerce Act. The MDAG proposal restricts generators from taking advantage of market power to set offers that are above cost by too much or for too long, and section 36 of the Commerce Act restricts generators from taking advantage of market power to set offers that are anti-competitive. For example, Russell McVeigh provided the example of predatory pricing.²⁶

The MDAG proposals provide an important safety valve for the wholesale electricity market in instances where competition cannot be relied on to operate the way it should. The incumbents are well aware of overseas experience where a loss of confidence in the market resulted in heavy-handed intervention such as retail market price control.

²² Meridian, MDAG review of the high standard of trading conduct provisions: Cross-submission, 27 May 2020.

²³ The incumbent retailers attempts to confuse the MDAG HSOTC proposals with price control is also reflected in Genesis and Meridian/Russell McVeigh's recommendation to remove clause 13.5A(3). Refer to the section of this submission "Potential amendments to the proposed HSOTC rules: Proposed clause 13.5A(3) should be retained" for a discussion of this matter.

²⁴ Mercury, Cross Submission on Discussion Paper – High Standard of Trading Conduct Provisions: A Review by the Market Development Advisory Group, 27 May 2020.

²⁵ We have previously noted that if an insurance company wants to price discriminate on the basis of age or gender that's fine if they can demonstrate the relative price of the product reflects a difference in risk. We are not aware of any suggestions the Human Rights Act applies price control.

²⁶ Russell McVeigh, MDAG REVIEW OF "HIGH STANDARD OF TRADING CONDUCT" PROVISIONS, 1 May 2020.

The incumbents' unfounded assertions should be put to rest with the revised HSOTC rules confirmation that "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".

Another example where our submission has been misinterpreted is Meridian's claim "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 ..."²⁷

Our actual position mirrors Meridian's (circa 2011) views on spot market pricing, and their relationship between SRMC and LRMC:

It is ... no answer ... to say that high, very high or excessive prices are a necessary part of an efficient spot market because they signal the need for investment and allow generators to recover fixed costs. While prices above SMRC are necessary for the recovery of fixed costs, there is no reason to think that such prices caused by the taking advantage of transient market power are necessary to ensure efficient investment or recovery of costs.²⁸

It is odd to suggest that generators with transient market power should have unconstrained ability to take advantage of that power, or that the resulting price outcomes are an essential feature of an efficient spot market. Rather than signalling the need for investment ... such outcomes are likely to result in a loss of dynamic efficiency. That is, there is no reason to think that high prices caused by the illegitimate exercise of transient market power are necessary to ensure efficient investment or recovery of costs. Investment has occurred in New Zealand in the past without the need for any such illegitimate exercise of market power ...²⁹

²⁷ Meridian, MDAG review of the high standard of trading conduct provisions: Cross-submission, 27 May 2020.

²⁸ Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.

²⁹ Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.