5 November 2020

Submissions
Market Development Advisory Group
Electricity Authority

By email: MDAG@ea.govt.nz

MDAG Review of the trading conduct provisions:
Supplementary consultation

Meridian appreciates the opportunity to provide feedback to the Market Development Advisory Group (**MDAG**) as part of the supplementary consultation for the review of the trading conduct provisions in Part 13 of the Electricity Industry Participation Code 2010 (**Code**).

This cross-submission should be read together with Meridian's primary submission to MDAG dated 4 May 2020 and cross-submission dated 27 May 2020.

In previous submissions Meridian tentatively supported MDAG's proposed option of a counterfactual test so that offers must be consistent with offers that the generator or ancillary service agent would have made where no generator or ancillary service agent could exercise significant market power. That tentative support was conditional on several changes being made to the drafting. Most importantly, Meridian did not support the "purpose statement" that was proposed to accompany the test as it contained several errors or omissions and would increase uncertainty, misapply the Authority's statutory objective, and risk significant unintended consequences.

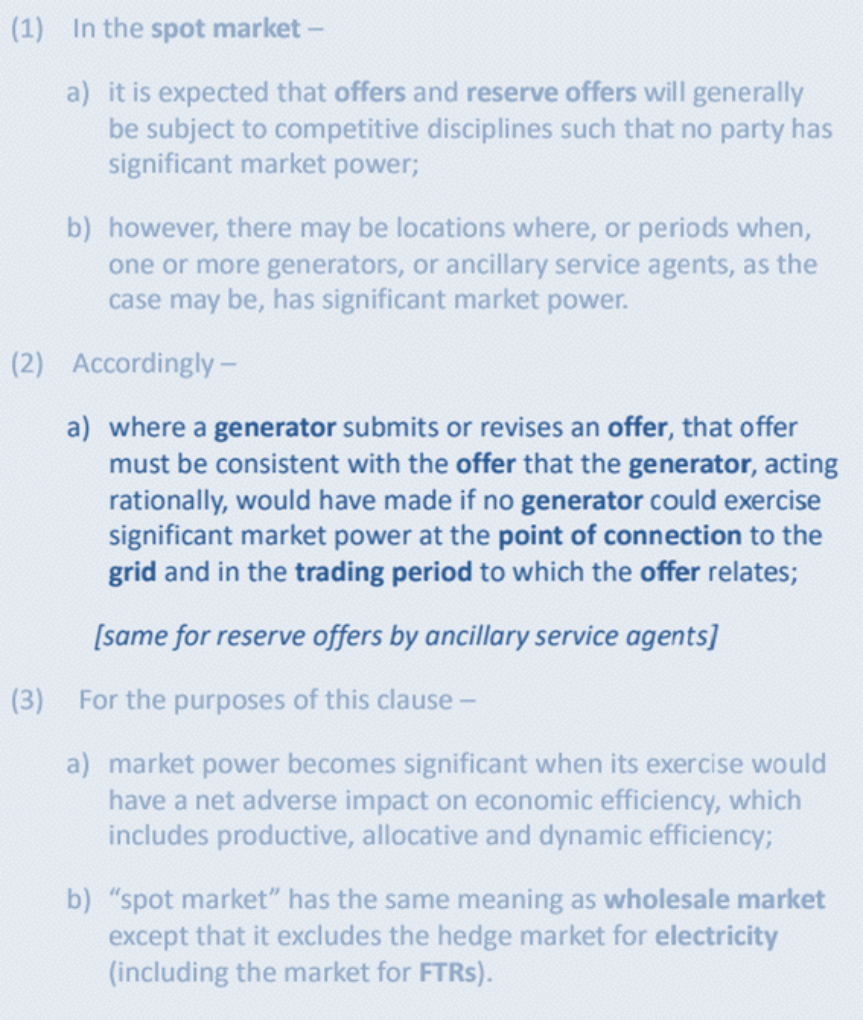
Meridian also asked that a full cost benefit analysis of the proposal be undertaken as part of consultation by the Authority. We believe the cost benefit analysis prepared by MDAG is inadequate and that regulatory change of this potential significance should be assessed and consulted on by the Authority, rather than the work of MDAG simply being rubber stamped.

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

In MDAG's supplementary consultation paper, MDAG has presented several changes to the proposed drafting of the rule. MDAG has made changes to the substantive rule and now proposes to delete the purpose clause and replace it with a simplified preamble (clause (1)) and an explanation of when market power becomes significant (clause (3)).



(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;

[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**).

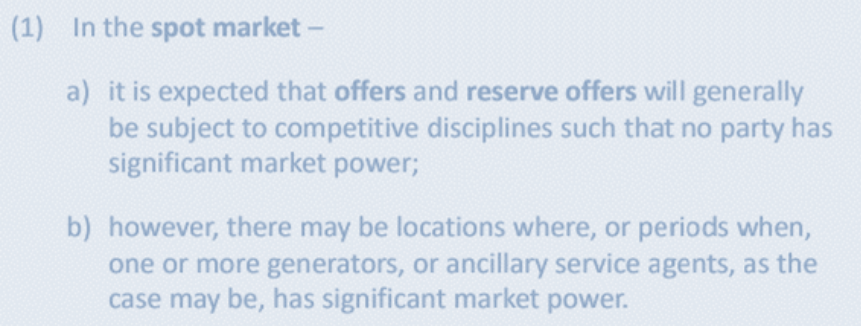
Meridian considers the deletion of the previous "purpose clause" to be an improvement on the previous drafting. We note the various concerns that were raised about the previous "purpose clause" by several other submitters and by both evaluation panels.

Meridian therefore continues to tentatively support the substantive test now in clause (2). However, Meridian still has concerns with aspects of the drafting, the lack of certainty for participants, and the potential for unintended consequences. This submission is structured under the following headings:

- Clause (1) makes observations
- 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 remains a significant risk of unintended consequences
- The process followed by MDAG has been less than ideal.

Meridian's responses to the consultation questions are also appended, however, for the most part Meridian's comments are in the body of this submission and not constrained by the consultation questions posed.

Clause (1) makes observations


(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 slightly 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.

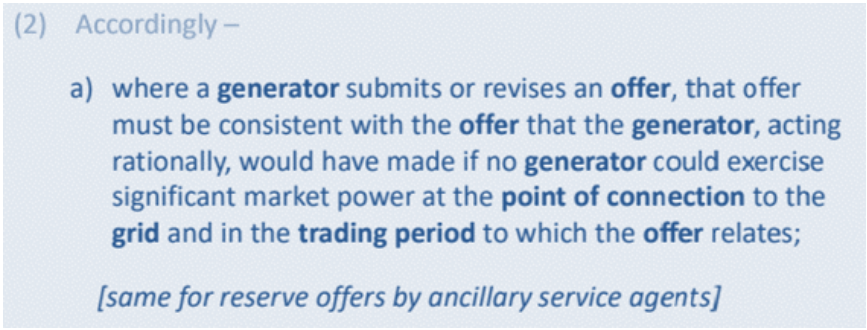
Meridian therefore suggests that the words "it is expected" simply be deleted. The word "generally" later in the sentence conveys similar meaning without seeming to imbue the Code with sentiments. The clause would then read as follows:

(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



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 several important caveats are addressed:

- 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". That text should be

[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."

replaced by a reference to the relevant market. 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 spot market ~~at the **point of connection** to the **grid** and in the **trading period** to which the **offer** relates~~.

The deleted words "in relation to that point of connection to the grid for that trading period" only add confusion to the proposed test. Their deletion would avoid the risk of the market being always defined as a point of connection or specific trading period when that is simply not the case. The MDAG presumably does not intend for market power to be assessed in relation to a market defined as a single point of connection; such an assessment would not encompass the factors that directly shape and constrain rivalry. Similarly allowing the Rulings Panel or courts to decide the relevant period over which a generator or ancillary agent's conduct is to be considered, whether that is a single trading period or a more extended period, would enable proper consideration of the nature of the market power that is alleged to have been exercised.

- Secondly, while the proposed behavioural standard can be considered by a generator ex ante, significant uncertainty would remain for traders in their day-to-day practice. To some extent this may be unavoidable. However, 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 counterfactual test would be applied and the sorts of things the Rulings Panel or courts would likely consider. The work of the MDAG appointed evaluation panels has provided some useful insights but was inevitably relatively superficial given the time available, the lack of real-world detail provided to the panel members, and the panel members' inexperience with spot trading in electricity markets.

In this latest iteration, MDAG has added the words "acting rationally" to the counterfactual test. This addition seems meaningless and has been made with limited explanation. The

short MDAG paper accompanying the latest iteration of the test simply states that the words "clarify that it is not the subjective view of the generator, but rather an objective view based on the generator behaving in an economically rational manner". It should go without saying that generators or ancillary service agents in any counterfactual test are expected to behave in a rational manner. It would be very difficult for the Rulings Panel or court to read irrational behaviour into any counterfactual test and we do not consider this a plausible scenario that needs to be addressed by the additional words proposed.

Furthermore, by claiming to be about objective rather than subjective rationality, there is a potential risk of unintended consequences. In counterfactual tests under the Commerce Act, the counterfactual scenario is one in which the *actual business* in question is put in the same situation but with only such changes as are necessary to remove any market power. The counterfactual test therefore remains about the business in question and how *that business* would (rationally) behave in the absence of substantial market power, and not about how some imaginary business might behave. We consider the MDAG counterfactual test would also operate in this manner, however we would appreciate clarification of what MDAG intended by the addition of the words "acting rationally" before commenting further.

Finally, clause (2) continues to impose regulatory burdens on all generators, whether or not the generator has market power. MDAG has not made the case for why a generator, without market power, should be required, in relation to each offer it makes, to assess what the market outcomes might be if no generator could exercise market power and then make its offer based on that speculation rather than the market circumstances it is experiencing. A requirement for generators to divorce their offer strategies from market conditions in favour of a hypothetical construct would not only impose unjustified administrative burdens on all generators, it would risk unnecessarily interfering in the price discovery process as the market imagined by the generator may not reflect reality. The text should be revised to place the obligation only on generators with market power. The 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 it ~~no~~ ~~**generator**~~ could not exercise significant market power in the spot market ~~at the~~ ~~**point of connection**~~ ~~to the~~ ~~**grid**~~ ~~and in the~~ ~~**trading period**~~ ~~to which the~~ ~~**offer**~~ ~~relates~~.

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. The reference to impact on economic efficiency does not improve the analysis, as it is unclear what economic efficiency the definition is concerned with – the efficiency of the spot market as a whole or in a region, or at a node, the efficiencies of all operators bidding into the sport market, the efficiency of the operator alleged to have market power, or the efficiency of some other set of market participants not directly involved in the conduct in question. Piecing this together with the counterfactual test proposed in clause (2) would effectively be an impossible task, requiring a large number of assumptions and some guess work.

Of even greater importance is that the proposed new clause (3) misapplies the economic texts upon which MDAG claims it is based. The texts referred to by MDAG note that market power is the ability to affect the market price even a little and even for a few minutes and that market power is almost ubiquitous. Yarrow and Decker observe that, for these reasons, the term market power in competition law and public policy generally appears with a qualifying adjective such as 'significant' or 'substantial' so as to focus on the issue of interest – the degree of such power. Meridian agrees.

According to the consultation paper, "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 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 MDAG 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 thought 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. In effect MDAG seems to be saying with this proposed clause that *all* market power is significant because exercising market power even a little would have an adverse impact.

The use of the word "net" in the MDAG proposal does little, if anything to, allay our concerns. It is not at all clear what is meant by a *net* adverse impact on economic efficiency as the rule does not say what the adverse impact is net of.

Meridian therefore considers that clause (3) as currently drafted suggests a novel and unworkable definition of significant market power that would lead to unintended consequences. With respect to MDAG, the concept of significant market power is something that the courts have discussed in detail and have been unable to distil into 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 MDAG would be able to succinctly redefine significant market power without oversimplification, errors, and unintended consequences. As stated in Meridian's earlier submissions, there is absolutely no need for the Code to abbreviate the detailed economic concepts and jurisprudence that will inform the counterfactual test – all of which are better to be inferred by decision-makers based on their own consideration of the relevant authorities and circumstances.

There remains a significant risk of unintended consequences

Whatever shape the MDAG proposal takes 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 form the Sapere report by way of summary:

> "Under the proposal, a generator, or supplier of interruptible load, would breach the Code if the Authority considered its offer price exceeds the price it would have offered were it to have faced stronger competition.
>
> The MDAG proposal is novel. It would apply price control after services have been supplied, when best practice regulation argues for ex ante regulation. MDAG justify ex post price regulation by referring to competition policy; a regulatory framework that does not attempt to set or regulate prices. And it would empower the Authority to review offer prices by generators that do not have significant market power.
>
> MDAG recommend these measures without first assessing whether market power has been exercised, or is a problem, in the wholesale electricity market; the potential benefits of its proposal are therefore unknown.
>
> 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 process followed by MDAG has been less than ideal

A more robust cost benefit analysis is required for such significant reform

As noted previously by Meridian, MDAG has not adequately assessed the costs and benefits of its proposal. MDAG said in the first consultation paper that costs "are expected to be negligible because direct costs are near-zero and we expect no increase in indirect costs". The term "indirect costs" is used by MDAG to describe efficient behaviour deterred by the proposed Code. MDAG has, in effect, asserted that its proposal can be introduced without deterring any efficient behaviour. MDAG explains that it holds this belief "because the proposed Code uses a standard that is more tightly linked to the relevant economic principles than the existing Code, and for this reason we expect more deterrence of 'bad' behaviour and less deterrence of 'good' behaviour".

For MDAG's claim to be true, investigations by the Authority and decisions by the Rulings Panel would need to always result in 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.

While the cost benefit analysis was not adequate for the first iteration of the MDAG proposal, it is non-existent for this most recent iteration. The extent of MDAG analysis supporting the latest proposal is a handful of summary slides.

We have yet to learn whether the Authority expects to consult on a Code change based on MDAG's proposal, but we will be surprised if they do not because of the importance of this rule to the workings of the market. Further, given the paucity of a cost benefit analysis by MDAG we expect that the Authority will want to do a robust cost benefit analysis as part of such consultation and be guided by the result before proceeding. We expect that the rule that the Authority proposes may yet be different from the MDAG's proposal especially given some of the points we make above.

Overreliance on evaluation panels rather than submissions and analysis

MDAG seems to have placed undue weight on the use of evaluation panels relative to submissions. While the MDAG consultation paper provides a very high level summary of submissions (a total of five bullet points), this largely dismisses the points made and fails to engage with the concerns presented to MDAG. The consultation paper purports to link to a more detailed summary of submissions, but none has been published to date. In contrast, MDAG has said that "the quality of the learning and insight gained in the evaluation panel process was considerable" and the views "strongly informed our revised proposal". Page 15 of the consultation paper makes it clear that MDAG primarily (if not exclusively) considered the recommendations of the evaluation panels ahead of submissions in forming its most recent proposal. The Authority has effectively outsourced policy development to MDAG, who has in turn outsourced it to panels of its own appointment. This is a long way from the due process that might be expected by participants under the Electricity Industry Act for the development of Code requirements.

The evaluation panel process was opaque and MDAG controlled the content to which panel members were exposed as well as the presentation of the evaluation panel's findings. MDAG should not underestimate the extent to which their own preparation of the panels may have steered their findings.

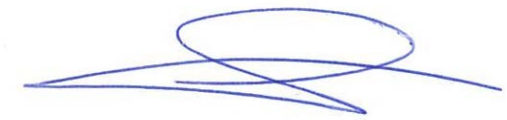
The role of advisory groups and need for further consultation

This part of our submission is addressed to the Authority rather than MDAG. Given the above concerns with the process run by MDAG, Meridian restates its concerns with the suggestion that the Authority may simply rubber stamp the recommendations of MDAG rather than carry out its own analysis and consultation. Meridian urges the Authority to follow due process and carry out its own consultation and analysis in respect of this potential change to the Code. Not doing so would contradict the intent of the Act as well as the

Authority's own foundation documents. It would also risk over-inflating the importance of advisory group membership and drive the industry participants that are fortunate enough to be represented on advisory groups towards more partisan participation.

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

(2) In the spot market –

c) ~~it is expected that~~ offers and reserve offers will generally be subject to competitive disciplines such that no party has significant market power;

d) 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.

(3) 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 spot 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]

(4) 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: Response to consultation questions

	Question	Response
1.	Do you agree that the proposed 'rule' [clause 2] is better than the existing rule, which requires parties to ensure that their "conduct in relation to offers and reserve offers is consistent with a high standard of trading conduct"?	Yes.
2.	Do you agree that the economic efficiency framework underpinning the proposed 'rule' is better than the existing HSOTC framework?	Yes.
3.	Do you agree that the new preamble [clause 1] is effective in conveying succinctly the intended framework and purpose of the 'rule' [clause 2]?	No. It is simply two observations. While these provide some context that may be useful, proposed clause 1 does not convey intent. Despite this, Meridian considers proposed clause 1 to be helpful because of the acknowledgement of competitive disciplines as the main driver of offers. See the body of this submission for further comments.
4.	Do you agree with clause 3(a), which states when market power becomes significant?	No. Proposed clause 3(a) is inconsistent with the economic texts upon which MDAG claims it is based and would result in unintended consequences. See the body of this submission for further comments.
5.	Overall, do you support the revised proposed code change in preference to the existing HSOTC provisions?	This question duplicates question 1 above. Meridian prefers the proposal to the existing HSOTC provisions. However, we do not wholly support the revised proposal. See the body of this submission for further comments.