

21 May 2020

Tony Baldwin  
Chair  
MDAG  
Electricity Authority

By e-mail: [MDAG@ea.govt.nz](mailto:MDAG@ea.govt.nz)

Dear Tony,

## **It should be non-contentious that the HSOTC rules should prevent mis-use of market power, and this is necessary to support the integrity of the market**

We agree with Contact that “the Market Development Advisory Group (MDAG) has provided a comprehensive review of its proposed alternative option for the High Standard of Trading Conduct (HSOTC)”.<sup>1</sup>

MDAG’s design work is fundamentally robust and makes sound use of economic principles. This is illustrated, for example, by the extensive and heavy overlaps we highlighted between the economic analysis in Meridian’s submissions on the 26 March 2011 UTS, the December 2019 HSOTC and UTS complaint, and the MDAG HSOTC discussion paper. Our cross-submission highlights that commentary provided by Mercury and Sapare in relation to the 26 March 2011 UTS also supports MDAG’s proposals.

### **Summary of Electric Kiwi and Haast’s views on the incumbent submissions**

We agree with Sapare that “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”<sup>2</sup> and “a fundamental function of market rules is to deter opportunistic behaviour and obviate costly self-protective measures. The rules of an organised market protect the integrity of the settlement process and protect the integrity of the price discovery process”.<sup>3</sup>

We similarly agree with Mercury that “The integrity of the wholesale electricity market ... is the paramount consideration”.<sup>4</sup> The MDAG proposals are important for protecting the integrity of the wholesale electricity market and the price discovery process.

We agree with Mercury that it is undesirable for generators to take advantage of pivotal positions, and market participants should be able to rely on predictable offer behaviour that is consistent regardless of whether the generator has market power.<sup>5</sup> This is exactly what MDAG is trying to achieve with their proposals. Our submission highlighted similar type comments from Meridian who is concerned that if transient market power isn’t regulated then “anything goes”.

We also agree with Mercury that a generator should not be able to “exploit” short term market power “to charge whatever it likes either in the wholesale or hedge markets as a means to artificially boost returns across their portfolio or for an individual station”.<sup>6</sup> The exploitation of market power to extract excessive revenues and returns is a key harm to the interests of consumers that

<sup>1</sup> The MDAG HSOTC review is polars apart from the previous saves and winbacks work and recommendations.

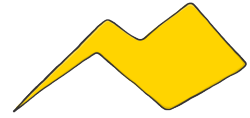
<sup>2</sup> Sapare, Kieran Murray, Toby Stevenson and Sally Watt, Comments on draft decision of the Electricity Authority: alleged UTS on 26 March 2011, 13 May 2011.

<sup>3</sup> Sapare, Kieran Murray, Claimed undesirable trading situation, 26 March 2011, 6 April 2011.

<sup>4</sup> Mercury, Undesirable Trading Situation on 26 March 2011 - Submission on Proposed Actions in Response to the Final Decision, 21 June 2011 (and elsewhere).

<sup>5</sup> Mercury, Consultation Paper - Draft decision regarding alleged UTS on 26 March 2011, 13 May 2011.

<sup>6</sup> Mercury, UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011, 19 May 2011.



the market rules should address. Mercury demonstrated this harm well in its 26 March 2011 UTS claim.

We also agree with Mercury that “During times when one party can become net pivotal in a constrained region purely through its own actions and without sanction, there is no short term supply side competition and consequently no competition ... The net pivotal party can squeeze the wholesale and hedge markets in the region ... The squeeze behaviour does lead to higher costs in the region (whether through wholesale or hedge market outcomes) which must through time be recovered from consumers in that region ...”.<sup>7</sup> We have not been able to reconcile these clear and reasonable positions with Mercury’s more laissez faire (or, using Meridian’s words, “anything goes”) MDAG submission positions.

The comments Sapare has made disputing claims that regulating for abuses of market power would result in some form of price cap or control are prescient. The comments Sapare made in relation to the 26 March 2011 UTS decision are equally valid in relation to the incumbent responses to the MDAG consultation.

Sapare was very clear that recalculating prices is justified where they are “artificial” and are not “an outcome of supply and demand built the result of market manipulation”. As was then, and as is now, the proposals “[do] not prevent prices from rising, or falling, to whatever level is needed to balance supply with demand. In an electricity market, in which electricity cannot be stored economically, prices at the margin should be free to rise or fall to the short-run marginal opportunity cost of supply ...” Nothing in the MDAG draft proposal “interferes with this economic concept of pricing”.

The MDAG proposals reflect that the Authority should intervene if prices “do not reflect the basic forces of supply and demand – that, is, it will intervene if the market has ceased to work as a process of price discovery and becalmed a means of exploitation ...”<sup>8</sup>

### **The MDAG proposals are important for protecting the integrity of the wholesale electricity market and the price discovery process**

We agree with Mercury that “The integrity of the wholesale electricity market ... is the paramount consideration”.<sup>9</sup>

We also agree with Mercury 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”.<sup>10</sup>

Similarly, Sapare has pointed out:

The work of Noble Laureate Ronald Coase, and other theoretical economists, who explain the role of market rules in deterring opportunistic behaviour and obviating the need for costly self-protective measures.<sup>11</sup>

... a fundamental function of market rules is to deter opportunistic behaviour and obviate costly self-protective measures. The rules of an organised market protect the integrity of the settlement process and protect the integrity of the price discovery process.

Many of the rules of an organised market express precisely what a participant can and cannot do; other rules, such as the Undesirable Trading Situation rule, are expressed in general or imprecise terms. Economists refer to imprecise rules as “standards”. Precise rules are used where it is possible to stipulate efficient behaviour in advance.

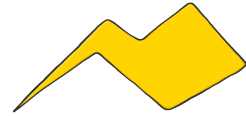
<sup>7</sup> Mercury, UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011, 19 May 2011.

<sup>8</sup> Sapare, Kieran Murray and Toby Stevenson, Cross-submission comments: draft decision on the Electricity Authority: alleged UTS on 26 March 2011, 19 May 2011.

<sup>9</sup> Mercury, Undesirable Trading Situation on 26 March 2011 - Submission on Proposed Actions in Response to the Final Decision, 21 June 2011 (and elsewhere).

<sup>10</sup> Mercury, UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011, 19 May 2011.

<sup>11</sup> Sapare, Kieran Murray and Toby Stevenson, Cross-submission comments: draft decision on the Electricity Authority: alleged UTS on 26 March 2011, 19 May 2011.



Standards are used where it is not feasible to specify behaviour in advance, or where the application of the rule may depend on the circumstances, and the interpreting body must determine after the event whether the behaviour met the intent of the rule. ...<sup>12</sup>

Similarly also, 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.<sup>13</sup>

... 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 ...<sup>14</sup>

The above is 'bullseye' what the MDAG paper and proposals are all about. The Mercury and Sapare comments about good market design highlight the MDAG discussion paper may have not explicitly captured all the benefits that would arise from its proposals and reinforce that the reforms are warranted.

### **The incumbent submissions highlight the need to protect the integrity of the market**

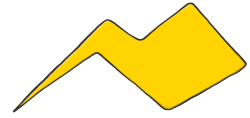
The following incumbent propositions are reasonable and should be non-contentious:

- "workable competition is the correct interpretation of the Authority's statutory objective" (Meridian).
- "... the existing High Standard of Trading Conduct provisions could be made more effective and ... reform is justified" (Genesis).
- "The proposal set out in the MDAG's discussion paper makes some logical improvements to the status quo and ... represents a significant step in the right direction" (Genesis).
- "... there are occasions where generators have the ability to exercise unfettered market power ..." (Genesis).
- "The problem to address is when pivotal generators are able to submit offers that take advantage of (transient) market power"/" a substantial increase in price is only of concern to the extent that it occurs due to a generator taking advantage of ... market power – which may only be one or two trading periods" (Genesis).
- "... it would not be inconsistent with the Authority's mandate for it to impose a regulation that properly restricts the exercise of market power by too much or for too long" (Russell McVeigh).

<sup>12</sup> Sapare, Kieran Murray, Claimed undesirable trading situation, 26 March 2011, 6 April 2011.

<sup>13</sup> Tusk Legal Services, Claimed Undesirable Trading Situation on 26 March 2011, 7 April 2011.

<sup>14</sup> Tusk Legal Services, Claimed Undesirable Trading Situation on 26 March 2011, 7 April 2011.



- The HSOTC rules “should promote offer behaviours and efficiency outcomes consistent with competitive markets” (Contact).
- “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” (Meridian).
- “Market participants must be able to rely on predictable offer behaviour inside a transmission constraint period that is consistent with offer behaviour outside the constraint under similar conditions” (Mercury).<sup>15</sup>
- “It must be undesirable to squeeze the market during a physical transmission constraint by modifying prices to take advantage of a net pivotal position” (Mercury).<sup>16</sup>
- “generators should not be able to exercise market power when making offers” (Genesis).
- “Genesis accepts MDAG’s intention, in part, is to limit generators’ ability to manage basis risk through their offers.”
- “A party could exercise market power through the unjustified withholding of generation or reserve volumes” (Contact).
- “... MDAG ... should ... address the ... problem ... of net pivotal situations where participants have scope to manipulate market power situations to extract excessive economic rents” (Mercury).
- “We ... do not agree that ... any ... generator should be able to exploit short term transmission constraints to charge whatever it likes either in the wholesale or hedge markets as a means to artificially boost returns across their portfolio or for an individual station” (Mercury).<sup>17</sup>
- “What keeps downward pressure on retail prices is competition, which was the substantial driver behind the many outcomes of the Electricity Industry Act 2010. During times when one party can become net pivotal in a constrained region purely through its own actions and without sanction, there is no short term supply side competition and consequently no competition for the supply of hedges. The net pivotal party can squeeze the wholesale and hedge markets in the region, behaviour which we have seen both during and subsequent to 26 March. The squeeze behaviour does lead to higher costs in the region (whether through wholesale or hedge market outcomes) which must through time be recovered from consumers in that region (in this case all customers north of Hamilton)” (Mercury).<sup>18</sup>

### **The market rules should not allow generators to abuse market power**

We agree “generators should not be able to exercise market power when making offers” (Genesis), “the EA [should] provide the strongest possible guidance regarding taking advantage of net-pivotal transmission constraints” (Mercury),<sup>19</sup> and the HSOTC rules “should promote offer behaviours and efficiency outcomes consistent with competitive markets” (Contact):

- Applying direct restrictions on abuse of market power would help preserve and protect the current wholesale electricity market arrangements and are not, contrary to Contact’s claims, “a significant departure from the current wholesale electricity market design”.

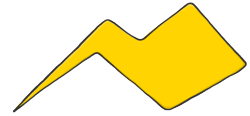
<sup>15</sup> Mercury, Consultation Paper - Draft decision regarding alleged UTS on 26 March 2011, 13 May 2011.

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

<sup>17</sup> Mercury, UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011, 19 May 2011.

<sup>18</sup> Mercury, UTS on 26 March 2011 - Cross submission in response to Submissions made 13 May 2011, 19 May 2011.

<sup>19</sup> Mercury, Undesirable Trading Situation on 26 March 2011 - Submission on Proposed Actions in Response to the Final Decision, 21 June 2011.



- Generators should not be able to “manipulat[e] market power ... to manage price separation risks” (Mercury). The fact Mercury and Meridian now claim this is “legitimate” (Mercury<sup>20</sup>) and is not in breach of the HSOTC rules (Meridian) highlights the size of the problem MDAG is trying to address.
- Telling generators they are not allowed to abuse their market power “by too much or for too long” would NOT have negative “impacts to competition and dynamic efficiency that are inconsistent with the Authority’s strategic [statutory?] objective” (Mercury). If “the electricity generation market is generally workably competitive but there are occasions where generators have the ability to exercise unfettered market power” (Genesis) then the MDAG proposals should have limited impact (applying to a small number of half-hour periods) on the competitive dynamics and operation of the wholesale electricity market.

### **MDAG is not proposing price control**

Setting market rules that tell generators they are not allowed to abuse their market power “by too much or for too long” is NOT price control. To be clear, Part 4 Commerce Act price control is designed to replicate outcomes in workably competitive markets, whereas the MDAG proposals are designed to ensure wholesale market outcomes do not depart from workably competitive market outcomes.

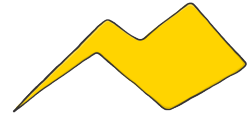
The incumbent submissions are uniform in their claim MDAG is proposing price control on the wholesale electricity market, albeit with different labels such as “de facto price control” and “discretionary price control”.<sup>21</sup> The entire Sapare report was based on the premise “MDAG proposes that all offers to sell electricity or ancillary services in the wholesale market be subject to a form of price control”.<sup>22</sup>

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<sup>20</sup> Mercury claimed “If generators are prohibited for example from using physical assets to close transmission constraints to manage downside risks, one solution could be to no longer offer products in those regions thereby reducing retail competition. This would clearly run contrary to the achievement of the EA’s statutory objective to promote competition”. If this statement is correct then it highlights that there are substantive problems with the hedge market. The way to resolve this is by the introduction of more robust mandatory hedge market arrangements, and not by allowing the vertically-integrated incumbents mis-use their market power in order to manage location risk. This is outside the scope of the MDAG HSOTC review, but the group may want to raise it with the Authority as something that should be addressed as part of the current hedge market development review.

<sup>21</sup> If the incumbents genuinely believed “MDAG would have the Authority extend price regulation to the wholesale market” they would have argued the MDAG proposal are ultra vires as they would overreach into the Commerce Commission’s responsibilities under Part 4 Commerce Act.

<sup>22</sup> Sapare contradicts its own point by also stating: “If the Authority determines that no generator has significant market in a given trading period, no amount of divergence [from economic cost] would breach the rule”.



If the abbreviation “EA” is replaced with “MDAG”, the following Sapare statement serves as an appropriate response to the incumbent submissions (including Sapare itself) (emphasis added):<sup>23</sup>

#### EA is not setting a price cap

32. A theme raised by several submitters is that the draft EA decision, if confirmed would cap wholesale electricity prices. These submissions seem to misinterpret the EA’s reason for re-setting the wholesale prices - a confusion not helped by the EA proposing a method for re-calculating prices that would not achieve its intention to restore prices to the level they would have been had buyers had the opportunity to arrange an alternative source of supply or to curtail demand.
33. The EA did not propose to re-calculate prices simply because they were too high. The EA and most submitters seem to agree that price level (high or low) is not on its own a UTS. The EA proposes to re-calculate the interim prices for specified periods on 26 March because those interim prices were ‘artificial’; the prices were not an outcome of supply and demand but the result of a market manipulation known as a squeeze.
34. This decision does not prevent prices from rising, or falling, to whatever level is needed to balance supply with demand. In an electricity market, in which electricity cannot be stored economically, prices at the margin should be free to rise or fall to the short-run marginal opportunity cost of supply – when existing capacity becomes constrained, the opportunity cost of electricity is the price point at which sufficient consumers would voluntarily take their next best alternative rather than consume an extra unit so that limited supplies are efficiently rationed among customers. Nothing in the draft EA decision interferes with this economic concept of pricing.
35. The EA, however, has (correctly) signalled that it will intervene if a UTS arises from prices being set which do not reflect the basic forces of supply and demand – that is, it will intervene if the market has ceased to work as a process of price discovery and becomes a means of exploitation (of either generators or purchasers).

#### MDAG and the Authority should not give weight to submissions based on the premise MDAG has rejected workable competition or is proposing price control

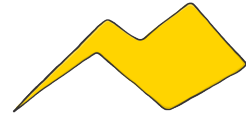
Other than the claim the MDAG proposal is price control, the other main premise of the incumbent submissions was that MDAG had “reject[ed] a workable competition objective”.

No reasonable person could draw the conclusion from the MDAG discussion paper or the HSOTC proposal that MDAG “fail[ed] to incorporate a “workably competitive” standard”, “MDAG expressly rejects a workable competition objective”, or “MDAG’s proposed standard compares a party’s offer to a hypothetical counterfactual that assumes a strongly competitive market where there is sufficient rivalry between sellers to push offer prices close to their associated efficient costs” (Genesis). It appears Genesis has a sound grasp of the problem, but did not understand MDAG’s proposal.

Russell McVeigh made similar errors in their claim it “appears to be the intention set out in the purpose statement and wider Discussion Paper” is to “best ensure market prices settle at a level that only just covers their (retrospectively assessed) costs in each half hour trading period”. As a novel variation on the incumbent interpretations, Sapare suggested the MDAG proposal is that the stronger the market power of the generator, the closer their offers are required to be to a perfect competition standard, with “by too much or for too long” inversely correlated to market power.<sup>24</sup>

<sup>23</sup> Sapare, Kieran Murray and Toby Stevenson, Cross-submission comments: draft decision on the Electricity Authority: alleged UTS on 26 March 2011, 19 May 2011.

<sup>24</sup> See Figure 1 of Sapare’s report and the related discussion.



### Meridian’s “up-you” response to its regulator”

Meridian’s commentary in relation to its 2 June 2016 breach of the HSOTC rules appears to represent “An “up-you” response to its regulator”<sup>25</sup> and to MDAG.

Meridian unequivocally disputed “The Authority held that it [Meridian] was in breach and outside the clause 13.5B safe harbours”.

Meridian dismissed the Authority’s letter of warning as no more than “its opinion”. According to Meridian the letter “does not amount to a finding of a Code breach”, and “carries no legal weight as the Authority has no statutory function or responsibility when it comes to deciding whether the Code has been breached”. Meridian “did not and does not agree with the Authority’s comments in respect of 2 June 2016 and made a public media release at the time saying as much” .:

It is apparent from Meridian’s submission that while the Authority considers it made a decision, Meridian does not acknowledge it to be a decision. The Authority was clear, in its Notification of the Authority’s decision under regulation 29 of the Electricity Industry (Enforcement) Regulations 2010, that “The Authority decided Meridian’s trading conduct on 2 June 2016 was not of a high standard and, therefore, breached clause 13.5A(1)”. Meridian’s commentary to MDAG on the decision ignored the Notice. Meridian claimed MDAG was “incorrect” in making “statements to the effect that the Authority made a decision finding Meridian in breach of the HSOTC provisions, despite the Notice clearly detailing “The Authority’s decision”.

While “Meridian would like the MDAG, Authority, and other participants to proceed on a shared understanding of what occurred in the 2 June 2016 event” it appears that the only party who does not have a shared understanding is Meridian itself:

“The Authority’s decision”	Meridian’s “Mischaracterisation of 2 June 2016 decisions”
<p><b>Reason for the Authority’s decision</b></p> <p>The Authority decided Meridian’s trading conduct on 2 June 2016 was not of a high standard and, therefore, breached clause 13.5A(1). The Authority also concluded that Meridian’s trading conduct for trading periods 36 and 38 on 2 June was outside of the safe harbour provisions under clause 13.5B(1).</p>	<p>Also, at paragraphs 48 and 49 and the heading between those two paragraphs, the MDAG paper repeats statements to the effect that the Authority made a decision finding Meridian in breach of the HSOTC provisions. This is incorrect. In fact, the only Authority decisions made in respect of the events of 2 June 2016 were:</p> <ul style="list-style-type: none"> <li>• a decision that there was no undesirable trading situation under Part 5 of the Code; and</li> <li>• a decision, under regulation 23(3)(a) of the Electricity Industry (Enforcement) Regulations 2010, to discontinue the investigation into the breach of the HSOTC provisions.</li> </ul>

The Meridian submission, including the Russell McVeigh and Sapare reports, didn’t offer any evidence its use of market power to manage locational risk was not in breach of the (existing) HSOTC rules.<sup>26</sup> This was just asserted and treated as axiomatic.

We posit that where a market participant rejects the regulator’s finding that it had breached the HSOTC rules, in such a dismissive manner as Meridian, it is reasonable to assume the warning was ineffective and the conduct is ongoing. Meridian and Mercury have basically said as much. This speaks strongly to the scale and nature of the problem the proposed HSOTC rules need to address.

### The December 2019 HSOTC and UTS breach complaint provides the “worked example, applied to real data” Sapare criticise MDAG for not providing

Sapare criticised MDAG on the basis that the group did “not provide a worked example, applied to real data, to illustrate its understanding of its proposed rule”.<sup>27</sup>

<sup>25</sup> E-mail from Brent Layton to James Stevenson-Wallace Subject: Re: Media - Matt Rowe commentary piece on LinkedIn, 2 July 2019 5:02 PM.

<sup>26</sup> Keiran Murray, Sapare, indicated their report would include this information at the Wellington HSOTC Workshop.

<sup>27</sup> Genesis, Mercury and Trustpower have also sought breach examples. For example, Mercury state: “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



It is not clear why Sapare consider MDAG should have done this, or why a “worked example, applied to real data” is needed to “illustrate” MDAG’s proposed HSOTC rules. This would effectively require MDAG to shift from its policy development role into a de facto market monitoring and compliance role. It is appropriate that MDAG provided some prima facie examples of potential breaches of the HSOTC rules.<sup>28</sup>

Fortuitously, however, the December 2019 HSOTC and UTS Code breach complaint provides a real world example, “applied to real data”, which illustrates conduct we consider is in breach of the existing and proposed replacement HSOTC rules. This includes modelling which compares the actual market outcomes (based on use of market power) and a conservative workably competitive market counterfactual.

Fortuitously also, the December 2019 breach complaint is an example which accords with two of Russell McVeigh’s examples of market manipulation/breach of the proposed HSOTC rules (withholding of capacity and excessive offer prices<sup>29</sup>):

- (a) **Withholding capacity:** If the capacity could not have profitably been withheld in a competitive market, withholding the capacity from the market is likely to breach the new test. The European Commission (“EC”) has investigated generators in the EU for abusing their dominance by withholding capacity, with any potential losses from that withheld capacity recouped through obtaining higher prices for the capacity that was dispatched.<sup>37</sup> This is consistent with the safe harbours in the current Code, which requires generators to offer all of its generating capacity that it is able to operate in a trading period.<sup>38</sup>
- (b) **Excessive offer prices.** Excessive offer prices are likely to breach the new test if such prices would not have been possible or profitable in a workably competitive market. The EU prohibition of market manipulation prohibits pricing wholesale energy products at an “artificial” level.<sup>39</sup> European case law and guidance has determined that artificiality considers whether prices “correspond to available production capacity or to fundamental market data”.<sup>40</sup> This includes considering:
  - (ii) the capacity of the generator to offer more electricity. This is linked to (a) above;
  - (iii) the demand for electricity at the point in time that prices increased (i.e. can the increased offer prices simply be attributed to perceived increased demand); and
  - (iv) any justifications offered by the defendant as to why prices had increased.

If Sapare want further “worked example[s], applied to real data” it should ask its client for details of when and how it has used its market power to manage location risk.

### **Sapare has already commented on “a worked example, applied to real data” which it could draw on**

Another “worked example, applied to real data”<sup>30</sup> is the 26 March 2011 UTS decision and related material. Sapare, for example, provided analysis which it considers demonstrates “the events of 26

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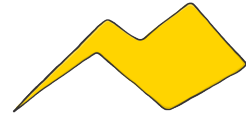
Panel (and Courts) so that those participants who will be most affected by a potential proposed Code change can gain a better understanding of the intent of the Code and provide further feedback under cross submissions”.

<sup>28</sup> We have not been able to reconcile Meridian’s comment that MDAG’s use of 2 June 2016 as a real world example was “prejudicial to Meridian” with Meridian’s advisor, Sapare, criticism of MDAG for not providing real world examples which, presumably, would be considered prejudicial by the particular incumbents assessed to have used market power in the examples.

<sup>29</sup> Withholding capacity and excessive offer prices can effectively be ‘two-sides of the same coin’ and have the same affect.

<sup>30</sup> Genesis, Mercury and Trustpower have also sought breach examples. For example, Mercury state: “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 a potential proposed Code change can gain a better understanding of the intent of the Code and provide further feedback under cross submissions”.





March was not a circumstance in which there was insufficient electricity available to meet demand and where prices needed to rise to levels sufficient for consumers to voluntarily reduce demand”.<sup>31</sup>

In summary, Sapare detailed the following about the 26 March 2011 UTS:<sup>32</sup>

20. In Kieran Murray 6 April report, we observed that the activities on 26 March bore strong similarities to a classic commodity market squeeze. We observed that:
  - a. “Genesis had gained a temporary dominant position in the supply of electricity north of the constraint; Genesis had gained a corner on the physical market.
  - b. Genesis appears to have altered its trading position to ensure price separation above and below the constraint; this gave Genesis the ability to set prices at an unprecedented “high” level North of the constraint.
  - c. These price changes were not well signalled to consumers in advance and took effect over a time period when it was almost impossible for consumers to respond; many consumers did not learn of the prices until after the event.
  - d. Mighty River Power, and others, were obliged to pay the extremely high prices for electricity taken by consumers (who were unaware of the price change), or face severe penalties for default.
  - e. The primary alternative to paying the high prices set by Genesis would be for market participants to buy a hedge from Genesis at a price set by Genesis; Genesis appears to have secured high (relative to prices prevailing prior to the squeeze) prices for hedges for the weekend of 2 April when Genesis could similarly corner the physical market.”

### **Sapare appear to think the Authority should commit to doing nothing**

Sapare criticised MDAG for purportedly not considering regulatory commitment; specifically that “without a binding commitment by the regulator to consistent long-term policies, investors in long-life assets would reasonably be concerned that once investments were made the regulator might switch to what appears a better policy ...”. Sapare did not expand on this point, but they seem to either be arguing: (i) against making regulatory change at all, or at least that there should be a high hurdle to pass to for regulatory change; and/or (ii) that the Authority has somehow made a commitment to permit ongoing abuses of market power.

### **Trustpower does not seem to understand the Authority’s statutory objective**

Trustpower’s statement “the statutory objective requires the promotion of competition not the achievement of particular price outcomes in pivotal periods” ignores that the statutory objective refers to “efficient operation” of the electricity market as well as competition. This includes the requirement that “prices reflect efficient costs”.<sup>33</sup>

Trustpower has not explained how misuse of market power which results in price outcomes inconsistent with workable competition would be consistent with the efficient operation of the market or how this would be to the long-term benefit of consumers.<sup>34</sup>

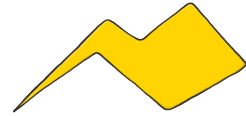
Trustpower goes on to assert “Based on advice from Yarrow (in the papers quoted in the bibliography of the discussion paper) we do not think that the “efficient operation” limb of the statutory objective requires the EA to ensure that prices at all times in all places across all markets are set at the efficient

<sup>31</sup> Sapare, Kieran Murray, Claimed undesirable trading situation, 26 March 2011, 6 April 2011.

<sup>32</sup> Sapare, Kieran Murray and Toby Stevenson, Cross-submission comments: draft decision on the Electricity Authority: alleged UTS on 26 March 2011, 19 May 2011.

<sup>33</sup> WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013].

<sup>34</sup> Trustpower also state that “The EA’s primary task is to promote competition in the wholesale market (including the spot, hedge and ancillary services markets)”, something which the Authority hasn’t done over the last ten years. Trustpower ignores promotion of competition in the retail market and other electricity markets, and that the Authority’s statutory objective also encompasses efficient operation and reliability.



level". Trustpower has created a 'strawman' or Aunt Sally argument. The MDAG proposals do not require prices to be set at an efficient level "at all times in all places across all markets" but rather that they do not exceed efficient levels "for too long or by too much".

### **MDAG provided sound evidence there is a problem**

MDAG provided details of the extent to which the North and South Island's are net and, more relevantly, gross pivotal. It is notable the incumbents largely ignored MDAG's evidence of a gross pivotal problem. The MDAG pivotal evidence was coupled with extensive prima facie evidence of potential breaches of the HSOTC (and UTS) rules.

This evidence is backed up by additional information we and the independent retailers provided, along with suggestions for additional analysis MDAG could undertake.

The incumbent submissions that claim there isn't a problem,<sup>35</sup> and MDAG has not provided evidence there is a problem, lack sound foundation e.g.:

- Contact claimed exercise of market power isn't a problem, and "the market is fundamentally competitive". Any objective assessment of the wholesale electricity market would identify that it is oligopolistic and concentrated, and transitory market power/pivotal situations are more common than would be desirable.<sup>36</sup>
- Mercury alleged "No evidence is provided in the MDAG consultation paper that the six identified instances of local pivotal situations have led to significant long-term consumer detriment". This is a curious statement. Mercury's criticism would be more correctly aimed at their 26 March 2011 UTS complaint. The Mercury UTS complaint was largely predicated on protecting Mercury against its spot market exposure at the time of the UTS.
- Mercury and Meridian have both intimated they use their market power to manage locational price risk.

### **Concluding remarks**

The incumbent submissions are littered with unsubstantiated claims such as that "... the MDAG proposal ... could have a chilling effect on capital flows into generation investment over the long term" (Mercury). These types of claims are little more than scaremongering and a pro forma response to potential new regulation. The purported severity of MDAG's proposals simply do not match the limited level of engagement from the incumbents (with Contact, Mercury and Trustpower's submissions amounting to between 3 and 4 pages in length).<sup>37,38</sup> Such statements should be considered in the context of the High Court position that "Where a proposition is simply asserted ..., we give it little or no weight".<sup>39</sup>

The sky won't fall in if the MDAG proposals are adopted. Quite the opposite.

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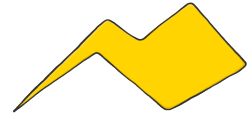
<sup>35</sup> For example, Trustpower claimed "We are uncertain, based on the evidence MDAG has presented, that there is a problem to address.

<sup>36</sup> Contact selectively ignored MDAG's evidence on the extent to which the incumbents' are gross pivotal, and relied on the narrower and less relevant net pivotal measure: "There are very limited occasions when competitive pressure may not exist among market participants as identified by the EA's 2012 review on locally net pivotal generation. This review identified 0.2% of traded energy that may be impacted by locally net pivotal generation."

<sup>37</sup> Mercury's submission also included an attachment which had no relevance to the HSOTC consultation whatsoever.

<sup>38</sup> This contrasts with the level of engagement in relation to the 26 March 2011 UTS complaint which did have substantial and real impacts (including financial impacts) for the incumbents' spot market trading conduct.

<sup>39</sup> WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], paragraph [1745].



The proposals would help protect and preserve the integrity of the current wholesale electricity market design by providing greater surety it will deliver workably competitive outcomes, and won't be subject to exploitation or abuse of market power.

We agree with Mercury that the “future orderly operation of the market” requires “The expected behaviour of participants and ... must be made very clear. This is important for all participants, investors, customers, retailers, the grid owner and operator and generators. It is also important for existing and developing hedge, demand side and derivative markets that the underlying wholesale market operates effectively and predictably”.<sup>40</sup>

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'L. Blincoe'.

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<sup>40</sup> Mercury, Consultation Paper - Draft decision regarding alleged UTS on 26 March 2011, 13 May 2011.