22 May 2020

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Dear Tony

Incumbents reinforce need for Trading Conduct reform

Ecotricity, Electric Kiwi, energyclubnz, Flick Electric, Pulse and Vocus (the independent retailers) appreciate the opportunity to cross-submit in relation to MDAG's High Standard of Trading Conduct (HSOTC) proposals. We acknowledge and appreciate that MDAG adopted our recommendation to add cross-submissions as part of the consultation process and did so well before submissions closed.

It is clear some amendments should be made to the drafting of the MDAG proposals. We proposed five enhancements in our submission, some of which overlap the incumbent submissions.[1] We have identified a further three potential changes, based on the incumbent submissions, that are worth considering. We recommend there be at least one further technical consultation step to ensure the final drafting does not contain errors and aligns with the policy intent.

Summary of the independent retailers' response to the incumbent submissions

- We agree with Contact Energy that "**MDAG … has provided a comprehensive review of its proposed alternative option for the High Standard of Trading Conduct**".
- **Most stakeholders (Contact, Mercury and Trustpower being the opponents[2]) support the general direction of MDAG's reform proposals:** We welcome Genesis and Meridian's qualified support for the approach MDAG is proposing for reform of the HSOTC rules.
- **We agree with Genesis, Meridian and Russell McVeigh that a workable competition standard is consistent with the statutory objective in the Electricity Industry Act.**
- **Major changes aren't needed to address the incumbents' concerns:** The independent retailers, Genesis and Meridian were the only submitters that provided specific drafting amendment of the MDAG proposal. The relative proximity of the drafting variations to MDAG's proposals – particularly given the purportedly substantive issues raised by the incumbents – is testament to the quality of the work by MDAG in developing its proposals.
- **We are comfortable with the proposed HSOTC rules being revised to include a direct prohibition on persons with significant market power taking advantage of or abusing that**

[1] Each of the five largest incumbent gentailers submitted: Contact, Genesis, Mercury, Meridian (including their advisors Russell McVeigh and Sapare) and Trustpower.
[2] Two of the three opponents are also represented on MDAG. It is likely this will result in a split MDAG recommendation to the Authority.

power: The incumbents were all concerned the proposed HSOTC rules could be construed as applying to all trading periods and to generators regardless of whether they have significant market power or are pivotal. These concerns could readily be resolved by aligning the HSOTC rules with the section 36 Commerce Act and including a rule that "A person that has a significant degree of power in a market must not take advantage of that power …".

- **Withholding of supply is a classic way of raising prices above workably competitive levels:** Contact and Meridian/Russell McVeigh have identified a legitimate concern that the MDAG drafting could be interpreted as allowing a party to exercise market power by withholding generation or reserves volumes. Clauses (1) and (2) may be broad enough to include both price and volume components of offers, but the purpose in clause (3) narrows the reference to "the prices of offers". We agree this needs to be tidied up such that "offers or reserve offers do not depart from offers that would be expected in a workably competitive market".

- **We are open to Genesis' proposal to include examples of what may constitute a breach.** The appropriate place for any examples would be in the MDAG Final Recommendations Paper or in Guidelines, not the HSOTC rules.

- **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.

- **HSOTC rules should target excessive economic rents:** Mercury stated "MDAG's focus should be on pivotal situations where generators exercise market power to extract excessive economic rents". Meridian and Russell McVeigh made similar comments. This aligns with our recommendation that proposed clause 13.5(A)(3) be amended to explicitly capture all workably competitive market outcomes, including that "workably competitive markets have a tendency towards … normal rates of return, and … prices that reflect such normal rates of return".

- **The HSOTC rules should include all elements of workable competition:** There seems to be general agreement that workably competitive market outcomes are an appropriate benchmark. The incumbents have attempted to have the workably competitive market standard watered down though. For example, the incumbents advocated transient market power abuses be permitted, changing "by too much or for too long" to "by too much and for too long", and allowing departures from workably competitive market outcomes (as opposed to efficient cost) as long as the departure isn't "by too much or for too long". **The long-term interests of consumers will not be achieved by permitting transient market abuses.**

- **Workably competitive market outcomes include outcomes in each half-hour as well as longer-term outcomes:** It is important that the HSOTC rules (including clause 3(b)) capture all elements of workably competitive market outcomes to ensure they clearly and unambiguously capture both short and long-term abuses of market power and inefficiencies. We want to avoid a situation where there are arguments about what forms of departures from workably competitive market outcomes are captured by the new HSOTC rules. Any evidence of departures from workably competitive market outcomes no matter over what timeframe should be evidence of a potential breach.

- **The approach of defining workably competitive market outcomes (clause 3(b)) needs to be retained to ensure the proposed HSOTC rules provide greater certainty:** The independent retailers were the only submitters that commented on the way clause 3(b) articulated workably competitive market outcomes. We pointed out was that 3(b) does not explicitly capture all elements of workably competitive market outcomes; specifically that prices are aligned to economic cost and limit excess returns and revenue. We interpret the silence of other submitters to mean they recognise the clause 3(b)(i) – (iv) provisions appropriately capture allocative, productive and dynamic efficiency.

- **Structural solutions are the "gold standard":** The independent retailers agree with Trustpower that structural solutions are the ""gold standard" approach to addressing market power issues". We are very open to consideration of vertical and horizontal structural reform options.

Genesis and Meridian acknowledged the need for reform

We welcome that Genesis and Meridian, and Meridian's advisor Russell McVeigh, have offered qualified support for the approach MDAG is proposing for reform of the HSOTC rules.

We agree with Genesis that "the existing High Standard of Trading Conduct provisions could be made more effective and that reform is justified. The proposal set out in the MDAG's discussion paper makes some logical improvements to the status quo and, in our view, represents a significant step in the right direction." Genesis also supports "the concept that MDAG is seeking to implement. That is, that generators should not be able to exercise unfettered market power when making offers into the market".

Meridian similarly "tentatively supports 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".

Russell McVeigh, on behalf of Meridian, stated that the MDAG proposal "… achieves the objective to support the efficient operation of the market by applying rules that are predictable in their application ex-ante. The prohibition at subclause (1) achieves this by applying a counterfactual test ("consistent with offers the generator would have made where no generator could exercise significant market power"), which draws on established competition law jurisprudence" and "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".

Meridian has also pointed out "Most if not all wholesale electricity markets have mechanisms to moderate the potential illegitimate exercise of market power when a participant could otherwise name its price".[3]

MDAG provided clear and substantial evidence of a problem with market power

MDAG provided evidence the incumbent generators are gross pivotal for large periods of time, as well as prima facie evidence of repeated and frequent misuse of market power.

Genesis recognised "the discussion paper correctly identifies the problem to be addressed – that generators should not be able to exercise market power when making offers", "there are occasions where generators have the ability to exercise market power" and "in some instances, generators are

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

pivotal more often than not. An example is some nodes in the South Island, for which Meridian is pivotal almost 100% of the time."[4] Genesis was the only incumbent to acknowledge MDAG's commentary on gross versus net pivotal.

The evidence in the MDAG paper is backed up by the independent retailer submissions[5] which detailed that the wholesale electricity market is concentrated. We have also suggested specific additional evidence MDAG could obtain to support its proposals, including more granular gross pivotal analysis. Trustpower's acknowledgement it is sometimes gross pivotal, albeit "rarely", which isn't captured in MDAG's Island level analysis highlights the desirability of this additional analysis.

We do not understand why Trustpower is "uncertain, based on the evidence MDAG has presented, that there is a problem to address". MDAG provided submitted prima facie evidence of potential breaches. Likewise, Contact incorrectly asserted "the [MDAG] proposal assumes that the exercise of market power is a problem" [emphasis added] and Sapare similarly asserted "MDAG recommend these measures without first assessing whether market power has been exercised, or is a problem".

It is unclear what additional evidence the incumbents want MDAG to provide, short of doing a full compliance/market monitoring investigation into abuses of market power over the last decade. A full compliance-type investigation would be needed to address Sapare's (for Meridian) criticism that "MDAG has not assessed whether market power has been exercised, or is a problem, in the wholesale electricity market".

Trustpower seem to be under the misapprehension that the MDAG proposals are solely a response to 2 June 2016 ("one swallow does not a summer make") while Contact ignored MDAG's gross pivotal evidence and focussed exclusively on the narrower net pivotal evidence.[6]

Mercury tried to characterise the problem definition purely in terms of potential negative long-run outcomes: "…. there is no evidence to suggest that any limited market power that might be available to participants has raised wholesale prices and brought forward generation investment sooner than would be otherwise be efficient or expected. Likewise, there does not appear to be evidence of generators being able to use market power to hold-up wholesale prices to defer the retirement of generation that was no longer economic".

However, Mercury ignored the harm use of transitory market power can cause. This is surprising given Mercury made a UTS claim against Genesis based on Genesis' use of transient market power on 26 March 2011. Mercury documented in detail the sizeable harmful impact the 26 March 2011 UTS had on their business financially and the adverse implications for end-user prices.

MDAG considered a wide range of options

Mercury claimed, "Participants have not been able to meaningfully comment on other options other than the MDAG's preferred approach". Mercury is incorrect.

The MDAG consultation paper discussed a number of different options ("Part D – High level alternatives"), though only developed one of these into a full proposal.[7]

[4] The Meridian submission concentrated on the problems with the current HSOTC rules rather than the competition problems the HSOTC rules are intended to or should address.

[5] Both the Electric Kiwi and Haast joint submission, and the independent retailers' joint submission.

[6] This is clear from Contact's comments in relation to net pivotal which ignore gross pivotal as a problem: "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."

[7] Mercury's comments highlight that it would have been preferable for MDAG to have formerly engaged and consulted with stakeholders prior to developing their preferred option.

The independent retailers commented on an enhanced version of MDAG's proposal, use of HSOTC rule based on section 36 Commerce Act, and structural separation options. In this cross-submission we discuss various variations to the MDAG proposal.

The other incumbent submissions also covered various alternatives, including amended versions of the MDAG proposal (Genesis and Meridian), removal of the HSOTC rules (Trustpower) and structural separation (Trustpower).

It is disingenuous to suggest the MDAG proposal is price control

The incumbent submissions coalesce on the claim MDAG is proposing price control.[8] These claims are little more than scaremongering.

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 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 Commerce Act restricts generators from taking advantage of market power to set offers that are anti-competitive e.g. Russell McVeigh provided the example of predatory pricing.

The MDAG proposal restricts offers in a similar way to the Human Rights Act restrictions on price discrimination (limiting the extent that prices can differ based on age, gender, race etc). We detailed in our submission that the MDAG proposal could be considered akin to the restrictions on discrimination in the Human Rights Act, and the specific provisions allowing for different prices to be set for insurance etc on the basis of age and gender. If an insurance company wants to charge women more (less) for a particular insurance product that's fine if they can demonstrate women are higher (lower) risk and the relative price of the product reflects that difference. We are not aware of any suggestions the Human Rights Act applies price control or has harmed the competitive operation of the insurance market, but this is analogous to what the incumbents, and Meridian's advisors, are claiming.

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.

[8] 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.

Incumbent claims MDAG's proposal is based on perfect competition and "expressly rejects a workable competition objective" make no sense

The MDAG proposal is modelled entirely on workably competitive market precedent. It is self-evident the benchmark MDAG's proposal sets is workable competition.

It is difficult to make sense of Genesis, Meridian, Russell McVeigh's and Trustpower's claims that MDAG rejected workable competition as a benchmark and proposes to apply perfect competition instead.

Genesis, for example, claimed "MDAG is concerned that, if the counterfactual was a market with workable competition, there would be certain periods of weak or limited competition, which would plausibly provide leeway for generators to make higher offers" and "By failing to incorporate a "workably competitive" standard (or variation thereof), MDAG's current proposal is inconsistent with the statutory objective of the Authority under the Electricity Industry Act" and "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. MDAG expressly rejects a workable competition objective". [emphasis added, footnote removed].

Russell McVeigh, on behalf of Meridian, made a number of similar statements which do not reflect the MDAG proposal, such as that "if markets are the primary mechanism for determining price, then market power must be allowed to be temporarily exercised from time to time as it is a necessary feature of workably competitive markets" and "it is not (currently) the obligation of each operator that may at times be pivotal in a half hour trading period at a node, to use their pivotal position to best ensure market prices settle at a level that only just covers their (retrospectively assessed) costs in each half hour trading period. Yet that appears to be the intention set out in the purpose statement and wider Discussion Paper".

Trustpower, similarly, "strongly caution MDAG against moving away from the concept of workable competition, however imprecise" even though MDAG's proposals would do the opposite: move the HSOTC rules closer to a workable competition standard.[9]

Our recommendations for enhancement of the MDAG proposals would make the link to workable competition even clearer, by:

- amending the proposed purpose to refer to workably competitive market outcomes, rather than competitive market outcomes or "efficiency outcomes"; and

- amending clause 13.5(A)(3) to explicitly capture all workably competitive market outcomes, including that "workably competitive markets have a tendency towards … normal rates of return, and … prices that reflect such normal rates of return".

The use of "workably competitive market", rather than "competitive market", and workably competitive market outcomes in the HSOTC rule drafting appears to be a point of industry consensus, but it is vital that all elements of workably competitive market outcomes, including both short and long-term outcomes are captured by the rules.00

[9] This could be clarified further by adopting our recommendation to refer to "workable competition" rather than competition in the proposed HSOTC rules.

Efficient pricing relies on competition and limits on market power

Mercury stated it "disagrees with the MDAG interpretation that efficient prices should always equate to underlying economic costs" and "Efficient prices are set through the price discovery process in competitive markets. Marginal prices in the wholesale market will be set with reference to what a participant considers is achievable before a competitor is able to compete away any surplus. In a competitive market, generators may offer energy at whatever level they wish but if this is above a competitive benchmark, they will neither be dispatched nor earn revenue. The determination of price may therefore be unrelated to economic cost but rather reflect participant views regarding what the market will bear before competition reduces any return".[10]

Mercury missed the point of the MDAG proposals.

The MDAG proposals are designed to protect the integrity of the price discovery process. MDAG isn't proposing (and nor are we with our enhanced version of MDAG's proposal) that the normal competitive market processes should not be allowed to set wholesale electricity prices.

The MDAG proposals are designed to address the circumstances where the normal competitive market processes breakdown or don't work as they should i.e. the circumstances where market power is such that it can result in prices that are too high for too long or by too much. Reliance in incumbent generators setting offers with reference to "what … is achievable before a competitor is able to compete away any surplus" is not adequate in a pivotal situation.

Genesis provided a better and more accurate articulation of the role of competition than Mercury:

> Where generators submit offers in a workably competitive market (i.e. where they are not pivotal), the process of rivalry will drive efficient offer conduct and pricing outcomes. Whether these prices are considered 'high' by participants is not, as MDAG notes, inherently a problem. The problem to address is when pivotal generators are able to submit offers that take advantage of (transient) market power. [emphasis added, footnote removed]

Contact's comments about "efficient SRMC" are spurious and irrelevant

Leaving aside questions about the validity of Contact's discussion on "efficient SRMC",[11] there is nothing in the MDAG proposals that would preclude a scenario where "plant will have volume offered at $0 to get a certain amount dispatched so it can run at its minimum load. If only that amount is dispatched (which can happen) then that offer would not achieve "efficient SRMC"".

Meridian has forgotten its own views about SRMC v LRMC and misuse of transient market power

We were surprised "Meridian would be very concerned if any trading conduct rule were adopted that required an assessment against economic costs over a short time period". It is unclear how Meridian's (correct) subsequent statement that "Any test must acknowledge that spot prices may deviate from long run marginal costs in the short term" follows from this claim.

Electric Kiwi and Haast detailed that Meridian has provided extensive commentary on the need to regulate against misuse of transient market power. Meridian has been very clear "in the absence of a transient market power mitigation regime in the Code … "anything goes" is an acceptable outcome" and "incentives are created for all participants to take advantage of transient market

[10] Trustpower similarly comment: "Competition is an information discovery process which will involve error and market consequence. As such, it will involve prices that are above and below the efficient level from time to time." This statement fails to recognise that the "by too much or for too long" proviso recognises that prices can be "above and below the efficient level from time to time".

[11] We are unsure what distinction Contact is trying to make between efficient SRMC and inefficient SRMC.

power, resulting in a reduction of the dynamic efficiency and wider credibility of the New Zealand electricity market".[12] Meridian's has also warned "If there is no consequence for [use of transient market power], then it would be irrational for generators not to consider doing so".[13]

Electric Kiwi and Haast also detailed Meridian's commentary that the appropriate short-run test is the extent to which prices deviate from SRMC, and Meridian has explained the interrelationship between SRMC and LRMC. For example, Meridian has submitted "in normal traditional conditions", "final prices should … approximate SMRC not LRMC".[14]

Meridian is correct "It is also no answer … to say that high, very high or excessive prices are a necessary part of any efficient spot market because they signal the need for investment and allow generators to recover fixed costs. While prices above SRMC 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".[15] The Meridian commentary reinforces the need for the HSOTC to clearly and explicitly address transient market power, consistent with MDAG's intent.

The MDAG proposals would provide increased certainty, but this does not mean absolute certainty

It is understandable market participants want "an increased level of certainty" (Contact). The MDAG proposals would provide increased certainty. The specification of workably competitive outcomes in the Code is a key component of this. Increased certainty does not mean absolute certainty however, and regulation cannot substitute for case law and jurisprudence. It is unclear what the basis is for Trustpower's claim "There is a risk that the proposal will replace one unclear test with another". The MDAG consultation paper provides lengthy explanation that the MDAG proposals would provide greater clarity than the current "obtuse" and "amorphous" rules.[16]

Potential amendments to the proposed HSOTC rules: We are open to options which would align the HSOTC rules more closely with section 36 Commerce Act

Contact claimed, "The proposed Code obligations in 13.5A(1) appear more stringent than section 36 of the Commerce Act (aimed at prohibiting parties from taking advantage of market power)".

While Contact does not explain the basis for this assertion, it appears to relate to a concern "The proposed wording for part 13.5(1) empowers the Authority to scrutinize all offers at all points of connection, whether or not competitive pressures were weak". We interpret this as a concern the proposed HSOTC rules may apply when there is no significant market power.

Mercury relatedly claimed, "If implemented, the Authority would potentially be placed in the untenable position of having to assess for each trading period whether prices reflected economic costs". Genesis also state "the scope should be limited to situations when a generator is pivotal or net pivotal. Indeed, throughout the paper MDAG correctly identifies that the problem is limited to situations where generators can exercise market power. We therefore do not understand why it nevertheless believes the proposal should apply to all offers".

[12] Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.
[13] Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.
[14] Meridian, Draft Decision regarding alleged UTS on 26 March 2011, 13 May 2011.
[15] Meridian, Draft Decision regarding alleged UTS on 26 March 2011, 13 May 2011.
[16] The approach of defining workably competitive market outcomes (clause 3(b)) is an important element of ensuring the proposed HSOTC rules provide greater certainty.

Sapare (for Meridian) objected that "Generators that respond (pro-competitively) to market conditions may have their offers reviewed if that response involves an offer at a node where another generator can exercise market power" and the MDAG proposal "would empower the Authority to revew [sic] offer prices by generators that do not have significant market power". We consider that generators without market power should not have to demonstrate their offers are "consistent with offers that the generator would have made where no generator could exercise significant market power".[17]

The incumbent concerns could readily be resolved by aligning the HSOTC rules more closely with section 36 Commerce Act and adding a test such that "A person that has a significant degree of power in a market must not take advantage of that power …".

We reiterate "There are alternative ways the proposed trading conduct rules could be rewritten or amended which could be worth considering, including a more direct prohibition on market participants using significant or excessive market power in a way that results in outcomes that are inconsistent with the outcomes in a workably competitive market".

Potential amendments to the proposed HSOTC rules: The HSOTC rules should make clear "significant market power" includes transient market power

We note Russell McVeigh's commentary on transient market power and that the Courts may interpret significant and substantial market power in a similar way.

Russell McVeigh's submission 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.

Potential amendments to the proposed HSOTC rules: The HSOTC rules should limit extraction of excessive revenue and returns consistent with workably competitive/efficient market outcomes

Mercury stated "the MDAG's focus should be on pivotal situations where generators exercise market power to extract excessive economic rents". Similarly, Meridian stated "If economic rents are being extracted by generators, these will ultimately be passed on to consumers".[18] We share Mercury and Meridian's concerns about extraction of excessive economic rents.

Russell McVeigh, for Meridian, also noted: "The High Court in Wellington Airport v Commerce Commission observed that workable competition ultimately refers to a market in which there is an observable tendency towards generating outcomes such as "the earning by firms of normal rates of returns, and the existence of prices that reflect such normal rates of return, after covering the firms' efficient costs.""

These comments align with our recommendation that proposed clause 13.5(A)(3) be amended to explicitly capture all workably competitive market outcomes, including that "workably competitive markets have a tendency towards … normal rates of return, and … prices that reflect such normal rates of return". Efficient market outcomes would capture all workably competitive market outcomes and not just a subset.

[17] Generators without market power should still be subject to restrictions on insider trading etc.
[18] Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.

Potential amendments to the proposed HSOTC rules: The HSOTC rules should recognise withholding generation can be an abuse of market power

We agree with Contact that "remov[al of] the obligation for generators to offer all available volume may have unintended consequences which do not align with the Authority's statutory objective. A party could exercise market power through the unjustified withholding of generation or reserve volumes".

Meridian similarly suggested exclusive focus on the prices of offers is a drafting error and stated: "offers are comprised of both prices and volumes. By ignoring volumes, the "purpose statement" seems to suggest that withholding generation is outside the purpose of the proposed prohibition, even though significant market power could equally be exercised by withholding generation to influence market clearing prices".

Russell McVeigh similarly also stated "The purpose statement is … deficient in that it isolates and amplifies the pricing element of offers without any regard to other components of offers – most notably volume. The purpose statement therefore appears incomplete, and at worst could imply that the test is not concerned with the exercise of significant market power through the unjustified withholding of generation or reserve volumes. The economic effect of a pure refusal to supply and a constructive refusal to supply (where capacity is offered but only at an excessively high price) are identical and should be treated the same."

Clauses 13.5A(1) and (2) may be open to a broader interpretation, but the purpose in clause 13.5(3)(a) focuses on "The prices of offers …". While 13.5(3)(b) makes no direct reference to price, it is constrained by the link to 13.5(3)(a) in the opening words "with the effect that …" Clause (3)(b) is essentially a subcomponent of (3)(a).

The Russell McVeigh drafting proposal to amend proposed clause 13.5A(3)(a) to refer to "offers" rather than "prices of offers" and to link the offers to "offers that would be expected in a workably competitive market" rather than to "associated economic costs" is one way this issue could be addressed. The Russell McVeigh drafting could not be adopted in full, however. Instead of allowing "prices are not too much or for too long significantly above costs", consistent with workable competition, the Russell McVeigh drafting would allow offers to "depart … from offers that would be expected in a workably competitive market". This is a substantial departure from the workable competition standard which we would not support.

The Code should be clear that offers refer to both price and volume. We recommend that MDAG consider the following drafting amendment (with consequential changes, elsewhere, so the link between prices and economic costs are not lost):

> ~~the prices of~~ **offers** or **reserve offers** do not depart~~exceed, by too much or for too long,~~ from offers that would be expected in a workably competitive market,~~the associated economic costs to the **generator** or **ancillary service agent** respectively, assuming a market~~ in which no **generator** or **ancillary service agent** has significant market power; and

Potential amendments to the proposed HSOTC rules: We are open to the Authority providing examples of what would constitute a breach

We are open to Genesis' proposal to include examples of what "may" constitute a breach. The appropriate place for any examples would be in the MDAG Final Recommendations Paper or in Guidelines, not the HSOTC rules.

Our expectation is that if the Authority properly monitored and enforced compliance with the HSOTC rules, current or proposed, a body of examples and precedent would build up regardless.

Consideration should be given to what value, if anything, the examples would potentially add. We note the comments from Sapare that it is not practicable to identify all undesirable behaviour in advance. Sapare's view is that "a clear standard is necessary (in the same manner that the road code prohibits dangerous driving without attempting to identify all possible forms of driving dangerously)".[19]

The three examples Genesis provided are obvious examples that can clearly be inferred from the MDAG proposed HSOTC rules. Russell McVeigh also provided some examples[20] MDAG could draw on. The first two describe the basis for the 2019 UTS/HSOTC complaint. If MDAG determine there is merit in including examples in the Guidelines the group could also consider reworking the safe harbour provisions into examples.

Potential amendments to the proposed HSOTC rules: A "for too much AND for too long" HSOTC threshold would permit abuses of transient market power and breach the workably competitive market outcome standard

We do not support Contact and Russell McVeigh's proposal that "by too much or for too long" be replaced with "by too much and for too long".[21] This would be akin to letting someone off for speeding because they were only driving at 160km/h for a short distance, or driving under the influence of drugs and alcohol for a short period of time.

By way of example also, under this formulation the Genesis 26 March 2011 trading conduct would not fall foul of the HSOTC rules, if "and" replaced "or", because only the "too much" condition was met and not the "too long". Contact and Russell McVeigh are effectively asking that the HSOTC rules sanction short-term market abuses and abuses of transient market power.

We share Meridian's concerns about "abuse of transient market power",[22] and that an "anything goes" regime could develop that permits "taking advantage of transient market power to set arbitrarily high prices [to] become an established feature of the electricity market".[23]

Potential amendments to the proposed HSOTC rules: The HSOTC rules do not require overlapping "pivotal" and "significant market power" tests

Genesis proposed MDAG amend proposed clauses 13.5A(1) and (2) by changing "generator" to "pivotal generator" and "ancillary service agent" to "pivotal ancillary service agent". We do not support this proposed amendment. The amendment would result in duplication and overlap, given that "pivotal" is a subset of the circumstances under which a supplier may have significant market power.

[19] Kieran Murray and Toby Stevenson, Sapare, Cross submission comments: draft decision of the Electricity Authority: alleged UTS on 26 March 2011, 19 May 2011.
[20] Appendix one.
[21] Meridian and Russell McVeigh also tried to depict "or" as "and" in their (both used) assertion: "The question for regulators is at what point does a firm have "too much" market power, exercised for "too long" so that competition is no longer workable. It is the point at which "acceptable market power" becomes "too much market power", which is the same as saying the point at which the market becomes "not workably competitive"."
[22] Meridian, Draft Decision regarding alleged UTS on 26 March 2011, 13 May 2011.
[23] Meridian, Draft Decision regarding alleged UTS on 26 March 2011 – Cross Submission, 19 May 2011.

Potential amendments to the proposed HSOTC rules: Proposed clause 13.5A(3) should be retained (with enhancements)

The independent retailers do not support Genesis and Meridian/Russell McVeigh's recommendation that proposed clause 13.5A(3) be removed. We maintain the view clause 13.5A(3) can be enhanced by the amendments we recommended in our joint submission.

Genesis and Meridian/Russell McVeigh's objections appear to be based on confused and specious linking of MDAG's reliance on High Court precedent for the definition of workable competition and regulation under Part 4 Commerce Act.

Genesis is incorrect in its assertion that "the proposed solution … legal and economic approach that has been developed for monopolies and is not applicable to workably competitive markets" and "in particular, while the Wellington Airport case contains a useful discussion of workable competition, it does not provide guidance on how to resolve transient market power issues".

Russell McVeigh similarly err in their statement "The jurisprudence relied on by MDAG in its discussion, and the purpose statement in the proposed cl 13.5A(3) reflects the approach taken in the Commerce Act's price control framework, rather than the Part 2 framework which supports the efficient operation of markets. MDAG's heavy reliance in its discussion document on the Wellington Airport case, which is the key authority in relation to the input methodologies process of setting price under Part 4, demonstrates the confusion that is likely to be caused if the purpose statement is included in its current proposed form".

As an adjunct, it is unclear why the incumbents raised objection to MDAG relying on High Court precedent for the definition of workably competitive market outcomes, but were happy to rely on Electricity Authority narrowly focussed commentary, which has no particular standing, on what workable competition means.

All MDAG did, which was appropriate,[24] is take guidance from legal precedent on the meaning of workably competitive outcomes and reflected this in the draft of clause 13.5A(3). The only valid criticism is that MDAG did not fully reflect the definition of workable competition in the proposed drafting (as reflected in our submission recommendations to improve 13.5A(3)). It is of secondary relevance that this legal precedent derived from a High Court case relating to regulation under Part 4 Commerce Act.

Potential amendments to the proposed HSOTC rules: Comments on Russell McVeigh's alternative HSOTC code draft

MDAG should take comfort that while Meridian and its advisors, Russell McVeigh and Sapare, raised what are apparently intended to be substantive issues with the MDAG proposals (and heavily overlap the other incumbent concerns), the drafting changes they proposed to resolve their concerns were relatively modest. This is testament to the quality of the work by MDAG in developing its proposals.

We have compared the Russell McVeigh drafting against the MDAG proposal and not our own:

- We agree with the inclusion of reference to "workably competitive market", but the proposed drafting is inconsistent. The chapeau refers to "competitive markets" and clause (a) refers to "workably competitive markets".

[24] And which separately was also done in the December 2019 UTS and HSOTC breach complaint.

- Changing “by too much or for too long” to “by too much and for too long” is inconsistent with precedent for the definition of workable competition.[25]

- Russell McVeigh’s drafting would help address the issue that withholding of generation capacity could be used to restrict supply and increase prices (a classic monopoly problem) but could not be adopted without amendment. One of the problems with the Russell McVeigh drafting is that it would allow departure from workably competitive market offers.[26]

- The Russell McVeigh wording addresses our “repetitive tautology” concern. Their drafting proposals confirm our view that proposed clause 13.5A(3)(b) can be simplified.

- The assessment of economic costs (or, using Russell McVeigh’s wording, “offers that would be expected in workably competitive markets”) needs to recognise that “scarcity rents and the opportunity cost of generating electricity or of providing instantaneous reserve” is relevant in the short-run only (as per MDAG’s drafting) and “recovery of capital costs with a suitable premium for risk” is relevant in the long-run only (as per MDAG’s drafting).

- Removal of the reference to “economic costs” would not serve any useful or desirable purpose. There needs to be a basis for determining whether offers or reserve offers depart “by too much or for too long.

- We do not support clause (d) which reads: “in construing the hypothetical workably competitive market the actual existing market is replicated, save for eliminating the significant degree of market power”. It is unclear what useful purpose this would serve. We are concerned about the risk of unintended consequences from unnecessary prescription. For example, the modelling undertaken for the 2019 HSOTC and UTS complaint did not “eliminat[e] the substantial degree of market power” per se, rather it removed the effect of taking advantage or use of that market power. The HSOTC rules shouldn’t prescribe how the counterfactual is determined, just as it should not prescribe how SRMC, LRMC, scarcity values etc are to be determined.

Structural solutions are the gold standard

Trustpower criticised MDAG on the basis that “We think that more options analysis needs to be undertaken” and “We agree with Figure 6 and the conclusions of Joskow and Littlechild (page 39) that the focus should be on structure and incentives, rather than conduct”.

We agree with Trustpower that “New Zealand has adopted a “gold-standard” approach to addressing market power issues at their source via structural solutions”. Consistent with Trustpower’s comments, Russell McVeigh stated: “Any attempt to replicate a competitive market outcome is necessarily imperfect and a second-best outcome to a competitive market outcome itself”. We believe behavioural regulation can only serve to attempt replicate competitive market outcomes, while structural solutions can deliver actual competitive market outcomes.

Trustpower’s comments are topical given the break-up of ECNZ left Meridian with a disproportionate market share/share of South Island generation plant to keep the Tiwai electricity

[25] See discussion above in the section “Potential amendments to the proposed HSOTC rules: A “for too much AND for too long” HSOTC threshold would permit abuses of transient market power”.
[26] See discussion above in the section “Potential amendments to the proposed HSOTC rules: The HSOTC rules should recognise withholding generation can be an abuse of market power”.

supply contract whole. This justification is materially weaker given other generators now also have contracts with Tiwai and would disappear if Tiwai exits the New Zealand market.

Consistent with Trustpower's position, we fully support consideration of structural solutions to market power, including vertical separation of the incumbents' wholesale and retail businesses and/or horizontal break-up of the incumbent generators (finishing the work started with the break-up of ECNZ and the Meridian-Genesis asset swap). A regrettable (unintended) consequence of the Electricity Industry Reform Act was that it substituted network-retail vertical-integration with wholesale-retail vertical-integration.

Electricity Authority market monitoring and enforcement is currently weak

Trustpower stated that "We regard the EA's market monitoring and rule-making powers and the current UTS provisions as a significant discipline on market conduct". We disagree.

It is widely recognised the Authority's market monitoring has been deficient. The Authority has recognised it has not "developed strong capability in this area" and needs to increase the resourcing and priority on market monitoring and enforcement. The MDAG paper provides prima facie evidence of HSOTC/UTS breaches where the Authority has taken no action.

Affected parties' views are being heard by the decision-maker

We agree with the incumbents' view (e.g. Trustpower) that "Affected parties have the right to have their views heard directly by the decision-maker". It is unclear to us how MDAG undertaking the consultation on the HSOTC, under the umbrella of the Authority, would inhibit this from happening.

Genesis stated it "believes the full Code change process would provide the opportunity for the costs and benefits to be fully understood". This would appear to be an issue with the absence of a quantified CBA, rather than about whether the Authority consults itself. If the Authority considers quantified CBA is needed, it can either provide that direction to MDAG or decide it needs to consult and undertake additional (and likely duplicate) analysis.

At the Wellington workshop we asked the question, in response to the issue of MDAG versus Electricity Authority-labelled consultation, what views stakeholders would want to convey to the Authority that they would not be able to provide in submission to MDAG?

The only incumbent that provided an answer to this was Meridian.

Meridian commented "Surely the Authority has a responsibility to articulate, publish and consult on its own views on the issues with the HSOTC provisions and its own preferred way forward" and that the "MDAG paper … includes a statement on the cover that the "paper has been prepared for the purpose of the Market Development Advisory Group. Content should not be interpreted as representing the views or policy of the Electricity Authority".

Our understanding is the Authority considers it may be able to avoid duplicate consultation if the MDAG views and recommendations align with its own views. Clearly, if the Authority views were not aligned with MDAG, as was the case with saves and winbacks, the Authority would need to consult. It is the Authority, not MDAG, that will determine whether additional consultation is needed, and they will do so ("directly") taking into account the stakeholder submissions and cross-submissions on the matter. All MDAG can do is ensure its consultation sound and meets the Authority's requirements.

The incumbents haven't explained why they disagree with MDAG about the practicability of quantified CBA

Each of the incumbents argued MDAG should undertake quantified CBA.

It is difficult to engage with the incumbents' views as they did not explain why they consider MDAG's position on the practicability of a quantified CBA is invalid. Genesis, at least, acknowledged "that a full quantitative cost benefit analysis would be difficult to produce, because it would be influenced by subjective judgements about participant behaviour".

The incumbents have also provided little in the way of direction as to the approach MDAG should take to quantified CBA – other than providing qualitative details of costs and risks they claim would arise from the reforms. Notably, this is despite Meridian's advisor Sapare being a CBA practitioner (including undertaking the original TPM CBA for the Authority).

Genesis suggested while "there are inherent difficulties" in undertaking quantified CBA, "a qualitative assessment, like that which supports MDAG's proposal, presents the same challenges". This position is novel. It is normal for qualitative analysis to be broader than quantitative analysis and CBA. This reflects that qualitative analysis is comparatively more straightforward and does not suffer from the practical limitations of quantified CBA.

Our position remains: "We do not contest MDAG's views about the practicability of quantifying the costs and benefits of its proposals. If MDAG was going to try and develop quantified CBA it could consider modelling the results of more competitive outcomes e.g. if offer prices were closer to SRMC. The modelling in the December 2019 UTS and HSOTC complaint shows how vSPD can be used to do this." We also note the Electric Kiwi and Haast submission provided examples of how MDAG could go about undertaking quantified CBA.

Concluding remarks and potential further enhancements to MDAG's proposals

After review of the incumbents' submissions, our recommendations for enhancement of MDAG's proposals remain but we are open to considering the following three additional changes:

- The HSOTC proposals (MDAG and/or our alternative drafting) should be amended to require that "offers or reserve offers do not depart from offers that would be expected in a workably competitive market";

- We are open to the proposed HSOTC rules including a direct prohibition on persons with significant market power taking advantage or abusing that power; and

- We are open to Genesis' proposal to include examples of what may constitute a breach, though the incumbents should know what behaviour is and isn't an abuse of their market power without being told. The appropriate place for any examples would be in the MDAG Final Recommendations Paper or in Guidelines, not the HSOTC rules.

Yours sincerely,

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